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Fiduciary Matters

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Trusts in the life insurance industry

Trusts

While trusts may have many valid benefits (such as estate pegging, protection against creditors and protecting the interests of minor children or the disabled) there can be severe consequences if particular attention is not paid to the structuring of life assurance benefits where trusts are involved.

Trust owned life cover

On the death of the life assured a lump sum benefit will be paid to the trust (please note this amount will still be a deemed asset in the estate of the deceased for estate duty purpose).

The trustees will be able to use this amount to provide for the beneficiaries of the trust.

This structure is especially useful if minor children rank as beneficiaries of the trust as it adds an additional layer of protection for the children.

Trust owned lump sum disability

Should an insured life become disabled (the definition of what constitutes permanent disability may vary from insurer to insurer) and the policy is owned by a trust, the lump sum disability benefit will be paid to the trust.

The trustees can then use the money to provide for the disabled person and his/her family.

Trust-owned income replacement policies

Relevant questions the financial adviser should be asking:

- Does the trust deed authorise this type of policy?
- Does the loss of income of the life assured trigger a loss of income for the trust? (This is to establish insurable interest)
- Is the life assured an income beneficiary of the trust? (This is to establish insurable interest)
- Is this policy authorised by a trust resolution? (This is a valid insurance contract requirement)
- Will the income replacement benefit pay to the trust or to the life assured? (This may vary from insurer to insurer; it is important to check with the relevant insurer)
- If the income does pay to the trust account is there a binding resolution by the trustees that the income will be paid over to the life assured? (Assuming he is a beneficiary of the trust)
- Will the income replacement policy qualify for a section 23(m) deduction? (It should be noted that the life assured must be the owner and payer of the policy for the deduction to apply).

A trust-owned income protection benefit will not qualify for a section 23(m) deduction.

It is also unlikely that the trust will qualify for a section 11(a) deduction, because in most cases the trust will not be trading, and especially if there is no certainty that the income will accrue to the trust.

In many cases the life assured is of the opinion that he can control the trust (in most cases he or she is a trustee of the trust) and that he is entitled to any benefit paid to the trust.

A recent court case highlights the risk associated with this line of thinking.

In Raath v Nel (473/2011) [2012] ZASCA 86, a businessman, Mr Nel, transferred some of his assets to a trust via a loan account structure. In a subsequent claim for a loss of income the court stated the following: "Applied to the present matter, the separateness of the trust estate must be recognised and emphasised, however inconvenient and adverse to the respondent it may be."

Mr Nel was a potential income beneficiary of the trust but he needed a unanimous resolution by the trustees for any income to be paid to him.

Unfortunately Mr Nel did not succeed in his claim against a doctor for a loss of income from a failed intubation as the court found that the loss was the loss of the trust and not his loss.

Some trust deeds may require a majority decision by the trustees (versus a unanimous decision as above) but again it would be dangerous to argue that the trustees will vote that the income will distributed to the beneficiary that suffered the loss of income as the trustees must look after the interests of all the beneficiaries of the trust.

Some financial advisers might argue that if the client (life assured) is severely disabled in an accident and the benefit does pay to the trust (again dependent on the specific insurer), the benefit will be held in trust for that client.

Again, even this scenario can be problematic. If the client is also a trustee of the trust he will not be able to fulfill his duties as a trustee and will need to be removed as a trustee. A new trustee will need to be appointed (and approved by the Master of the High Court) in his place to assist with the running of the trust and with the distribution of the client's income.

Again this is not the ideal situation to be in.

If the full income from the income replacement policy is not paid to the "injured" beneficiary and the balance is retained in the trust, that portion of the proceeds will be taxed at 40%.

The trustees will be faced with a scenario of either retaining the unused portion or distributing the proceeds to the "injured" beneficiary (who might be in coma) or to any other beneficiary (maybe the wife or children) to try and soften the negative tax consequences.

It is also important to note that the fact that the premiums on the policy were not deductible does not preclude the payout on the policy from being taxed, as income replacement payouts are taxable under common law principles.

This article was written by Martin Swanepoel, a FISA member and Senior Legal Adviser at Discovery Life.

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