



CONSTITUTIONAL COURT OF SOUTH AFRICA

The Thistle Trust v Commissioner for the South African Revenue Service

CCT 337/22

Date of hearing: 8 February 2024

Date of judgment: 2 October 2024

MEDIA SUMMARY

On 2 October 2024, the Constitutional Court handed down judgment in an application for leave to appeal and a conditional application for leave to cross-appeal against a judgment of the Supreme Court of Appeal. The application concerned the applicability of the “conduit principle” to capital gains when distributed by multiple trusts in the same tax year in terms of the common law, section 25B and paragraph 80 of the Eighth Schedule of the Income Tax Act 28 of 1962. The conditional cross-appeal concerned whether the circumstances giving rise to the tax treatment by the Thistle Trust warranted the imposition of an understatement penalty.

During the relevant period, the Thistle Trust (applicant in the main appeal and respondent in the cross-appeal), an *inter vivos* discretionary trust, was a beneficiary of ten vesting trusts. During the 2014, 2015 and 2016 tax years, the vesting trusts realised capital gains after disposing of capital assets and distributed the proceeds to the Thistle Trust, which then distributed these proceeds to its beneficiaries within the same tax years. It did not declare the capital gains in its income tax returns; instead its beneficiaries declared the capital gains and paid capital gains tax on these gains.

The Commissioner for the South African Revenue Service (respondent in the main appeal and applicant in the cross-appeal) raised an assessment against the Thistle Trust for those years for capital gains that the Commissioner contended had accrued to the Thistle Trust. The Commissioner also imposed a 50% understatement penalty and required the Thistle Trust to pay interest on the outstanding tax liability. The Thistle Trust filed an objection to this assessment on the basis that the Thistle Trust was merely a conduit for the movement of gains to its beneficiaries which, in terms of the common law and the Income Tax Act at the time, were taxable in the hands of only the beneficiaries. The Commissioner disallowed the objection.

The Thistle Trust challenged the Commissioner's disallowance in the Tax Court. The Tax Court found in favour of the Thistle Trust, concluding that the conduit principle applicable to dividends was equally applicable to the capital gains at issue. Accordingly, the Thistle Trust was not liable for tax on the capital gains in question and these capital gains were taxable only in the hands of the beneficiaries. The need to deal with the dispute over understatement penalties and interest fell away.

The Commissioner appealed to the Supreme Court of Appeal against the Tax Court's judgment. The Supreme Court of Appeal set aside the order of the Tax Court in so far as it applied to the issue of the tax liability and held that the conduit principle did not apply beyond the Thistle Trust which was accordingly liable for tax on the capital gains. However, it upheld the objection of the Thistle Trust on the issue of the imposition of an understatement penalty. No costs were ordered.

The Thistle Trust then applied for leave to appeal in this Court on the issue of its tax liability. The Commissioner conditionally applied for leave to cross-appeal on the issue of the understatement penalty.

On its tax liability, the Thistle Trust contended that it was not liable to pay capital gains tax on amounts received from the vesting trusts and distributed to its beneficiaries. It relied on the common law conduit principle to argue that if a trust receives an amount which it distributes to its beneficiaries within the same tax year, the amount is regarded as having accrued directly to the beneficiaries and not the trust, locating tax liability in the person who ultimately receives and benefits from the amount concerned. The Thistle Trust further relied on section 25B of the Income Tax Act, arguing that the provision should be interpreted to apply to capital gains, and on paragraph 80(2) of the Eighth Schedule to the Income Tax Act which applies the conduit principle specifically to capital gains. It argued that a proper interpretation of paragraph 80(2) provides for the application of the conduit principle to stream tax liability for capital gains through multiple tiered trust structures to the ultimate beneficiaries of those capital gains.

The Commissioner contended that the common law conduit principle was relevant only to the extent that it reflected in the applicable provisions of the Income Tax Act. The Commissioner argued that section 25B did not apply to capital gains distributed through trust structures because these are addressed specifically in paragraph 80 of the Eighth Schedule. It contended that paragraph 80 of the Eighth Schedule did not allow trusts that received capital gains as beneficiaries of vesting trusts to avoid tax liability for such capital gains by distributing the gains on to their own beneficiaries.

On the issue of the imposition of understatement penalties, the Commissioner contended that the Thistle Trust did not have reasonable grounds for its tax position, nor was its filing an inadvertent error or an innocent misstatement as the Supreme Court of Appeal found. The Thistle Trust contended that it was not liable for penalties because of its alleged understatement because it resulted from a *bona fide* inadvertent error, having relied in good

faith on the opinion of a senior counsel. It reasoned that the deliberate nature of its tax position was irrelevant.

First judgment

The first judgment, which holds the majority, was written by Chaskalson AJ (Majiedt J, Mathopo J, Mhlantla J, Theron J and Tshiqi J concurring). It held that the main application engaged this Court's general jurisdiction as it raised an arguable point of law of general public importance. It stated the point of law as the proper interpretation of section 25B and paragraph 80(2) and the application of the common law conduit principle. This point of law is of general public importance because it would affect the capital gains tax liability of trusts in tiered trust structures in respect of all tax years up to 2021, and would have implications for other trusts and their beneficiaries in cases that are affected by the application of the conduit principle. The two competing decisions of the lower courts made it clear that the interests of justice required leave to appeal to be granted.

On the merits, the first judgment held that the common law conduit principle was introduced into South African law to deal with issues of the taxation of trusts when taxation statutes did not address these issues directly. Since the Income Tax Act (as it applied at the time) was amended to address the taxation of trusts specifically, it is necessary to give effect to the direct legislative intention expressed in the statute. In matters relating to the taxation of trusts, the common law conduit principle may inform the Income Tax Act's interpretation but statutory interpretation remains the primary exercise.

The first judgment held that the wording of paragraph 80(2) indicates that the conduit principle applied only to the first beneficiary trust in a multi-tiered trust structure. Paragraph 80(2) cannot be reasonably interpreted to allow the conduit principle to run through a multi-tiered trust structure to attribute liability for capital gains tax in respect of the disposal of an asset to a beneficiary beyond the first beneficiary of the trust that realised the capital gain by disposing of that asset. The legislative history of paragraph 80(2) and the Explanatory Memorandum to the Revenue Laws Amendment Bill of 2008 both confirm that paragraph 80(2) was amended for the purpose of preventing the conduit principle operating through multiple discretionary trusts in a tiered trust structure. Paragraph 80(2) must be interpreted accordingly. The first judgment held that paragraph 80(2) does not apply because the Thistle Trust did not realise a capital gain by disposing of an asset.

In relation to the argument of the Thistle Trust that the conduit principle reflected "robust common sense", the first judgment held that "robust common sense" would militate against the application of the conduit principle to the capital gains distributed by a trust, because the legislature had chosen to tax the capital gains of a trust at twice the rate of those of an individual. Application of the conduit principle to treat capital gains as taxable in the hands of a natural person, not a trust, would appear to subvert the legislative intention of taxing capital gains realised by trusts at the higher rate. The main appeal was therefore dismissed.

In respect of the cross-appeal, the first judgement held that this Court's general jurisdiction was engaged. It held the issue to be an arguable point of law because the phrase "*bona fide* inadvertent error" in section 222 of the Tax Administration Act 28 of 2011 is open to

different plausible interpretations. It is of obvious public importance, because it would determine how courts would approach the imposition of understatement penalties in future tax cases and it would affect SARS' attitude to individual taxpayers who understate their income.

Notwithstanding the public importance of determining the proper interpretation of section 222, the first judgment held that it was not in the interests of justice to grant leave to appeal for two reasons. First, the Tax Court and the Supreme Court of Appeal did not address the issue which would make this Court effectively the court of first and last instance. It is undesirable for this Court to decide a matter without the reasoning of the lower courts.

Second, SARS had no sustainable case for penalties. SARS pinned its case to the categories of "no reasonable grounds for 'tax position' taken", in terms of item (iii) of the table in section 223(1) of the TAA, and "reasonable care not taken in completing return", in terms of item (ii) of the table in section 223(1) of the TAA. It bore the onus of proving that the Thistle Trust fell within either of these categories, which it had no reasonable prospects of discharging. The tax position taken by the Thistle Trust was one taken on legal advice – perhaps incorrect advice, but it could not be said to be a tax position which the Thistle Trust had no reasonable grounds to take. SARS argued that if the Thistle Trust had taken reasonable care in completing its return, it would have ignored the advice given to it and followed the stated SARS position. This would elevate SARS to the status of an authority that could decree the only reasonable interpretations of tax legislation. The first judgment held that this argument was untenable.

The first judgment held that SARS' understatement penalties claim would fail on factual grounds irrespective of this Court's determination of the meaning of "*bona fide* inadvertent error". Leave to appeal was therefore refused in the conditional counter-application.

On costs, the first judgment held that the Thistle Trust advanced an argument of substance in respect of a constitutional argument, that although failed, was not frivolous. *Biowatch* applied in favour of the Thistle Trust and it should not be ordered to pay the costs of the appeal. However, it held that *Biowatch* did not apply in favour of SARS as an organ of state and SARS must accordingly pay the costs of the cross-appeal.

Second judgment

Bilchitz AJ penned the second, dissenting judgment (Madlanga J concurring). The second judgment disagreed with the interpretation of paragraph 80(2) of the Eighth Schedule of the ITA adopted by the majority. It found that there are significant ambiguities in the language of paragraph 80(2) of the ITA, which is evidenced by the differences in opinion between tax experts and amongst academics regarding the meaning of the paragraph. According to the second judgment, a reasonably possible alternative interpretation of paragraph 80(2), is that the provision gives full effect to the conduit principle such that capital gains are taxed in the hands of the ultimate beneficiaries in a multi-tier trust structure. The second judgment found that this interpretation was to be preferred in that it

did not arbitrarily block the application of the conduit principle at the second-tier trust or distinguish between capital gains and other taxable amounts without any reason.

The second judgment found that, according to the dictates of statutory interpretation in the constitutional era, legislation must be interpreted with reference to the text, context and purpose but also so as to preserve its constitutionality where reasonably possible. The latter requirement requires legislation to be interpreted in line with the constitutional principles this Court has developed in relation to the rule of law. These include the requirement that legislative provisions should be interpreted, where reasonably possible to do so, to avoid rendering them arbitrary, or irrational – and, in a manner that discloses a legitimate purpose and that conforms with common sense. Fiscal legislation should also be interpreted in accordance with the *contra fiscum* rule – that is, where fiscal legislation is ambiguous, it must be interpreted in favour of the taxpayer.

The second judgment found that its interpretation of the impugned provision accorded with the purpose of the provision, which was to apply the conduit principle to capital gains. It found that its interpretation also accords with the context of the provision. The second judgment held that the Legislature sought to embody the conduit principle in section 25B of the ITA, which principle applies to all levels of a multi-tier trust in relation to other forms of monetary accruals. The second judgment found that paragraph 80(2) and section 25B should not be interpreted to enshrine different approaches to the conduit principle in the same statute, particularly where there was no attempt by SARS to explain why this should be the case. Without any purpose or rationale for the interpretation of the provision contended for by SARS, its interpretation of paragraph 80(2) renders the provision irrational and arbitrary. In light of the interpretive principles enunciated, the second judgment would thus have found in favour of Thistle Trust and upheld the appeal.