SUNDAY TIMES, Business Times Money & Careers
17 Feb 2013, p.1

Trusts are a pricey way to dodge taxes

Do your sums before choosing this option

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WHEN children play games like catch, they often have a safety zone or "den" where the catchee cannot be caught. Trusts are a little like that zone in that they keep assets safe, at least partially, from creditors and predators.

There are times when a trust is worth having, although a careful consideration of the cost benefits — mostly financial — needs to be done before you get the legal ball rolling.

A trust is a legal agreement between the person who wants to establish it — a founder or settlor — and a trustee, or a group of trustees. The founder puts certain assets into the trust and hands over ownership and control of the assets to the trustees. Trusts are set up for beneficiaries such as children, charities, surviving spouses, or even the founder himself.

They are often created to avoid paying certain taxes. However, said Angélique Visser, chairwoman of the Fiduciary Institute of South Africa, this could backfire if tax laws change, which they do fairly regularly.

When a person dies in South Africa, the first R3.5-million of her estate is exempt from estate duty. Anything above this is subject to an estate tax of 20%. If her assets are in a trust, no estate tax needs to be paid because the assets did not belong to her, but to the trust.

Trusts are not cheap to create or maintain. Henry van Deventer, financial planner at financial services group Acsis, said trusts incur fees of about 1% of the value of the assets each year, on average. And although they might protect against estate tax and creditors, they are subject to a host of other taxes and costs.

One tax a trust does not protect against is capital gains tax. When a person dies, his personally held assets are legally deemed to have been sold at market value and capital gains tax is triggered at a rate of 13.3% of the gain.

As with an individual or a company, trusts must pay income tax. The tax rate for a trust is set at 40%. If the trust makes any money — from the sale of an asset, for example — capital gains tax will be triggered, but unlike the 13% payable by an individual or a company, trusts must pay 66.6% of the tax rate (40%), putting capital gains tax for a trust at about 26% or 27%. There are ways around this when, for example, a beneficiary is ceded the gain, in which case capital gains tax will be payable at 13.3% or less.

When a trust is formed, the founder must decide how to get his assets into it — either through a sale, a loan or a donation. If he sells the assets to the trust, he will have to pay 13% capital gains tax right then. This can be difficult because there is no new cash in the bank to use as there would be if the asset was sold to a third party.

If he donates the assets, a donations tax of 20% of the value of the assets must be paid. (A donation of cash would automatically attract a 20% tax rate.) Also, if the assets donated are worth more than they originally cost to buy, capital gains tax will be triggered on this excess amount. To avoid the donations tax, people often lend the purchase price of the assets to a trust. However, said Ernest Mazansky, head of tax at law firm Werksmans, this only protects the growth in the value of the assets. When the founder dies, estate tax still applies to whatever the loan balance is when the loan was made (although the first R3.5-million is still free from any tax).

In this situation, it only makes sense for the trust to be set up if the founder is relatively young. There will not be much point if the founder is, say, 85 years old, because no significant value growth is likely to happen before the person passes away. The cost of setting up the trust and making the transfers will most likely erode any benefit that can accrue from the growth that does take place.

There are reasons to create a trust other than protecting one's assets from tax erosion. Some of them are:

- To protect the assets from creditors in case a beneficiary, possibly the founder, becomes insolvent;
- To allow for the efficient management of a person's affairs when they die. According to Mazansky, if assets are held personally, they are "frozen" when the owner dies and remain this way until the executors get a chance to wind up the estate. A trust, on the other hand, carries on its business unaffected by the planner's death;
- To maintain confidentiality. On death, one's assets and liabilities become part of the public record, whereas assets in a trust do not; and
- To take care of a surviving spouse, under-age or special-needs children, or beneficiaries who might squander or otherwise dispose of the assets in a way the founder of the trust did not want.

TRUSTEES AREN'T PUPPETS

CREATING a trust means that ownership and control of one's assets is handed over to trustees. This can be difficult for people who are used to managing their own affairs and mistrustful of their trustees' ability to manage the assets.

But a trust planner or founder who treats the trustees as puppets, getting them to do his or her bidding without using their own discretion and running the affairs of the trust as if the assets were still his or her own, can run into legal trouble when the receiver or creditors come after the assets.

According to Ernest Mazansky, head of tax at Werksmans Attorneys, if the court finds the planner has not properly ceded control of the trust's assets to the trustees, the existence of the trust can be effectively set aside and the assets treated as though they still belong to the planner in his or her personal capacity. This could mean the assets become liable for estate duty or that creditors (an ex-wife, for example) are able to access them.