



September 2023

Proposed amendment to the taxation of non-resident beneficiaries of Trusts

Currently, the general principle^[1] governing the taxation of trusts, which are tax resident in South Africa, is that where **any** beneficiary of a trust has or acquires a vested right to an amount that has been received by or accrued to the trust, that amount is deemed for normal (income) tax purposes to have accrued directly to that beneficiary.^[2] Thus, the amount is liable to normal (income) tax in the hands of the beneficiary and not in the hands of the trust.

Further, the amount so deemed to have accrued to the beneficiary retains its nature/identity (this is colloquially referred to as the "conduit principle"), provided that the amount vested in the beneficiary in the same year of assessment^[3], as the year in which the amount accrued to or was initially received by the trust.

The application of the conduit principle may, depending on the circumstances, result in the amount being taxed at a lower rate of (or even being completely exempted from) normal (income) tax in the hands of the beneficiary, when compared with the position had the amount been subject to tax in the hands of the trust. For example, should the amount vested in the beneficiary be out of foreign dividends received by the trust, the beneficiary of the trust is treated as if the beneficiary received foreign dividends directly. In this example, since non-residents are only liable to normal (income) tax on amounts accrued or received from a South African source, the amount so vested will not be subject to normal (income) tax in South Africa at all, should the beneficiary be a non-resident (as is often the case where the beneficiaries are the adult children of the founder that have emigrated from South Africa). However, should the same amount have been taxed in the hands of the trust, absent the application of a specific exemption, the receipt of the foreign dividends would only be partly exempted.^[4]

In this regard, the South African Revenue Service (**SARS**) has opined that the flow through of amounts in South African trusts to non-resident beneficiaries places it in a difficult position to collect tax on these amounts, since:

- as in the example above, non-residents are not liable to normal (income) tax on amounts that are not regarded as being from a foreign source;
- tax recovery actions against non-residents are difficult to enforce; and
- in the case of beneficiaries that are non-resident trusts, SARS is unlikely to have information on the persons in whom the foreign trusts, in turn, vest the income.

In response to the above, the Draft 2023 Taxation Laws Amendment Bill^[5] proposes that the application of the conduit principle be limited only to resident beneficiaries.

As further justification for the proposed amendment, National Treasury asserts that the proposed amendment will better align the normal (income) tax provisions, with the capital gains tax (**CGT**) provisions, which, do distinguish the CGT treatment of amounts, which were derived from capital gains determined by a resident trust and vested in resident beneficiaries and such amounts vested in non-resident beneficiaries.

As explained above, the proposed amendment may result in amounts being taxed in the trust at a higher rate, than the rate that would have applied, had the amount been taxed in the hands of the non-resident beneficiary, as is currently the case. In addition, the proposed amendment may lead to (economic) double taxation, as the same amount may now be subject to normal (income) tax in South Africa in the hands of the trust and the non-resident beneficiary may also be subject to tax on the same amount in the beneficiary's home country. However, the non-resident beneficiary will no longer be able to claim treaty relief in respect of the South African tax suffered by the trust, as it is no longer the same taxpayer who is subject to tax in South Africa and abroad.

The conduit principle, which was first articulated in South African common law, before being codified in the Income Tax Act, is long entrenched in South African domestic law and the proposed limitation thereof, albeit only in relation to non-resident beneficiaries, represents a paradigm shift from the existing position.

The proposed amendment is still in draft form and may change in response to the public comments received. The revised 2023 Taxation Laws Amendment Bill which would contain any changes in this regard is expected to be released in early November 2023.

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¹¹ Section 25B of the Income Tax Act, No 58 of 1962 (the **ITA**)

² For the sake of completeness, we note that the ITA does, in addition, contain anti-avoidance provisions (colloquially referred to as "**attribution rules**") aimed at discouraging taxpayers from moving income (and the concomitant tax liability on such income) away from themselves by, for example, donating assets to a trust or selling them to a trust on an interest-free or soft loan basis. In such instance, should these attribution rules apply, the income generated on assets donated to the trust is deemed to accrue to the donor. These attribution rules override any other provisions governing the taxation of trust income.

³ The year of assessment referred to here, is the year of assessment of the trust, as opposed to the year of assessment of the beneficiary.

⁴ Section 10B of the ITA.

⁵ Published by National Treasury on 31 July 2023.

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