

Capital Gains Tax: Trusts vs Individuals

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Many financial planners, and the general public at large, have expressed concern regarding when and to what extent they or their trust is liable for capital gains tax (CGT). Knowing the different tax treatments will assist in choosing how to structure your estate and trust more effectively.

In this article we highlight some of the most important differences in CGT from either a trust or an individual's perspective.

As most people are aware, a normal trust is taxed on all taxable income at a fixed rate of 40%, whereas individuals earning above the threshold are taxed at their personal marginal rate, ranging between 18% to 40%, and qualify for certain exemptions and rebates.

When a capital gain is realised within a trust, 66.6% of that gain has to be included for income tax purposes (taxed at 40% as stated), effectively meaning that a trust's CGT is 26.7%. A trust has no yearly exclusion.

Individual taxpayers who make a capital gain will be able to exclude R30 000 of

any gains in a year (or R300 000 in the year of death) and will include 33.3% of the remaining gain for income tax purposes. The gain will be taxed at their specific marginal rate (between 18% and 40%), which effectively means that an individual will have a maximum CGT rate of 13.3%.

Without taking any other factors into consideration, one would therefore pay more than double the CGT in a family trust than if you held and sold the assets in your own name. Enter the conduit principle...

Distributing the gains from the trust

The 'conduit principle' with regard to trusts has been written about extensively and is also at the centre of National Treasury's proposed changes to the taxation of trusts.

In simple terms, income or gains that are realised inside a trust, can 'flow through', or be distributed to the beneficiaries of the trust, while retaining the nature of the income.

This means that dividends received get passed on as dividends and taxed as dividends, that interest earned and distributed gets taxed as interest, and that capital gains that are distributed get taxed as capital gains. These amounts are then taxed in the hands of the beneficiaries and not the

trust. The fact that the nature of the income is also retained is very important, as natural persons receive certain exemptions, exclusions and/or rebates on certain items and get taxed differently.

In terms of paragraph 80 of the Eighth Schedule of the Income Tax Act, *where a capital gain is vested in a beneficiary of the trust, the trust will not have that gain included in its own tax calculation, but it will be taxed in the hands of the beneficiary. This means that where a trust deed authorises the trustees to do so, the trustees are able to distribute the capital gains of the trusts, vesting it in the beneficiaries.* It is also possible to distribute the gains to multiple beneficiaries, each paying at their assumed lower marginal tax rate and each having their own annual exclusion of R30 000. Substantial capital gains tax savings can thereby be achieved.

It is important to keep in mind that to achieve savings of this nature, the capital gain has to be allocated to a resident natural person in the year in which it was realised by the trust. Many trusts have beneficiaries that include another trust.

If the gain passes to another trust first and then to an ultimate beneficiary of the second trust, the higher effective tax rate applies.

Tax savings vs protection

What is vital to remember is that the main purpose of a trust should be the protection of trust assets and beneficiaries' interests, and any possible tax savings should receive only secondary consideration. If capital gains are vested in a beneficiary, the protection that the trust offers on the portion that is vested falls away. If the gain is distributed, there might be a temporary tax saving, but if the gain vests in the beneficiary, it becomes an asset in his or her estate and is open for attachment by creditors and ex-spouses, as well as increasing the estate value for estate duty purposes. Trustees should therefore consider all the implications before taking this route merely to potentially save on CGT.

Other CGT considerations

Many people with family trusts received advice years ago to transfer their family homes into their trust.

This was done at a time when trusts were slightly more tax efficient than they are today and before SARS started removing any tax advantages that trusts might have had. One of the consequences of SARS's current treatment of trusts is the exclusion of the primary residence rebate.

An individual who sells their primary residence does not have to include the first R2 million of any gain made, but only if it meets the requirements set out - one of these being that the property had to be registered in the individual's name. Having your primary residence inside a trust will mean that any gain made on the sale will have to have all of it included or distributed.

Changes to the law?

During last year's budget speech, the Minister of Finance managed to alarm a number of people when it was indicated that government was looking at various changes to tax law regarding

trusts to prevent what they perceived as tax avoidance.

After various meetings with the financial planning industry and regulatory bodies, including the Fiduciary Institute of Southern Africa (FISA), the Financial Planning Institute (FPI) and the Law Society of South Africa, it was explained what the general benefits of having a trust are, and highlighted that less individuals than believed used trusts in a manner to save on capital gains tax. Treasury has not finalised any tax changes and indicated these were not likely to happen in the short term.

Keeping the status quo

As things stand, the taxation of trusts is unchanged and will remain that way for the foreseeable future.

Trustees are still able to let income flow through to beneficiaries, thereby reducing the trust's tax liability. It is important to remember that trustees may only distribute capital gains to beneficiaries if the trust deed empowers them to do so. It is therefore vital to consult an adviser in order to get the right structure and advice.

Tax rates at a glance

	Tax rate	Capital Gains inclusion rates and exclusions	Effective CGT tax rate
Normal Trust	40%	66.6% of gain included and taxed at 40%, no annual exclusion	26.7%
Individual	18 - 40% marginal tax rate, exemptions and rebates may apply	R30 000 annual or R300 000 death exclusion, 33.3% of remaining gain included and taxed at marginal tax rate	13.3% maximum