DAVEY'S Locker

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Soft loans to nonresident trusts

More on s 7C of the Income Tax Act

by Tony Davey

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The recently enacted s 7C of the Income Tax Act—which [purportedly—Ed] deems an interest-free or low-interest loan to a resident trust to be a donation of the interest component, to the extent [purportedly—Ed] that the rate is less than 8% a year—effective as from 1 March 2017 (162 *TSH* 2016, 167 *TSH* 2017), has fuelled speculation about the tax treatment of such soft loans by residents to nonresident trusts.

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016* states that s 7C does not apply to nonresident trusts subject to the transfer-pricing rules of s 31.

Attribution rules

Section 7(8) provides that when a resident provides a donation, settlement or other disposition (including a soft loan) to a nonresident entity, including a trust, any taxable income causally accruing to the nonresident is attributable to the resident.

In similar vein, para 72 of the Eighth Schedule to the act attributes capital gains of the nonresident to the resident.

Section 31

Section 31 seeks to inhibit tax avoidance by way of a financial assistance transaction to a nonresident entity, in circumstances in which the transaction is not concluded at arm's-length. A soft loan made by a resident to a nonresident trust would be included.

Practice Note 2 of 14 May 1996 and its Addendum of 17 May 2002 were withdrawn with effect as from the years of assessment commencing on or after 1 April 2012. Intended as a replacement, is the SARS draft interpretation note of 30 June 2013 on international transactions.

Its stated purpose is to provide taxpayers with guidance on the application of the arm's-length basis in a determination whether a tax benefit has accrued under s 31.

It notes that each instance is decided on its own merits, on the basis of its specific facts and circumstances, but with regard to the applicable principles. A transaction should be considered from both the lender's and the borrower's perspective. What is required is both a functional analysis and a comparability analysis, to determine the appropriateness of the arm's-length debt assessment, in the light of, first, the amount of debt and, secondly, the rate of interest. For outbound loans, no interest rate is specified.

Fair administrative action and double taxation

The advent of the Constitution in 1994, including the right to fair and just administrative action under the Bill of Rights, means that the decisions of SARS can be reviewed by the judiciary, on the basis of unreasonableness, with the Tax Administration Act potentially providing remedies first to be exhausted.

It follows that SARS cannot impose double taxation on the same taxpayer (*CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 52 SATC 9 and the cases there cited), both under s 7(8) or para 72 and under s 31.

Lex specialis

Lex specialis, in legal theory and practice, is a doctrine relating to the interpretation of laws, and can apply in the context of both domestic and international law. It states that when two laws govern the same factual situation a law governing a specific subject matter (*lex specialis*) overrides a law governing general matters (*lex generalis*).

Taxable income can be accurately determined under s 7(8) or para 72, as distinct from s 31, since s 31 provides no guideline other than a

reference to arm's-length factors.

Conclusion

In my view, s 7(8) and para 72 override s 31, under the *lex specialis* doctrine, until such time (if ever) that SARS provides certainty about the determinant of an arm's-length interest rate on loans denominated both in domestic currency and foreign currency.

If a final interpretation note is ever published, a deemed determined interest rate would perhaps result in the dominance of s 31 over s 7(8) and para 72.

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