CSARS v The Thistle Trust (516/2021) [2022] ZASCA 153 (7 November 2022)

On whether the conduit principle may be used in conjunction with the Eighth Schedule

On 7 November 2022, the SCA delivered judgment on a matter involving the attribution of a capital gain through multiple trusts.

Background

The Thistle Trust is a resident discretionary trust and a vested beneficiary of various vesting trusts Tier 1 Trusts. During the 2014 to 2016 years of assessment, Tier 1 Trusts had disposed of capital assets which gave rise to capital gains to which Thistle Trust became entitled. During the same years of assessment, Thistle Trust had simultaneously vested these amounts in its resident beneficiaries, who had declared them as capital gains in their tax returns.

The case was originally heard at the Tax court where SARS contended that these capital gains had accrued to Thistle Trust rather than its resident beneficiaries and raised additional assessments on the Thistle Trust. The Thistle Trust appealed against the additional assessments, contending that the capital gains had not been received by or accrued to it as it had merely acted as a 'conduit pipe', and the amounts had been received by or accrued to its resident beneficiaries. The matter was decided in favour of the Thistle Trust on 18 March 2021 at the Tax court.

SARS escalated the matter to the SCA who found in favour of SARS on 7 November 2022.

The law

Thistle Trust relied on section 25B and paragraph 80(2) of the Eighth Schedule to the Income Tax Act (Eighth Schedule to the ITA) to determine that the capital gains made by Tier 1 Trusts were meant to be taxed in the hands of the resident beneficiaries of Thistle Trust. During the years of assessment in question, s 25B(1) read as follows:

> '25B. Income of trusts and beneficiaries of trusts.—(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.'

During the years of assessment in question, para 80(2) read as follows:

> '(2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62 (a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or the portion of the capital gain so vested—
>
> (*a*) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and
>
> (*b*) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.'

Arguments

Hughes JA, in the SCA, noted that the first issue to contend with is whether:

> '…the capital gains accrued as a result of the disposal of capital assets by the Tier 1 Trusts are taxable in the hands of the Thistle Trust or in the hands of the beneficiaries of the Thistle Trust to whom those gains were distributed.'

Section 25B was introduced into the ITA deal with the taxation income accrued to trusts and beneficiaries and ultimately to ensure an 'amount' will be taxed in the hands of the person who holds a vested right the that 'amount'. Should a beneficiary not hold the vested right, the 'amount' will be taxed in the hands of the trust.

Paragraph 80(2) of the Eighth Schedule states that the capital gain must be taken into account by the beneficiary of the trust that disposed of the asset, in this instance, that beneficiary would be Thistle Trust.

SARS argued that paragraph 80(2) of the Eighth Schedule applies exclusively to Thistle Trust and that section 25B of the ITA does not apply. The capital gain realised by Tier 1 Trusts should then be taxed in the hands of Thistle Trust and not in the hands of the resident beneficiaries of Thistle Trust. For the subsequent distribution to the resident beneficiaries of Thistle Trust, paragraph 80(2) does not apply and the distribution to them can be seen as a distribution of monies, which are not categorised as an asset for the purposes of the Eighth Schedule.

Thistle argued that paragraph 80(2) of the Eighth Schedule should be read in conjunction with section 25B. Read together with the 'conduit' principle, the capital gains realised by Tier 1 Trusts would accrue to the ultimate beneficiary (the resident beneficiaries of Thistle Trust).

The court's findings

Referencing principles set out in *Commissioner, South African Revenue Service v United Manganese of Kalahari (Pty) Ltd*[1], Hughes JA noted that:

> 'Section 25B, read in its entirety, demonstrates that the amount is of a taxable income nature and not of a capital gains nature – 'any amount' will thus not include capital gains.'

This indicates that the Thistle Trust was misguided to focus on section 25B of the ITA as it was not intended to apply for amounts which are capital in nature. Further, the judge noted, through *Milnerton Estate Ltd v CSARS*[2], it can be seen that:

> 'the [Eighth – added by author] Schedule seems to provide a self-contained method for determining whether a capital gain or loss has arisen'

The Eighth Schedule applies more specifically to capital gains and thus should have been considered by the Tax court in this instance.

Insofar as the 'conduit' principle, the SCA considered both *Armstrong v the Commissioner of Inland Revenue*[3] and *Secretary for Inland Revenue v Rosen (Rosen)*[4] but concluded that the 'conduit' principle must be applied on a case-by-case basis and was not relevant in this matter as in the cases listed, it served to prevent the double taxation of dividend income. In this case, the Eighth Schedule specifically notes that the capital gain must vest in the beneficiary of the trust which determines the capital gain (in this instance, Thistle Trust). The capital gains will be taxed only in Thistle Trust, preventing double taxation.

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[1] See C:SARS v United Manganese of Kalahari (Pty) Ltd [2020] ZASCA 16; 2020 (4) SA 428 (SCA) para 8
[2] Milnerton Estates Ltd v CSARS [2018] ZASCA 155; 2019 (2) SA 386 (SCA) para 22
[3] Armstrong v Commissioner of Inland Revenue 1938 AD 343 at 348-349
[4] Secretary for Inland Revenue v Rosen 1971 (1) SA 172 (A) at 190H-191A

The court found in favour of SARS.

Opinion

It is our opinion that the SCA correctly determined that paragraph 80(2) of the Eighth Schedule should be applied to the vested capital gains and that the paragraph cannot be used in conjunction with section 25B or the "conduit principle" (related to section 25B).

Amendments to section 25B

It is interesting to note that the judgment contains the current reading of section 25B, which was amended by Act 23 of 2020 to specifically exclude amounts of a capital nature. The matter of whether section 25B may be used to determine the vesting of a capital gain was pivotal to the case.

Had the legislation been read as it stood in the years under contention (2014-2016), the following would have to be considered. During the years of assessment in question, section 25B was named 'Income of trusts and beneficiaries of trusts'. The term 'income' is defined in section 1 of the Income Tac Act as being gross income less exemptions. This indicates a likely intention to utilise the section for amounts which are income in nature. The SCA's ruling would still stand given this interpretation.

It must also be noted that newly enacted legislation may not be applied retrospectively. Any form of 'retroactive legislation' makes it almost impossible for taxpayers to arrange their affairs, comply with the relevant legislation and determine the amount of tax to be paid, should they not have certainty on the consequences to be attached to transactions. This was evident in the judgment of *Pienaar Brothers (Pty) Ltd v the Commissioner for the South African Revenue Service*[5] and the issues surrounding retroactive fiscal legislation, which became particularly topical following the judgement.

"Trapping gains" in the trust and the conduit principle

It is important to distinguish between income and capital, as capital gains are taxed at a lower rate. The determination of whether proceeds from an asset disposal capital or revenue in nature can be complex, as it involves a rigorous assessment of objective and subjective factors. The assessment is arguably simpler when dealing with other types of income such as dividends or interest received. Furthermore, the subjective element of this assessment makes it imperative to determine the nature of an amount with reference to a particular taxpayer's specific facts and circumstances. One needs to exercise careful judgement in a re-attribution of capital gains to another taxpayer when the assessment of the nature of the amount received heavily depends on facts and circumstances related to the taxpayer with the disposal.

Capital gains have additional crucial differences to income, these include the ring-fencing of capital losses against only capital gains and the determination of South African source for non-residents. Unlike section 9 (of the Income Tax Act) source rules, non-residents are specifically taxed on disposals of capital assets that constitute immovable property in South Africa (including an interest therein) and those that are attributable to a South African permanent establishment. To use over-arching and general income tax principles (such as the 'conduit pipe' principle) to re-attribute capital gains may interfere with South Africa's well-defined capital gains taxing rights.

The issue of whether the conduit-pipe principle has general application to attribute capital gains to non-resident beneficiaries has been debated in the past. This argument centred around whether paragraphs 80(1) and 80(2) can apply to non-resident beneficiaries. In fact, SARS's Capital Gains Tax Guide

[5] Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue Service and Another (87760/2014) [2017] ZAGPPHC 231; [2017] 4 All SA 175 (GP); 2017 (6) SA 435 (GP) (29 May 2017)

concluded that the conduit-pipe principle cannot override the intent of the legislature and paragraph 80 'remains the sole mechanism for attributing a capital gain arising in a trust to a beneficiary[6].

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[6] South African Revenue Services, 2000, Comprehensive guide to Capital Gains Tax (Issue 9), South Africa, viewed 2 November 2022, https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-CGT-G01-Comprehensive-Guide-to-Capital-Gains-Tax.pdf