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Avoid these trust mistakes

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Trusts

Discretionary trusts are popular financial planning tools these days. However, the incorrect use of a trust could lead to trouble and, unfortunately, it is usually the trust beneficiaries that suffer the consequences.

From personal experience and a look at recent case law it would seem that trouble in trust-land is usually the result of three errors. Firstly, clients often treat the trust's assets as if they were their own. Secondly, trustees often unwisely allocate trust income and capital gains to beneficiaries, forgetting in the process the original reasons for deciding to use a trust.

Thirdly, trustees often act without being properly authorised.

The trust as an alter ego

For a trust to exist, the law requires that you hand over the trust assets and that you fully divest yourself of the ownership thereof.

The trustees have to administer these assets for the benefit of a beneficiary or group of beneficiaries. And, this administration has to be done in accordance with the terms of the trust agreement. As stated in the Parker-case[1], it is largely about separating the control of the assets from their enjoyment. These principles are important as the courts have proven willing to ignore the existence of a trust if they are not adhered to.

In the Badenhorst-case[2] the court effectively ignored the existence of the trust and treated the trust assets as the assets of the founder for the purposes of sec 7(3) of the Divorce Act[3], because of the founder's de facto control of the trust assets. In similar circumstances in 2001 the court had come to the same conclusion in the case of Jordaan v Jordaan[4] where the husband had used the trust as his "alter ego".

Indiscriminate allocation of trust assets to beneficiaries

The second problem has its origin in a common accounting practice. Briefly, the trust's income or capital gains (or a portion thereof) is allocated to a specific beneficiary and then credited to that beneficiary on loan account. This is done to reduce the trust's liability for income tax and capital gains tax by means of the conduit pipe effect created by section 25B and Paragraph 80. These sections allow trust income or capital gains to be taxed in the hands of a beneficiary, at that beneficiary's marginal rate of tax as opposed to the trust's flat rate of 40% - provided that the allocation is done within the tax year in which the income or gain accrued to the trust. In this way the trust acts as a conduit pipe, in that the trust income or capital gains flows through it to the beneficiaries in whom it has been vested.

The problem with this practice, however, is that it forgets, or ignores, the reasons for choosing a trust in the first place rather than choosing to vest the assets in the beneficiaries from the start. These reasons often include the protection of the assets and the beneficiaries and estate duty savings. However, such an allocation means that the income or capital gain which was allocated vests in the beneficiary and as a result is susceptible to attachment by that beneficiary's creditors as well as estate duty in the beneficiary's estate.

Trustees acting without proper authority

The third problem has the trustees acting on behalf of the trust without being properly authorised thereto. There has been a spate of recent cases in which the lack of authority of trustees to act have come to the fore.[5] From these cases it is abundantly clear that actions taken by trustees who have not been properly authorised in accordance with the terms of the trust deed are invalid.

Typically these issues arise in property transactions where the lack of proper authority has been, successfully used as an excuse by either the purchaser or the seller to renege on the sale.

The facts in the case of Thorpe v Trittenwein[6] highlights the relevant issues and risks regarding transactions involving trusts and the need for trustees to act jointly.

a) Mr Thorpe entered into a contract of sale to purchase a property in the name of the Brian Edward Thorpe Trust. The trust deed provided for three trustees at all times.
b) Thorpe signed the agreement both as trustee and as the authorised agent of the other two trustees. This authority was given verbally. His actions were later, but after entering into the agreement on behalf of the trust, ratified in writing by the other trustees.
c) When the seller reneged on the deal the trust approached the court to force performance by the seller.
d) The Supreme Court of Appeal found that Thorpe had exceeded his powers. Co-trustees are required by law to act jointly and in the absence of a joint decision (in writing) by the co-trustees the assent to the contract by any single trustee will not bind the trust.
e) As such the agreement of sale is void ab initio and of no force and effect.

The legal reasons for the decision aside, I think that one of the most important aspects to be taken from this case deals with the attitude of clients when using a trust. It is important for clients, when using the trust form, to realise that it is not acceptable to take short cuts in the decision making and administrative processes of "their" trusts just because they may, as founder, have been the originating cause of the trust, maybe a trustee, even the dominant trustee, and a beneficiary.

The following quote from the case indicates an unwillingness on the part of the court to assist parties who take such shortcuts: "*Those who choose to conduct business through the medium of trusts of this nature do so no doubt to gain some advantage, whether it be in estate planning or otherwise. But they cannot enjoy the advantage of a trust when it suits them and cry foul when it does not. If the result is unfortunate, Thorpe has himself to blame.*"

I would, however, argue that it is bad business for a trust, and for that matter a party contracting with a trust, to enter into a transaction and not ensure that the transaction will be enforceable. Shortcuts such as the above are likely to expose the trustees, in their personal capacities, to claims for damages by the beneficiaries of the trust and possibly by the other party to the agreement.

Persons availing themselves of the trust form should familiarise themselves of the terms of the trust deed as well as that of the Trust Property Control Act. They should also obtain specialist advice in regard to their rights and responsibilities in respect of specific transactions. The same goes for parties entering into transactions with trusts. Failure to do so could have unforeseen and expensive consequences.

This article was written by Franscois van Gijsen, CFP®, FISA member and Director Legal Services at Finlac Risk & Legal Management. FISA is a non-profit organisation that represents practitioners in the fiduciary industry and sets high minimum standards to protect the public's interests. Activities of FISA members include but are not restricted to the drafting of wills, administration of trusts, beneficiary funds and estates, tax and financial advice and the management of client funds. FISA has over 700 individual members who collectively manage in excess of R250 billion. Membership is open to any professional who meets the membership criteria.

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