TRUSTS - IS THE CONDUIT PRINCIPLE IN PERIL?

The announcement regarding trusts in the 2013 budget is notable for two reasons: its brevity and its lack of detail.

Any comments made in advance of the publication of the first draft of the Taxation Laws Amendment Bill expected in June can therefore only be speculative.

Treasury and the South African Revenue Service (SARS) seem to be concerned about trusts, largely because of the income-splitting opportunities that trust law affords. These are based on the well-established conduit principle in terms of which, if income accrues to a trust and the trustees award it to one or more beneficiaries in the same year, the income retains its nature in the hands of the beneficiary. In fact, the Eight Schedule to the Income Tax Act, No 58 of 1962 provides specifically for this application in the context of capital gains tax (CGT) in that it provides:

- that any gain arising in a trust from distribution of an asset to a beneficiary is taxed as a capital gain in the hands of the beneficiary; and
- that where a capital gain arises in a trust as a result of the disposal of an asset of the trust, the trustees may in the same year award the gain to one or more beneficiaries.

The problem for the fiscus is that the conduit principle may be used for income splitting and deduction splitting. On the income side, interest income is perhaps the best class of income to use in an example. Assume that there are three beneficiaries of a trust, who are natural persons, and in the current year the trust earns interest of R75,000. If the trust retains the interest and pays tax on it, it gets no exemption and the tax liability at 40% is R30,000.

Now assume that the trustees award the interest in equal proportion to the beneficiaries. The tax liability of each beneficiary will be as follows: interest income R25,000, of which R23,800 is exempt (this would be R34,500 for a beneficiary older than 65). The taxable balance is thus R1,200 on which, even at the maximum marginal rate of 40%, the tax would be R480. The total tax payable on the interest would thus be R480 x 3 = R1,440.

For CGT purposes there is a similar result. On a capital gain of R120,000 the trust's tax liability would be 120,000 x 66% x 40% = R32,000. On the same gain distributed equally to them, the three beneficiaries would pay a maximum between them of 120,000 x 33% x 40% = R16,000; and this result ignores the fact that the tax rate of a beneficiary could be as low as 18% depending on the beneficiary's total taxable income.

On the deduction side, the expenditure relating to a particular item of income awarded to a beneficiary is deemed to be that of the beneficiary. However, it is possible, with some astute planning, to retain in the trust more than a proportionate share of expenditure incurred by the trust, where it is most beneficial because of the 40% tax rate applicable to trusts.

How Treasury intends to override the conduit principle is unclear. Are trusts going to be taxed on their income before it is distributed? Will they enjoy a deduction in respect of income then awarded to beneficiaries (which seems to be the intention) and, if so, will the income retain its nature in the hands of the beneficiary or will it be taxable without the benefit of the interest exemption, where it applies? None of this is clear. We await the draft amending legislation with interest.

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