INTRODUCTION TO TRUSTS

FINSERVE

TRUSTS | ACCOUNTING | TAXATION
REAL ESTATE | PROPERTY MANAGEMENT

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FinServe: Who Are We?

----CELEBRATING 12 YEARS OF PROFESSIONAL SERVICE IN 2020---

FinServe was founded in September 2008 by husband and wife team, Michael and Anthea Dryden. Their goal? To take the privilege out of the power of using Trusts by sharing such valuable information freely, and openly.

Over a decade later, FinServe has grown from a small accounting business specializing in Trusts to become a powerhouse group of companies with over 40 skilled staff, operating out of our Headoffice in Kenilworth, Cape Town.

Our Executive Team comprises the Founders, along with Jameel Dalvi and Jody Dryden. Working together, our vision and mission to provide comprehensive, unorthodox solutions to our clients in the Tax, Accounting and Real Estate fields lives on, and continues to grow from strength to strength.

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PART I: AN OVERVIEW OF TRUSTS

What Is A Trust?

The Trust is a separate legal entity, but not a legal persona or a juristic person per se. A Trust can transact, contract and hold wealth. Trusts are generally not used as a trading vehicle (companies are used for this purpose), but rather to hold and control wealth. The Trust and its purpose are contained in a Trust Deed which should detail all aspects of the Trust, including the parties to the Trust and its objectives. Trusts are governed by the Trust Property Control Act 57 of 1988, as well as various case law that has set precedents. There are various types of Trusts, but the most effective Trust used in Risk Management and Estate Management is one that is created when the **Founder is alive** (Inter Vivos Trust) and

the **Beneficiaries have no vested rights** (discretionary Trust). Therefore, this particular overview is in terms of an **Inter Vivos Discretionary Trust.**

Who Are The Parties To A Trust?

Founder

The Founder is the person who wishes to create the entity. If he is alive at the time of creating the Trust, the Trust is called an **Inter Vivos Trust**. Where the Founder is deceased and the Trust is created in terms of his/her Last Will & Testament, the Trust is called a **Testamentary Trust.**

Trustees

The Founder will appoint a class called the Trustees who are appointed to administer the Trust. This would be similar to a director of a company. The Trustees are given the powers to run the Trust in terms of the Trust Deed. There should always be at least 2 Trustees administering the Trust, as this will ensure the independence of the Trust from the respective Trustees individual capacities. Essentially, no *one* person should have the power to control the activities of Trust.

Beneficiaries

The Founder will also state the Beneficiaries of the Trust, who are legally entitled to the benefits of the Trust, whether it be an entitlement to Income or Capital (or both) of the Trust. A Trust Deed that states the Beneficiary is entitled to specific benefits of the Trust is called a **Vested Trust.** A Trust whose beneficiaries only receive benefits according to the will of the Trustees (not defined in the Trust Deed) is called a **Discretionary Trust.**

Why Would I Need A Trust?

The formation of a Trust is required for two broad instances namely, **Risk Management** and **Estate Management**.

Risk Management is the process of limiting the amount of risk that one's wealth is exposed to. Such risks could include divorce, business risk, civil risk and the more popular risk of having debt such as mortgage bonds.

Estate Management involves the process of limiting the vast amount of time-consuming and expensive procedures that are carried out on one's estate upon one's death.

Why Is My Wealth Exposed To Risk?

Simply put, the problem that many people face is that all wealth is owned in a single entity, namely your personal capacity - *you* own your home, your car, furniture, unit trusts,

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investment properties and so on. The issue here is that if you are sued for whatever reason, all assets linked to you could be exposed and could potentially be attached and sold to settle debt owing as a result of any *other* asset *you* own.

For example, you are unable to pay the Hire Purchase on your vehicle – the bank repossesses and claims that you still owe another R50,000. The bank can then obtain a court order to attach your furniture or a property and have them sold to generate cash to settle the R50,000 on the vehicle. Although the vehicle lost to repossession is technically unrelated to your furniture, legally the assets *are* related, as you own those assets - we call this the '**domino effect**'. The problem starts with the vehicle, and then rolls over to your furniture, then to your home and so on. Many of us know someone who has suffered this fate, where you lose *everything* due to the above effects.

Typical risks that an individual is exposed to include the following:

- Business Creditors
- Failure to Service Debt Repayments (Hire Purchases; Mortgage Bonds)
- Divorce
- Civil Matters

How Would A Trust Help Protect My Wealth (Risk Management)?

With the use of Trusts, we are able to **'compartmentalize'** different assets based on their respective risk profile. For example, we can legally separate **Paid Up Assets** (Risk Free Assets such as Furniture and a paid-up Vehicle) from the **Debt Funded Assets** (Risk Assets such as your bonded home). Therefore, the loss of your home will not affect the furniture or paid up vehicle – there is no 'domino-effect'.

Why Would I Need To Manage My Estate?

Upon your death, many issues arise as the process of winding-up your estate begins. The winding-up of your estate involves the rather long-winded process of valuing your wealth at date of death in order to evaluate the amount of taxes payable to SARS and the process of moving the remaining wealth to the heirs of your estate in terms of your Last Will and Testament. The issue here is simple; the heirs of your estate can only benefit after all of the following has been concluded/considered:

Estate Duties

All estates are subject to Estate Duties of 20%; fortunately some relief is allowed in the forms of rollover and abatements. Estate Duties are taxed on your Net Estate (Assets less Liabilities) in excess of R3.5mil.

Capital Gains Tax

Your death is seen as a disposal of your assets, and therefore triggers Capital Gains Tax on a sliding rate of 0 – 18% (2020/2021 Tax Rates). The tax is levied on the growth of the

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asset since its acquisition, and therefore assets such as properties and shares in one's business are highly susceptible to this tax and are quite often overlooked. Liabilities attached to the particular asset is not relevant in this tax calculation – therefore, even if you home is financed to the hilt, the said finance is not included in the Capital Gains Tax calculation.

Executors Fees

Generally an attorney is appointed to wind-up your estate. The prescribed fee in this respect is 3.5% plus vat on the gross estate (not taking your liabilities into consideration). Most Executors are VAT registered, there the total fee to the Estate is around 4%. On the face of it, 4% seems small but it is important to note that this fee is levied on the value of your total assets, not taking liabilities (debt) into consideration. Therefore, an Estate with R10million Assets and R10million Liabilities, will still carry an Executor Fee of around R400,000 (R10million Assets x 4%).

Debt

One cannot die with debt, and therefore all debt (mortgage bonds, hire purchases and so on) must be settled. This places a huge amount of pressure on the liquidity of the estate, and is one of the leading causes of assets of an estate being auctioned off to generate cash.

Freezing

While the winding-up process above is being concluded (which could take a long, long time), the estate remains frozen and your loved ones have very, very little access to the wealth which you have left behind. Estates can take anything from 6 months to 5 years to wind-up, all essentially depending on the complexity of your estate.

Minor Heirs

Minors (under 18 years old) cannot benefit directly from an estate. Any assets bequeathed to a minor are liquidated and paid to the Guardian's Fund which is a money market fund administered by *government*. Needless to say, one should avoid this.

All in all, the process is painful and long, requires a large amount of liquidity (cash), and is extremely expensive in that up to 35% of the estate could be lost to various taxes and winding-up fees, all of which should have been for your loved ones.

How Would A Trust Help With Managing My Estate (Estate Management)?

If structured and administered correctly, all wealth owned by a Trust falls outside of your estate, and therefore is not subject to the various tax and winding-up issues mentioned previously. Your death will remain an emotional event, but the use of the Trust will reduce or eliminate the various issues mentioned above. The objective is to ensure a seamless

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transfer of wealth from you to your loved ones, which is virtually impossible when wealth is owned in your individual capacity. Upon your demise, a replacement Trustee will be appointed and the Trust will continue as before.

PART II: SPECIFIC CONSIDERATIONS AND FUNDAMENTAL ASPECTS OF TRUSTS

The Typical Trust Structure

Although the use of a single Trust will reduce the numerous issues experienced upon one's demise (see "Why Would I Need to Manage My Estate"), it will not adequately protect assets against the various risks of everyday life (see "Why Is My Wealth Exposed to Risk"). This is because the 'Domino-Effect' is essentially a ripple effect throughout an entity, in that **a single asset can affect all other assets in the same entity**. For this reason assets should be 'compartmentalized' within separate Trusts, thus avoiding the dreaded domino-effect.

For the above reasons, the **typical Trust Structure involves more than one Trust**. The number of Trusts one would require depends on an individual's sensitivity to risk and the different risks that the particular assets are exposed to. The most common Trusts that clients utilize include *inter alia:*

The Family Trust

The Family Trust is intended to be a 'No Risk' Trust. In order for the entity to be exposed to no risk, the assets it should own should have no risk. Typically, the Family Trust will own Personal Paid Up Movable Assets (eg: household contents and paid up vehicles), Risk Free Investments (eg: listed share portfolios and unit trusts) and Structured Life Policies.

The Property Trust

The Property Trust is intended to own Investment Properties. Many of these Trusts acquire properties with bank finance (mortgage bonds) and therefore these properties hold a fair amount of risk. For this reason, these investment properties should not be purchased into the Family Trust where risk-free assets will be exposed.

The Residence Trust

The Residence Trust is intended to own the Primary Residence. The Primary Residence falls in between the Risk-Free and Risk Assets, and for this reason it is generally purchased into a separate Trust. The individual occupying the property as his/her home will enter into a lease agreement with the Trust for a market related rental.

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The Share (Business) Trust

The Share or Business Trust is intended to own the shares in a Private Company. Such shares is generally owned in the individual's capacity which represents wealth, and therefore is exposed like any other asset. Having the Trust own the assets limits shareholder exposure and also reduces the impact upon the demise of the shareholder.

The Business Asset Trust

The Business Asset Trust is intended to own the assets that are used in a business. It is a **common misconception that the operations and assets should exist in a single entity**, as generally the assets hold no risk, whereas the operations holds a lot of risk. By separating the business assets from the operations, one essentially minimizes the impact of liquidation should the company fail.

The Independent Trustee

In order for a Trust to fulfil its functions, it should always be viewed as completely independent (or separate) to the trustees/beneficiaries in their respective personal capacities. The independence of the Trust is dependent on many factors, such as ensuring that it has its own bank account through which its transactions are conducted, and ensuring that resolutions are duly signed by the Trustees to effect transactions in the Trust. **Another aspect which helps with the independence aspect of the Trust is appointing an unrelated (or 'independent') Trustee.**

Many Trusts would appoint an attorney or accountant as an Independent Trustee as they are professionals and are less likely to act negligently; ideally such attorney or accountant should have a thorough knowledge of Trusts to ensure that he/she actually adds value to his/her appointment as Trustee.

The Independent Trustee generally also acts as a mediator on the Trust, as the other Trustees are usually also beneficiaries and therefore at times a deadlock in decision-making occurs.

Life Policies and Trusts

The purpose of a Life Policy is to create liquidity upon the demise of the Life Assured. Generally, these policies are poorly structured with little regard awarded to minimization of taxes and continuity. As the purpose of Trusts is to create a seamless transition from one generation to the next, the structure of Life Policies is integral to the ongoing functioning of the Trust Structure upon the demise of the Founder or Trustees.

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When structured correctly, the Life Policy will form part of the Family Trust. The Estate Duties Act allows for substantial savings on the Estate Duties if structured in a particular manner, and the proceeds of the policy will remain liquid and easily accessible by the remaining Trustees upon the Life Assured's death.

The structuring of Life Policies through a Trust is a highly specialized field, with very few brokers being properly educated in this area. A full discussion of Structured Life Policies is always reserved for an individual consultation as this knowledge represents valuable Intellectual Property.

PART III: COMMON MISCONCEPTIONS AND FAQS

Trusts Are Expensive

Unfortunately, many Trust Specialists are in a good position to charge exorbitant fees as thorough Trust knowledge is rare. Fortunately, FinServe has endeavoured to meet the demands of everyone, and in so doing our fees are certainly affordable. Generally, the only running costs for the average Trust is accounting fees and bank charges, although this will be entirely dependent on the activities of the Trust. Typically, the cost of running a Trust is more than a sole proprietor, but less than a company or close corporation.

Trusts Are For The Wealthy

Although the wealthy most definitely make use of Trusts, the average Joe can benefit greatly from Trusts too. The wealthy individual can afford large legal costs to protect their respective wealth, whereas the average Joe needs to avoid costly legal battles and complex wealth management. The Trust system is simple, affordable and extremely effective in protecting any and all wealth.

Trusts Have The Worst Tax Rate

Indeed they do, but only where the Trustees opt to retain profits and not distribute such profits to the beneficiaries. Tax law accommodates Trusts in terms of a concept called the **Conduit-Pipe Principal**, where one can shift the tax burden from a Trust to a beneficiary (such as an individual) and thereby be taxed at much lower rates. In actual fact, as the distribution can be done proportionately to multiple beneficiaries, the taxation payable can be less compared to the tax that would have been payable in any other entity. Beware though; the use of the Conduit Pipe Principal is a highly specialized field that should only be dealt with by knowledgeable Trust Accountants.

A full discussion of the Conduit Principal is always reserved for an individual consultation as this knowledge represents valuable Intellectual Property.

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Trusts Are Difficult Or Complicated To Administer

A Trust does not generally trade, and for this very reason, it is surprisingly simple to administer. With the on-going assistance of your Trust Accountants, you will always be on top of the administration.

Why Can I Not Just Use a Close Corporation or Private Company

Administration and compliance in a Close Corporation or Private Company is cumbersome and expensive, involving complicated tax compliance and directors meetings. A trust is a lot simpler.

It is also a misconception that a Company (CC or Pty Ltd) is completely separate to you. Although a company is a separate legal entity in terms of trading, its wealth (or value) is contained in the equity (shares or members interest) which is usually owned by the individual. This equity then forms part of your estate and is subject to the various issues upon death and is also exposed to your life risks. The value of the equity is equal to the value of the company which could be substantial and therefore subject to a lot of tax upon your demise if owned in one's personal capacity.

I Will Lose Control of My Assets If Owned By A Trust

In order for a Trust to be seen as independent, you will indeed lose individual control of the respective assets. The control of the assets will vest jointly in the Trustees of the Trust, which would typically be you and your spouse. Therefore, even though it is no longer owned by you, you maintain joint control over the assets as a co-trustee of the Trust.

Regardless of the control, you will be a beneficiary of the Trust and therefore you will remain entitled to the Income and/or Capital of the Trust.

It Is Expensive To Move Assets To A Trust

The only assets that could be costly to move are those which *appreciate* in value, especially Properties and Shares. Many other assets are depreciating assets and therefore the transfer of such assets is certainly not costly. Appreciating assets are dealt with individually to ensure that the cost is minimized, and more importantly, not incurred unnecessarily. As your accountants, we will aid in the process of moving assets to the Trust.

Tax law in South Africa is comprehensive and seems to have been designed to discourage the transfer of assets after its initial acquisition. As a general rule, it is advisable to acquire assets in the Trust immediately as opposed to first acquiring in your individual capacity.

A Trust Pays High Transfer Duties When Acquiring a Property

After the tax amendments made in February 2011, the cost of acquiring a property in a Trust is no different to acquiring the property in your personal capacity. The Trust no longer pays Transfer Duty at a flat rate of 8% - rather, it pays at the same rates as an individual.

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Where the property purchase is subject to vat (such as purchasing from a developer), no transfer duty is payable.

Should I Appoint An Independent Trustee?

In a pertinent case many years ago (Landbank vs. Parker), a judge made a comment that it would be beneficial to appoint an independent trustee (such as a knowledgeable attorney or accountant) to reduce misuse and mismanagement of Trusts. Although this is a good recommendation, the proper use of a Trust which ensures its independence depends on various factors, not just the independent trustee. In order for a Trust to be seen as independent, the Trustees must ensure that every aspect of the Trust is dealt with in an independent manner. This applies to financial reporting, resolutions for transactions, tax compliance and so on. Therefore, the appointment of an independent trustee is at your discretion, but is certainly not a legal requirement. Note however that where the Trustees are too closely related, the Master of the High Court will enforce the appointment of an Independent Trustee.

Trusts Are Being Investigated By SARS

Trusts, just like any other entity, have moments when its misuse is brought to the public arena. Every now and then, a court case is concluded where it is stated that a Trust was severely mismanaged resulting in fraud and unpaid taxes. This is most certainly not reserved to Trusts, and it most certainly does not mean that a Trust that has sound management in place will be frowned upon by SARS. If the Trust is administered correctly, SARS will have no issues with the Trust.

What Is A Sham Trust?

A sham trust is a trust which has been proven to lack independence to a sufficient degree to ensure proper separation of assets. For example, if you move assets to a Trust where you are the only trustee, the court can easily accept that although the assets are in a Trust, you have complete control and therefore there is not a proper separation of assets (ie: no independence).

Does The Trust Require a Bank Account?

To ensure the independence of a Trust, a bank account must be opened in the Trust's capacity. All Trust transactions should be conducted through the bank account, including income and expenditure related to the Trust. Adequate resolutions should be prepared and duly signed by the Trustees authorizing transactions.

What Taxes Should The Trust Comply With?

Generally, the Trust should not be used as a Trading Entity other than to hold Investment Properties which generate rental. Therefore, unless the Trust owns Commercial Property, it would only be required to register and comply with Income Tax (which is mandatory). VAT will only become applicable where the Trust supplies a VATable service or product such as

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the supply of Commercial Accommodation, and the value of such services have exceeded the threshold for mandatory VAT registration. Employees Tax will only become applicable where the Trust employs staff. Typically though, only Income Tax compliance is required.

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