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Vesting of Capital Gains through Multiple Trusts

5 May 2021 *13 min read*

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The recent tax court decision IT 24918 (delivered on 18 March 2021) is the first case in which it was considered whether capital gains can be "conduited" through more than one trust in accordance with the provisions of the Income Tax Act, No 58 of 1962 ("**Act**").

Even though this case does not have any binding effect on other courts, it raises some interesting points, especially insofar as the vesting of capital gains by trusts in non-resident beneficiaries are concerned.

Before considering the case, a general overview of the taxation of trusts is necessary. References to sections in this article are to sections of the Act and references to paragraphs of the Eighth Schedule to the Act, containing South Africa's Capital Gains Tax ("**CGT**") legislation.

Taxation of trusts and their beneficiaries

The taxation of trusts and their beneficiaries is governed by section 25B (for receipts and accruals of an income nature) and paragraph 80 (for capital gains).

A trust is deemed to be a separate "person" for income tax purposes, even though it is not a person in law. As a general principle income and capital gains that are received by or that accrue to a trust are subject to income tax (at 45%) and CGT (at 36%) in its hands, unless such income and capital gains are treated as having accrued to a beneficiary in terms of section 25B (for receipts and accruals of an income nature) and paragraph 80 (for capital gains), in which case, such income and capital gains will be subject to income tax and CGT in the beneficiary's hands at the tax rates applicable to such beneficiary.

In *Armstrong v CIR*[1] ("*Armstrong* case") it was held that the income of a trust retains its identity until it reaches the beneficiary in whose hands it is taxable. Therefore, in terms of our common law, if a trust receives dividends that are vested in or distributed to a beneficiary, then the beneficiary will be treated as having received dividends for purposes of applying the applicable income tax exemption. On the same basis, if a trust vests interest, rentals, royalties or capital gains in a beneficiary, then the beneficiary will also be treated as having received interest, rentals, royalties or capital gains as the case may be. This is known as the conduit pipe principle, i.e. the trust acts as a conduit pipe for transferring the income to the beneficiaries, but if it does not do so, it is taxed in its own right on such income.

The conduit principle, as formulated in the *Armstrong* case, was cited with approval in a number of subsequent cases. In *SIR v Rosen*, Trollip JA stated the following in this regard:[2]

> *"Consequently Armstrong's case in my view* ***authoritatively established the conduit principle for general application in our system of taxation in appropriate circumstances*** *... The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends." (Emphasis added)*

Section 25B, which appears in the Act and not in the Eighth Schedule, to a large degree encapsulates the common law conduit principle. Prior to its amendment in January 2021, it stated the following:

> *"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.*
>
> *(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 deed of trust, agreement or will of a deceased person, that amount shall for the purposes of* ***that*** *subsection be deemed to have been derived for the benefit of* ***that*** *beneficiary." (Emphasis added)*

Paragraph 80, which appears in the Eighth Schedule, stated the following during the 2014 to 2016 years of assessment insofar as it is currently relevant:

> *"(1) ... where a capital gain is* ***determined*** *in respect of the vesting by a trust of an* ***asset*** *in a trust beneficiary ...* ***who is a resident****, that gain-*
>
> *(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 to whom that asset was so disposed of****.*
>
> *(2) .... 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 ...* ***who is a resident*** *has a vested interest* ***or acquires a vested interest (including an interest created 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****." (Emphasis added)*

The net effect of section 25B and paragraph 80 is that if a beneficiary of a trust has or obtains a vested right to the income and/or capital gain of a trust during the same year of assessment as that in which such income and/or capital gain is received by or accrues to the trust, then the beneficiary and not the trust will be subject to income tax on the income or CGT on the capital gain at the tax rates applicable to such beneficiary. If no such vested right is obtained by a beneficiary during the same year of assessment as that in which the income and/or capital gain accrues to the trust then the trust will be subject to income tax on the income or CGT on the capital gain at the tax rates applicable to the trust. The trust, if a resident, will then in a subsequent year of assessment be able to award the taxed income and/or capital gain to a beneficiary on a tax-free basis.

Paragraph 80 only allows a trust to disregard a capital gain on the disposal of a trust asset to a resident beneficiary (subparagraph 80(1)) or on the vesting of the realised proceeds of a capital gain in a resident beneficiary (paragraph 80(2)). The ostensible purpose of this limitation is to protect South Africa's tax base as it would otherwise be possible for a capital gain to escape taxation if it is vested in a non-resident beneficiary (on the basis that non-residents are only subject to CGT on South Africa on interests in South African immovable property and assets attributable to South African permanent establishments). That said, the fact that these provisions mention only resident beneficiaries cannot automatically mean that if a distribution is made to a non-resident, the trust is taxable. But that is how SARS interprets the provision. Section 25B does not contain such a limitation and it is, therefore, possible for amounts of an income nature to flow through to non-residents for tax purposes. This point is revisited later on.

Conduiting income and capital gains through multiple trusts

It is a well-established principle that amounts of an income nature such as dividends, interest, rentals and royalties can be conduited through multiple trusts to a final beneficiary in terms of section 25B, provided that the vesting by the various trusts take place during the same year of assessment. Consider the following example.

> *Trust 1 and Trust 2 are both fully discretionary and irrevocable resident trusts for the benefit of the same class of natural person beneficiaries. Trust 1 receives portfolio dividends during the year of assessment which it vests in Trust 2 during the same year of assessment. Trust 2 proceeds to vest the dividends during the same year of assessment in its natural person beneficiaries. In this example, section 25B will require the natural person beneficiaries to account for the dividends for tax purposes and not Trust 1 or Trust 2.*

Subparagraphs 80(1) and (2) refer to a trust "determining" a capital gain, which must then be "disregarded" by such trust and "taken into account" by the beneficiary in whom the asset (subparagraph 80(1)) or capital gain (subparagraph 80(2)) is vested. It is generally accepted that the capital gain is "determined" by the trust which actually disposes of the asset (by deducting the base cost of an asset from the actual or deemed proceeds derived from the disposal) and not by the beneficiary in whom the asset or capital gain is vested. Such beneficiary, therefore, only "takes into account" the capital gain "determined" by the trust. It is not, therefore, possible, according to SARS, for a capital gain to be "conduited" through multiple trusts as it is only the first trust in the chain which "determines" the capital gain. Consider the following example.

> *Trust 1 and Trust 2 are both fully discretionary and irrevocable resident trusts for the benefit of the same class of natural person beneficiaries. Trust 1 derives capital gains from the disposal of shares and vests the proceeds in Trust 2 during the same year of assessment as that in which the disposal takes place. Trust 2 proceeds to vest the capital gains during the same year of assessment in its natural person beneficiaries. In this example, Trust 1 will "determine" the capital gains which will be disregarded in its hands. The capital gains must, according to SARS, then be "taken into account" by Trust 2 under subparagraph 80(2). As Trust 2 did not "determine" a capital gains from this transaction, it will not, according to SARS, be able to transfer the tax implications resulting from the capital gains to its beneficiaries. In this case, Trust 2 will be required to pay the CGT, notwithstanding the fact that it vested the proceeds in its natural person beneficiaries during the same year of assessment.*

Issue in dispute in IT 24918

In this case a resident trust ("**ABC Trust**") was a vested beneficiary of various other resident trusts which vested capital gains in it over the 2014 to 2016 years of assessment. The ABC Trust, in turn, vested the said capital gains in its own resident beneficiaries during each of the relevant years of assessment. In calculating their tax liability for the relevant years of assessment, the beneficiaries of ABC Trust accounted for the capital gains and the ABC Trust disregarded the capital gains.

The issue in dispute was whether the capital gains should have been taken into account by the ABC Trust or by its own beneficiaries. In other words, whether it was possible for the capital gains to be conduited through the ABC Trust to its beneficiaries for tax purposes. This *inter alia* turned on whether section 25B could apply to the capital gains as paragraph 80(2) does not (according to SARS) allow for capital gains to pass through more than one trust, as explained above.

In dealing with this issue Wright J held that the reference to "*any amount*" in section 25B should be interpreted widely so as to include the realised proceeds of capital gains, irrespective of the fact that the vesting of capital gains in trust beneficiaries is specifically dealt with in paragraph 80(2). He further relied on the remarks of Trollip JA in the *Rosen* case that the *Armstrong* case "... *authoritatively established the conduit principle for general application in our system of taxation in appropriate circumstances*". He, accordingly, held that the capital gains were rightly conduited through to the beneficiaries of the ABC Trust as a result of the application of section 25B (as opposed to paragraph 80(2)) and that such beneficiaries, as opposed to the ABC Trust, were required to include the capital gains in their aggregate capital gain or loss calculations.

Subsequent amendment to section 25B

The Taxation Laws Amendment Act, No 23 of 2020 ("**TLAA**") amended section 25B(1) with effect from 20 January 2021 by specifically excluding from its application "*an amount of a capital nature which is not included in gross income* ...". The purpose of the amendment is said to "clarify"

that section 25B does not apply to the proceeds derived from the disposal of capital assets and that such proceeds should rather be dealt with in terms of paragraph 80. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020 states the following in this regard (at 58):

> *"Furthermore, some commentators have contended that section 25B(1) also applies to amounts of a capital nature (for example, proceeds on disposal of a capital asset).* ***There is no substance in this contention because the Eighth Schedule contains specific provisions dealing with such amounts, but for the purposes of clarity it is proposed to exclude amounts of a capital nature that are not deemed to be included in gross income from the ambit of section 25B(1)****." (Emphasis added)*

It is clear that from 20 January 2021, one would not be able to contend that section 25B allows for the realised proceeds of capital gains to be conduited through to beneficiaries as the section now specifically excludes such proceeds from falling within its ambit. However, up to the effective date of this amendment, one could choose to rely on this argument, both in cases having similar facts and potentially also in cases where capital gains were vested in non-resident beneficiaries as paragraph 80 only allows for capital gains to flow through to resident beneficiaries. One would, however, expect that SARS would challenge such a tax position as it did in IT 24918.

It should be noted that the taxpayer relied on other arguments as well in support of its appeal, but this is the aspect that the court mainly relied upon in arriving at its decision.

Conclusion

Even though the judgement handed down in IT 24918 does create binding precedent, it does have persuasive authority. The principles emanating from this case should apply equally to capital gains that are vested by resident trusts in non-resident beneficiaries prior to the effective date of the 2020 amendment to section 25B(1). It is, accordingly, important that the said principles be taken into account where trusts and trust beneficiaries are currently under audit where the tax position was adopted that a capital gain can pass through more than one trust to the beneficiary or where a capital gain was vested in a non-resident and the tax position was adopted that the non-resident should account for the resulting CGT, if any. As SARS has noted an appeal to the judgement handed down by the Tax Court, this matter will in due course be settled by the Supreme Court of Appeal.

[1] 1938 AD 343, 10 SATC 1.

[2] [1971] 1 All SA 180 at 189.



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