TRUSTS AND TAX: THE BEGINNING OF THE END?

Over the last few years trusts have increasingly come under pressure - mostly due to the perception that there are many tax loopholes to take advantage of.

DENVER KESWELL
SENIOR LEGAL ADVISOR

We have seen in recent Budget speeches as well as tax law changes that National Treasury is looking to close these loopholes and therefore trusts have lost most of their tax advantages. We will explore some of the tax loopholes closed over the last few years as well as potential legislation that will further close tax loopholes.

POPULAR REASONS FOR USING TRUSTS

Although tax advantages is undoubtedly one of the reasons that has made trusts popular in the past, it is not the only one. Generally trusts have been set up for the following 3 reasons:

1. **Protection from creditors**
   One of the benefits of transferring an asset into a trust is to protect that asset from creditors as the asset is then owned by the trust and not the founder/trustee. However, if a loan account was used to fund the transfer of the asset then the loan account becomes an asset in the founder/trustees estate which is not protected from creditors.

2. **Succession planning**
   Another reason founders like to transfer assets into trust is for succession planning. Once the asset forms part of the trust, it will be owned by the trust itself and the death of the founder, trustee or any of the capital beneficiaries does not affect the ownership of the asset. Only the trust deed itself will dictate current and future ownership of the asset. It is however important that the trust deed is specific about what should happen to the asset in the event of the death of any of the capital beneficiaries as well as what should occur if any of the capital beneficiaries want to sell their "share" of the asset. Not catering for these scenarios could result in disputes years down the line.

If it is not the intention that ownership will stay with the trust for a long time, then the trust option is perhaps not the best as the effective rate for capital gains tax (CGT) within the trust is much higher than it is for individuals.

3. Tax

3.1. Pegging your estate for estate duty

One of the biggest advantages of holding a growth asset in a trust is that you will peg your estate for estate duty. A growth asset can either be donated or sold to a trust:

- Donated: if donated the donor will immediately be liable for donations tax at a rate of 20%
- Sold: if sold then a loan account is usually used to fund the sale. The capital portion does not need to be repaid immediately and can be bequeathed to the trust in terms of the founders will. Section 7C of the Income Tax Act requires that the interest portion of annual repayment (at the market rate) must in fact be serviced. If it is not then the said interest portion (or reduced portion) not paid in the tax year will be deemed as a donation by the seller and donations tax will be levied in that year.

The growth asset sold to the trust will become an asset owned by the trust and will therefore not be subject to estate duty in the estate of the seller. The asset however, created in the estate of the seller, will be the loan account. Assuming the loan account is not settled by the trust, on death of the seller the loan account will be subject to estate duty. The benefit of this however to the seller is that should he/she die many years later and assuming the growth asset has substantially increased in value, the amount liable for estate duty will be the lesser amount of the loan account. This is effectively known as pegging your estate for estate duty by removing a growth asset from your estate and selling it to a trust.

3.2. Conduit principle

As it stands any income or capital gain earned by the trust can be transferred to the beneficiary - provided the income or capital was distributed or vested in the beneficiary in the same year. This is another tax advantage of a trust, as beneficiaries' income tax and CGT rates are more favourable than that of a trust. The conduit principle is currently being reviewed and there is a suggestion that Treasury may tax the income/capital gain within the trust before it is vested in the beneficiary and then provide relief to the beneficiary. Considering that the income tax rate of a trust has increased to 45% and the effective CGT rate for trusts is 36%, it is obvious why some trustees are concerned regarding this proposal.

OPPORTUNITIES FOR TRUSTS

If a trust has no intention to distribute income earned or any capital gains, then an endowment can be used to be tax efficient. Considering that an endowment is taxed within the individual policyholder fund an income tax rate of 30% and an effective CGT rate of 12%, one can see why a trust with only natural persons as beneficiaries are finding endowments much more attractive.

A NOTE OF CAUTION: BEWARE OF UNWINDING TRUSTS

Whilst you can understand why opening up a trust is becoming increasingly less popular from a tax perspective, beware of simply unwinding a trust without considering the tax consequences of doing so. Unwinding a trust will trigger CGT on the disposal of the trust's assets and result in an increase in the value of the personal estates of the beneficiaries - which in turn will increase their liability for estate duty. It's best to speak to your financial planner prior to making such a decision. ■