South African Institute of Tax Professionals

20 July 2020

The South African Revenue Service

Lehae La SARS,

299 Bronkhorst Street

PRETORIA

0181

BY EMAIL: policycomments@sars.gov.za

RE: SAIT COMMENT IN DRAFT RULING: VESTING OF INCOME IN A RESIDENT BENEFICIARY BY A NON-RESIDENT TRUST: INTERACTION BETWEEN SECTION 25B(1) AND SECTION 7(8)

Dear Sir/Madam

We thank you for the invite to comment on this draft interpretation note dealing with the interaction between section 7(8) and section 25B(1). This area is indeed very complicated and much in need of clarification.

1. Nature of the interpretation

As a general matter, SARS interpretation notes normally offer wide coverage of a single area of law (such as the comprehensive note on section 10B). In other cases, SARS interpretation notes fully cover a wide range of impacts related to a series of similar transactions (such as the draft note on the impact of VAT on loyalty points).

On a procedural level, this draft note simply deals with a single issue, related to a single transaction. The note is thus more akin to a binding class ruling. At a substantive policy level, we also find the interpretation note fairly shallow because a series of tax act sections potentially apply to transfers to non-resident trusts that are either donative or not at arm's length. The narrow nature of the draft note essentially leaves more questions than the questions answered. We would accordingly suggest that the draft note deal with variety of tax sections that that typically intertwine (see Part 3 of this submission below) when donative or non-arm's length transfers are made to foreign trusts.

2. Section 7(8) and Section 25B(1) Interaction

a. Common law trust accruals

It goes without saying that section 7(8) prevails when both section 7(8) and section 25B(1) apply by virtue of a simple plain English reading. Of concern, however, is whether section 25B(1) actually applies in the example contained within the draft note.

More specifically, the draft note states at the top of page 2:

> "Section 25B(1) overrides the principle that income cannot be disposed of after accrual. For example, if income accrues to a trust on 1 July of year 1, and the trustees vest the income in a beneficiary on 30 November of year 1, under common law principles the income would accrue to the trust, but under section 25B(1) it is deemed to accrue to the beneficiary.'

At issue is the draft note's reference to common law. The draft note implies that the trustees must have resolved to distribute the amount to the beneficiary before the income actually accrued to the trust. While this notion of accrual seemingly makes sense, the case law actually provides a different outcome. A full reading of Supreme Court of Appeals in *SIR v Rosen 32* SATC 249 instead suggests that the conduit pipe remains open the whole year, and only closes at the end of the year if no vesting in a beneficiary has taken place. In the facts of the judicial decision, the beneficiary was entitled to a fixed amount of R50 per month, but the trustees could increase this amount and then reduce it again. In January, they agreed to increase the annual amount of R600 to a total of R7 200 for the year to end in February. The question was whether the dividends retained their identity in the beneficiary's hands. The Supreme Court of Appeal said this was the case. The court also made the well-known statement at 269-270 as follows:

> "It is unnecessary to decide in the present appeal what limitations, if any, should be placed on the wide language of that phrase, and to what extent it applies to cases other than trust cases. It suffices to say that the trust deed may itself entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit-pipe for passing them on to the beneficiary, that in his hands their source as dividends can no longer be identified or they otherwise lose their character and identity as dividends, and that the beneficiary is thus entitled to receive mere trust income in contradistinction to the benefit of the dividend rights in terms of the above crucial phrase. Thus, a trust deed may endow the trustee with a discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think (but express no firm view) that the dividends might then lose their identity and character as dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit-pipe had turned itself off at the relevant time. ***But if he decides on the former,*** i.e. to pass the dividends on to the beneficiary, the condition suspending the beneficiary's entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed, ***i.e. as if the conduit pipe had always been open*** …" (emphasis added).

Hence, under common law principles as applied in *SIR v Rosen*, the income vests to the beneficiary without regard to section 25B(1). This is so notwithstanding the example within the draft interpretation note because the receipt and vesting occurs within the same year. In particular, the amount is received by the trust on 1 July of year 1 and vested in the beneficiary on 30 November of year 1.

The net result is that there is no overlap in the example between section 7(8) and section 25B(1) because section 25B(1) simply does not apply. The common law prevails instead. Section 25B(1) and (3) are about flowing through the character of underlying receipts / accrual and expenses as opposed to the simple flow-through of net income itself.

b. Why?

The clear purpose of the interpretation note is to ensure that income is reallocated back to the initial domestic donor / transfer versus an allocation to a domestic beneficiary. The question is why?

Both the domestic / donor and the domestic beneficiary are domestic parties, presumably with roughly the same tax rates applying. Without no more, it would appear that the tax is best charged on the beneficiary who will economically own the underlying income (e.g. cash). While the donor / transferor may have a right of recovery (e.g. section 90), it is always best to apply the tax where the cash lies as long as both parties are within the tax net.

c. Resident versus non-resident confusion

In order section 7(8) to apply, the income at issue must ultimately apply to a non-resident. In this regard, the example is once again confused. According to the example, all of the R120 000 of income vests to a South African beneficiary. This vesting to a South African beneficiary means that section 7(8) does not apply per se because section 7(8) applies only if the income accrues to the non-resident trust. The outcome is the same regardless of whether section 25B(1) or the common law of *SIR v. Rosen* applies.

d. Attributable amounts

Section 7(8) reallocates income back to the donor / transferor only in a limited way. Income is reallocated back to the donor / transferor but "only so much of that amount as is attributable to that donation, settlement or other disposition." While the draft note is clear in this respect in terms of its general statement of law, the draft note becomes confusing in terms of the example.

In the example, the transfer is by way of an interest free loan, which should be charging a fair market rate (which is deemed to be 10%). This interest rate appears to be relevant in the analysis of the section 7(8) reallocation; whereas, the interest charge is actually irrelevant when determining the quantum of reallocation. The market-related nature of the interest is only relevant to determine whether section 7(8) applies in the first instance. The sole issue in the draft note is how the loan corpus is applied. In the example, the full R100 000 loan corpus was applied to acquire the foreign bonds. Therefore, setting aside the triggering event of section 7(8), section 7(8) has full potential application without regard to the market-related nature of the interest charged.

3. <u>Integrally related issues</u>

As noted above, interpretation notes are intended to be more comprehensive than rulings. Therefore, if the topic to be addressed is one of donative or non-market related transfers to foreign trusts, the following areas should be covered for basic completeness.

a. The muddy relationship between sections 7(8) and 31

The discussion of section 7(8) is blatantly incomplete if not referenced to the transfer pricing provisions of section 31. Section 7(8) applies to donations and non-arms length transfers to foreign entities (e.g. foreign trusts). Section creates a deemed arm's length price. Query which antiavoidance rule takes precedence. Presumably, section 31 applies to create an arm's length transfer so as to override section 7(8).

This conflict is apparent in terms of the example provided by the draft note. The interest-free loan is clearly not of arm's length triggering section 31. The net result is deemed interest for the donor without regard to how the transferred funds were utilised by the trust. Given that a deemed arm's length transfer has now occurred, section 7(8) should not apply. As a policy matter, taxation of the underlying trust funds in the hands of the transferor (in addition to the deemed interest charge) would amount to effective double taxation.

We note that the duality of section 7(8) vis-à-vis section 31 presumably was not an initial consideration because section 7(8) was created at a time when section 31 had to be asserted by SARS before that section could apply. Under current law, section 31 is a potential consideration. We note that section 31 specifically overrides section 7C (special rules for loans to trusts) via section 7C(5)(e). We believe section 31 should similarly override section 7(8).

b. Section 7(8) and other subsections within section 7

Section 7 contains several income reallocation provisions. The purpose of these provisions is to reallocate income from wealthy spouses to less wealthy spouses (e.g. section 7(2), or more often, from wealthy parents to their children (e.g. section 7(3)). These provisions do not have a residence or non-residence distinction so these provision often overlap with section 7(8). If so, which apply?

c. Capital Gains Tax

The Capital Gains Tax contains its own comparable provisions to section 7(8) and 25B(1). Paragraph 72 of the 8th Schedule serves as the comparable to section 7(8). Paragraph 80(3) serves as the comparable to section 25B(1). The draft interpretation note needs to equally cover these provisions, especially since capital assets are often a common subject of transfer to a trust.

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You are welcome to contact me (082 455 5597 or kengel@thesait.org.za) should you have any comments or questions.

Yours faithfully,

Keith Engel

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CEO of SAIT