

Retirement Vehicles Vs Inter Vivos Trusts

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Dear Paul

The debate as to whether to use an inter-vivos Trust [IVT], a retirement annuity [RA] or living annuity [LA] for estate planning is interesting as it challenges some fixed beliefs. I also find it interesting that there are still so many IVTs being used for estate pegging purposes, notwithstanding that these days IVTs are, in many cases, no longer fit for this purpose. Lastly, it is unfortunate that not enough public focus is placed on the benefits that retirement vehicles can add to estate planning.

Before assessing these vehicles, it is helpful to view them in their historical context.

Inter Vivos trusts

The 1980s were the heyday of IVTs as the MRT of estate duty [35%] was reached when an estate exceeded R400 000; and even adjusting for inflation, this was a low hurdle and estate duty was thus a major concern for many. The then poor taxpayer didn't even enjoy the benefit of Section 4(q) and thus the use of IVTs was seriously enticing for the not so wealthy.

In real terms, estate duty revenues dropped by over 2/3rds from its peak in the mid 1980s to its lowest, circa 1990. Interestingly, this took place just as we approached our change in Government. Even today, in real terms, estate duty revenues are still a third less than the peak in the 1980s.

Lastly, there were fewer IVT administrative burdens, cost of their setup was low and the settlor received a number of income tax benefits [e.g. income splitting]. As an aside, the current estate duty increase to 30% for estates over R30 million is not unreasonable when compared to the high wealth taxes of the past.

Retirement Annuities

In the 1980s, the RA deduction was limited to 15% of non-retirement funding income and a negligible amount for clients who were members of retirement funds. The amount that could be saved via RAs could seldom generate enough capital to make a meaningful difference to one's estate duty liability.

More importantly, in those days LAs were not around and thus the maturity capital had to be invested in compulsory purchase annuities which defeated the objective of passing on wealth to heirs.

Further, the factors inhibiting the use of RAs were the high penalty structure of the RA products then offered by the life offices and the fact that they had to be matured at age 69.

Current IVT Environment

As the burden of estate duty liability eased [via larger rebates, lower rates, Section 4 (q) etc] more & more constraints [e.g. Section 7 & 25B] were being placed on IVTs resulting in onerous income tax & CGT implications. Further, IVTs are attracting more oversight from the

Master and many settlors & trustees face the uncomfortable reality that they have not held regular meetings, do not have minutes, balance sheets, audit history etc.

In short, the tax benefits, ease of admin and the settlor's perceived control of his assets are waning and being replaced with tax liabilities, potential administrative burdens, real loss of control over his assets and potential high costs if he tries to unwind the IVT.

Income tax & CGT changes are making many existing IVTs unsustainable and what fun & games awaits as these clients face the challenges of unwinding these structures to get the capital back into their names without sacrificing too much capital. Failing unwinding of problem IVTs, the clients will just have to come to terms that it will cost more in tax and administration than they originally expected.

Given that RAs & LAs are exempt from estate duty, they play an important part of my estate planning.

Herewith a quick sketch of my basic game plan for my wealthy clients:

Given that all capital within retirement vehicles is exempt from estate duty and is executor fee exempt, this capital is maximized.

The retirement vehicle capital for many investors represents the largest part of their investable capital, and thus their estate duty is significantly reduced.

Maximise their RA deductions [H & W] and post retirement, cash flow permitting, to continue at their maximum deductible rate to grow their "estate duty free" estate.

To reduce the drawdown from LAs and compensate for this, lower drawdown by increasing drawdown from discretionary investments. This is tax efficient in two ways:

- Inside the Fund: The build-up in the RA & LA is tax exempt; whereas the build-up in the discretionary investment has limited tax savings, if any.
- Personal Income Tax: Reducing a LA reduces the clients' annual income tax liability as the Living annuity drawdown is fully taxable and this results in a reduction in income tax. The size of the drawdown from a LISP of discretionary capital doesn't impact on income tax liability.

House most of his total portfolio's interest & rent bearing asset allocation within the LA. This renders their return tax free and thus you are assured of a real return from this secure asset allocation.

The costs of RAs & LAs are nominal, especially if one uses UT type RA & LA products.

There are no additional costs. You get many of the benefits of an IVT without the IVT level of costs or administrative liability.

Time costs

Clients are unaware of the onerous duties of trustees. One will see this becoming more of an issue as the Master begins reviewing IVTs. For many clients this will come as an unwelcome surprise. It will be worse than a surprise FSB audit for us; for we know our obligations & potential liabilities, but for many settlors & trustees, it will be a klap out of the blue.

The RA & LA estate duty protections are not guaranteed, but will probably be the last thing a government will attack

RAs & LAs are criticised because you lose control of your retirement capital. However, it is retirement capital and as such exists to provide a retirement income stream.

Although one does not have full control over retirement capital [e.g. Section 37 C], the loss of control can be less than that of an IVT.

You retain the right annually to change income and to manage your invest as you please.

I am a bit tired of hearing 'smart' people bragging about their IVTs. These folk often erroneously believe that they have full control & access to the capital of the IVT; however, if that were the actual legal case, then no income or estate duty benefits would accrue to the settlor and all he would be left with would be an expensive charade. The boasting at braai's goes along the lines of "My IVT, the Joe Blogs family trust...." is no different to the lady who has to draw to your attention that her handbag is a Louis Vuitton. In both cases, they may be nice to have, but both can be detrimental to one's wealth retention.

Today, I submit that before you can even begin considering the use of an IVT for estate pegging purposes, one needs a mega estate and secondly, the use of RAs & LAs are not being sufficiently exploited.

Lastly, I have great difficulty understanding the reluctance of some to use RAs for senior citizens. At a seminar, Prof Matthew Lester quipped that with the income & estate duty benefits provided by SARS, we need to thank them for making it silly for our clients not to maximise RA investments [cash flow permitting].

John Bustin is a highly experienced independent financial adviser with a legal, training and corporate background.