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The Cinderella trust story

Trusts

I like to compare a trust with the Cinderella figure because the value of a trust seems generally to be misunderstood.

People tend to view a trust as a clever tax saving tool, whereas during its humble beginnings, tax was pretty far from the mind of a founder who created a trust to serve as a vehicle in which his belongings could be safeguarded for himself, during his absence, or for his descendants if he were to die. We would be wise to remember this.

The true calling of a trust

A trust is a vessel that firstly does not form part of the asset base of any human being and secondly has, or rather should have, perpetual existence.

It is the combination of these two elements that plays into the science that an estate planner practises as he manages the flow of assets across generations.

Having made my philosophical point, what is new on trusts and how do these changes effect estate planning?

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Ugly stepsisters in the Budget

The 2012 Budget introduced two ugly stepsisters: an increase in the inclusion rate for capital gains tax purposes; and a rise in the rate of dividend tax.

This is a truly horrendous pair that will surely struggle to find any entrepreneurial suitor.

Yet, if you already have a trust and you have built up a large capital amount in the trust, I would be surprised if these changes to the tax rates will convince you to abandon your trust and have the assets transferred into your personal estate.

The death duty (another ugly stepsister) that those assets will attract and the complications it will introduce on the administration of your deceased estate should prevent that urge.

If the maths come out square, the structural benefits afforded by a trust should sway the decision in favour of keeping assets in a trust.

Bear in mind that when CGT was introduced at the turn of the century, the rate on trusts effectively increased from 0% to 20% and that did not dampen the spirit for the creation of trusts as some commentators predicted. So why now should the increase from 20% to 26% do so?

It also seems as if the authorities wish to equalise the tax payable on capital gains and income and equalise the tax paid on interest and dividends.

If that happens in the future, the rate of CGT on individuals and trusts will become the same, albeit very high. I believe the CGT rate increase will have a limited impact primarily on account of the advantages trusts provide for individuals in their estate planning, rather than a pure tax driven incentive and also because we very rarely pay CGT and income tax in the trust itself. If we do, it is by choice and not by design.

The tax rules still provide us with a choice on where the tax burden will fall.

The tax that is payable in the trust, if all other options have been exploited, is also offset by the saving over time in estate duty (20%) and executors fees (3.5%). To argue that this benefit only accrues to the next generation is correct, but remember that it is the next generation that is top of mind when setting up a trust.

The CGT increase itself therefore is fairly moot in some instances and is still offset by other savings in other circumstances.

Creating a trust and funding a trust with an interest-free loan account still makes significant sense - if you are comfortable with the trust concept where you need to accept that you will lose control over assets transferred into a trust.

Trusts funded with loan accounts will ensure that for the foreseeable future most of the gains, whether income or capital gains, are taxable in the hands of the donor to the trust, with the growth being retained in the trust.

This is the case due to the interest-free nature of the loan and the attribution rule that applies in terms of the Income Tax Act.

To conclude, to my mind the changes announced in the Budget do not have a significant impact on the future use of trusts in estate planning. Cinderella still retains her charm.

This article was written by FISA member Louis Venter, Fiduciary Specialist at RMB Private Bank.

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