Proposal to tax capital distributions as income will kill off discretionary trusts

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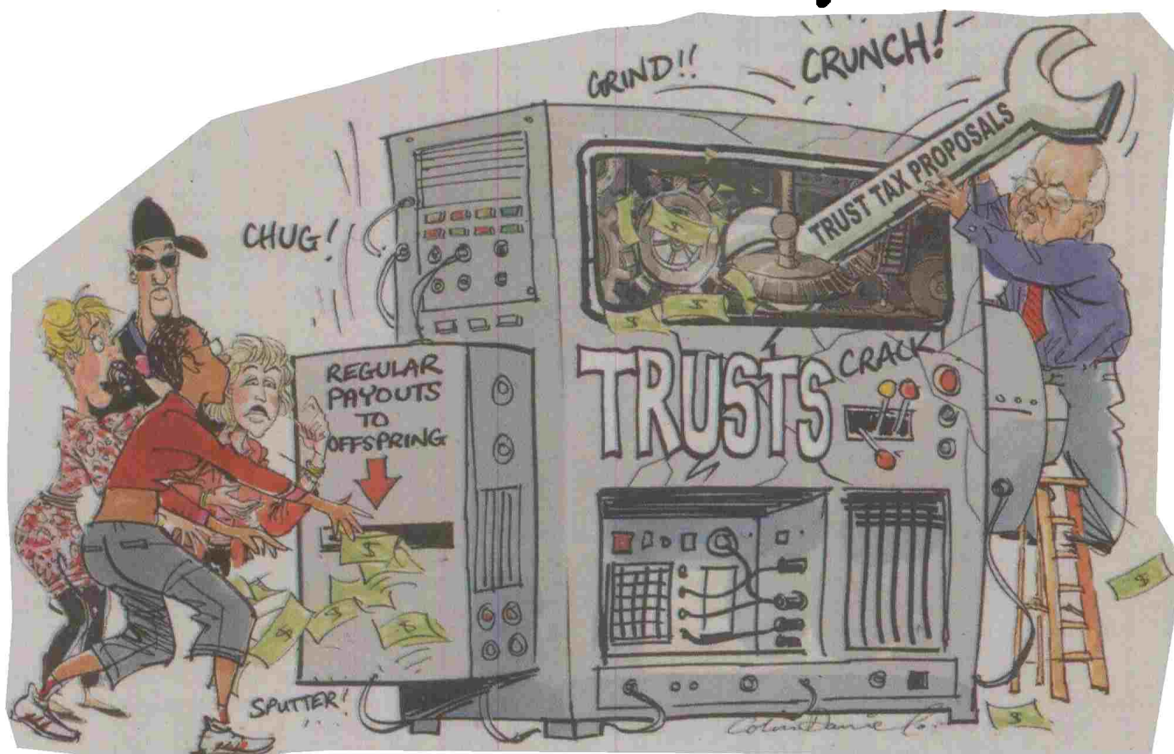

Government is proposing to change the way that discretionary trusts are taxed, by treating as ordinary income the capital gains that are distributed by these trusts – a move that threatens to make the use of discretionary trusts punitive from a tax point of view, a trust expert says.

Currently, a trust can distribute the capital gains made by the trust to beneficiaries, and these gains are then taxed as such in the hands of the beneficiaries. This is a result of what tax and trust experts refer to as the flow-through principle.

The Budget Review says government plans to introduce several legislative measures in the 2013/14 tax year to put a stop to discretionary trusts acting as flow-through vehicles and taxpayers using such trusts to avoid tax.

The measures will not affect testamentary trusts and special trusts set up for the benefit of minors (those under the age of 18) and people who are disabled.

SOCIAL FUNCTIONS

Rupert Worsdale, a partner at Maitland Group, which provides trust services, says the proposal outlined in the Budget Review will make all discretionary trusts, whether offshore or local, "highly tax-inefficient". He says this is despite the fact that trusts fulfil important social functions, such as ensuring the orderly transfer of wealth, protecting the financially inexperienced and shielding widows from avaricious future spouses.

"There are very few people who would think that the age of 18 is an appropriate age to inherit substantial wealth, but this is what the Budget Review implies, because that is the age at which the punitive treatment of a trust would start," Worsdale says.

Discretionary trusts pay income tax at the highest marginal tax rate of 40 percent, and 66.6 percent of any taxable capital gain is included in the income of a trust, giving them an effective capital gains tax (CGT) rate of 26.7 percent. Individuals pay income tax at a rate of between 18 percent and 40 percent, and CGT at a maximum effective rate of 13.3 percent.

If the income earned by a discretionary trust in the current tax year is distributed to a beneficiary, the trust does not pay income tax and the beneficiary pays tax on the distribution at his or her marginal tax rate.

Professor Keith Engel, director of tax policy at National Treasury, says the proposal to tax capital distributions as income is aimed at those who avoid tax by splitting the income earned within a trust among beneficiaries who have lower tax rates than those of the founder of the trust.

However, Worsdale says the proposal as it is currently framed does not achieve this objective.

The Budget Review states that once the flow-through principle is stopped, if a trust does distribute income or capital, the trust can deduct the distribution from its taxable income and the beneficiary will pay tax on the distribution as ordinary income. Alternatively, if the income tax is paid by the trust, the beneficiary can receive the payment tax-free.

Worsdale says there is no denying that the tax laws relating to trusts are benign, but National Treasury's proposal to end tax abuse takes a hacksaw to trusts rather than cutting out the problem with a scalpel.

Trust practitioners are likely to engage with Treasury on the matter through the Society of Trust and Estate Practitioners, Worsdale says.

MORE TRUSTS REGISTERED

The Fiduciary Institute of South Africa (Fisa) says that, according to figures it obtained from Lester Basson, the Chief Master of the High Court, an average of 16 500 discretionary trusts were registered each year over the past three years.

Angélique Visser, chairperson of Fisa, says that compared with previous years, there is definitely an increase in the number of trusts being registered annually.

Visser says Fisa believes the main reason to set up a trust should be to protect assets for the benefit of someone, whether it is yourself, a spouse, minor children, incapacitated people or charities. A trust should never be registered with the sole purpose of trying to save on taxes, because the tax laws can change, Visser says.

Government's intention to stop tax abuse may ultimately have severe implications for settlors (founders of trusts) who have transferred assets to trusts with tax as the only consideration. Fisa recommends that people with trusts seek fiduciary and tax advice to limit the implications of the possible changes, Visser says.

Giselle Gould, business development director of Fairheads Benefit Services, says it hopes that the tax-free limit on retirement fund death benefits, which is currently R315 000, will be increased.

Trustees of retirement funds may decide to pay a member's death benefit into a trust, which will distribute an income to minor children.

Gould says the average death benefit is about R500 000, and increasing the tax-free limit would increase the payout available for dependants of deceased fund members. This would be particularly beneficial for the families of blue-collar workers, who are more likely to die before retirement.