27 February 2025

To: **The South African Revenue Services**
Lehae La SARS
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Re: Potential for Double Taxation Arising from Trust Distributions

Dear Colleagues,

1. Background

It is common practice that many trustees are advised to distribute all trust income and capital gains to beneficiaries to escape the high tax rates in trusts. Even though a trust carries the highest income tax rate (a flat rate of 45%) and capital gains tax rate (a flat rate of 36%), when trust distributions are considered, cognisance is not taken of the 'knock-on' effect of potential further taxes that may be triggered.

2. Section 7C Donations Tax (often considered a 'prepayment' of Estate Duty)

One of the major changes, to date, in trust tax law – in terms of combatting the postponement or avoidance of Estate Duty – was the introduction of Section 7C of the Income Tax Act (the Act). Section 7C seeks to tax loans with interest below the variable official rate of interest (repo rate plus one percent – currently 8.50%) as a 'deemed donation'.

Donations tax is payable on the interest that should have been charged on the loan. This is taxed in the hands of the funder at a rate of 20% of the amount of the 'donation' if the aggregate of that amount and all other donations during a person's lifetime (on or after 1 March 2018), excluding all exempt donations during the same period, is less than or equal to R 30 million. The rate is increased to 25% of the amount of the 'donation' if the aggregate of that amount and all previous donations during a person's lifetime (on or after 1 March 2018), excluding all exempt donations during the same period, exceeds R 30 million. The rationale is that donations tax and estate duty are both charged on a gratuitous disposition (during your life and at death) at the same rates.

At current, the issue with the application of donations tax and estate duty is that no apportionment is allowed between the two tax brackets (20% or 25% explained above). Therefore, if the aggregate donations/estate is pushed above the R30 million threshold, the entire donation/estate will be taxed at 25%, and no portion will be taxed at 20%.

Through this provision, it appears that SARS is reconsidering the traditional approach, where individuals would choose to transfer their assets to 'their' trusts through interest-free loan accounts, which remained unpaid. The effect of this arrangement was that the individual's estate got 'pegged', and all the growth happened in the trust. No estate duty would therefore be paid on the growth of the asset upon a person's death. Section 7C of the Act now ensures that a person pays tax during their life to make up for this 'loss' to the fiscus by assuming a growth rate on trust assets. For example, if an individual sold a building to the trust for R3 million on an interest-free loan account, that individual would pay R 31 000 tax (R3 million x 8.50% (current official rate of interest) – R 100 000 (the annual Donations Tax exemption applicable to each South African resident individual)) x 20% (Donations Tax; if cumulative donations did not exceed R 30 million)} annually, subject to changes in the variable official rate of interest and the cumulative amount of donations after 1 March 2018.

3. Distributions

A trust has unique tax treatment in that others may pay tax on income and capital gains generated in the trust rather than the trust itself. Most commonly, the 'Conduit Principle' allows trustees to shift the tax burden from a trust to its beneficiaries, thereby paying tax at the individual's marginal tax rate. In many cases, this may be lower than the trust's tax rates listed above. Therefore, one can legally use this mechanism as part of one's tax planning and achieve better tax efficiency.

One can also apply the 'income splitting' (and capital gain splitting) principle to reduce the effective tax rate on income or capital gains generated in a trust, by distributing income and capital gains to multiple beneficiaries who pay tax at low rates. This, in many instances is the sole reason for trustees to move all the net income and capital gains generated in the trust during a year to beneficiaries.

This is frequently done in an 'automatic' manner, simply to reduce taxes, that the compulsory application of the 'attribution rules' of the Act (whereby all or some of the trust income and capital gains are to be attributed to the donor or funder for them to pay tax on income and capital gains generated as a result of their donation or soft funding) are overlooked. Given SARS renewed focus on the 'attribution' rules, such behaviour may trigger penalties and interest on the incorrect treatment of trust income and capital gains.

Due to the introduction of Section 7C (explained below), transferring assets into a trust has become quite challenging, often resulting in individuals not deeming it be wise to 'bleed' growth out of a trust that was set up as a generational wealth transfer trust through making distributions to reduce tax that year. Resultantly, if the trustees sell the building (asset) after 10 years and make a capital gain of R5 million, they may distribute it to a beneficiary to make a tax saving of R 900 000 [R5 million x [36% (CGT rate for a trust) - 18% (maximum CGT rate for an individual)], which is often regarded as an incentive for trustees to distribute the amount to a beneficiary. Often this is perceived as the preferred outcome sought by the revenue authority, as it would result in the amount being included in the beneficiary's estate, which could be subject to estate duty.

4. Estate Duty

Estate planners and trustees are mindful that once distributions are made to beneficiaries, such amounts or assets have to be unconditionally vested in those beneficiaries to qualify for the more favourable tax treatment discussed above. It is common cause that distributions are either physically paid to beneficiaries or left in the trust as amounts payable to beneficiaries. In both instances, these amounts are included in and inflate beneficiaries' estates. These amounts may even push a beneficiary's estate over the R30 million mark, which in turn triggers an additional 5% estate duty upon the person's death, as discussed above.

Additionally, any future income and growth on these amounts (whether the amounts are physically paid out to the beneficiary concerned or retained in the trust for them) also vest in these beneficiaries' hands, which will in turn inflate their estates.

5. Potential double tax

Following the introduction of Section 7C (which is often considered as a 'prepayment' of estate duty on assumed growth) no provision has been made for any rebates on amounts already paid annually (since 31 March 2018) on the assumed growth explained above, against the calculated estate duty upon the deaths of beneficiaries who have received distributions during their lifetimes. Following the example above, applying the current rates, double taxation (Estate Duty and Section 7C Donations Tax) will be paid on R 265 000 (10 years x R 26 500).

6. Conclusion

When trustees consider distributions, detailed calculations are performed to understand the total tax consequences resulting from distributions. Each beneficiary's estate is taken into consideration, as one would want to avoid the additional 5% donations tax and/or estate duty because of any transaction or distribution.

If trustees blindly distribute trust income and capital gains to avoid paying higher taxes only for that year, they may trigger other unintended tax consequences. When free cash is available after a trust asset has been sold, it may be wiser to rather repay a loan attracting Section 7C Donations Tax, as it will forever attract Section 7C Donations Tax, even if it is bequeathed to a family member after the death of the original funder.

The purpose of this submission is to bring to your attention the instances of potential and actual double taxation that have arisen in the above-described instances.

We remain at your disposal to clarify aspects raised herein and ways in which to remedy.

Yours sincerely,
SAIT Tax Technical

End.