

TAX

“All change is good”: potential implications of the proposed changes to taxation of income subject to withholding taxes awarded by South African trusts to foreign beneficiaries

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and Benedict Ngobeni – Candidate Attorney

Reviewed by Ernest Mazansky – Director, Werksmans Tax (Proprietary) Limited

Currently, income arising in a South African trust that is distributed to a beneficiary within the same tax year is treated as the income of the beneficiary, irrespective of their tax residence. Effectively, the trust is disregarded. The current proposal seeks to forgo this regime in the event that the income is awarded to a foreign beneficiary, the rationale being to strike a balance between South African tax resident and non-resident beneficiaries of South African trusts.

Current Legal Position

As a general principle, any amount of an income nature (i.e., dividends, interest, rentals, trading income, etc) that is received by a South African trust and onward distributed to the beneficiaries, regardless of the beneficiaries' country of residence, in the same tax year will be taxed in the beneficiaries' hands. If it is not distributed in the same year the trust is taxed. The trust is treated as merely a vehicle through which the amount “flows” and such amount retains its nature. As to amounts representing capital gains, the difference is that SARS treats such capital awards to a beneficiary during the same tax year as taxable in the beneficiary's hands if they are South African tax resident, alternatively taxable in the trust if they are non-resident. This is the “disparity” that the proposal seeks to correct.

In our last update on this matter, we alluded to there being potential far-reaching implications of these proposed amendments especially for the foreign beneficiaries of South African trusts. This article focuses on the potential impact on the liability for withholding taxes and available relief to the foreign recipient.

Dividends

A “beneficial owner” of a cash dividend is liable for the dividends withholding tax, currently at a rate of 20%, that is withheld and paid by the declaring company. A “beneficial owner” is defined as the person entitled to the benefit of a dividend. It is trite that the registered owner of shares is not necessarily the beneficial owner of a dividend paid in respect of such shares. Currently, it is accepted by SARS that the beneficial owner of a dividend is the person who receives the dividend for their own use and enjoyment and assumes the risk and control of the dividend received. Thus a beneficiary of a discretionary trust who has a vested right in a dividend, arising out of a distribution by the trustees, is regarded as the beneficial owner of the dividend. With the current “flow through” rules, upon distribution the tax treatment of the income being that it accrues for the benefit of the beneficiary coincides with the principle that the recipient beneficiary is considered the “beneficial owner” of the cash dividend and therefore is liable for the tax.

The proposed amendment would cause the dividend to accrue to the trust for its own benefit. Essentially, the accrual of the dividend no longer “flows-through” to the foreign beneficiary but is trapped and treated as taxable in the hands of the trust. Potentially, the trust itself could be considered the “beneficial owner” of the dividends. This creates disparity between who SARS accepts as the beneficial owner of a dividend and for whose benefit the dividend accrues. A number of issues arise in this regard: (i) in the case of a foreign beneficiary the same amount of dividends taxed in the trust’s hands will potentially be taxed in the beneficiary’s hands in their country of residence under the domestic tax laws without a credit for the South African tax being given, on the basis that the beneficiary did not bear the dividends tax here; (ii) the foreign beneficiary could potentially, on that interpretation, not be able to claim a reduced rate of withholding tax under an applicable treaty (for example in terms of the South Africa / United Kingdom double tax treaty reducing the withholding tax rate from 20% to 10%); and (iii) trapping the income in the trust could create uncertainty as to the nature of the receipt from the trust by the foreign beneficiary.

Interest

An even more jarring consideration is the treatment of interest income received by a trust and onward distributed to the foreign beneficiaries in the same tax year. South African tax resident beneficiaries will be subject to tax on the interest at their marginal rate of tax up to a maximum of 45%. With respect to payment of interest to non residents (‘a foreign person’), there is a levy of withholding tax at a rate of 15%. The payor of the interest must withhold the tax but the non resident bears the liability. On the current proposed amendments, (i) the interest income will accrue to the trust and no longer to the foreign beneficiary making the trust liable for the tax on the interest income at the flat rate of 45%; and (ii) the same issues as relate to dividends will apply here as well, i.e. potentially no foreign tax credit for the beneficiary, the inability to rely on the reduced rate of withholding tax (or even the 15% imposed under our law) and uncertainty as to the nature of the receipt.

Effectively, the proposed amendments could have the effect of subjecting the same income to double tax i.e. in the hands of the trust and in the hands of the foreign beneficiary potentially without any relief in the domestic jurisdiction of the foreign beneficiary.

Implication on the application of tax treaties

Tax treaties apply mainly to prevent double taxation (i.e. juridical double taxation where one taxpayer is being taxed on the same amount in two different jurisdictions). In this regard, treaty relief may be claimed by the taxpayer who is the beneficial owner of a particular income stream. This comes into consideration as both jurisdictions may want to tax the amount with respect to that taxpayer, the one on a source basis and the other on a residence basis. The treaty would apply to either allocate or limit taxing rights.

With regards to dividends, if the trust is considered the beneficial owner and therefore liable for the withholding tax, the foreign beneficiary may not be able to rely on treaty relief in terms of the article dealing with taxation of dividends because they are seen as not bearing the liability for the withholding tax. Alternatively, the foreign beneficiary could rely on the general elimination of double taxation article available in treaties. But this would require that they prove that the income upon which the trust paid the tax is the same income that had been subject to withholding tax. Relief on this basis is uncommon and much less certain compared to relying on the specific article dealing with the relevant stream of income.

Foreign trusts

The proposed new rules make no distinction between South African and foreign trusts, and there are going to be significant problems if the proposed legislation will have to apply to foreign trusts in the same way.

Conclusion

The extent of the potential impact of the proposed amendments (were they to be enacted in their current form) on the liability for withholding taxes and the available relief to the foreign recipient are yet to be observed in practice. While the proposed

changes are geared toward protecting South Africa's tax base and the ease of revenue collection for the fiscus, it will result in non-residents having less certainty as to the taxation of dividends and interest received from a trust.



@werksmans