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OFFSHORE INVESTMENT PORTFOLIOS: DISCRETIONARY VS TAX EFFICIENT STRUCTURES

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We all know the saying 'Give to Caesar what belongs to Caesar'. If you don't, you will pay the price. Without a doubt and as far as possible, all of us would like to stay on the right side of Caesar and his law, otherwise we could pay the (financial) price if we fail to do so.

However, what one would like to achieve is channel one's portfolio so that there is as little leakage to Caesar as possible, especially with regards to direct offshore investments.

What I have seen come across my desk far too often, are investors with direct offshore investment portfolios in simple discretionary structures, with no tax or succession planning mechanisms built into the structure.

This simply means that though you might be invested in a well-diversified portfolio with an extremely successful track record of historical returns, you will most likely end up unnecessarily giving a big percentage of these gains back to Caesar.

Assuming the fact that trusts were used as the structure of choice by wealthy South Africans to accrue assets and wealth, capital gains are the issue at hand when any changes are considered within the trust. Opting for any other structure and making changes within the trust will trigger capital gains events, leading to tax implications.

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From a structural perspective, trusts have been the 'go-to' solution for many wealthy SA families over the last couple of decades. However, the scenario has changed, to a great extent, over the last few years due to a number of factors:

- Certain tax benefits of trusts have been diminished by various changes to the law and legislation.
- 'Globalisation' of families. Gone are the days where it was 'tradition' for a family of four to attend school and university and then work in the same jurisdiction over their entire lifetime.
- To a large extent, the 'reach' of SA trusts is limited, especially with the focus on direct offshore investments. Offshore property portfolios and direct shares in offshore companies, to name just a few, are all out of reach of SA trusts.

Assuming the fact that trusts were used as the structure of choice by wealthy South Africans to accrue assets and wealth, capital gains are the issue at hand when any changes are considered within the trust. Opting for any other structure and making changes within the trust will trigger capital gains events, leading to tax implications.

SCENARIO:

A trust invested in JSE-listed companies in March 2002. R300 000 capital invested in an equal-weighted portfolio across Sasol, Nedbank and Shoprite would have accrued a value of R4m today. (An annualised return of 13%.) To terminate this investment and consider alternatives with the capital, CGT of R1.33m would be payable to Caesar.

Using the conduit principle of SA trusts, income and capital gains can be transferred from the trust through to the beneficiaries and be taxed in a personal individual capacity as opposed to within the trust, which is far less favourable.

One must keep in mind that the primary objective of using the trust was to preserve and accumulate wealth over a long period of time for future generations. So by distributing all capital and earnings from the trust to the said individuals proves to have the opposite outcome to the initial and main objective of the trust.

A family trust's primary objective is wealth accumulation – preserving the capital within the trust to build generational wealth where it can be safely managed by the trustees and not be exposed to the opinions of various individuals.

When these distributions are made from the trust to affluent individuals, it will simply increase their personal marginal tax rates which means most of the tax efficiency of the trust dissipates and, in addition, the capital has now been externalised from the trust. Furthermore, this capital is now also exposed to estate duty as opposed to when the capital was held within the trust. By now, Caesar is smiling all the way….

ALTERNATIVE? THE SINKING FUND

A SA trust could opt to invest the capital in a sinking fund. This structure is very similar to an endowment policy, with the exception that a sinking fund does not require a life assured.

Therefore, the investment can exist into perpetuity without the requirement for trustees and/or advisors having to appoint new life assureds. With an endowment, the policy is realised when the last life assured passes away.

The sinking fund's structure is such that the fund, in its own capacity, is liable for the tax consequences of the investment, therefore, the trust is not taxed for the earnings. Income within the sinking fund is taxed at a flat rate of 30% and CGT is a mere 12%, as opposed to a trust's income which is taxed at a flat rate of 45% and the capital gains at 36%.

Keeping in mind that the primary objective of trusts is to accumulate generational wealth (meaning it is normally large amounts of capital), this difference between the two CGT rates of 45% and 12% will have a HUGE impact on the net assets within the trust over the long term. On multiple occasions we have seen this play out.

SA trusts are not allowed to make direct offshore investments, which is a big drawback for wealthier South African families and investors, especially considering that these families normally live and spend in global terms.

The sinking fund also addresses this issue in that the capital can have up to 100% exposure to offshore markets. Although not in a direct offshore jurisdiction, the investor has access to the big global names, such as the FAANG (Facebook (now Meta platforms), Amazon, Apple, Netflix and Google (now Alphabet)) stocks, global indices, etc. This also provides a very strong rand hedge for the capital within the trust, whereby the trust is not only exposed to offshore companies, but also protected against the ever-weakening rand.

Given the way that the modern wealthy family lives and spends their money, this is a generational wealth-building mechanism that simply cannot be ignored! If generational wealth building is the primary objective of your SA trust capital, this is a very important option to consider.

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Ruan joined the Brenthurst Wealth team in 2021 as an advisor/paraplanner and currently works under the direct supervision of Sonia du Plessis and André Basson in our Stellenbosch office.

He obtained his BCom (Financial Sciences) degree at the University of Pretoria in 2018. Consequently, he also enrolled with CIMA (Chartered Institute for Management Accountants) as a prospective CGMA candidate and will complete all the relevant CIMA exams. He is also currently studying towards his Diploma in Investment Management at the University of the Free State.

Ruan's previous experience includes "tax and advisory" at Crowe Tax and Advisory Services in Stellenbosch.

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