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TAX & EXCHANGE CONTROL **ALERT**

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A vested interest in a capital gain: to be taxed in the trust or in the hands of its beneficiaries?

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A vested interest in a capital gain: to be taxed in the trust or in the hands of its beneficiaries?

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In the recent Tax Court judgment of *ABC Trust v Commissioner of the South African Revenue Services* (IT 24918)(18 March 2021), the court had to determine whether the conduit principle (as it pertains to trusts) can be applied in circumstances where a beneficiary trust receives amounts from a vesting trust and in turn, vests those amounts in its beneficiaries.

Facts

The Appellant in this case was a South African resident trust –

1. whose beneficiaries were also all resident in South Africa during the relevant years of assessment, being 2014, 2015 and 2016 (Relevant YOAs); and
2. which was itself a beneficiary of various other South African resident vesting trusts.

In each of the Relevant YOAs, several of the vesting trusts (in respect of which the Appellant was a beneficiary) disposed of certain capital assets held by those trusts. By virtue of the fact that the Appellant was a vested beneficiary of those trusts, the Appellant became entitled to various capital gains derived from the disposal of the vesting trusts' capital assets.

During each year of assessment in which the Appellant became entitled to the specified capital gains, the trustees of the Appellant awarded (vested) the amounts that had vested in it, to its beneficiaries.

It was the Appellant's contention that no tax liability had arisen in respect of the amounts that had vested in it as the Appellant had merely acted as a "*conduit pipe*", such that the receipts and accruals of the amounts took place in the hands of the beneficiaries of the Appellant to whom the awards and distributions had been made. On this basis, the Appellant did not reflect any taxable capital gains in its tax returns for the Relevant YOAs.

As a result, SARS raised additional assessments for each of the Relevant YOAs, which assessed the Appellant for capital gains tax, understatement penalties and interest.

Judgment

At issue in the dispute between the Appellant and SARS was the correct treatment of the capital gains derived by the Appellant from the disposal of the capital assets by the vesting trusts and the consequent taxability of those gains in the hands of the Appellant.

In terms of section 25B(1) of the Income Tax Act 58 of 1962 (ITA), (prior to its amendment in January 2021), any amount received by (or accrued to) a person in their capacity as the trustee of a trust will be deemed to be an amount received by (or accrued to) the beneficiary of the trust to the extent that the amount has been derived for the immediate or future benefit of the said beneficiary, who must have a vested right to that amount during the relevant year of assessment. In terms of section 25B(2), the aforementioned principle applies equally in the event that the beneficiary acquires a vested right to the amount in question in the year of assessment by virtue of the exercise of a discretion by the trustees of the trust. This principle is commonly referred to as the conduit principle and allows for the taxation of income and capital gains in the hands of the beneficiaries of a trust rather than in the trust itself (in specified circumstances).

A vested interest in a capital gain: to be taxed in the trust or in the hands of its beneficiaries?...*continued*

It was concluded that capital gains are to be included within the ambit of section 25B(1) (as it applied in respect of the Relevant YOAs) and that to the extent that the requirements of that section are fulfilled, a capital gain may be taxed in the hands of the beneficiary of a trust rather than in the trust itself.

Given the broad meaning ascribed by the court to the words *"any amount"* in section 25B(1), it was concluded that capital gains are to be included within the ambit of section 25B(1) (as it applied in respect of the Relevant YOAs) and that to the extent that the requirements of that section were fulfilled, a capital gain may be taxed in the hands of the beneficiary of a trust rather than in the trust itself.

Taking cognisance of section 26B of the ITA (which provides that taxable capital gains – which are to be included in a taxpayer's taxable income – are to be determined in terms of the Eighth Schedule to the ITA), the court considered the taxability of the capital gains in question, having specific regard to the provisions of the Eighth Schedule.

Paragraph 80 of the Eighth Schedule deals with the attribution of a trust's capital gains to its beneficiaries. A distinction is drawn in paragraphs 80(1) and 80(2) between capital gains determined in respect of the vesting by a trust of an asset in a beneficiary, and capital gains determined in respect of the disposal of an asset by a trust, where the beneficiary has a vested interest in the capital gain but not in the asset in respect of which the capital gain was derived. Notwithstanding this distinction, in either of the aforementioned circumstances the capital gain must be disregarded for the purposes of calculating the trust's taxable income, and must be taken into account when calculating the taxable income of the trust beneficiary in whom the capital gain vests.

A vested interest in a capital gain: to be taxed in the trust or in the hands of its beneficiaries?*...continued*

The court found that the capital gains that passed from the vesting trusts to the Appellant, and subsequently from the Appellant to its beneficiaries, were capital gains that were "*determined in respect of the disposal of an asset*" and which constituted a "*capital gain but not an asset*" within the meaning of paragraph 80(2) of the Eighth Schedule.

The court considered whether the capital gains derived by the Appellant (by virtue of it being a beneficiary of the vesting trusts), and the subsequent distribution of those capital gains to the Appellant's beneficiaries, fell within the purview of either paragraph 80(1) or 80(2), as a result of which the capital gains could rightly be taxed in the hands of the Appellant's beneficiaries rather than in the hands of the Appellant.

On the facts of the case, the court surmised that the vesting trusts disposed of capital assets, as a consequence of which capital gains were derived. The Appellant received the realised proceeds of these capital gains from the vesting trusts, which were accurately described as "amounts" in the agreed facts. The Appellant then awarded these amounts to its beneficiaries, which were proceeds of, and represented, capital gains.

On this basis, the court found that the capital gains that passed from the vesting trusts to the Appellant, and subsequently from the Appellant to its beneficiaries, were capital gains that were "*determined in respect of the disposal of an asset*" and which constituted a "*capital gain but not an asset*" within the meaning of paragraph 80(2) of the Eighth Schedule.

Ultimately, the court held that the capital gains in question fell within the ambit of sections 25B(1) and 25B(2) of the ITA, and paragraph 80(2) of the Eighth Schedule (as these provisions read for the years under consideration) and therefore stood to be taxed in the hands of the Appellant's beneficiaries. On this basis, the Appellant's appeal was upheld and the additional assessments issued by SARS for the Relevant YOAs were set aside.

Comment

It is a well-established rule of statutory interpretation that newly enacted legislation does not apply retrospectively except in very limited circumstances where the legislature has unambiguously provided for it. In this case, the court adopted an approach consistent with the rules of statutory interpretation as it applied the relevant provisions of the ITA as they read during the Relevant YOAs and not as they read presently.

To this end, it is noteworthy that on 20 January 2021, an amendment to section 25B(1) was promulgated to the effect that the previously wide concept of "*any amount*" as contemplated in this subsection has now been qualified to exclude "*amount[s] of a capital nature which [are] not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule*".

The court stated that the impact of this amendment would be to trap certain capital gains and lump sums in the trust in order to ensure that they are taxed in the trust rather than in the hands of the beneficiaries of the trust. However, it should be appreciated that the attribution of the capital gains of a trust to its beneficiaries is specifically dealt with in paragraph 80 of the Eighth Schedule. As the court was not asked to interpret section 25B(1) after its amendment, its statement regarding the effect of the amendment could potentially be seen as obiter dictum. Where a similar issue arises to the one discussed in the judgment at hand after the amendment of section 25B(1), one would have to carefully consider the relevant sections and their interaction with one another, to determine whether the capital gains should be taxed in the hands of a trust (such as the Appellant) or its beneficiaries.

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