



Tax Cases and Interpretation webinar

Tax Practice on the Move Series

YOUR KEY TO THE TAX COMMUNITY

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Keitumetse Sesana holds a Bcom (LLB) and a LLM specialising in Tax Law.

She specialises in international corporate tax and related matters. She presently manages stakeholder relations by driving and facilitating meaningful engagement with Government departments regarding tax policy legislative design on the varying areas of taxation.

Duncan McAllister



Duncan is a Chartered Accountant and specialises in income tax with particular expertise in capital gains tax and corporate tax. He has 39 years' experience in the tax field.

From July 2000 he worked for head office on: drafting CGT legislation, presenting seminars on CGT throughout the country, writing numerous guides and interpretation notes and reviewing most of the guides and interpretation notes produced by the Corporate Income Tax Section, participating as an external committee member of the Advance Tax Rulings Section, providing input on selected objection and appeal matters, member of the GAAR committee, and drafting income tax and CGT legislation and reviewing draft tax legislation.

Unpacking the Thistle Trust Decision: A Key Ruling from the Constitutional Court

Applicability of the conduit principle to capital gains distributed by trusts.

This case in a nutshell

Parties:

- The Thistle Trust (**Applicant**) vs. Commissioner for the South African Revenue Service (**Respondent**)

Facts:

- The Thistle Trust (Thistle) is a beneficiary of 10 vesting trusts known as the Zenprop Group (Zenprop).
- During the 2014 to 2016 tax years, Zenprop disposed of assets and realized capital gains, which were distributed to Thistle.
- Thistle then distributed these gains to its beneficiaries.
- Thistle did not account for these capital gains in its tax returns, based on legal advice that the gains were taxable in the hands of the ultimate beneficiaries, not Thistle.
- SARS conducted a tax audit and held Thistle liable for the capital gains tax, arguing that the gains **did not** pass further from Thistle to its beneficiaries.
- SARS raised additional assessments and imposed understatement penalties on Thistle.

This case in a nutshell

Key provisions

- Income Tax Act: Sections 25B and 26A
- Tax Administration Act: Section 222(1)
- Eighth Schedule to the Income Tax Act: Paragraph 80(2)

Let's start at the very beginning

Litigation history

- **Tax Court:**

- Thistle's attorneys argued that, according to section 25B and paragraph 80(2) of the Act, the capital gains should be taxed in the hands of the **beneficiaries**, not Thistle.
- Understatement Penalties: Thistle contended that any failure to account for these gains was a **bona fide inadvertent error** under section 222(1) of the Tax Administration Act (TAA).

Outcome: Held that the capital gains were not taxable in Thistle's hands but in the hands of the beneficiaries, applying the conduit principle.

Let's start at the very beginning (cont.)

Litigation history

- **Supreme Court of Appeal:**
 1. Application of the Conduit Principle
 2. Interpretation of Section 25B
 3. Role of Paragraph 80(2)
 4. Tax Liability of Thistle
 5. Understatement Penalties

Outcome: Reversed the Tax Court's decision, holding Thistle liable for the capital gains tax but dismissed the understatement penalties.

Constitutional Court

1. Jurisdiction and Leave to Appeal:

- The court found that the application raised arguable points of law of general public importance, particularly concerning the interpretation of section 25B and paragraph 80(2) and the application of the common law conduit principle.
- The issues were deemed significant enough to affect the capital gains tax liability of trusts in tiered trust structures for tax years up to 2021.

2. Origins and Application of the Conduit Principle:

- The conduit principle, adopted from English common law, treats a trust as a conduit for transferring taxable amounts to beneficiaries without changing the nature of those amounts.
- The principle ensures that income is taxed in the hands of the true beneficial owner and protects legislative choices regarding the tax treatment of specific income categories.

Constitutional Court

3. Interpretation of Section 25B and Paragraph 80(2):

- The court emphasised that section 25B, introduced in 1991, was not intended to apply to capital gains, as capital gains tax did not exist in South Africa at that time.
- Section 26A and the Eighth Schedule, particularly paragraph 80(2), were identified as the relevant provisions governing the taxation of capital gains realized by trusts.

4. Role of Paragraph 80(2):

- Paragraph 80(2) was interpreted to apply the conduit principle only to the first beneficiary trust in a multi-tiered trust structure.
- The court found that the capital gains realized by Zenprop and distributed to Thistle were taxable in the hands of Thistle, not the ultimate beneficiaries, as Thistle had not disposed of any capital asset or determined any capital gain.

5. Purpose of the 2008 Amendment:

- The 2008 Amendment to paragraph 80(2) clarified that the conduit principle should not operate beyond the first beneficiary trust in a multi-tiered trust structure. was to ensure that a second-level trust in a tiered trust structure could not avoid liability for capital gains tax on the proceeds of a capital gain it received from its vesting trust, by distributing the relevant amount to its beneficiaries.

Constitutional Court

6. Understatement Penalties:

- The court dismissed SARS' claim for understatement penalties, stating that SARS had conceded that the understatement by Thistle was a bona fide inadvertent error.
- According to section 222 of the TAA, this precluded the imposition of any understatement penalties.

Outcome: The Constitutional Court upheld the Supreme Court of Appeal's decision, confirming that Thistle was liable for the capital gains tax, as the gains did not pass further from Thistle to its beneficiaries under the conduit principle.

Expert Insights

Highlights and insights from the recently released draft interpretation note on the meaning of “similar finance charges”

Draft interpretation note: Meaning of “Similar Finance Charges”

Purpose

- The document aims to clarify the meaning of “similar finance charges” under paragraph (a) of the definition of “interest” in section 24J(1) of the Income Tax Act 58 of 1962.
- It examines whether various finance charges payable under a financial arrangement fall within this definition, from both the borrower’s and lender’s perspectives.

Background

- Taxpayers often engage in financial arrangements involving loans or debt funding.
- These arrangements typically include interest and various finance charges such as:
 - Loan application fees
 - Service fees
 - Administration fees
 - Structure fees
 - Raising fees (also known as front-end fees)

Draft interpretation note: Meaning of “Similar Finance Charges”

Key provisions

- **Section 24J(1):** This section of the Act defines “interest” to include the gross amount of any interest or similar finance charges, discount, or premium payable or receivable in terms of or in respect of a financial arrangement.
- **Section 24J(2):** This section of the Act deems interest amounts to be incurred and deductible from the taxpayer’s income if certain conditions are met. It regulates the timing of the incurral and accrual of interest over the term of specified instruments on a yield-to-maturity basis.

Draft interpretation note: Meaning of “Similar Finance Charges”

Example:

- **Raising fees (Front end costs)**

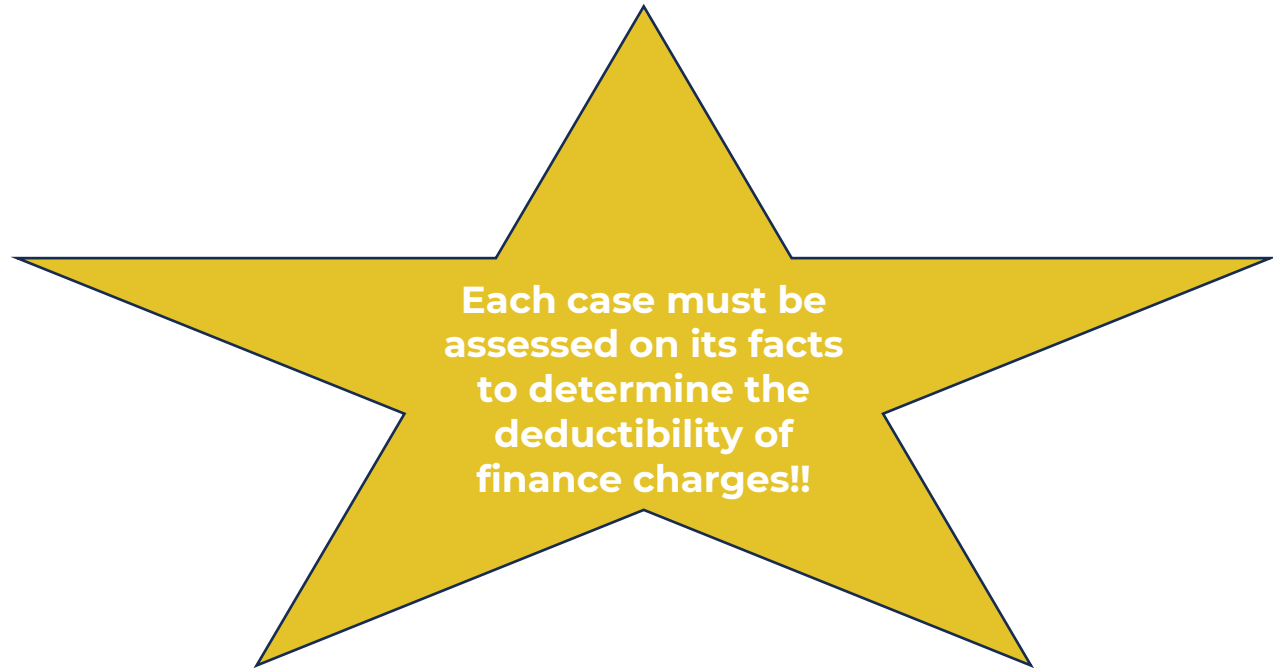
- Generally, a fee payable to the lender or arranger of a loan for work done in providing or arranging the loan. It is typically related to the acquisition of capital and not for the use of money.

- **Treatment**

- **Distinction from Interest:** Raising fees are a cost of raising capital, while interest is a payment for the use of capital. Raising fees are usually a one-time payment, whereas interest is a recurring payment calculated by reference to time.
- **Deductibility:** Raising fees do not qualify as “similar finance charges” and are not deductible under section 24J(2). They are often considered capital in nature and not deductible under section 11(a).

Key take away

- The term “similar finance charges” should be **interpreted narrowly** to include **only those charges that are of the same nature or character as interest.**



Expert Insights

Top legislative interpretation queries in 2024

Top legislative interpretation queries that were submitted through the SAIT Tax Helpline in 2024

1. Should a person make a further late second provisional tax payment?
2. Can interest on bond be claimed as part of a home office?
3. Is interest payable to a non-resident taxable in SA?
4. When a beneficial owner of a trust acts in multiple capacities, must details of each capacity be captured separately on the trust return?
5. Are interest-free loans between trusts subject to section 7C?
6. Is a loan by a trust to a beneficiary subject to section 7C?
7. If interest is credited to a trust's loan account, will it be subject to section 7C?
8. Does the exemption from section 7C apply to the land on which a primary residence is situated?
9. Can a ring-fenced rental loss under section 20A be set off against the taxable capital gain on sale of the property if the taxpayer has other rental properties?

Conclusion

Key take aways for tax practitioners



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