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Making distributions to trust beneficiaries to save tax at all cost?

TRUSTS TO TRUST

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A TRUST CAN hold and distribute trust funds at any time, but this must be done in accordance with both the terms of the trust instrument and the purpose for which the trust was created.

This may involve distributing the income of the trust among family members in a tax-effective way over many years, or providing capital from the trust at a time when it will most benefit the beneficiaries in the future, for example when purchasing a home.

In practice, often trustees disregard the purpose for which the trust was set up, as reflected in its objective in the trust instrument, and blindly allocate all income and capital gains to beneficiaries (without making any payment to them) in an attempt to avoid or save tax.

Little do they realise that they are slowly undoing the purpose of the trust. The tax tail should never wag the estate plan dog.

The vesting of trust assets in beneficiaries may negate the benefit of asset protection. It was held in the ITC 76 case of 1927 that a "vested right was something substantial; something which could be measured in money; something which had a present value and could be attached".

The benefit arising from a vested right will therefore be exposed to the risk of attacks from creditors in the event of financial difficulty on the part of a beneficiary thereby negating one of the main benefits of using a trust for asset protection.

Creditors can, however, only have the same rights as a beneficiary where payment or delivery is to be made at the discretion of the trustees.

A creditor will not be able to demand immediate payment or delivery or to be given preferential treatment over the beneficiary in any way.

Many trust instruments stipulate that in the event of a beneficiary's insolvency, the beneficiary will be deemed to have died, and the amount will cease to be payable to the beneficiary, and, by consequence, their creditors.

This is not allowed.

A "vested right" is defined as a "right accrued to a possessor with no conditions", or the legal definition being "a right belonging completely and unconditionally to a person as a property interest which cannot be impaired or taken away without the consent of the owner".

A vested right cannot be conditional, it then never existed in the first place.

The trustees must carefully consider the provisions of the trust instrument when establishing what their specific powers are regarding the making of distributions – are they allowed to retain distributions once they have been made, and are they allowed to invest such retained distributions in the name of the trust, or must they invest it in the name of the relevant beneficiary?

Even though the ownership of such distribution lies with the beneficiary once it "vests" for tax purposes, often trustees retain it in the trust and invest it in the name of the trust, rather than in the name of the beneficiary.

This equates to a loan to the trust from the beneficiary, to the extent of the amount that "vested" in that beneficiary.

In these circumstances, a loan agreement should be drawn up which stipulates the repayment terms, as well as whether it is interest-bearing or interest-free.

If the loan is interest-free or attracts interest at a rate below the variable official rate of interest, Donations Tax will be payable on the interest "donated" in terms of Section 7C of the Income Tax Act, which taxes loans to trusts from connected persons in relation to those trusts – beneficiaries of those trusts or connected persons in relation to such beneficiaries – with interest rates charged at below the variable official rate of interest.

The SA Revenue Service confirmed this view in a Binding Private Ruling (BPR 350) on August 26 last year, dealing with the tax treatment of the vesting of a capital gain in a beneficiary of a trust where payment of the capital gain is deferred at the discretion of the trustees and the capital gain is invested on behalf of the beneficiary and not the trust for its benefit.

If the investment or money is being held on behalf of the beneficiary, then no loan account exists since the beneficiary has a "vested" right in the investment or money, and any income or benefits arising from such investment will accrue directly to the beneficiary.

Since Section 1 of the Income Tax Act defines "gross income" as "the total amount in cash or otherwise, received by or accrued to or in favour of that resident", any income earned on the vested amount will be deemed income in the hands of the beneficiary and will accrue to the beneficiary.

If no income is declared, it will, in all probability, be necessary to prove that the asset did not yield income.

It is, therefore, essential that trustees carefully word resolutions when amounts are awarded to beneficiaries, especially when these amounts are not actually paid over to beneficiaries at the time.

It should stipulate all the terms of the decision in alignment with the trust instrument. Trustees' actions should also be in alignment with the resolution to avoid any unintended tax consequences.

There are also consequences when a beneficiary has amounts owed to them resulting from distributions made, but dies before such amounts are paid. Trust benefits vested in the deceased beneficiary, which remain unpaid, is "property" for the purposes of the Estate Duty Act.

This may lead to unforeseen taxes and liquidity issues in a deceased estate if not taken into account during a person's estate planning.

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