**Legal Bulletin**
**08 May 2020**

# THE DEMISE OF TRUSTS?

For many years Trusts provided a useful tool for estate planning. This is spelt out in my memorandum which is also one of my listed publications. The primary benefit of a Trust is to allow continuity of investments for a family and to separate control from ownership. Most existing Trusts still provide benefits although some have required restructuring to take account of changes in legislation. However establishing a new Trust has challenges.

Some of the issues affecting Trusts are: -

1. The housing of assets in a separate entity secures the assets from creditors. This advantage is reduced if the estate planner stands surety for the Trust.

2. In the past Trusts were funded by interest free loans so that the growth in value of assets took place in the Trust. The value of the assets of the estate planner thereby were “frozen” thus limiting liability for the payment of estate duty. This advantage has been curtailed by Section 7C of the Income Tax Act which requires a Trust to pay interest on loan accounts at the rate of 8% per annum. Trusts which are passive investors and hold shares often do not earn enough income to pay the interest.

3. Until 2001 CGT was not payable and so growth in the Trust assets took place for the benefit of the beneficiaries. The current high flat CGT rate of 36% obliges trustees to award capital gains to beneficiaries to enable them to pay CGT in their own hands at a maximum rate of 18% (but which often is less). However the entire gain has to be awarded which means the estates of the recipients increase. Generally the gain is lent back to the Trust on loan account which in turn attracts interest of 8%. In some instances the amount of the gain is recorded as having been awarded but not distributed. This appears to avoid liability for interest. Note that if all gains are awarded and the original investments are equal in value to the original loan accounts then the capital value of the Trust will be nominal, leaving nothing to be distributed to capital beneficiaries (other than capital gains).

4. A major advantage of a trust is the ability to apportion income to major beneficiaries and also to minor beneficiaries if the estate planner or founder is a grandparent but not a parent. This enables income tax to be paid at the marginal rate of the beneficiary and not at the maximum rate applicable to the estate planner. So, for example, a beneficiary

who is not in receipt of other income can be awarded R100 000.00 a year tax free (which includes the annual interest exemption). Assume that three beneficiaries each were to receive R100 000.00. The savings in income tax at the highest marginal rate of 45% is R135 000.00. This is a useful mechanism if a grandparent contributes towards educational and other costs of grandchildren. A disadvantage is that if the money is not spent, the loan accounts of the beneficiaries grow in the Trust which can be a good or bad thing depending upon family relationships.

5. The above advantages of distributing income and capital gains arise from the application of the conduit principle whereby the Trust does not pay tax because the beneficiary who receives the income or capital gain pays the tax. The Davis Tax Committee recommended the abolition of the conduit principle. If a cash strapped government decides to implement that recommendation then most Trusts will lose their remaining appeal and may require to be dismantled which could be a costly exercise because of the CGT which would need to be paid.

6. The risks inherent in the use of the conduit principle can be overcome by the assets in the Trust being transferred into a company by means of an asset for shares swop. This must be carefully thought through and tax advice received. The Trust then becomes a passive shareholder and receives only any dividends declared. Having already being taxed, there is no need to distribute such income so the dividends can be accumulated as Trust capital.

7. If a company is interposed, the company pays income tax of 28% and dividends tax of 20% which results in an average or effective rate of tax of 42,4%. If the investor in the company has a lower average tax rate (which generally is lower than the marginal rate) then the use of a company is not attractive. However if dividends are not declared or if the acquisition of assets by the company is funded by loans, it may make sense to use a company. When the company eventually sells its assets, CGT and dividends tax will absorb over 38%. This is in addition to selling commission, STT and other costs.

8. Perhaps the biggest disadvantage which has arisen in the use of Trusts is that many beneficiaries have emigrated. Capital gains cannot be awarded to a beneficiary who is a non-resident for tax purposes. Accordingly trustees either have to pay CGT of 36% or need to award the gains to the estate planner and spouse (if they are capital beneficiaries). This then negates the benefit of divesting one's estate to a Trust. Correspondingly it increases the size of the estate of the estate planner and the future liability for estate duty. In some instances the estate planner and spouse are not capital beneficiaries. This creates additional difficulties.

9. Another fairly recent disadvantage is that several countries treat distributions from foreign Trusts as income and the distributions are then taxed at the marginal rates of the beneficiaries. This is proving problematic to resolve and requires careful and sometimes complicated consultations with foreign tax advisors and skilled local tax advisors specialising in this field. The dismantling of a Trust can be costly and stressful.

10. There has always been the risk (often overlooked) that if not properly structured or administered, SARS could, on the death of a capital beneficiary or trustee construe all the assets of the Trust to be assets of the estate planner, beneficiary or trustee, as the case may be, thereby completely wiping out any perceived benefits of having formed a Trust. There needs to be a complete divestment of control to trustees who must be able to override the wishes of the estate planner or capital beneficiary. We often see Deeds of Trust which, although based upon a good template, in practice are deficient or non-compliant. Occasionally we point this out to the parties which then earns a rebuttal from the uninformed advisor who established the Trust!

11. Another factor to be borne in mind is that it is becoming prevalent for files of Trust documents to be lost in the offices of the Master. As the Trust documents are the repositories of valuable assets, this is of particular concern when

parties lose their Trust documents or deeds of amendment. They cannot obtain certified copies from the Master's office. This could lead to mischief. It is therefore most important that trustees and beneficiaries retain legible and up to date copies of all Trust instruments.

12. Deregistering a Trust used to be a relatively straight forward affair. Unfortunately the Master now requires more and more information, notwithstanding that a Trust may already have disposed of all of its assets and is an empty shell.

13. There are instances where it may be advisable for a testator to bequeath assets to a Trust, particularly if there are minor beneficiaries. However this usually can be done more easily by creating a testamentary trust in the Will. Each set of circumstances needs to be carefully considered.

In summary, the main disadvantages affecting Trusts are the imposition of Section 7C, the emigration of beneficiaries and the threat against the conduit principle. One must recognise the aversion of SARS to what is perceived to be an instrument designed for the avoidance or even evasion of tax. However if the disadvantages can be overcome or taken into account, the benefits of a Trust can still be enjoyed. The enquiry must be:-
What does the estate planner want to achieve?

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12 May 2020
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