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Submission File

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South African Revenue Service
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BY E-MAIL: policycomments@sars.gov.za

Dear SARS

COMMENTS ON THE DRAFT INTERPRETATION NOTE – VESTING OF INCOME IN A RESIDENT BENEFICIARY BY A NON-RESIDENT TRUST: INTERACTION BETWEEN SECTION 25B(1) AND SECTION 7(8)

1. We herewith take an opportunity to present our comments on behalf of the South African Institute of Chartered Accountants (SAICA) on the Draft Interpretation Note (IN) providing clarity on the interpretation and application of the words "subject to the provisions of section 7" in section 25B(1) and, more specifically, whether section 7(8) or section 25B(1) applies when income received by or accrued to a non-resident trust by reason of or in consequence of a donation, settlement or other disposition by a resident, is vested in a resident beneficiary by the trustees of the non-resident trust.

COMMENTS

Section 7(8) – overrides section 25B(1)

2. We have reviewed the Draft IN on sections 25B(1) and 7(8) and it is our understanding from the Draft IN that section 7(8) will override s25B even if there is a vesting in a beneficiary from the offshore trust. This is not how we have understood the provision, and is surely is not the intention as this principle would also impact local trusts.

3. Before going into the merits of the interpretation it must be said that applying the legislation in this way is impractical. It is not the way the legislation has traditionally been interpreted in all the 20 years it has been in place. Furthermore, it would necessitate beneficiaries that receive or accrue income from an offshore trust having to disclose the income but also explaining to SARS why they should not be taxed on such amounts (assuming they have even been advised accordingly) which would be administratively difficult.

4. We also believe the interpretation is arguably incorrect for the following reasons:

    4.1. Section 7(8), only applies if any amount is, firstly, *received or accrued* to any person that is a non-resident. It is debatable whether a trust that has vested beneficiaries with income ever actually “receives” or “accrues” such income for tax purposes.

Receipt of income for the benefit of another is not a receipt in terms of case law (*Geldenhuys v CIR*). Furthermore, trusts, which are subject to the terms of their trust documents, cannot be said to have an unconditional right to income that is vested in a beneficiary, hence there is no accrual. Trusts therefore effectively act as conduits to their beneficiaries ie an amount distributed by a trust to its beneficiary in the same year as it is "received" or "accrued" to the trust, results in taxation of the amount in the hands of the beneficiary. This is supported in the case of *SIR v Rosen* (1971(1) SA 172 (A)). Section 25B(1) thus merely codifies a principle of law as opposed to actually creating a new one. Even having section 25B(1) subject to section 7(8) may not alter the principle that foreign trusts that distribute income within the same tax year to their beneficiaries have not "received" or "accrued" such income from a common law perspective.

4.2. Secondly, section 7(8) cannot apply even where an amount is received or accrued to a non-resident when that amount would not have been included in the income of that non-resident had they been a resident. If a non-resident trust were resident and distributed to a resident beneficiary within the tax year, the trust would not have been subject to tax on the amount unless sections 7(3) (6) or (7) apply. Assuming the latter provisions do not apply, s7(8) would not have applied (ie. section 25B applies without further consideration of section 7(8)) and the example in the Draft IN is incorrect.

4.3. Furthermore, this interpretation seemingly ignores the long held principle that specific provisions override general ones. Section 25B(1) applies specifically to income vested by a trust; whereas s7(8) deals more generally with amounts received or accrued by non-residents (which need not be trusts). Interpreting the words "subject to" in a manner contrary to this principle would undermine traditional jurisprudence on tax legislation.

4.4. More broadly, the interpretation runs counter to Adam Smith's maxim that every tax ought to be levied at the time or manner in which it is most convenient for the contributor to pay it. If a resident beneficiary receives or accrues the income, that beneficiary should be the taxpayer making the payment rather than the donor who did not receive or accrue the income. The anti-avoidance principle which we understand underlies section 7(8) (ie. preventing funds escaping the South African tax net) would not be served by having the resident donor pay the tax as opposed to the resident beneficiary. It makes sense that the donor may be taxed on amounts vested in a non-resident (which, under s7(8) would be the case even if the donation settlement or other disposition were to that non-resident beneficiary directly and not through a trust) since the amount will not otherwise be taxed in South Africa.

5. It appears that, for a discretionary beneficiary, one needs section 25B(2) to deem the accrual to the trust, to not be an accrual to the trust, but to be an accrual to the discretionary beneficiary who obtained the right following the vesting event post the initial accrual to the trust.

6. The wording in section 7(8) is "any amount is received by or accrued to any person who is not a resident". With regard to trusts, resident in the RSA, section 7(8) would apply if the

income is vested in a non-resident beneficiary – on the strength of the 'in consequence' part.

7. But the reverse is what creates the problem. The principle is that the vesting event, subsequent to the accrual to the trust, in the beneficiary means that it ultimately doesn't accrue to the foreign trust. But, the clarification that is required is whether one would have to apply section 25B(2) first to achieve that. If section 25B(2) isn't applied, the foreign trust is the beneficial owner of the income and there is a subsequent 'disposal', to use SARS's words.

8. Submission: We request SARS to reconsider the merits of the interpretation based on the points raised above.

Limitation to section 7(8)

9. The phrase 'subject to' is relevant to all the subsections of section 7 and it is not certain why the Draft IN limits its interpretation to section 7(8) only. It is uncertain, as far as the other subsections of section 7 are concerned, if the interpretation may well be different.

10. Submission: The Draft IN should interpret the phrase 'subject to' with respect to section 7 as a whole or stipulate why section 7(8) is singled out.

Principle of accrual

11. Page 2 of the Draft IN contains the following sentence:

"*Section 25B(1) overrides the principle that income cannot be disposed of after accrual*". [our underlining]

12. The words 'disposed of' is misleading. As noted above, the purpose of section 25B was to codify the conduit principle. Even if one takes the position, contrary to that propounded in point 4.1 above, that trusts that vest distributions in beneficiaries within the same year do "receive" or "accrue" such income within the tax year prior to vesting, it cannot be said that the vesting results in a "disposal" by the trust after accrual. With respect to a beneficiary with a discretionary right to the income, the conduit principle creates the fiction that an amount that accrued to the trust is deemed to have accrued to the beneficiary, with a discretionary right, if the discretionary beneficiary obtained a vested right after accrual to the trust during the same year, due to the trustees exercising their discretion and vesting took place thereafter. The fiction then is that, because section 25B(2) deems the accrual to the trust to be by the discretionary beneficiary, there was no accrual to the trust.

13. Submission: The trustees are not disposing of the amount that accrued. This principle is clearly illustrated in the two Draft INs on withholding taxes and the Guide on the dividends tax (and by the example that follows the sentence).

14. On the top of page 3, the following sentence is included:

"*For example, it includes a loan on which interest is charged at a rate that is significantly below an arm's length rate of interest" sentence".* [our underlining]

15. The addition of the word ‘significantly’ is not linked to any legislation and we are not sure that SARS applies this in practice.

16. Submission: The correctness and meaning of the word ‘significantly’ should be clarified and reference to the applicable legislation and case law should be included.

Broader scope of Draft IN

17. We are of the view that more value can be added if the interpretation note also deals with other sections that (potentially) apply to cross-border loans and specifically sections 7C and 31.

18. There is uncertainty as far as the interaction between these sections, as well as section 7(8) is concerned. There is no ‘subject to’ clause in sections 7(8) and 31 in relation to each other, which makes it difficult to decide which one prevails.

19. Subsection 7C(5)(e) contains a ‘subject to’ clause with reference to section 31, but the application of this is not that clear because of the requirement that the loan must be an ‘affected transaction’ ie not arm’s length rather. Thus, if no interest charged the exemption from s7C applies but if interest is charged at a rate that is arm’s length (ie. not an affected transaction) but it is below the “official rate” the exemption from s7C does not apply

20. Similarly, although it is generally understood that s31 will not be applied were s7 is applied or vice versa there is no legal basis for this and clarification needs to be provided.

21. Submission: More examples dealing with cross-border loans, such as section 7C s7 and section 31 and their interactions, should be included in the Draft IN to provide clarity on the above.

Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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The South African Institute of Chartered Accountants