

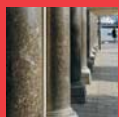
SYNOPSIS

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Regional offices

<i>Bloemfontein</i>	<i>(051) 503-4100</i>
<i>Cape Town</i>	<i>(021) 529-2000</i>
<i>Durban</i>	<i>(031) 250-3700</i>
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Medical claims uncertainty - a remedy

SARS releases draft guide on tax-deductibility of medical expenses

Many taxpayers are feeling the pinch of soaring contributions to medical aid schemes and the additional financial pain of outlaying the gap between the medical aid's share of medical expenses and overall cost of medical and hospital care.

A tax deduction in respect of all or some of a taxpayer's out of pocket medical expenses would provide welcome relief. However, the rules as to what is and is not deductible are complex, as are the rules on the way in which contributions to medical aid schemes are capped (and the exceptions to such capping) and the limitation of allowable medical expenses to the amount by which they exceed 7.5% of the taxpayer's taxable income.

Only tax professionals are comfortable with interpreting the text of the Income Tax Act itself and other relevant legislation in this context, such as the Medical Schemes Act 131 of 1998.

The SARS guide, which comes with a detailed index, is expressed in non-technical language and will go a long way toward promoting an understanding of the detailed working of the tax system in this regard, and assist taxpayers to ensure that they are claiming all that they are entitled to.

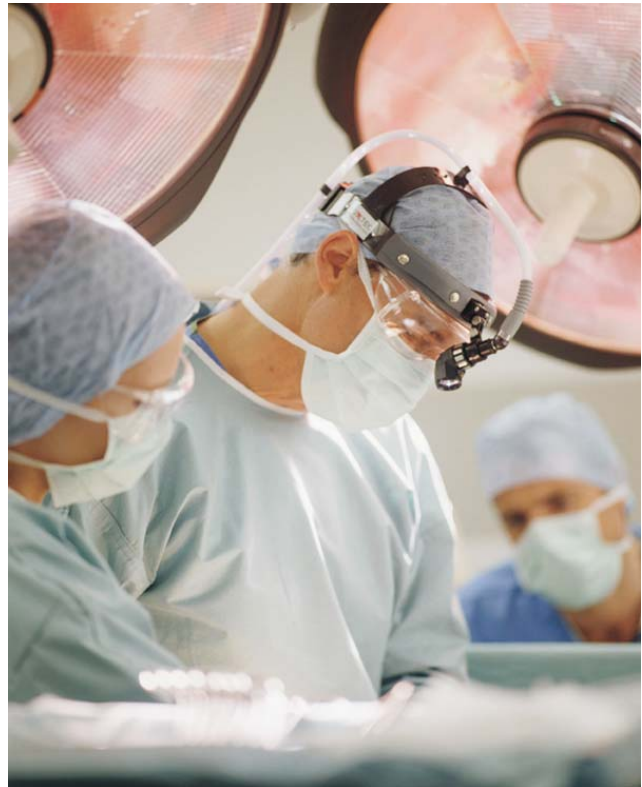
People with heavy medical expenses

The tax-deductibility of medical expenses is an important issue for people who incur – or whose spouse or dependants incur – heavy expenses of this kind. This includes elderly persons in frail health, people with acute or chronic medical conditions, and people who have dependants with special medical needs.

The medical aid allowance is generous in its treatment of persons over the age of 65 and those who fall (or whose dependants fall) within the definition of a "handicapped person".

Technical terms

As with all areas of tax, key concepts in the legislation have a technical meaning, as defined in the Income Tax Act and the Medical Schemes Act.



For example, account is taken of qualifying medical expenses incurred by the taxpayer, the taxpayer's spouse and the taxpayer's dependants.

But **who qualifies as a "spouse"**? Section 1 of the Income Tax Act provides that a spouse includes a partner in a marriage or customary union or a union recognised as a marriage in accordance with the tenets of any religion or a partner "in a same-sex or heterosexual union of a permanent nature".

Who qualifies as a "dependant" of the taxpayer? This is an issue of particular importance to taxpayers who bear the medical expenses of a parent or relative, and those whose children embark on tertiary studies and remain financially dependent into their mid-twenties and sometimes beyond.

In this regard, section 18 of the Income Tax Act adopts the definition of "dependant" as laid down in section 1 of the Medical Schemes Act 131 of 1998, as including the taxpayer's –

The 7.5% limitation does not apply where the taxpayer, the taxpayer's spouse or any of their children is a "handicapped person", as defined.

"spouse or partner, dependent children or other members of the member's immediate family. in respect of whom the member is liable for family care and support or any other person who, under the rules of a medical scheme, is recognised as a dependant of a member".

This definition in turn raises the issue of **who qualifies as the "children"** of the taxpayer. The answer is given by way of a complex and lengthy definition of the expression "child of the taxpayer" in section 18 of the Income Tax Act.

Significantly, the definition does not include a foster child or a child not yet legally adopted. But the definition includes a child of any age who is incapacitated by physical or mental infirmity from maintaining him or herself, provided he or she is not liable for the payment of normal tax for the year.

Qualifying medical expenses and capping

Contributions paid by the taxpayer in respect of him or herself, a spouse and any dependants, to a registered medical aid scheme are taken into account.

However, as from 1 March 2006, such contributions are limited ("capped") to the following monthly amount, namely –

- R500 in respect of the taxpayer;
- R1 000 per month for the taxpayer and one dependant, plus R300 per month for every additional dependant.

Where the taxpayer is aged 65 years or over, or where the taxpayer, the taxpayer's spouse or a child is a handicapped person, there is no such cap and the full contribution is deductible.

Contributions to a medical aid scheme in excess of the capped amount, plus other qualifying medical expenses, are not ignored, but are deductible only to the extent that their aggregate exceeds 7.5% of the taxpayer's taxable income as determined before taking account of any deduction for medical expenses.

The 7.5% limitation does not apply where the taxpayer, the taxpayer's spouse or any of their children is a "handicapped person", as defined. In those circumstances all contributions to a medical aid fund plus all qualifying medical and physical disability expenses for that year are deductible. This is so even if no physical disability expenses were in fact incurred for that particular tax year.

Subjective purpose test retained in new general anti-avoidance rule

The Revenue Laws Amendment Bill 33 of 2006 foreshadows the repeal of section 103(1) and (3) of the Income Tax Act 58 of 1962 ("the general anti-avoidance rule" or GAAR) and its replacement, with effect from 2 November 2006, by a new Part IIA which will deal with "impermissible tax avoidance arrangements".

Currently, section 103(1) provides that, for a scheme to fall foul of its provisions, it must inter alia have been "entered into or carried out solely or mainly for the purposes of obtaining a tax benefit".

This form of words imposes a subjective purpose test, in which the court has to determine whether the particular taxpayer, in the particular circumstances, entered into the scheme in question for the sole or main purpose of obtaining a tax benefit.

If the court determines that the answer to this question is negative, the scheme does not fall foul of section 103(1), no matter how "abnormal" the scheme and the Commissioner has no power to act against it.

The proposed change to an objective purpose test

In the *Discussion Paper on Tax Avoidance*, published in November 2005, SARS announced that it was proposed that the purpose requirement in the GAAR be changed from a subjective basis (which had regard to the purpose of the particular taxpayer) to an objective basis which had no regard to the subjective purpose of the particular taxpayer, saying that –

"The proposed amendments would also change the purpose requirement to an objective test in accordance with the practice in other countries. In particular, the proposed amendment would require the determination to be made 'objectively by reference to the relevant facts and circumstances' "

In an *Interim Response*, published in March 2006, in reaction to public commentary on the Discussion Paper, SARS held firm on the need for the subjective purpose requirement to be replaced by an objective purpose.



The Bill retains the subjective purpose test

It is therefore surprising to find that the 2006 Bill provides that a scheme does not fall foul of the new Part IIA unless “its sole or main purpose was to obtain a tax benefit”.

This represents a very minor change in wording from section 103(1), as quoted above. Are we to infer from this subtle change in wording that the purpose requirement has indeed changed from a subjective to an objective basis?

It seems not. The *Explanatory Memorandum on the Revenue Laws Amendment Bill 2006* published by SARS does not say that the new form of words is intended to achieve such a change, and the Explanatory Memorandum is strangely silent on the protracted and contentious subjective purpose/objective purpose

debate that has engaged commentators for the past year.

The Explanatory Memorandum offers no explanation as to whether the Bill is intended to effect any alteration to the current subjective purpose test and, if not, why there has been a change of mind on this very important aspect of the GAAR, which seemed to be one of the main driving forces behind the need, in the eyes of SARS, for a radical overhaul of section 103.

The basic anomaly

The reason put forward by the *Discussion Paper on Tax Avoidance* as to why the subjective purpose requirement was unsatisfactory was that there was a “basic anomaly” in the current linking of a subjective purpose test with an objective abnormality test as expressed in section 103(1), because –

“In essence . . . a taxpayer could with impunity enter into a transaction with the (subjective) sole purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner or in the rights and obligations which it created. Conversely, a taxpayer could with impunity enter into a transaction which was objectively ‘abnormal’ provided that he did not, subjectively, have the sole or main purpose of tax avoidance”.

In terms of section 80A of the proposed new Part IIA of the Income Tax Act, as set out in the Revenue Laws Amendment Bill 33 of 2006 –

“An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and –“

and then follows an “abnormality” and a “commercial substance” test.

Expressed in this way, determining the “sole or main purpose” of the arrangement remains an over-arching requirement, and the new GAAR will not apply to a scheme unless the requisite purpose of obtaining a tax benefit is present.

It seems, therefore that the current “basic anomaly” in section 103(1), outlined above, will be carried forward into the new Part IIA of the Act.

Editor’s note: Perhaps the main impact of the overhaul of the GAAR requirements is to be found in the power that is now given to SARS to examine each step in or part of any arrangement, and apply the GAAR principles to that step or part exclusively. This power may be to enable SARS successfully to challenge arrangements that have an overall commercial foundation, but have been fine-tuned to deliver an enhanced after-tax result, by isolating those steps or parts that deliver the enhanced benefits. Attacking aspects in isolation limits the taxpayer’s recourse to a defence that the general purpose was not avoidance. It remains to be seen how the courts will apply the new provisions.

Advisers on the small business tax amnesty - Exemption from the FIC Act

The small business tax amnesty, provided for in the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006, applies from 1 August 2006 to 31 May 2007 and is available to businesses with a turnover not exceeding R10 million.



During the period of the amnesty, many consultants will be asked by their clients for advice on whether they qualify for the amnesty and, if so, whether they should apply.

On 13 October 2006 the Minister of Finance issued an exemption from the reporting obligations imposed in terms of section 29(1)(b)(iv) of the Financial Intelligence Centre Act 38 of 2001 (the FIC Act). In terms of that Act, a person who carries on a business, or is in charge of or manages a business, has a duty to report any suspicious transaction to the Financial Intelligence Centre Act, where that business is party to a transaction that may involve an investigation of tax evasion or any other duty or levy imposed by SARS.

The exemption applies to persons such as tax advisers, accountants and tax practitioners, when they advise or assist a client in regard to the small business amnesty. In terms of the exemption, such persons are not required to report a suspicious transaction in respect of information disclosed to him or her by the client, irrespective of whether or not the client actually applies for amnesty.

The exemption does not, however, absolve any person from liability for their own involvement in illegal activities.

The Explanatory Memorandum provides further information regarding the exemption

The Explanatory Memorandum makes clear that the exemption comes into force by operation of law and does not have to be applied for. Further, that the amnesty applies to a specific category of advisers, namely those who give advice or assistance to clients in connection with the small business tax amnesty.

The Explanatory Memorandum identifies three scenarios in which the amnesty will be relevant to tax advisers.

1 The first scenario is where the owner of a small business approaches a tax adviser specifically to determine whether he or she qualifies for the small business tax amnesty and to get assistance in submitting the relevant application to SARS. In this situation, the exemption exempts the tax adviser from having to report information which the client may disclose concerning past failures to comply with tax obligations relating to that small business.

2 The second scenario is where the owner of a small business asks a tax adviser for generic tax advice, without referring specifically to the small business tax amnesty. During the consultation, it may become apparent to the tax adviser that the client has previously failed to comply with certain tax obligations pertaining to the business in question. In this situation, the adviser would have to advise the client of the small business tax amnesty and recommend that he or she apply for the amnesty. In these circumstances, the exemption would exempt the tax adviser from having to report information that the client discloses regarding past failures to comply with tax obligations relating to the business in question. If the tax adviser did not advise the client of the amnesty or did not recommend that the client apply for amnesty, the information disclosed to the adviser would not be covered by the exemption, and the exemption would not apply.

3 The third scenario is where the owner of a small business approaches a tax adviser in circumstances which lead the adviser to suspect that his or her services will be abused to conceive of, carry out, or perpetuate a scheme to conceal the source or the nature of proceeds of unlawful activities or to evade tax. In such circumstances the exemption does not apply.

Welcome clarification

Most professional consultants are by now well aware of the duties imposed on them by the FIC Act in circumstances where a client discloses suspect transactions, and the unpalatable obligation to inform on their own client.

The exemption will therefore be widely welcomed. It is not restricted to the organised professions, such as attorneys and accountants, and extends to anyone who carries on a business or is in charge of or manages a business or is an employee of a



with the advice I was given, and thought that I was acting within the law”.

For this reason, it is important for the consultant to record what disclosures the client made, and what advice was given.

The exemption from the FIC Act provides welcome relief from the duty to report irregularities and the Explanatory Memorandum offers valuable clarification of its implications.

There may, however, be difficulties in interpreting an adviser’s legal

It is important for the consultant to record what disclosures the client made and what advice was given. The situation can arise where a client is caught out by SARS and proffers as a defence, “I acted in accordance with the advice I was given, and thought that I was acting within the law”.

business and, in that capacity, assists or advises a client in connection with an application or prospective application for the small business amnesty.

For their own protection, consultants would do well to ensure that they keep a careful record of consultations with clients in relation to issues covered by the amnesty – including the date of the consultation (so as to establish that it occurred within the amnesty period), the matters disclosed by the client, and the advice given.

Every consultant is fearful of the situation that can arise where a client is caught out by SARS or by any other governmental agency for a contravention of law falling within the scope of the FIC Act, where the trapped client proffers as a defence or in mitigation that, “I made full disclosure to my professional advisers” – or worse still – “in doing what I did, I acted in accordance

obligations where, after the expiry of the amnesty period, a client refers in the course of a consultation to reportable irregularities – or elaborates on such irregularities –which were originally disclosed to the adviser during the amnesty period, thereby re-affirming the commission of improprieties, but this time outside the sanctity of the amnesty period.

A further difficulty occurs where the client, after telling the truth to the adviser during the amnesty period about past reportable irregularities, thereafter (when the amnesty period has closed) gives the adviser instructions or documents, to be conveyed to SARS, which are inconsistent with the incriminating truths told to the adviser under cover of the amnesty. It is submitted that the adviser would be acting improperly if he or she put forward that information or those documents to SARS, knowing that they are misleading or untruthful.

Synopsis is now 13 years old! To ensure that we continue to provide you with a useful publication that is interesting, relevant and informative, in the format you prefer, we have arranged for a survey to be undertaken to find out exactly what you think, and what you would like to see in the future.

We will keep you posted of the outcome!

Taxability of ex gratia payments to employees

Consider the tax consequences

The recent decision of the Supreme Court of Appeal in Stevens v CSARS [2006] SCA 145 (RSA) stands as a warning to taxpayers of the difficult tax questions that can arise from an ex gratia payment.

In this case, Safmarine and Rennie Holdings Ltd had implemented a share incentive scheme for its employees in terms of which they were given options to acquire shares in the company. "

This particular case (which, the judgment tells us, was a test case, which would presumably decide the issue for many other shareholders in a similar situation) involved the group company secretary who, on 6 August 1998, was granted an option to buy 51 000 of the company's shares at R3.70 per share. The terms of the share incentive scheme provided that all options issued on this date ("the R3.70 options") could not be exercised for a period of three years from the date they were granted.

As a result, the taxpayer (like all other employees who had been granted options on 6 August 1998) was not in a position to exercise those options in the lead-up to the declaration of a special R1 dividend by the company on 4 October 1999. Hence, employees holding R3.70 options lost out on the additional dividend income they would have received (and the capital value of the new shares) if they had been entitled to exercise their options and acquire further shares before the declaration of the special dividend.

At the time the special dividend was declared, it had been decided to put the company into liquidation.

The company's board of directors decided to make an ex gratia payment of 75 cents per share held by any employee who had been granted R3.70 options. The resolution of the board recorded that the reason for the ex gratia payment was "to compensate for the gain which [the holders of the R3.70 options] had reasonably expected to make prior to the declaration of the R1 special dividend".

The Commissioner assessed the taxpayer on the basis that the ex gratia payment was taxable in terms of paragraph (c) of the definition of gross income in section 1 of the Income Tax Act 58 of 1962, which provides that a taxpayer's gross income includes –

"any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount



... received or accrued in respect of or by virtue of any employment or the holding of any office..."

The taxpayer's objection and appeal to the Cape Tax Court failed because that court held that the taxpayer's services and employment were directly linked to the granting of the options.

The taxpayer took the decision of the Tax Court on appeal to the Supreme Court of Appeal.

The terms of the share option scheme

The terms of the Scheme in terms of which share options were originally issued to certain of the company's employees, selected by the board of directors, provided that –

"The Scheme is intended to promote the retention of employees of ability and expertise who are primarily responsible for the profitability and continued growth of Safren ..."

Astonishingly, given this stated purpose of the scheme, the taxpayer gave oral testimony to the effect that the share options were awarded to employees in recognition of services rendered or to be rendered to the company.

In the Supreme Court of Appeal, counsel for the taxpayer argued that the reason for the granting of the options was to compensate, not for any loss the employees in question had suffered through not receiving the special dividend, but "for the unfairness which the R3.70 option-holders would have suffered as a result of the special dividend".

The reason why counsel put forward this reason for the granting of the options was to try to put as much distance between the granting of the option to the taxpayer and the rendering of services by him.

The judgment of the Supreme Court of Appeal

The Supreme Court of Appeal held that –

“There can be no doubt that the R3.70 option was a benefit directly linked to the taxpayer’s employment. Options were given as a benefit to those whose past services prompted the employer’s wish to secure their future services.”

The court said that it was “unhelpful to argue that the ex gratia payment was aimed at compensating unfairness”, because the key question to ask was not what factor had prompted the board of directors to make the ex gratia payment, but rather, why was the payment made to the particular recipients?

Where an ex gratia payment is made by an employer to an employee, it is difficult to rebut the natural inference that it must have been a reward for services rendered, and thus within the scope of the definition of “gross income”.

The court answered the latter question by holding that – “the recipient were employees ... who had enjoyed a benefit directly linked to their employment, who had lost that benefit and who, in the board’s discretion, were deserving in the particular circumstances of a substitute ex gratia payment. The point is that the self-same quality of service which motivated the grant of the option to them in the first place was still operative in motivating the award of the ex gratia payment to them. ... As long as the motivation was to give the recipients a benefit in recognition of their service in Safren’s employment – as I think the evidence shows it was – then there was an unbroken causal link between the employment on the one hand and the receipt on the other. ... Payment was made because the recipients were employees whose standard of service, past or current, warranted, in the light of their loss, the ex gratia payment.”

A factual issue

The key issue in this case was essentially one of fact – on what basis were particular employees singled out to receive the ex gratia payment in question? Once the court found, as a fact, that the recipients were chosen on the basis of the services they had rendered the company, it followed ineluctably that the ex gratia payment was income in terms of paragraph (c) of the definition of gross income.

Where the court said that it was “unhelpful” for the taxpayer to argue that the ex gratia payment was to compensate for them for “unfairness”, the court could

more cogently have said that the “unfairness” stemmed from the fact that, despite rendering valuable services to the company, they had been denied the benefit given to other valued employees.

Alas, the unfairness was, in the event, redoubled, in that the employees who received the special dividend, received it as exempt income, while those who received the cash ex gratia payment were fully taxable on it.

A failure of tax planning?

It seems, from reading the judgment, that this was possibly another case where a commercial decision was taken without full consideration of the possible tax consequences.

In many circumstances, an ex gratia payment will be a mere gift, and thus a receipt of a capital nature. However, where an ex gratia payment is made by an

employer to an employee, it is difficult to rebut the natural inference that it must have been a reward for services rendered or to be rendered, and thus within the scope of paragraph (c) of the definition of “gross income”.

Most commonly, where there is scope for deduction by the employer of the amounts paid, there is an opportunity for some form of arbitrage, in terms of which the employer makes an ex gratia payment out of pre tax income which is equal to the “grossed up” equivalent of the after tax value of the required compensation. The after tax yield to the employees if this had been done would have been greater than that which was ultimately enjoyed by the employees in this case as, although still slightly lower than the loss that was being compensated.

In hindsight, although the company might have been better advised, if it wished to compensate the recipients, to try to devise some way of giving the ex gratia payment in a form that was tax neutral to it and more beneficial to the recipients, it is not possible to conclude that such avenues were open to it based on the evidence set out in the judgment. It is highly questionable whether, in light of its impending liquidation, the company had income against which to claim a deduction in respect of the ex gratia payments.

• Editor: Ian Wilson • Written by R C (Bob) Williams • Sub-editor and layout: Carol Penny Tax Services Johannesburg
• Distribution: Elizabeth Ndlangamandla • Tel (011) 797-5835 • Fax (011) 209-5835 • www.pwc.com/za

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