TRUSTS The Conduit Principle & CSARS v Thistle Trust

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Introduction

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- The Conduit Principle and CGT
- CSARS v Thistle Trust
- Conclusion

The Conduit Principle: a recap

- Basic income tax principles relating to trusts
  - A trust = person for income tax purposes (even though it is not a person in law)
  - Income and gains that are received by or accrues to trust are subject to income tax at 45% and CGT at 36%
  - Unless income and gains are treated as having accrued to a beneficiary
- The common law Conduit Principle
  - *Armstrong v CIR* 1938 AD 343, 10 SATC 1: income received by a beneficiary retains its nature until it reaches the beneficiary in whose hands it is taxable
    - Known as the "conduit pipe principle": trust acts as a conduit pipe for transferring income to beneficiaries, but if it does not do so, it is taxed in its own right on such income
  - Confirmed by the Appellate Division in *Estate Dempers v SIR*, in *SIR v Sidley* and *SIR v Rosen*
  - Exception to the conduit principle: section 10(2) – no exemptions in 10(1) (including dividend exemption) applies in respect of any portion of an annuity
    - Dividend exemption not available to a trust beneficiary if the dividends pay out by way of an annuity

The Conduit Principle: a recap

- Section 25B
    - Contains special rules applicable to the taxation of the income of trusts and their beneficiaries
    - Encapsulates the common law conduit principle to a large degree
    - *“(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.”*

The Conduit Principle and CGT

- Par 80 of the Eighth Schedule
  - Contains the statutory conduit rule for capital gains
  - Only applies to distributions by resident trusts to resident beneficiaries
  - *"(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

    (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 purposed 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."

CSARS v Thistle Trust

- First case in which it was considered whether capital gains can be "conduited" through more than one trust
- Facts
  - Thistle Trust is a beneficiary of various trusts (the "Tier 1 Trusts") comprising the Zenprop Group
  - Tier 1 Trusts disposed of certain capital assets during 2014, 2015, 2016 tax years
  - Gains distributed to Thistle Trust in the same tax periods
  - Thistle Trust distributed the amounts received to its beneficiaries, also in the same tax periods
  - Treated the amounts as taxable in the hands of its beneficiaries
  - SARS raised additional assessment taxing the amounts in the Thistle Trust and imposing an understatement penalty and interest
- Tax Court
  - Found that gains constituted "amounts" that fell within the parameters of sections 25B(1) and 25B(2) and par 80(2) of the Eighth Schedule and that gains were taxable in hands of the Thistle Trust's beneficiaries

CSARS v Thistle Trust

- SCA
  - Thistle Trust argued that par 80(2) must be read together with section 25B and that the gains constituted an "amount" for the purposes of section 25B which can be distributed and taxed in the hands of the Thistle Trust's beneficiaries
  - SARS argued that par 80(2) applied exclusively to the Thistle Trust and not to the subsequent distribution to the beneficiaries of the Thistle Trust. The latter distribution should be seen as a distribution of monies which are not categorized as an asset for the purposes of the Eighth Schedule.
  - The Court agreed with SARS and ruled that par 80(2) concerns proceeds from the disposal of a capital asset and that these provisions were triggered only when the Tier 1 Trusts disposed of the assets. The vesting of the capital gain by the Thistle Trust did not arise from the disposal of a capital asset by that Trust and therefore, the paragraph had no application.
  - The Court also held that the distribution received by the Thistle Trust were received as a capital amount and not income – therefore cannot rely on section 25B as this section only concerns income received by a trust and vested in a beneficiary.
  - Understatement penalty and interest reversed – Thistle Trust acted on *bona fide* belief that section 25B applied

Conclusion

- Decision has far-reaching implications for structures with layered trusts
- The Conduit Principle is not dead, but inapplicable to capital gains distributed through multiple trusts
- SCA did not provide any insights as to why par 80 cannot apply to gains distributed through multiple trusts
- These types of structures are not usually put in place to achieve a tax benefit – purely for commercial reasons
- The result is an apparent penalization for a *bona fide* commercial arrangement

Questions