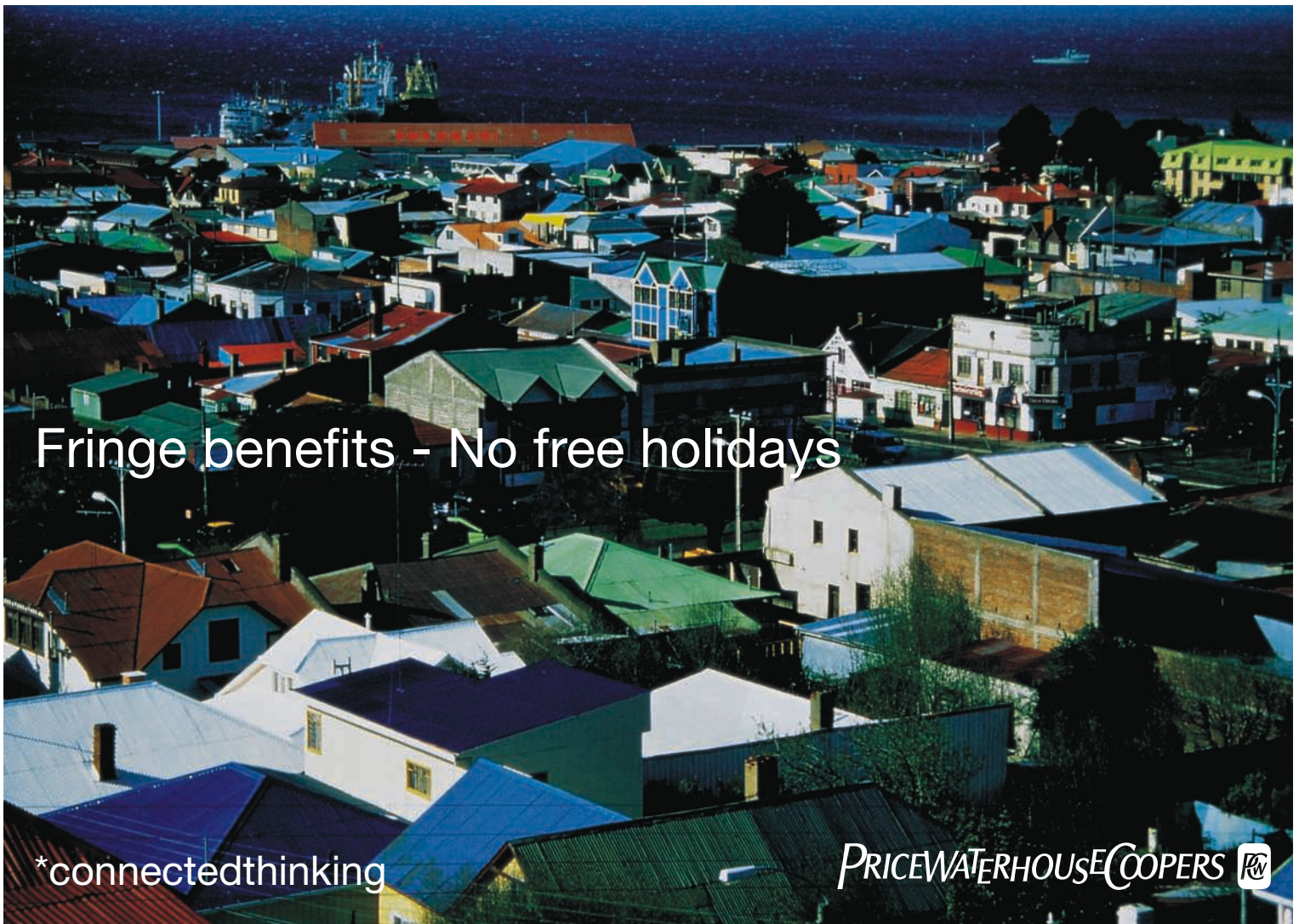


# Synopsis


August 2009

Tax today\*



Fringe benefits - No free holidays

\*connectedthinking

PRICEWATERHOUSECOOPERS 

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## Fringe benefits tax

# No such thing as a free holiday

In a judgment handed down in the High Court in the Western Cape this month (*Vacation Exchanges International (Pty) Ltd v Commissioner for the South African Revenue Services* – judgment given on 7 August 2009), the Court provided clarity on who must pay the tax when the taxable value of a fringe benefit is adjusted by SARS on the basis that it has been incorrectly calculated by an employer.

It may be recalled that in 2008, a timeshare operator had unsuccessfully appealed against an assessment for PAYE related to the provision of “points” in respect of its timeshare properties to sales staff, who could then utilise the points by occupying a timeshare unit operated by the employer for a period as vacation accommodation. The appeal in that instance had proceeded on two points, namely that the taxable value was zero (contending that the employer did not own the units and did not pay the occupational levies, but merely administered the units on behalf of the owners – on this basis the cost incurred by the employer was zero and therefore there was no taxable value to the benefit) and secondly that the law required SARS to assess the tax in the hands of the employees and not to recover it by way of PAYE from the employer.

The employer appealed against the decision of the Tax Court, which had found for the Commissioner on both issues. However the High Court pointed



out that success on either of the grounds of appeal would effectively dispose of the matter in the company’s favour. The Court first dealt with the issue of who is liable for the tax.

The judgment dealt with the remedies that are available to SARS in relation first to the valuation of fringe benefits and secondly to the collection of PAYE where this has been underpaid.

### Taxable value of fringe benefits

The Seventh Schedule to the Income Tax Act deals with the determination of the taxable value of fringe benefits and contains provisions which enabled

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SARS to question and adjust the determination by an employer of the taxable value of a fringe benefit. In terms of paragraph 3(2), SARS has the power to redetermine the taxable value of a fringe benefit if the employer's determination appears to be incorrect *upon the assessment of the employee to whom the taxable benefit has been granted*. Paragraph 17(4) includes a remedy that entitles SARS to penalise the employer in such circumstances, by imposing a penalty equal to 10% of the amount by which the fringe benefit was under-declared.

## Calculate and deduct PAYE

The Fourth Schedule to the Income Tax Act deals with the responsibility of employers to calculate and deduct PAYE from the remuneration of employees and pay the amounts so deducted over to SARS. Paragraph 12(1) empowers SARS to estimate the amount of PAYE that should have been paid where an employer fails to furnish a return, if SARS is not satisfied with the return furnished, if the employer has failed to deduct PAYE or failed to make payment of any amount deducted. In such circumstances, the employer is liable to make payment of the amount so estimated. Provision is also made for the payment of a penalty in such circumstances equal to 10% of the PAYE that was not correctly paid.

The representative for SARS argued that the law gave SARS the option as to which of the provisions should be applied, and that SARS had acted correctly in electing to use the remedy provided under the Fourth Schedule. The company, on the other hand contended that the procedure that should have

been followed was for SARS to make a redetermination when assessing the employees and to collect the tax from the employees.

The Court, in a technical analysis, came to the decision that the structure of the Income Tax Act requires that an "amount" be determined and included in a taxpayer's income. In particular paragraph (i) of the definition of "gross income" requires the quantification of the value of fringe benefits in terms of the Seventh Schedule. The amount so quantified would then form part of the employee's remuneration upon which PAYE is calculated.

## Value of a fringe benefit

Where the value of a fringe benefit is under-estimated, the Seventh Schedule provides a remedy if SARS considers the value to be inadequate. On the other hand, the Fourth Schedule provides for remedies in relation to failures to report or pay PAYE in respect of remuneration, but not for the determination of the amount of the remuneration.

The Court therefore allowed the appeal, holding, in effect, that the remedy available to SARS was to adjust the assessments in respect of the individual employees. While the Court was mindful of the additional administrative effort that this would entail, it was not for the Court to make new law, but for the lawmaker to enact the necessary law to provide for the remedy that SARS sought to apply.

In the circumstances the PAYE assessment was declared invalid and it was unnecessary to determine whether the fringe benefit value had been correctly determined.

It is to be expected that the matter will be taken on appeal to the Supreme Court of Appeal as it involves an important area of administrative effectiveness for SARS. In addition, it is likely that next year's tax amendments will include provisions to overcome the problems that have resulted from this judgment. In the meantime, employers who are in dispute with SARS over the value of employee fringe benefits should consider the application of this judgment in relation to their disputes.

# Tax-deductibility of fee paid by a professional footballer to his agent

## Touchdown for the taxpayer

In *Spriggs v Commissioner of Taxation; Riddell v Commissioner of Taxation* [2009] HCA 22 the High Court of Australia handed down a judgment on 18 June 2009 in regard to whether a professional footballer is entitled, in terms of Australia's income tax legislation, to deduct, for income tax purposes, the fee he had paid to his agent for negotiating a contract to play for a new club.

The tax authorities were of the view that the fee was not deductible, and assessed the taxpayer accordingly.

The case had been a ping-pong battle in the lower courts.

The Federal Court of Australia had ruled that the management fees were deductible, and set aside the assessment which disallowed the claimed deduction. On further appeal, the Full Federal Court reached a contrary conclusion, and reinstated the assessment, disallowing the deduction.

The matter then came before the highest court in Australia.



### Taxpayer's contract with agent entitled the latter to a percentage of his earnings as a professional football player

The facts were as follows:

The Australian Football Competition was the elite football competition conducted by the Australian Football League ("AFL"). Sixteen clubs participated in the competition.

The taxpayer, Spriggs, a professional footballer, entered into a "representation agreement" with Connors Sports Management Ltd ("CSM") in terms of which CSM agreed to "represent, advise, counsel and assist" Spriggs in negotiating his playing contract in the AFL.

In terms of the contract, CSM was to charge Spriggs two fees; first, a fee equal to 3% of Spriggs's gross total earnings for the term of the contract;

secondly, a fee equal to 20% of Spriggs's total gross earnings in relation to marketing and media activities.

In December 2004, CSM issued a tax invoice reflecting payment by Spriggs of A\$2 100, being CSM's fee of 3% for negotiating Spriggs's 2005/6 playing contract.

It was this fee that was the focus of the case. The tax authorities contended that it did not qualify as a deduction for income tax purposes in terms of the general deduction provisions of Australia's Income Tax Assessment Act.

### The Australian income tax legislation

The relevant provision in the Australian tax legislation stated that a taxpayer was entitled to deduct any loss or outgoing that was –

incurred in gaining or producing assessable income; or

was necessarily incurred in carrying on a business for the purpose of producing assessable income;

save that no loss or outgoing was deductible if it was of a capital nature.

For this purpose, the Australian tax legislation provided that –

"business" includes any profession, trade, employment, vocation or calling but does not include occupation as an employee.

The interest of the decision for South African tax consultants is that the above provisions closely parallel the general deduction formula in section 11(a) of South Africa's Income Tax Act 58 of 1962, and the definition of "trade" in section 1 of that Act.

The points at issue when Spriggs's case came before the Australian courts were –

whether the taxpayer was “carrying on business” as a professional footballer, and whether the management fee was an expense incurred in gaining or producing income from that business, (affirmative answers were given in the court of first instance); or

whether the fee paid by Spriggs to his agent was not deductible on the principle that was determinative in *Federal Commissioner of Taxation v Maddalena* (1971) 45 ALJR 426; 2 ATR 541, namely that it was an expense incurred “in getting, not doing” work as an employee and was therefore incurred “at a point too soon to be properly regarded as incurred in gaining assessable income”; and

whether the agent’s fee was expenditure of capital nature.

In the present matter, the penultimate Australian court, the Full Federal Court, had held that the *Maddalena* principle, outlined above, was applicable and operated to deny the deductibility of the fee paid by Spriggs to his agent.

## The judgment of the High Court of Australia

A significant hurdle for the taxpayer was that the definition of “business” in Australia’s income tax legislation excluded occupation as an employee.

If, therefore, Spriggs was an employee, and if the fee in question that he had paid to his agent was outlaid in respect of his services as an employee, then the fee was not deductible.

But was Spriggs’s contract with the Australian Football League a “contract of employment”?

His counsel argued that Spriggs was a professional sportsman who had –

“turned his sporting prowess to account for money, and was engaged in income-producing activity, a business, which encompassed two related streams

## How would the South African courts decide a case involving similar facts?

The general deduction formula in our Income Tax Act 58 of 1962 is similar to that of Australia.

Thus, in terms of section 11(a) expenditure is deductible if it was incurred in the production of income and was not of a capital nature.

Unlike its Australian counterpart, our Income Tax Act does not define “trade” as excluding occupation as an employee, and this is therefore not, of itself, a barrier to deductibility of expenditure in terms of section 11(a).

Indeed, it has been held that a salaried university lecturer carries on a “trade” as defined in the Act (see *KBI v Van der Walt* 1986 (4) SA 303 (T)).

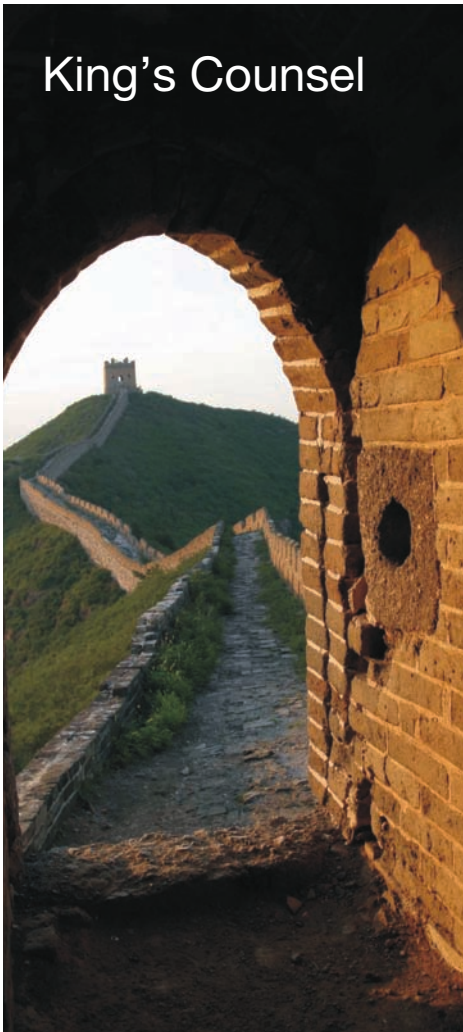
However, our Income Tax Act provides in section 23(m) that, save for a few excepted categories of expenditure, no deduction can be claimed for any expenditure which relates to employment in respect of which the taxpayer derives “remuneration” as defined in the Fourth Schedule to the Income Tax Act.

This provision therefore bars an employee from deducting any expenditure incurred in the production of wages or salary, except for a few specific types of expenditure.

If a case involving the facts of Spriggs were to come before our courts, the taxpayer would have to prove, as in the Australian courts, that the fee paid to the agent was incurred in the production of income, and was not of a capital nature – and would also have to prove that the expenditure was not barred from deduction by reason of section 23(m).

In this regard, the same issues would arise as in Spriggs’s case, namely whether, in exploiting his sporting prowess for reward, he was an “employee” in relation to the clubs or other entities that were paying him and, if so, whether he was “exclusively and simply” (to use the expression in the High Court of Australia’s judgment) an employee.

The case would of course turn on the precise facts of the particular matter, including the terms of the contract under which the sportsperson was paid, the extent of his or her income-earning activities as a sportsperson and a celebrity, and the terms of the contract which provided for a fee payable to the agent or manager.



## King's Counsel

# King III zeroes in on share-based remuneration

The third report of the King Committee echoes the global call for robust governance and transparency with respect to the remuneration of company executives and directors.

To a degree there is a continuation and extension of the principles contained in King II, and it is evident that recent global economic events and the fallout concerning this sensitive area have persuaded the Committee to provide more detailed guidance on governance and reporting.

The basic principles are clear and unambiguous:

Companies should remunerate directors and executives fairly and responsibly;

Companies should disclose the remuneration of each individual director and certain senior executives; and

Shareholders should approve the company's remuneration policy.

The report deals in detail with the much publicised issue of share-based incentives. Whereas the second report left much of the governance in this regard to the shareholders, the new recommendations are far more detailed. They suggest that:

Share based incentives should be restricted to executive directors, and that the chairman and non-executive directors should be excluded;

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## Tax-deductibility of fee paid by a professional footballer to his agent

of income, namely "playing income" from playing Australian Rules football for his club and "non-playing income" derived from sponsorships, endorsements and similar non-playing activities".

Thus, so the taxpayer argued, the playing contracts in respect of which the fee was payable were not solely contracts of employment because they contained provisions which envisaged that Spriggs would turn his sporting prowess and celebrity status to account for money from both playing and non-playing activities.

It was also argued that the fee paid by Spriggs to his agent was not only for negotiating his playing contract but for all the services provided by the agent.

In the result the High Court of Australia held (at para [69]) that, looking at his activities as a whole, Spriggs was engaged in the business of commercially exploiting his sporting prowess and associated celebrity status, and that this business had been well established before the agency fee in question was incurred. Moreover, Spriggs was not "exclusively or simply" an employee of his club.

The court went on to hold that there was a sufficient connection between the fee that Spriggs paid to his agent and the gaining of income from that business for the fee to be deductible in terms of the income tax legislation.

The court rejected the argument put forward by the tax authorities that the fee paid by Spriggs to his agent was of a capital nature and therefore not deductible.

The contracts negotiated by the agent, said the court, were not lasting assets, but were of a relatively short-term nature and subject to renewal. They were moreover recurrent expenditure and did not secure a lasting asset.

Consequently, the fee was held not be expenditure of a capital nature and was not disqualified from deduction on that ground.

It was thus held that the fee met all the statutory criteria for tax-deductibility.

Vesting of benefits should be deferred over a period appropriate to the company's strategic objectives, which should be not less than three years;

If objectives are not met within the required timeframe, subsequent re-testing should not be permitted;

Regular annual awards of grants is desirable;

Grants that are "underwater" should not be re-priced or surrendered and re-awarded;

Performance conditions should not be waived on a change of control, capital restructure or termination of service, although it may be appropriate to apportion existing benefits in such an event; and

Proportional vesting of benefits in the event of early termination of service should be made taking account of attainment of strategic objectives and not be related solely to time spent.

It is desirable that a company's remuneration policies should be aligned with the company's strategy, and the role of the executives should be the achievement of these strategies to create

long-term shareholder value. These themes are evident in King III.

Globally, share-based long-term incentives have become an important part of total remuneration packages paid to executives. In South Africa, this has been a less well-defined area of governance and it is illuminating that King III has laid down explicit rules regarding the operation of such plans.

### New recommendations on disclosure and transparency

Some important new recommendations are also made in relation to the disclosure of remuneration and the process of informing shareholders.

It is recommended that disclosure be made not only of directors' remuneration but also of the remuneration of the three highest paid executives that are not directors. Disclosure is also recommended of the company's remuneration policy, linkage between remuneration and strategy and the role of base pay and benchmarks in the remuneration policy.

A new recommendation is that the company's remuneration policies should be tabled for consideration by the shareholders in annual general meeting for a non-binding advisory approval. Such a motion would afford shareholders the opportunity to signify their views on the policy and its implementation.

### Best practice

Given the focus placed on executive remuneration in the last twelve months and the part it has played in the reversal in the global economy and turmoil in the financial services sector, the King III principles around the governance and disclosure of executive remuneration will ensure that South African companies are at the forefront of international best practice. It is worth noting that, in a comparison of the King III principles on remuneration with the UK Combined Code, the similarities are noticeable. King III has ensured consistency between local and international governance, thus enabling South African companies to attract global investment and compete effectively.

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## Who is the "beneficial owner" of a dividend for purposes of a double tax agreement?

Where dividends are paid by a company that is resident in one country to a company that is resident in another, a question arises as to which of the two countries the dividend will be taxed in.

International double tax agreements commonly provide that dividends paid by a company resident in one of the treaty states which are "beneficially owned" by a resident of another treaty state, may be taxed in the latter state. This is a feature of the OECD Model Tax Convention on Income and Capital, and

is present in South Africa's double tax agreements.

Such a provision in a double tax agreement raises the question as to what is meant by the "beneficial ownership" of a dividend.

This issue has not, to date, come up for decision by a South African court. A

decision by the Tax Court of Canada in April 2008 is therefore of considerable interest.

The Tax Court of Canada, established in 1983, is a court that deals with tax issues involving companies or individuals and the government of Canada.

In *Prevost Car Inc and Her Majesty the Queen* 2008 TCC 231, *Prevost Car Inc* (“*Prevost*”), a company resident in Canada, had paid a dividend to its wholly-owned subsidiary, *Prevost Holding BV*, a company resident in the Netherlands. The latter in turn declared a dividend to its two shareholders, one a Swedish company and one a UK company.

This was in accordance with a shareholders’ agreement which provided that not less than 80% of the profits of *Prevost* and *Prevost Holding* were to be paid to the latter’s shareholders, that is to say, to the Swedish company and the UK company.

The Canadian tax authorities took the view that the “beneficial owners” of the dividend declared by *Prevost* was not *Prevost Holding BV* (the company which received the *Prevost* dividend) but the Swedish and UK corporate shareholders of *Prevost Holding BV* to which *Prevost Holding BV* had, in turn, declared a dividend.

### Concept of beneficial ownership

The problem confronting the court was that the concepts of a “beneficial owner” and “beneficial ownership” were not recognised in the civil law of Quebec, nor indeed in the other civil law (that is to say, Roman-law based) countries which are members of the OECD.

Beneficial ownership is, however, a concept well known in English law. Thus, for example, in English law a trustee holds property for the benefit of someone else, namely the trust beneficiaries. The trustee is the legal owner of trust property, but does not enjoy the fruits of ownership. The trust beneficiaries are the “beneficial owners” of the trust assets.



According to evidence laid before the court (see the judgment at [59]), it was not intended that the concept of “beneficial ownership” should bear the English law meaning in the context of OECD tax treaties.

Expert evidence was laid before the court on the likely meaning of “beneficial owner” and “beneficial ownership”.

It was pointed out that international tax treaties that use the concept of beneficial ownership do not stipulate that the beneficial owner of the dividend must be the owner of the share.

Thus the fact that, in this particular case, *Prevost Holding BV* was the owner of the shares in respect of which a dividend was declared did not necessarily mean that this company was the beneficial owner of those dividends.

If, for example, the owner of the shares were to be legally obligated to pass on the dividend to another party, then the owner of the shares would not be the beneficial owner of the dividends.

It seems that the reason why the term “beneficial owner” was introduced into international double tax agreements was to deny treaty benefits to intermediaries, such as agents and nominees, who were not the beneficial owners of the dividends that they received.

The court recognised (at para [57] of the judgment) that, as a matter of law, a holding company is not a mere agent or nominee for its shareholders.

Hence, a holding company is the beneficial owner of dividends received by it unless there is strong evidence that the company is a mere conduit for the transmission of that dividend to its own shareholders.

In giving judgment of the Canadian Tax Court in this case, Justice Rip concluded (at para [100]) that –

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. 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. ... It is the true owner of property who is the beneficial owner of the property. When 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. 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 ...”

In the present case, it was held that there was no evidence that *Prevost Holding BV* was a mere conduit for its shareholders, the Dutch and UK companies. There was no evidence that the dividends received by *Prevost Holding BV* “were ab initio destined for” those shareholder companies, with *Prevost Holding BV* a mere “funnel” for the dividends. There was “no predetermined or automatic flow of funds” to those two shareholder companies. *Prevost Holding BV* was not obligated to pay any dividends to those shareholder companies and it could use the dividends it received as it wished.

Consequently, the “beneficial owner” of the dividends in question was *Prevost Holding BV*, and not its two shareholder companies in the UK and Sweden.

# Tax Technical Training for Taxpayers



Taxation in South Africa remains a minefield, to the extent that even a basic level of tax knowledge is hard to maintain. Many taxpayers are not even sure what they should know themselves, and what should be the domain of tax professionals.

The PricewaterhouseCoopers Business School is pleased to present *Tax Technical Training for Taxpayers*. This initiative is designed to equip taxpayers with a working knowledge of taxation in South Africa, giving stakeholders such as managers, accountants and financial directors, an increased awareness of the tax risks affecting your business and/or personal finances.

Knowledge is fundamental to effective relationships between taxpayers and their tax advisors. If advisors have insufficient understanding of taxpayers' industries and issues, their advice is reactive and narrow. On the other hand, a taxpayer that does not fully appreciate the complexities of the tax system may overlook areas where advice is crucial.

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For details of the 2009 general seminars and to book, please see overleaf. (Booking forms for the 2010 seminars will be available closer to the time.)

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# Tax Technical Training for Taxpayers

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