Synopsis

Tax today

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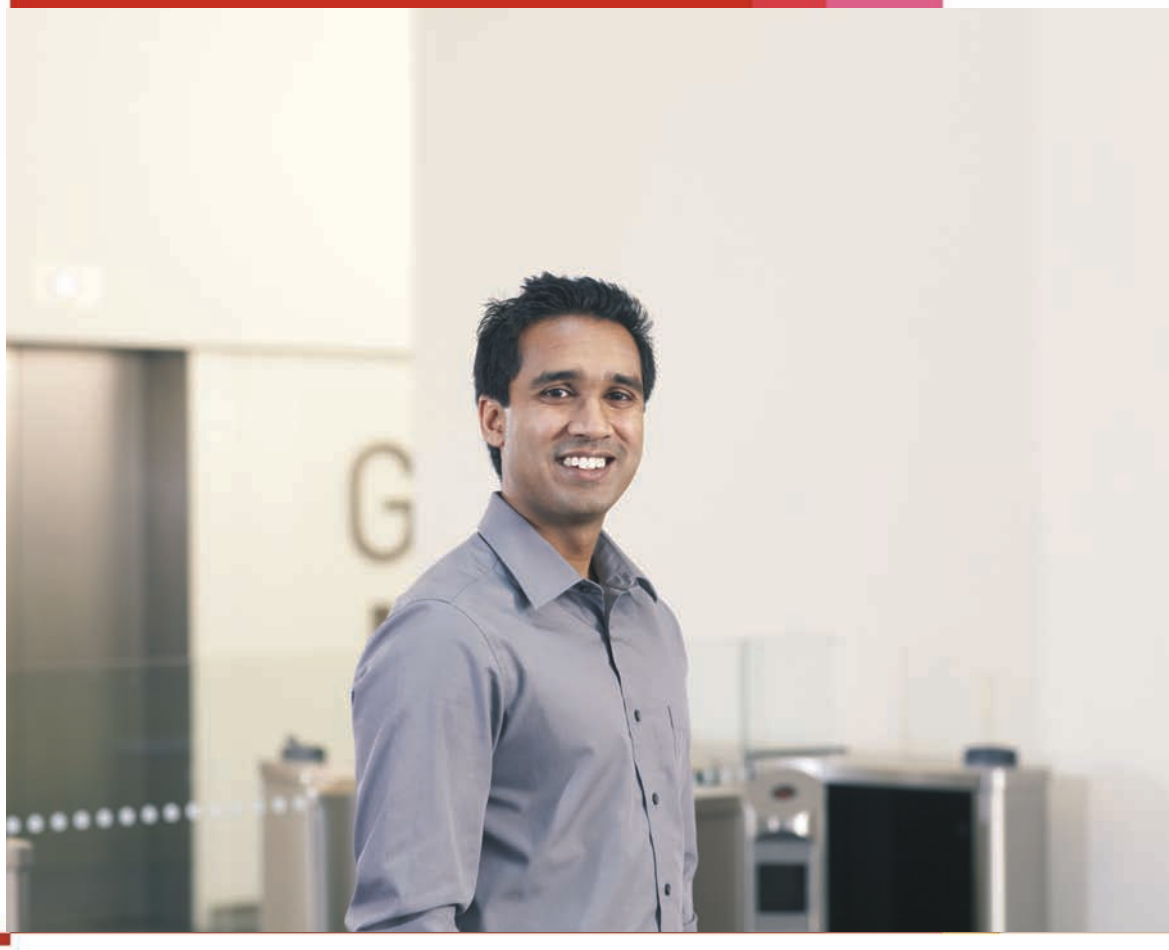
A monthly journal published by PwC South Africa providing informed commentary on current developments in the tax arena, both locally and internationally. Through analysis and comment on new law and judicial decisions of interest, it assists business executives to identify developments and trends in tax law and revenue practice that might impact their business.



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The new medical scheme fees tax credit

The Taxation Laws Amendment Act 24 of 2011 provides for a section 6A to be inserted into the Income Tax Act to provide for the new medical scheme fees tax credit, which is to come into effect for years of assessment commencing on or after 1 March 2012.

Hitherto, a taxpayer has been entitled to a *deduction*, up to specified thresholds, for fees paid to a registered medical scheme. Under the new system, the taxpayer is instead entitled to a fixed-amount *rebate* (which the legislation, perhaps confusingly, calls a *credit*,) the quantum of which is geared to whether the fees are paid in respect of prospective benefits to the taxpayer, or to benefits for the taxpayer and one or more dependants.

The intent is to treat taxpayers equally, in that a tax credit will have the same value to all taxpayers, whereas a deduction under the old system was more valuable to taxpayers on high marginal tax rates.

However, the new fiscal system is likely to have confused many people - and certainly all those who have a hazy understanding of the technical difference between a tax "deduction", a tax "rebate" and a tax "credit". They may well ask what the difference is between a *rebate* and a *credit* - to which the answer is that there is no difference. They are two words which mean exactly the same thing. Perhaps it is time that the Income Tax Act opted for uniformity in this regard by dropping the opaque word rebate and replacing it with the more straightforward and readily understandable expression, tax credit.

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Nor will it be plain to any, except those with time on their hands to study the legislation and the official explanatory memorandum, that the new medical scheme fees tax credit relates only to fees that a taxpayer pays to a medical scheme and has nothing to do with the tax-deductibility of medical expenses paid by a taxpayer to doctors, dentists and other medical practitioners.

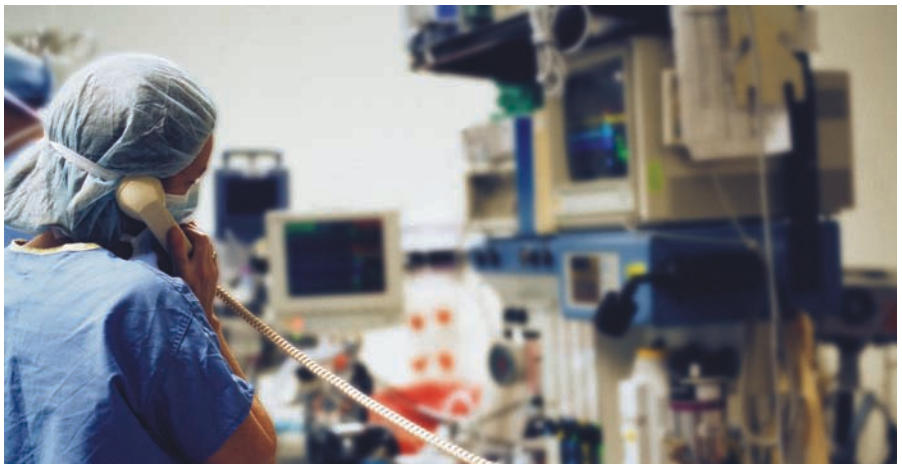
In brief, the new "medical scheme fees tax credit" merely replaces the previous fiscal arrangement in terms of which taxpayers received a tax deduction for contributions to medical aid schemes. Under the new system, taxpayers will receive a tax credit for those contributions, up to a specified amount.

The rules regarding the tax-deductibility of medical and dental expenses outlaid by a taxpayer in respect of himself and his spouse, children and dependants, as provided for in section 18 of the Income Tax Act, remain intact, except that such expenses are now taken into account only to the extent that they exceed four times the amount of the medical scheme fees tax credit. The aggregate of qualifying medical expenses paid by the taxpayer is then deductible to the extent that such aggregate exceeds 7.5% of the

taxpayer's taxable income, excluding any retirement fund lump sum benefit and retirement fund lump sum withdrawal benefit.

Physical impairment or disability expenses

The Act draws a distinction between a mere medical condition and a "disability", as defined in section 18, and provides for substantial fiscal benefits where the taxpayer, his



spouse, child or dependant has a "physical impairment or disability". In such circumstances, the taxpayer is entitled to deduct the full amount of

"any expenditure that is prescribed by the Commissioner ... necessarily incurred and paid by the taxpayer in consequence of any physical impairment or disability suffered by the taxpayer, his or her spouse or child or any dependant of the taxpayer."

The expenditure so "prescribed by the Commissioner" is set out in Annexure B of issue 3 of the *SARS Tax Guide on the Deduction of Medical, Physical Impairment and Physical Disability Expenses*, which was published in October 2011.

Taxpayers who are entitled to a deduction for expenditure consequential upon a "physical impairment or disability" would be well advised to seek professional advice in order to ensure that they claim all that they are entitled to, for the wide range of deductible expenditure (which includes, in appropriate circumstances, the cost of structural modifications to a residence, such as the installation of elevators and the enlargement of halls and doorways) is not generally appreciated. It should be borne in mind that, to claim the special fiscal benefits, the disability must be confirmed by a duly registered medical practitioner by way of form *ITR – DD Confirmation of Diagnosis of Disability*.

Entitlement to the medical scheme fees tax credit

The new medical scheme fees tax credit is available to a taxpayer who is a natural person, except for a taxpayer who already qualifies for the age-related "over 65" rebate and is therefore already entitled to deduct all qualifying medical expenses. The new tax credit is non-refundable and is to operate in the same way as the primary, secondary and tertiary rebates under the Income Tax Act.

The medical scheme fees tax credit applies to fees paid by the taxpayer to a medical scheme registered under the Medical Schemes Act 131 of 1998 or to a fund which is registered under any similar provision contained in the laws of any other country where the medical scheme is registered.

The amount of the medical scheme fees tax credit, as set out in section 6A(3) is

R216 in respect of benefits to the taxpayer

R432 in respect of benefits to the taxpayer and one dependant

R432 in respect of benefits to the taxpayer and one dependant plus R144 in respect of benefits to each additional dependant

for each month in that year of assessment in respect of which those fees are paid.

Any amount that has been so paid by -

the estate of a deceased taxpayer is deemed to have been paid by the latter on the day before his death, or

an employer of the taxpayer is, to the extent that the amount has been included in his income as a taxable benefit in terms of the Seventh Schedule, deemed to have been paid by the taxpayer.

For the purpose of these provisions, a "dependant" in relation to a taxpayer means a dependant as defined in section 1 of the Medical Schemes Act 131 of 1998. It is noteworthy that, for the purposes of the deduction that is available under section 18 for medical expenses, the term "dependant" is accorded a wider definition in section 18(4A).

Overview

In overview, therefore the new medical scheme fees tax credit is separate from and co-exists alongside and does not replace the statutory provisions for the deduction of medical and dental expenses.

The medical scheme fees tax credit is solely concerned with the fiscal relief given, in the form of what would usually be called a *tax rebate* and is now called a *tax credit*, in respect of contributions paid by the taxpayer to a registered medical scheme.

"Beneficial owner" – Canada shows the way

Tax practitioners and academics will have noted that the concept of a shareholder has disappeared from our income tax law – the definition of "shareholder" in section 1 of the Income Tax Act has been repealed. The dividends tax, which came into effect from 1 April 2012, imposes a tax on the "beneficial owner" of the dividend. However, the term "beneficial owner" is not defined in the legislation and, until an interpretation is provided in our courts, the meaning of the term has the potential for dispute between SARS and dividend recipients.

The interpretation of the term "beneficial owner" in the context of double tax agreements has been considered in Canada, and recently come under consideration again in the Canadian courts.

In *Velcro Canada Inc. v The Queen* (Tax Court of Canada judgment given on 24 February 2012), the issue related to whether a Netherlands company (VHBV) was the beneficial owner of royalties paid by Velcro Canada (VCI).

The facts

The intellectual property (IP) of the Velcro group was, at all material times, owned by its Netherlands Antilles IP company (VIBV). VIBV had entered into a licensing agreement with VCI in terms of which VCI was permitted use of the IP in consideration for the payment of a royalty based on its net sales of products. VIBV then assigned its rights under the royalty agreement to VHBV, but retained ownership of the underlying IP. In consideration for this assignment, VHBV was obliged to pay to VIBV an amount equal to 90% of the revenue that it (VHBV) derived from royalties payable by VCI within 30 days of receipt of such payments. VHBV was obliged to take action to protect VIBV against any infringement of the IP in Canada, but, in the event that it should fail to do so, VIBV retained the right to take protective action in its own name.

VHBV performed three functions. It was the manager of all group royalty streams, the group treasury company and performed management services for companies within the same group. Its revenue streams comprised principally of royalties, but also included interest on loans and management fees. Income received was placed on deposit in US Dollar or Euro currency accounts and disbursed for a variety of purposes, including the payment of operating expenses, making advances to group companies and paying fees to VIBV. The cash received from VCI was not immediately matched with a corresponding 90% outflow to VIBV, and payments to VIBV were made after the dates that the VCI royalties were received, not necessarily in the currency of receipt, but in some other currency.

The dispute

In paying the royalties to VHBV, VCI withheld tax at the reduced rate as provided in the double taxation agreement (DTA) between Canada and the Netherlands. The DTA permitted the application of a reduced rate if the recipient of the royalties is a resident of the Netherlands and the beneficial owner of the royalties. If the

royalties had been paid directly to VIBV, they would have been liable to tax at the full statutory rate, as there is no DTA between Canada and the Netherlands Antilles.

The Canada Revenue Agency (CRA) took the view that, by virtue of the on-payment of substantially all of the royalty flow by VHBV to VIBV, VHBV was not the beneficial owner of the royalties, and that the reduced rate provided for in the DTA was not available to VHBV. It therefore issued assessments claiming payment of taxes that had not been correctly withheld, being the difference between the full rate and the reduced rate, together with penalties.

VCI objected to the assessments, and, after the objection had been disallowed, took the matter on appeal to the Tax Court of Canada.

The position of the parties

The crux of the CRA case was that VHBV was merely an agent or conduit company for VIBV with respect to the royalty income.

VCI, on the other hand, placed reliance on the test for beneficial ownership as laid down in an earlier decision (*Prévost Car Inc v R* 2008 TCC 231, which had been affirmed on appeal to the Federal Court of Appeal 2009 FCA 57), and claimed that it fell within these requirements. Further, it argued that there was no evidence of an agency or nominee arrangement, which, it submitted, is a necessary element to find that some other party is the beneficial owner.

The decision

The court analysed commentary of the Organisation for Economic Cooperation and Development (OECD), whose model tax convention forms the basis for the majority of DTAs that are negotiated and whose opinions are regarded as highly persuasive. In this regard, it cited an example that was substantially similar to the matter in dispute, which had been raised in a commentary on the OECD model tax convention and noted:

"The Commentary then poses the question as to whether it is justifiable to extend the Article's tax exemptions to the party who is the source of the royalties and then recommends that countries may want to agree to special exemptions when negotiating that take into account the situation described."

It then considered the principles that determine that a person is a conduit for another. Here it referred again to commentary of the OECD, which suggested that a conduit arises in the following circumstances:

"The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has similar functions to those of a nominee or agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company)."

It noted that, in the *Prévost Car Inc v R* decision, the Federal Court of Appeal had affirmed the position in law that:

"When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients." (Court's emphasis)

The court analysed commentary of the OECD whose model tax convention forms the basis for the majority of DTAs that are negotiated and whose opinions are regarded as highly persuasive.

Considering then the decision in *Prévost Car Inc v R*, which concerned the beneficial ownership of dividends, the court identified the core element of beneficial ownership, citing the following dictum from the judgment in that matter:

"The word "beneficial" distinguishes the real or economic owner of the property from the owner who is merely a legal owner, owning the property for someone else's benefit, i.e., the beneficial owner."

It then went on to consider the test for beneficial ownership, which was stated in the following terms:

"In my view the "beneficial owner" of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership. In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income. … Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatory is acting or for whom the nominee has lent his or her name."

To find beneficial ownership, the court stated that there are four

elements to be addressed, namely possession, use, risk and control, which must be determined by reference to the key documentary evidence in the form of contracts, the flow of funds, bank statements and accounting records.

On a detailed examination, it was found that VHBV had possession in its own right and full use of the royalties that it received, that the cash so receivable was liable to currency risk and seizure by creditors and that it controlled the funds which it received, which were mingled with its other operating funds and accounted for in this manner.

The Court held that:

"Despite the [CRA's] assertion to the contrary, there was no predetermined flow of funds. What there is is a contractual obligation by VHBV to pay to VIBV a certain amount of monies within a specified time frame. These monies are not necessarily identified as specific monies, they may be identified as a percentage of a certain amount received by VHBV from VCI, but there is no automated flow of specific monies because of the discretion of VHBV with respect to the use of these monies."

The agency argument of the CRA was also rejected. The essential element of agency is that the agent must act on behalf of the principal and be able to affect the principal's legal position with third parties. The court found that VHBV did not have capacity to affect the legal position of VIBV.

On the issue that VHBV was a nominee of VIBV, the guiding principle that the nominee should have absolutely no discretion with regard to the use of the funds received was not present. Further, in relation to an assertion that VHBV was a mere conduit, it was found that the financial statements of VHBV revealed no evidence that it was acting as a conduit.

The court summarised its position by reference to the most recent Canadian decision on beneficial ownership (*Matchwood Investments v Canada* 2009 TCC 2), finding that:

"The person who is the beneficial owner is the person who enjoys and assumes all the attributes of ownership. Only if the interest in the item in question gives that party the right to control the item without question (e.g. they are not accountable to anyone for how he or she deals with the item) will it meet the threshold set in Prévost. In Matchwood, the Court found that the taxpayer did not have such rights until the deed was registered; likewise, VIBV is not a party to the license agreements (having fully assigned it, along with its rights and obligations, to VHBV). It no longer has such rights and thus does not have an interest that amounts to beneficial ownership."

Significance for South Africa

The Canadian precedent is useful persuasive precedent, particularly in relation to the identification of the beneficial owner of dividends that are subject to dividends tax. However, it raises issues that may require interpretation by SARS, particularly in relation to participation exemptions for foreign dividends and capital gains on disposal of shares in foreign companies, which require that the taxpayer holds a specified percentage of the equity shares and voting rights.

If it is recognised that economic ownership and legal ownership are different, there is a distinction between ownership of the asset and ownership of the economic benefit. Where a trustee holds shares in trust (legal owner) for the benefit of beneficiaries (economic owner), can it be said that the beneficiaries "hold" the shares? If the voting rights are exercised by the trustee acting in accordance with the legal requirement that he must exercise these rights in the interests of the beneficiaries, does the beneficiary "hold" the voting rights? If the answer to either of these questions is negative, the participation exemption will not be available to the beneficiary.

These are among the issues that may have been overlooked by Treasury and SARS when framing amendments to the Income Tax Act and require urgent consideration.

Mozambique

Tax treaty interpretation creates the risk of double taxation

South African multinationals carrying out contract work in Mozambique stand to be taxed twice by the tax authorities on their income earned in that country.

Worldwide, countries enter into treaties with each other to avoid double taxation. Double taxation arises when the same amount of income is taxed in the hands of the same person in more than one country and neither country provides relief from tax incurred in the other country.

A problem has been identified in respect of the treaty between South Africa and Mozambique that results in double taxation. The guiding principle is that the income of a South African resident is taxable only in South Africa, except to the extent that the income is attributable to a permanent establishment of that person in Mozambique. If a permanent establishment is created in Mozambique, then the South African person must register for tax in Mozambique and pay tax in that country on the income that is attributable to the permanent establishment.

A permanent establishment is a fixed place through which the business of an enterprise is carried on. In the case of construction contracts, a special rule applies, and a permanent establishment arises in respect of:

"a building site, a construction, assembly or installation project or any supervisory activity in connection with such site or project, but only where such site, project or activity continues for a period of more than six months ..."

Apparently, the problem with the double tax treaty between South Africa and Mozambique is that the English and Portuguese versions are interpreted differently as to when a permanent establishment arises.

The interpretation of the English version, which is applied by the South African Revenue Service (SARS), is that a permanent establishment is only created in Mozambique when a South African person has been in the country, carrying on business activities, for more than six months.

On the other hand, the Portuguese version, which is used by the Mozambican tax authorities, is interpreted to mean that a permanent establishment will be created in that country if the contract with the Mozambican customer provides for services to be rendered for more than six months, even if the South African is only present for one day during the contract period.

In these circumstances, Mozambique will seek to tax the South African person on his business profits at the rate of 32% and South Africa will seek to tax the person (assuming it is a company) on the same profits at the rate of 28%. South Africa may not provide any tax credits for the Mozambique tax suffered because the authorities are of the view that a permanent establishment was not created in Mozambique and therefore it has incorrectly taxed the profits.

The principles generally applied in determining when a site is first established are found in paragraph 19 of the OECD Commentary on the Model Tax Convention relating to Article 5:

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"A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established ..." (emphasis added)

On this basis, preparatory work carried out in South Africa does not constitute a permanent establishment in Mozambique, but, once the contractor moves on site, the period for determining the six-month requirement commences and will terminate on the date that the contractor's activities on the site finally terminate. The taxable income attributable to the site will be determined by reference to the services actually performed on site and not to the entire services performed both outside and within Mozambique.

The interpretation applied by the Mozambican tax authorities is clearly in conflict with international opinion that the critical determinant is the duration of services actually performed within the host country.

This is a matter that can only be resolved by the tax authorities. A stated objective of the treaty is to promote and strengthen economic relations between the two countries. However, in these circumstances, South Africans were actually better off in the absence of the treaty. South Africa has at least introduced a new limited tax credit provision into the Income Tax Act that may provide some limited relief to the South African taxpayer in certain circumstances, but the risk of double taxation remains. South Africans that plan to engage in business with Mozambican clients or customers should plan in advance to try and avoid adverse tax implications.

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