Taxation and Trusts

Donations tax

Estate duty

Income tax

Transfer duty and

Capital gains tax

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How do we get fixed property or other assets into a Trust?

- By way of a **donation**
- By way of a **disposal** of assets (sale)
- By way of a **bequest**

DONATION OF ASSETS - DONATIONS TAX

A donation is any **gratuitous disposition** of an asset (the asset itself or a right in an asset or the rights to the fruit of the asset). An inter vivos trust is usually created by way of a **donation** (gratuitous disposal) of property by the Founder/Donor to the Trustee.

The initial donation is often followed by further donations once the trust has been created. Such disposals to an inter vivos trust for **no consideration**, will be subject to donations tax in the hands of the Founder/Donor.

Donations tax are levied at a rate of 20% on amounts up to R30 million and 25% on amounts exceeding R30 million. Donations tax threshold of R100 000 per annum.

Section 58 of the Income Tax Act, deems a donation to have been made if property is disposed of **for a consideration that the commissioner regards as inadequate**, for example for less than the market value of the property.

DISPOSAL (SALE) OF ASSETS – The funding of a property to be held in Trust

A person can sell an asset to the Trust at market value, but leave the purchase price outstanding, creating a loan account in his/her favour **or fund the purchase of a property that will be held in Trust.**

Pre-Section 7C of the Income Tax Act

Before the enactment of Section 7C, it was common practice for individuals to transfer assets to trusts via **interest-free loans or low interest loans**. This method allowed individuals to move ownership of assets from their personal estates to trusts without incurring immediate tax liabilities (other than Capital Gains Tax and Transfer Duty). By lending money to a trust that is interest-free or at very low interest rates, individuals could effectively reduce their taxable estates, thereby avoiding estate duties and donations tax.

Section 7C of the Income Tax Act - 1st of March 2017

Section 7C is an anti-avoidance provision designed to address a situation where a loan is made to a qualifying borrower **interest-free** or **at a rate lower than the official rate of interest.**

What it means for taxpayers?

Taxpayers must now account for the **deemed donation** resulting from the forgone interest on these loans. This means that the interest that would have been payable had the loan been at a market-related interest rate is treated as a donation and is subject to the donation tax.

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Examples of how Section 7C works and is applied

Example 1: Interest-free loan to a trust:

Mr. X, a founder of a family trust, provides an interest-free loan of R2 million to the trust to buy a fixed property. Under Section 7C, Sars would calculate the deemed interest that would have been payable had the loan been at the official rate of interest, which is currently 11.75% per annum.

The deemed interest for the year would be: *R2 000 000 x 11.75%* = R 235 000

R235 000 is considered a deemed donation and is subject to donations tax at the applicable rate. (R235 000 – R100 000) X 20%= R27 000.

Example 2: Low-interest loan to a trust

Mrs. Y provides a loan of R3 million to her family trust to purchase a fixed property at an interest rate of 2% per annum, which is below the official rate. The deemed donation is calculated based on the difference between the official rate and the actual interest rate charged.

The difference in interest for the year would be *R3 000 000 x (11.75% – 2%)* = R292 500. This amount is treated as a deemed donation and taxed accordingly. (R292 500 – R100 000) X 20% = R38 500.

ESTATE DUTY

Any deceased estate, provided it yields a dutiable estate, is as a matter of course subject to estate duty. The tax rate for estate duty is set at 20% for the first R30 million and 25% for any value above R30 million, subject to abatements.

Section 4q abatement between spouses and the rollover of the Section 4A abatement.

A trust is **not regarded as a "person"** in terms of the Estate Duty Act and estate duty is **not levied on trust property** in the hands of the trust or its trustees.

A **loan account** in favour of a person – an asset in his/her Estate and may be subject to Estate duty.

THE CONDUIT PIPE PRINCIPLE – Distribution of Income and Capital Gain

Trusts are often used for estate planning, asset protection, and tax planning purposes. One of the features of our income tax law is the **"conduit pipe principle"** which, when applicable, determines how trust distributions should be taxed.

During the Trust's tax year, **income earned** by the Trust, such as **interest, dividends, or rental income**, can either be **retained** by the Trust or **distributed** to its beneficiaries. The conduit principle provides that if the Trust distributes the income earned during the year to the beneficiaries in the same tax year, the income retains its nature and is taxed **in the hands of the beneficiary**, at the beneficiary's marginal rates. If the trust retains the income, it is taxed in the hands of the trust at a fixed rate of 45%.

In Armstrong v CIR3 it was held that **income** that is the subject of a trust retains its identity until it reaches the parties **in whose hands it is taxable**. A trust is a mere conduit pipe through which the income flows, and the income retains its identity in the hands of the beneficiaries.

Taxation Laws Amendment Act, No. 17 of 2023

It's important to note that until the promulgation of this Amendment Act, it was possible to distribute income to **non-resident beneficiaries** without paying tax in the trust but in the hands of the non-resident beneficiary, at his/her marginal tax rate.

Capital gains is treated similarly, except the tax residency of the beneficiaries did come into play. If a trust realised a capital gain and distributed it to **South African tax resident** beneficiaries in the same tax year, the gain would have been taxed in the hands of the beneficiaries at their individual capital gains tax rates, up to a maximum of 18%. If the trust did not distribute the capital gain, it would have been taxed within the trust at the effective rate of **36%**. Furthermore, if a capital gain was distributed to a **non-South African tax resident beneficiary**, it would also have been taxed within the trust at a rate of **36%.**

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Changes to the Income Tax Act, No. 58 of 1962 , effective from **1 March 2024**, align the tax treatment of income distributions with the tax treatment of capital distributions made to **non-South African tax resident beneficiaries**. Therefore, effective from 1 March 2024, the Income Tax Act was amended to limit the flow-through principle **only to distributions made to South African tax resident beneficiaries.**

Why?

Reasons provided by the government for these amendments include that the flow-through of amounts by South African trusts to non-residents places SARS in a difficult position to collect income tax from those beneficiaries. Since they may not be taxed on foreign-sourced amounts, tax recovery actions may be difficult and, in the case of non-resident trusts that are beneficiaries, SARS may not have information on the persons in whom the foreign trusts vest the income.

TRANSFER DUTY

Transfer Duty will be levied on fixed property donated or sold to a Trust.

Transfer Duty is exempt if a fixed property is bequeathed to a Trust.

Transfer Duty is exempt if a fixed property is transferred from a Trust to a beneficiary, up to the third degree of the Founder.

CAPITAL GAINS TAX

Levied on disposal and deemed disposal of assets, including bequests.

Disposal of a fixed property by a Trust – The primary residence abatement does not apply.

Capital Gains Tax

What to consider when selling a fixed property

1. Is it a primary residence?
2. Is it being transferred from or to an entity?
3. What is the base cost and what does it mean?
4. What can be deducted from the base cost?
5. Is the seller a non res for tax purposes?
6. How is CGT calculated?

What is Capital Gains Tax and who is liable for it?

CGT applies to individuals, trusts and companies.

Capital Gains Tax is basically a **tax on the resale of assets**. Anyone that disposes or sells their fixed assets is liable for CGT. CGT is <u>not a separate tax</u> but forms part of income tax

SA Tax resident - When submitting your annual income tax return, any gains or losses based on a transaction during that period must be declared and submitted.

- Non-Tax resident – Treated as a withholding tax.
- A resident, as defined in the Income Tax Act 58 of 1962, is liable for CGT on assets located **both in** and **outside** South Africa.
- A non-resident is liable to CGT **only on immovable property in South Africa**. Certain indirect interests in immovable property such as shares in a property company are deemed to be immovable property.

Events that trigger a disposal include a sale, donation, exchange, loss, death and emigration.

Specific exclusions:

R2 million gain or loss on the disposal of a primary residence- Does not apply to Trusts;

annual exclusion of R40 000 capital gain or capital loss is granted to individuals and special trusts.

What if I sell a home that's jointly owned?

In this case, both parties need to declare the total gain to SARS. The profit and the primary residence exclusion will then be split. Both parties will also be able to utilise their individual annual exclusion of R40 000.

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When should it be paid?

CGT becomes payable when you receive your income tax assessment (IT34).

The withholding tax must be paid to SARS –

within 14 days of the date on which the amount was withheld by a resident buyer; and

within 28 days of the date on which the amount was withheld by a non-resident buyer.

When do provisional taxpayers pay CGT?

If you're a provisional taxpayer, when you submit your first provisional tax return, you should include the taxable portion of any capital gains in your income estimate.

To calculate CGT, you will need to know the following information:

- The date on which the asset was acquired
- The date on which the asset has been disposed of
- The proceeds of the sale of the asset
- The base cost of the asset

The base cost of the asset is the amount you paid for it, plus any costs incurred to acquire or improve it, such as transfer costs, attorney fees, and renovations.

Once you have this information, you can calculate the capital gain by subtracting the base cost from the proceeds.

For example, if you bought a property for R1 million and sold it for R1.5 million, your **capital gain** would be R500,000.

You must apply the relevant inclusion rate to the capital gain to calculate the **CGT payable**. The inclusion rate is currently 40% for individuals and special trusts, and 80% for companies and other trusts.

Using the previous example, if you are an individual or special trust, your **taxable capital gain** would be R200,000 (40% of R500,000).

You can then apply any applicable exemptions or deductions to reduce the amount so to be included. For example, individuals and special trusts are entitled to an annual exclusion of R40,000 on capital gains and a small business exclusion of R1.8 million when disposing of a small business with a market value not exceeding R10 million.

The taxable capital gain will then be included in your taxable income and taxed at your applicable rate. The maximum an individual will pay is 18% - if you are in the highest income tax bracket

- Step 1. Calculate the total profit
- Step 2. Deduct R40 000 (“annual capital gains exclusion”) from your profit
- Step 3. Multiply by 40% (“the inclusion rate”)
- Step 4. Multiply by your marginal income tax rate

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