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Setting up a trust to reduce tax 'should be stopped'

A recommendation by the Davis Tax Committee to stop taxpayers from using trusts to reduce tax could result in people who have established trusts for tax purposes only reconsidering their viability.

The trustees of a discretionary trust can cause the income and/or capital gains of the trust to be distributed to, and taxed in the hands of, the beneficiaries of the trust. This is known as the conduit principle, because, although the trust receives the income or gains, the trust is merely a conduit, or channel, through which the income or gains flow to the beneficiaries.

Trusts, excluding special trusts, pay income tax at a flat rate of 41 percent and pay capital gains tax (CGT) at an effective rate of 27.31 percent (inclusion rate of 66.6 percent x 41 percent).

Individuals and special trusts must have a taxable income of R701 301 a year to pay income tax at a rate of 41 percent, and they pay CGT at a maximum effective rate of 13.65 percent (inclusion rate of 33.3 percent x 41 percent).

They are also entitled to an exclusion of R30 000 of capital gains made in any year.

WHAT IS A DISCRETIONARY TRUST?

There are a number of different types of trusts, and one of the ways in which trusts can be distinguished is the nature of the rights enjoyed by the beneficiaries.

With a **discretionary trust**, a beneficiary does not have a right to receive any income or capital in the trust. Income or capital is allocated solely at the discretion of the trustees. This is unlike a **vesting trust**, where a beneficiary has a right to receive income or capital, or both.

Another type of trust is a **"bewind trust"**, where the beneficiary becomes the owner of the assets in the trust when it is created, but the control and administration of the assets is transferred to the trustees for a certain time or until a certain event occurs.

Special trusts are established for the benefit of disabled adults, or minor children. These trusts are taxed at the income tax and capital gains tax rates that apply to individuals.

If you have a high net worth, you can use the conduit principle to reduce your tax liability. You can place assets in a trust that distributes the income earned by the assets to family members who are on lower marginal rates of tax. The tax-saving can be even more pronounced if the trust distributes capital gains to the beneficiaries.

Trusts can also be used to save estate duty, because assets can be donated to a trust, where they can grow in value outside of the estates of the donor or the beneficiary; therefore, they will not be included in the estate duty calculation.

The Davis Tax Committee has recommended that the conduit principle should not apply to South African trusts, because it enables taxpayers to divert revenue or capital gains away from trusts, to be taxed in the hands of beneficiaries with lower effective rates of tax.

The committee says its recommendation to repeal the conduit principle cannot be extended to foreign trusts, because they are not registered for tax in South Africa.

However, most gains distributed to South African beneficiaries by a non-resident trust cannot, in terms of existing tax law, be subject to CGT. The committee therefore recommends that, because of the difficulties of identifying whether or not income distributed by foreign trusts was a capital gain, all distributions made by foreign trusts should be taxed as income. This means that capital gains distributed to individuals will not be taxed at a maximum effective rate of 27.31 percent, but will be subject to the marginal income tax rates of up to 41 percent.

The committee recommends that special trusts continue to be taxed as natural persons.

Ronel Williams, the national chairperson of the Fiduciary Institute of Southern Africa, says the recommendations, if implemented in their current form, will have a negative affect on people who established trusts purely to reduce tax.

However, Williams says, there are other, valid reasons for establishing a trust, such as to protect assets and ensure the financial welfare of future generations, and trusts will continue to have a role to play in estate planning if they are established for the right reasons.

Williams says the "gut reaction" among some taxpayers to the recommendations may be to close down their trusts. However, they will need to examine what the trust deed states about winding up the trust. Importantly, there will be tax consequences if the trust is closed and its assets are disposed of.

She says trusts can play an important role in a holistic estate and financial plan, and it would be unwise to terminate a trust simply because of the negative tax consequences.

Williams says that, if implemented, the recommendation to tax capital gains distributions made by foreign trusts as income will have a very negative impact on the estate planning of people who have offshore trusts.

The committee stated in its report that it wants to discourage the formation of offshore trusts.

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