Anti-avoidance rules for trusts: Refinement of section 7C

29 August 2017

In brief

Section 7C of the Income Tax Act, 1962 (Act No. 58 of 1962) ("the Act") was introduced in 2016 in order to address avoidance of donations tax and estate duty through the transfer of assets to trusts on loan account. Generally, section 7C (which applies from 1 March 2017) deems the interest foregone on a loan made to a trust to be a donation that attracts donations tax.

On 19 July 2017, National Treasury released the Draft Taxation Laws Amendment Bill, 2017 ("the Draft Bill"), for public comment. The Draft Bill proposes two sets of amendments relating to section 7C: one set addresses certain avoidance schemes that have been identified by government, and the other provides for an exclusion from the application of section 7C in the case of certain employee share schemes.

In detail

New anti-avoidance measure (1): loans made to companies

In order for section 7C to apply, a loan must have been made by a natural person (or, at the instance of a natural person, by a company that is a connected person in relation to the natural person) to a trust. In addition, the trust must be a connected person in relation to the natural person, the company or any other person that is a connected person in relation to the natural person or the company.

It appears that taxpayers are seeking to avoid the application of section 7C by advancing the relevant loan to a company, the shares of which are owned by a trust. Where this is the case, the anti-avoidance measure will not apply (section 7C is only triggered where the loan is made to a trust).

Accordingly, it is proposed that section 7C should also apply to loans made by a natural person (or by a company at the instance of the natural person) to a company where the company to which the loan is made is a connected person in relation to the trust.

New anti-avoidance measure (2): transfer of loan claims to current or future beneficiaries of trusts

Where section 7C is triggered and applies in respect of a loan made by a natural person (or by a company at the instance of the natural person), the natural person must treat as a donation the amount of the interest foregone by the trust on the loan.

Taxpayers have apparently therefore argued that where the loan claim is transferred to another natural person (usually a current or future beneficiary of the trust), the link between the loan and the natural person who advanced that loan is broken. Because this link is broken, it is argued, the natural person to whom the loan claim is transferred need not account for the deemed donation.

In order to address this avoidance, it is proposed that where a loan claim is transferred to a natural person as envisaged above, the natural person to whom the loan claim is transferred must, for the purposes of section 7C, be treated as having provided the loan to the relevant company or trust.

Anti-avoidance measures: effective date

It must be noted that it is proposed that both of the above anti-avoidance measures should apply with effect from 19 July 2017 (i.e. the date of the release of the Draft Bill for public comment), irrespective of when the relevant loan was advanced.

Exclusion of employee share incentive scheme trusts from the application of section 7C

When the first draft of section 7C was released for public comment in 2016, one of the main criticisms of the section was that it ignored the fact that trusts are used for various legitimate purposes other than the transfer of wealth through the use of interest-free or low interest loans.

In order to ensure that section 7C does not act as an impediment to legitimate uses of trusts, changes were made to the then proposed section 7C before its introduction to allow for such legitimate uses. Thus, for example, section 7C does not apply to loans provided to trusts in terms of sharia-compliant financing arrangements, and trusts that are public benefit organisations or small business funding entities are not subject to section 7C.

The Draft Bill proposes that, in addition to the existing exclusions from section 7C (which are listed in section 7C(5)), a specific exclusion for employee share incentive schemes should be provided. It is proposed that this exclusion be available from 1 March 2017.

In order to prevent abuse of the exclusion, a number of requirements must be met. Generally:

- the trust must have been created solely for purposes of giving effect to an employee share incentive scheme;
- the loan must have been provided in terms of the scheme;
- the purpose of the loan must have been to enable the trust to fund the acquisition of shares in a "scheme company" (i.e. the company making the loan or any other company in the same group as that company);
- entitlement to participate in the scheme must be limited to persons who are in the full-time employment of or who are directors of a scheme company;
- the scheme must prohibit participation in the scheme by persons who are, in terms of paragraph *(d)*(iv) of the definition of "connected person", connected persons in relation to a scheme company (i.e. generally any person who, individually or jointly with any connected person in relation to that person, holds 20% or more of the equity shares or voting rights in a scheme company).

The take-away

Although the above proposals are contained in draft legislation, it is important to note that it is proposed that the anti-avoidance measures be effective from 19 July 2017 (i.e. the date on which the draft legislation was released for public comment).

It was to be expected that anti-avoidance measures would be introduced to counter avoidance that only became apparent after the introduction of section 7C. However, it may be argued that the anti-avoidance measure dealing with loans made to companies is far too broad. This is because the relevant trigger for the proposed measure is a connected person relationship between the borrowing company and the trust (a shareholding by the trust in the company is not required). As part of the legislative process, PwC has made written representations to the National Treasury and

SARS on this issue, and will engage further thereon.

Regarding the introduction of an exclusion from the application of section 7C in the case of employee share incentive schemes, this exclusion (which applies from 1 March 2017) is welcomed. However, missing from the draft legislation is an exclusion for business trusts (which was mentioned in the National Budget Review in February this year). It is hoped that such an exclusion is still being considered, and PwC will engage further with National Treasury in this regard.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Cape Town
Charl du Toit
(021) 529 2376
charl.du.toit@pwc.com

Gauteng
Jan Coetsee
(012) 429 0051
jan.coetsee@pwc.com

Durban
Richard Pickup
(031) 815 2418
richard.pickup@pwc.com

Port Elizabeth
Leigh Petrie
(041) 391 4477
leigh.petrie@pwc.com

Bloemfontein
Hesna Rheeder
(015) 503 4202
hesna.rheeder@pwc.com