TAX & EXCHANGE CONTROL
ALERT

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INCORPORATING
KIETI LAW LLP, KENYA

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A thistle in the side of tax policy

The well-established "*look-through*" (or "*conduit-pipe*") principle relevant to trusts under South African tax law allows beneficiaries of a trust who have a vested right to an amount to be subject to tax on that amount, and not the trust itself. However, in the recent case of *Commissioner, SARS v Thistle Trust* (516/2021) [2022] ZASCA 153, the South African Revenue Service (SARS) challenged the application of this principle to tiered trust structures, specifically in the context of capital gains.

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FACTS

Thistle Trust concerned a trust (the Thistle Trust) that was itself a beneficiary of various other, property-owning trusts (so called Tier 1 Trusts). Following the disposal of assets by these Tier 1 Trusts, the trusts vested the relevant capital gains in the Thistle Trust, which in turn vested the proceeds in its beneficiaries during the same tax year.

The Thistle Trust and the Tier 1 Trusts applied the "*look-through*" principle in section 25B of the Income Tax Act 58 of 1962 (ITA) and paragraph 80 of the Eighth Schedule to the ITA. As a consequence, only the ultimate beneficiaries (of the Thistle Trust) accounted for capital gains tax on the proceeds realised from the sale of properties by the Tier 1 Trusts.

On a strict interpretation of section 25B and paragraph 80, SARS took exception to this. It was of the opinion that the Thistle Trust, as beneficiary of the Tier 1 Trusts, should account for capital gains tax on the proceeds. Therefore, SARS raised an additional assessment for the Thistle Trust, levying capital gains tax on it together with the imposition of an understatement penalty.

The Thistle Trust objected to this, and, on SARS' dismissal of its objection, appealed to the Tax Court. The Tax Court agreed with the Thistle Trust, but granted SARS leave to appeal its decision to the Supreme Court of Appeal (SCA). In a brief judgment, the SCA overturned the Tax Court's ruling on the interpretation of the ITA but ordered SARS to reverse the understatement penalty.

2022 RESULTS

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Gerhard Badenhorst was awarded an individual spotlight table ranking in **CHAMBERS GLOBAL 2022** for tax: indirect tax. **CHAMBERS GLOBAL 2009–2021** ranked him in Band 1 for tax: indirect tax.

Mark Linington ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 1: Tax: Consultants.

Ludwig Smith ranked by **CHAMBERS GLOBAL 2017 - 2022** in Band 3: Tax.

Stephan Spamer ranked by **Chambers Global 2019-2022** in Band 3: Tax.

Cliffe Dekker Hofmeyr

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THE LOOK-THROUGH PRINCIPLE

The Thistle Trust did not account for capital gains tax on the basis of the "*look-through*" (or "*conduit-pipe*") principle originating in *Armstrong v Commissioner, Inland Revenue* [1938] AD 343 and entrenched in South African law in *Secretary, Inland Revenue v Rosen* [1971] (1) SA 172 (A). In its original form, this principle allows income received by (or that accrues to) a trust which is vested in a beneficiary in the same tax year to be taxed in the hands of that beneficiary, and not the trust.

However, where proceeds from capital assets are concerned, it has always been unclear whether only paragraph 80 to the Eighth Schedule to the ITA should apply, or whether section 25B of the ITA should also apply in conjunction with paragraph 80.

Section 25B currently states that:

"(1) *Any amount (other than an amount of a capital nature which is not included in gross income …) received by or accrued to or in favour of any … trust, shall … to the extent to which the 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.*

(2) *Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant [trust deed], that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.*"

Paragraph 80 states that:

"(1) *… where a trust vests an asset in a beneficiary of that trust … who is a resident, and determines a capital gain in respect of that disposal:*

(a) *that capital gain must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and*

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(b) that capital gain or the amount that would have been determined as a capital gain must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.

(2) … where a trust determines a capital gain in respect of the disposal of an asset in a year of assessment during which a beneficiary of that trust … who is a resident has a vested right or acquires a vested right (including a right created by the exercise of a discretion) to an amount derived from that capital gain but not to the asset disposed of, an amount that is equal to so much of the amount to which the beneficiary of that trust is entitled in terms of that right:

(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 as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of that beneficiary."

SCA'S DECISION

In upholding SARS' appeal, the SCA ruled that paragraph 80(2) of the Eighth Schedule concerns proceeds from the disposal of capital assets, and that these provisions were triggered only when the Tier 1 Trusts disposed of the relevant assets. Conversely, the vesting of this capital gain by the Thistle Trust did not arise from the disposal of a capital asset by the Thistle Trust and, consequently, paragraph 80(2) of the Eighth Schedule to the ITA had no application.

Additionally, the SCA found that when these proceeds that gave rise to the capital gain were received by the Thistle Trust, they were received as a capital amount and not income. Therefore, the SCA found that the Thistle Trust could not rely on section 25B of the ITA as this section only concerns income received by a trust and vested in a beneficiary. As the proceeds from the sale of assets by the Tier 1 Trusts was not income received by the Thistle Trust, the SCA determined that it was the beneficiary that should account for capital gains tax under paragraph 80(2) of the Eighth Schedule.

In light of this, the SCA upheld SARS' appeal on the interpretation of the ITA. Despite this, the SCA found that the Thistle Trust had accounted for tax on the basis of a *bona fide* belief that section 25B of the ITA applied. Therefore, the SCA concluded that SARS was not entitled to levy an understatement penalty on the Thistle Trust, and this penalty was thus reversed.

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RAMIFICATIONS

Although not doing away with the "*look-through*" principle, the SCA's decision in *Thistle Trust* has far reaching implications for structures involving the layering of trusts. Effectively, this decision has rendered the principle inapplicable to a trust which itself is a beneficiary of another trust and has a vested right to, and receives, a capital gain from this other trust.

Regardless, it is questionable why the considerations allowing the "*look-through*" principle to apply to a single trust do not equally allow this principle to apply to layered trusts. Neither the SCA nor SARS provided any insight into this. In both instances there is only one ultimate set of beneficiaries, while there is no tax benefit (and indeed now only a tax liability following *Thistle Trust*) derived from layering one trust atop another – such a structure would be used for purely commercial reasons. *Thistle Trust* therefore appears only to penalise a taxpayer for a *bona fide* commercial arrangement.

LANCE COLLOP AND
NICHOLAS CARROLL

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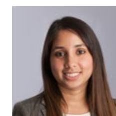

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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