Hogan Lovells

Section 7C

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Tax Alert

Raising the red flag on low interest and interest free loans to trusts

Over the years, trusts have consistently proved to be a reliable and attractive vehicle for many, offering flexibility and benefits with regard to estate planning, investments, the protection of assets and tax planning.

However, the increased use in trusts has led to a corresponding increase in the abuse of trusts and trust structures specifically with respect to tax avoidance schemes and practices.

National Treasury and the South African Revenue Service (SARS) have responded by promulgating various anti-avoidance provisions to deter such practices and prevent such abuses from occurring.

The most recent addition to the armoury of SARS to combat these practices is the amendments to section 7C (s7C) of the Income Tax Act 58 of 1962 (ITA).

These latest anti-avoidance provisions target instances where a person "sells" their assets to the trust on loan account where the loan is subject to interest that is below market related rate, or charges no interest on the loan at all.

The result of the above is that the person avoids triggering a 20% donations tax on the assets now "sold" on loan account to the trust and where there is no interest charged on the loan, they avoid income tax on the interest that should have been charged.

Coupled with the above, where the person reduces or waives the loan capital that was supposed to have been repaid to them, this has the result of avoiding estate duty through the reduction or waiver of the asset base of the lender in respect of the loan capital owed to them by the trust.

In light of the above, it becomes clear why low interest or interest free loans are targeted by the amendments to s7C.

The amendments target "affected loans" which encompass interest free loans or loans with interest below market value rate that are made to a trust directly or indirectly by:

- a natural person;
- a company that is a connected person in relation to that natural person (where the loan is made at the instance of that natural person);
- to a trust in relation to which:
    - (a) that person or company is a connected person; or
    - (b) any person that is a connected person in relation to the person or company referred to paragraph (a) above;

  is a connected person; or

- to a company that is a connected person in relation the trust referred to above.

The inclusion of "connected persons" in the wording of s7C has a "catch-all" effect. The wording attempts to close any loopholes that a person may try to utilise by way of advancing the low interest or interest free loan through a relative, a company in which they are a shareholder (with an interest of more than 20%), a beneficiary of another trust to which they are related and so on.

Once a loan is seen to be "affected", s7C seeks to deem any interest foregone (or interest that should have been charged) in respect of the affected loan made to a trust, to be an ongoing annual donation by that person. The interest foregone will be determined as the difference between the interested charged by the lender, and the interest that would have been payable by the trust had the interest been charged at the official rate of interest as defined in the Seventh Schedule to the ITA (which varies from period to period).

For example, if X has advanced a loan of ZAR100 to his trust on an interest free basis and the official rate of interest was 7.75%, X should have charged ZAR7.75 interest on that loan annually. Accordingly, that ZAR7.75 that should have been charged will be treated as a deemed donation by X to his trust and he will be liable to pay 20% donations tax on the ZAR7.75 annually.

While it is apparent that people can use trusts to circumvent tax obligations, it is equally true that trusts are also used for a number of legitimate purposes and accordingly, there are a number of exclusions to which s7C will not apply, some of which being:

- vesting trusts;
- trusts that hold a primary residence;
- special trusts and trusts classified as public benefit organisations in terms of section 30 of the ITA;
- loans that constitute affected transactions which are subject to section 30 of the ITA; and
- trusts created solely for the purposes of an employee incentive scheme.

The anti-avoidance measures under s7C are effective as of 1 March 2017 and operates retrospectively as well as to all affected loans advanced on or after that date. The retrospective operation of these provisions will have far reaching consequences and we have yet to see how SARS handles investigations into all existing loans with existing trusts, many of which were established decades ago.

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