FINANCE MATTERS

Hewett Wealth

Donations: A practical perspective

Part 1: Looking a gift horse in the mouth

The proverb states: "Don't look a gift horse in the mouth". It refers to the practice of evaluating the age of a horse by looking at its teeth. As a financial adviser you may find that you must do exactly this and question the value of a gift which a client has received.

We concern ourselves with the value of a gift because it may qualify as a donation in terms of the Income Tax Act, on which donations tax is payable. A person donates something if they dispose of assets or property gratuitously – in other words, free of charge or for less than its market value.

In this article, we will attempt to answer the most common and pertinent questions relating to donations and donations tax while looking at the practical aspects often overlooked. Here are some of those questions and their answers

1. Why is the South African Revenue Service (SARS) taxing donations; it seems unfair?

If you assume that the gift you are giving is generally purchased with after tax money, most people fail to understand why they cannot give it away without paying any taxes.

Estate planners have historically (and still do), tried to avoid the 20% (25% for estates of more than R30m) estate duty payable on their dutiable assets when they die. One way that this was achieved was by giving assets away prior to death – to prevent them from being seen as part of the deceased estate. Since estate duty is a tax levied on the disposal of assets after death, donations tax was introduced as a tax on the disposal of assets during your lifetime – therefore, also levied at 20%.

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The outcome is that if an asset is disposed of during your lifetime or upon your death, the tax cost is potentially the same (subject to exemptions and abatements, etc.). Therefore, donations tax was introduced to close the estate duty 'loophole'.

2. Who must pay donations tax?

The donor (that is, the giver) is liable for payment. But, if the donor fails to do so in the prescribed time, then donor and donee are jointly and severally liable for payment. Payment must be accompanied by the donations tax return, an IT44.

3. When is donations tax payable?

At the end of the month following the month in which the donation took place. For example: If a donation took place on 20 October 2017, the tax is payable by 30 November 2017.

4. All donations to a spouse are exempt from donations tax, how will it work if the donation is to a trust where the spouse is a beneficiary?

This donation to the trust will still be exempt from donations tax if the spouse is the only beneficiary of the trust.

5. Each natural person can donate up to R100 000 per annum, free of donations tax. Can this amount be used to write off a debt by donating R100 000 per annum to the debtor?

The annual exemption is a very good estate planning tool and over time it can be used to reduce the dutiable estate of the estate planner quite effectively.

For example: Pete sells a block of flats, worth R5 million, to his son rather than donating it in an attempt to avoid donations tax. His son does not have the money to pay him for the block of flats; therefore, they set up a loan agreement between them whereby Pete's son owes him R5 million. In an effort to minimise the value of the loan account, which will be asset in Pete's estate and will attract estate duty, he writes his annual donations tax exemption of R100 000 off against this loan every year. He dies 20 years later with the value of the outstanding loan in his estate being R3 million. Therefore, he saved R400 000 in estate duty (R2 million x 20%), if we ignore the abatement.

6. Is there donations tax on payments to dependents?

In terms of the Income Tax Act, a bona fide contribution to the maintenance of another person qualifies for an exemption from donations tax, provided that the Commissioner considers it to be reasonable. A vintage Rolls Royce valued at R4 million given by a father to his student daughter, is clearly not reasonable as maintenance; however, amounts paid for her university fees and residence costs are indeed reasonable maintenance costs that will not be taxed as a donation.

7. How does it work if a person pays less than market value for an asset?

This will result in a 'deemed donation'. A deemed donation exists where any property is disposed of for a consideration which in the opinion of the Commissioner, is not an adequate consideration – so not in line with the fair market value of that asset. In such instances, the property is deemed to have been disposed of under a donation and the value of the donation is the difference between the market value and the actual amount received for the asset.

Example: Jenny owns a beach house. The true market value of the beach house is R10 million. She sells it to a family trust for R6 million. The R4 million below market value is treated as a deemed donation and Jenny will have to pay donations tax on this amount, which is as follows:

R4 million-Annual donation tax exception of R100 000
=R3 900 000 ×20%
=R780 000 donations tax payable

8. It seems unfair that if I donate an asset to my sister for example, I will pay donations tax on the value and because a donation is a 'disposal' for Capital Gains Tax (CGT) purposes, I must also pay CGT on the gain?

It is correct that it seems unfair and the Commissioner of Inland Revenue provides relief by allowing a portion of the donations tax that was paid to be added to the base cost of the asset when calculating CGT. This will have the effect that the base cost is inflated and the GCT is therefore smaller.

For example: Andre donates shares to his daughter at a time when its market value is R1.5 million. The base cost was R500 000. Andre pays donations tax as follows.

Market Value of asset	R1 500 000
Less: annual exemption	- R100 000
Taxable donation	R1 400 000
Donations tax at 20%	= R280 000

Allowable addition to base cost formula is as follows.

$$\frac{(\text{Market value of asset-base cost})}{(\text{Market value of asset})} \times \text{Donations Tax}$$

$$\frac{(\text{R1 500 000 - R500 000})}{(\text{R1 500 000})} \times \text{R280 000}$$

=0.6667 x R280 000
= R186 666

Therefore, the base cost of the shares are increased by R186 666 and it is now R686 666. Thus, Andre will be liable for CGT on R1.5 million less R686 666.

Part 2: Donations and trusts

Inter vivos trusts are typically set up by way of a donation to a trust. Trusts are flexible vehicles, capable of providing a plethora of continuously changing solutions to nearly all estate planning challenges. It is important that we understand the rules surrounding donations to trusts in order to fully utilise the trust structure benefits.

Do not forget the anti-avoidance measures when advising on donations to trusts!

Section 7C was introduced to curb the avoidance of income tax through the 'abuse' of the trust structure in certain circumstances. I will explain by way of example.

Trix donates a commercial building to the Trix Family Trust. She does this because:

- Her marginal income tax rate is 40% and the rental income of R600 000 per annum which this building generates will push her into the 45% bracket, and
- She wants to avoid 45% tax on R600 000, (which is a considerable amount).

Her plan is for the trust to distribute the income by way of the conduit principle to the beneficiaries (that is, her four minor children); she will achieve the following:

- The minors will only pay 18% income tax on the proportionate net rental income they receive, saving a great deal of income tax; thereby, benefitting from the 'splitting' of the income between each of the four beneficiaries.

However, Trix's plan is flawed because of Section 7(5) of the Income Tax Act: The income from the commercial building will be deemed to be the income of Trix, the donor, and not that of the beneficiaries even if the income is vested in the beneficiaries. This is because the income earned by the beneficiaries is only possible due to Trix making a gratuitous disposition to the trust – the donation.

In addition, the Taxation Laws Amendment Act 2016 introduced Section 7C and the amendment is effective since 1 March 2017. It was introduced to prevent trusts from being used to avoid or reduce estate duty or donations tax.

It stipulates that: When a loan, advance or credit is made to a trust by a natural person (who is a connected person in relation of the trust), or a company at the instance of a natural person (where that natural person is a connected person in relation to that company and the trust), and no interest is charged on that loan, or at a rate below the official rate (currently 7.50% per annum), then there is a **deemed donation** to the trust, equal to interest at 7.50% per annum, or equal to the difference between the actual interest rate being charged and the official rate of 7.50% per annum.

It is interesting to compare the cost of a loan of R5 000 000 by a connected person to a trust if the lender charges the trust 7.50% interest on the loan **versus** the lender paying the Section 7C deemed interest on a deemed donation on a zero-interest loan.

1. The lender charges the trust 7.50% interest on the R5 million loan

The trust will have to pay the lender R375 000 per annum. This will be gross income in the hands of the lender and the annual interest exemption will apply. Therefore, the taxable interest is R351 200 (assuming that the lender is under 65 and the interest exemption is R23 800). The income tax payable will be as follows.

- At marginal rate of 18%: R63 216
- At marginal rate of 30%: R105 360
- At marginal rate of 45%: R158 040

Therefore, the trust will have an annual expense of R375 000 and generally this interest expense will not be tax deductible as most loans to trusts are used to acquire capital assets and not income producing assets. In addition, the lender will incur income tax on the interest paid. Therefore, the cash flow position of both lender and trust is impacted negatively.

2. The lender pays the Section 7C donations tax on the deemed donation of the deemed interest on a zero-interest loan

The deemed interest of 7.50% on the loan is R375 000. If you take the annual exemption in respect of donations into account (R100 000), it will result in R275 000 being subject to donations tax. Therefore, the lender will be liable for R55 000. To determine which option is most economical, the size of the loan and the marginal tax rate of the lender will be the deciding factors.

However, in most cases the application of Section 7C will be the most cost-effective – quite a surprise!

Conclusion

Giving a gift can result in costs that were not foreseen and many taxpayers are not even aware that there is such a tax. A thorough understanding of donations tax and its interplay with other tax is required to ensure that you may utilise all the estate planning tools available to you to your best advantage.

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