DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

WHO GETS THE CREDIT: MEDICAL TAX CREDITS EXPLAINED

Effective 1 March 2012, the new medical tax credit system (credit system), under the Income Tax Act 58 of 1961 (Act), applies to persons below the age of 65 years. The medical tax credit is a fixed monthly Rand amount that will be offset against tax payable. The rationale behind this system is to address the disparity in medical deductions available to persons falling into different income categories. This is achieved by ensuring that each person in the same category (over 65, under 65, under 65 with a disability), receives exactly the same number of fixed credits for medical aid deductions on a monthly basis. The number of credits received will be upwardly adjusted on an annual basis. The previous "deduction" system will still apply to persons over the age of 65 years.

The question that arises is how a tax deduction and a tax credit differ. If one considers that a tax deduction reduces the taxable income of a person, this means that one's tax payable is calculated on a smaller amount, thus reducing the amount on which tax is calculated. Conversely, a tax credit is rather like a tax rebate, which is deducted after your tax payable has been calculated, thus reducing the amount of tax you pay.

The Explanatory Memorandum on the Draft Taxation Laws Amendment Bill, 2012 has recently introduced further amendments to s6A of the Act as well as an additional new section, s6B. Section 18 has been removed. These amendments are aimed specifically at the taxation of additional qualifying medical expenses and the conversion of these to medical tax credits under the credit system.

Currently, the credit system provides that a taxpayer under 65 will receive a monthly tax credit of R230 for the taxpayer and a further R230 in respect of his/her first dependent. In respect of each dependent thereafter the taxpayer will receive a monthly credit of R154. Any qualifying medical expenses not covered by medical aid, will receive an additional tax credit. This additional credit will depend on whether the taxpayer's medical aid contribution makes provision for a person with a disability or not.

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Where the taxpayer or one of his/her dependents is disabled, the taxpayer will receive:

- the standard monthly medical scheme tax credit for the taxpayer, spouse and dependents; and
- an additional credit for 33.3 per cent of medical scheme fees in excess of three times the value of the standard tax credit calculated; and
- a credit for 33.3 per cent of all qualifying medical/out-of-pocket expenses.

Where there is no disability factor and the taxpayer is under the age of 65 years, he/she will receive:

- the standard monthly medical scheme tax credit for the taxpayer, spouse and dependents; and
- a credit for 25 per cent of the amount by which (X+Y) exceeds 7.5% of the taxpayer's taxable income (R200,000 x 7.5% = R15,000. Thus 25% of ([R5,000 + R20,000] – R15,000) = R2,500 credit).

  where

  - X: equals the amount by which the actual amount of medical scheme fees paid by the taxpayer in a year exceeds four times the standard medical scheme credits (eg R5,000); and
  - Y: equals all the annual qualifying expenses (eg R20,000).

These proposed amendments, if introduced, will be effective in respect of contributions made or other medical expense incurred in the years of assessment commencing on or after 1 March 2014.

Danielle le Roux and Andrew Seaber

TRANSFER PRICING IN SOUTH AFRICA

South Africa's transfer pricing and thin capitalisation regime, as contained in s31 of the Income Tax Act, No 58 of 1961 (Act) has undergone some extensive principle changes over the past two years.

In respect of transfer pricing, the focus had always been on the supply of goods and services between certain connected persons, usually a resident and a non-resident. Where the price for such goods or services was not at arm's length, the South African Revenue Service (SARS) could adjust the consideration paid so that the parties would be taxed as if they did deal at arm's length. A secondary adjustment also entailed a deemed distribution of a dividend in respect of which the now-repealed secondary tax on companies would have had to be accounted for.

Thin capitalisation had always been dealt with as something separate from transfer pricing. The principle was always that where a non-resident granted financial assistance to a resident, SARS could deny the resident a deduction in respect of excessive interest or finance costs paid to the non-resident. Any such excessive amount was also deemed to be a dividend declared by the resident. Thin capitalisation was, however, subject to the so-called safe-harbour rule which was that where the debt to equity ratio of the resident was less than or equal to three-to-one, deductions would not be denied.

With effect from 1 April 2012, transfer pricing now focusses not only on the supply of goods or services but on any cross-border "transaction, scheme, agreement or understanding" between or for the benefit of certain parties, usually a resident and a non-resident (but it also applies to certain other parties), where one or both of the parties gain a tax benefit.

Another change is that, instead of SARS simply being empowered to adjust the price concerned for tax purposes, the parties are actually required to calculate their own tax as if the price had been at arm's length. In fact, this is so not only in respect of price, but in respect of any term or condition of the transaction, scheme, agreement or understanding.

Thin capitalisation is also no longer treated as separate from transfer pricing but has been incorporated into the transfer pricing rules and is now treated as an extension of the transfer pricing provisions. The transfer pricing provisions are sufficiently wide to include the provision of financial assistance, and therefore, if a party derives an undue tax benefit, such as excessive interest deductions from such financial assistance, the arm's length principle will apply and the parties will have to calculate their taxes accordingly. The rule also now incorporates the making available of intellectual property.

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A secondary adjustment mechanism was also introduced. In terms of this mechanism the amount of any difference in price (ie the amount of the 'adjustment') will be regarded as a loan extended by the resident party to the other, which itself will be subject to the transfer pricing rules. In other words, the terms of the loan will have to be at arm's length, including the charging of interest. The resident will therefore be treated as having interest accruing to it in respect of the deemed loan, until such time as the other party pays the amount of the loan to the resident. If the non-resident pays the amount to the resident within the same year of assessment in respect of which the "adjustment" is made, no deemed interest will accrue to the resident.

It should also be noted that the transfer pricing rules do not only apply to income tax, but also other taxes such as dividends tax and possibly donations tax.

There also exists certain exclusions from the transfer pricing provisions for headquarter companies.

In the draft Taxation Laws Amendment Bill, 2012 it is proposed that the transfer pricing provisions should not apply in respect of loans or intellectual property where the holder is a South African company and the debtor or licensee is a Controlled Foreign Company (CFC) in relation to that South African company. The CFC also has to be highly taxed and has to have a foreign business establishment. The CFC will be considered "highly taxed" if it has an effective tax rate of 75% of the applicable South African tax rate.

It is expected that SARS will take a more aggressive stance in respect of transfer pricing, especially given the fact that the new provisions are wide and geared towards eliminating undue tax benefits.

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