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TAX

Tax avoidance could be a tax trap

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INTRODUCTION

In 2016, the Income Tax Act ("the Act") was amended to provide for a further tax burden where (by and large) individuals had advanced loans to local or offshore trusts at low or zero rates of interest. The new provision – section 7C of the Act – deems the difference between the "official rate of interest" for fringe benefits tax purposes (currently 8% for rand denominated loans) multiplied by the loan owing from time to time, to result in a donation deemed to be made on the last day of February, i.e. the last day of the tax year, to be subject to donations tax at the rate of 20%. This gives rise to an effective tax rate of 20% of 8% = 1.6%. (Given that the official rate of interest is linked to the equivalent of the repo rate in foreign currency denominated loans, the effective rate of tax for loans to offshore trusts denominated in foreign currency is much lower.)

Not surprisingly, despite the fact that the effective rate of tax is quite low, there has been a significant amount of resistance and concern at the imposition of this new tax. And it must be remembered that an interest-free loan also gives rise to a deemed donation for the purposes of section 7 of the Act, so that the whole or portion of the income of the trust is attributable to the lender (and there is a corresponding provision in the Eighth Schedule to the Act so that capital gains are similarly attributable).

But not in all structures is there an interest-free loan to a trust. Sometimes the trust's sole asset represents a nominal investment in shares in a company, and all of the assets are held in the company, with the planner having made an interest-free loan to the company (and this can be found both onshore and offshore). Hitherto this arrangement has escaped section 7C of the Act, as it applies only to a loan to a trust, and not to a company owned by a trust. In the February 2017 Budget, it was announced that this oversight last year would be remedied this year.

OFFSHORE STRUCTURES

In their haste to avoid the application of section 7C to loans made to offshore companies held by offshore trusts, certain individuals are contemplating capitalising these loans into zero coupon redeemable preference shares. In this way the section cannot apply, because it clearly refers only to a loan. Moreover, it is hoped that section 7 of the Act will not apply to attribute income, because there is no longer an interest-free loan.

The consequences of such action are much worse than realised. In fact this is a case of the cure being far worse than the illness. Assume that the trust was formed and invested USD100 in share capital of an offshore company, and the planner advanced an interest-free loan of USD1 million to the company. With the base rate in the USA being 1%, the official rate for fringe benefits purposes would be 2%, so that the effective rate of donations tax under section 7C of the Act would be 0.4% per annum. In addition, for the purposes of determining how much of the company's income and capital gains should be taxed in the hands of the lender, one would probably say that it is an amount equal to, say, 8% of the loan (this is not to say that the lender will pay tax ***on*** 8% of the loan, because if the actual income and capital gains amount to less than an amount equal to 8%, he or she will pay tax on the lesser amount).

By capitalising the loan into a zero coupon redeemable preference shares, the planner now renders that offshore company to be a controlled foreign company in terms of section 9D of the Act. The reason is that he or she has USD1 million worth of preference shares as against the trust holding USD100 of ordinary shares, so that the planner holds 99.99% of the participation rights (as defined in section 9D) in the offshore company. As a result, he or she will be taxed on 99.99% of the annual income and capital gains of the offshore company – and this notwithstanding the fact that the preference shares are non-participating.

ONSHORE TRUSTS

Similar planning for an onshore situation would not have the same adverse results. There would be a cure for the application of section 7C of the Act (but one wonders how long it will take the legislature to incorporate preference shares into the section in addition to loans, as has been done in other sections of the Act). A zero-coupon preference share will not, however, defeat the attribution rules under section 7 of the Act, because it will still be considered to be a donation for this purpose, which results in such attribution.

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