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TAX ALERT

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INCENTIVISING NON-RETIREMENT SAVINGS

The fourth paper (Paper) in National Treasury's series of discussion papers dealing with changing the retirement provision system in South Africa, focuses on encouraging a greater level of saving in South Africa, it being a key economic policy item for Government. As such, there is nothing controversial about this policy goal.

The interesting thing that flows from the research in the Paper is that the tax exemption in respect of interest (currently limited to R22 800 for individuals under 65 and R33 000 for individuals 65 years or more), has had little impact on the savings culture in South Africa. This is so despite the fact that the limit has been substantially raised since the change of government in 1994.

The English have what is called Individual Savings Accounts (ISAs) and readers will no doubt have seen these advertised in UK publications. There are two types of ISAs namely cash ISAs, which are deposit accounts that are risk free and provide for savings. The second is stocks and shares ISAs, which are funds intended for longer term investments similar to our unit trust funds. What I think has been most persuasive to Treasury in wanting to shift towards an ISA type account is that the British research shows that these accounts have attracted a large number of low to moderate income earners whereas the interest exemption does not seem to have attracted savings and is thus really only of benefit to high net worth individuals.

The British research shows that high income individuals have accessed the ISAs by shifting existing savings into the tax favoured accounts. In Government's mind, they estimate the cost of the tax free interest threshold at R3 billion in the 2008/09 fiscal year. This is admittedly a substantial cost if the savings policy aspects of the exemption are not filtering into the wider economy. One of the issues that Government wishes to achieve from introducing such an ISA based account is to try and get the tax exemption shifted from pure interest deposit accounts into a wider ranging account where the exemption will apply to longer dated savings for instance in a balanced fund unit trust. In this way, National Treasury sees the exemption as integrating better with the new Dividend Withholding Tax and the Capital Gains Tax system.

The National Treasury’s proposal is that this ISA type account would be exempt from all taxes, and you could make an annual contribution of up to R30,000 into this account. There will be a lifetime contribution limit of R500,000. They are considering allowing older taxpayers to effectively top up their ISA account so that the R500,000 limit could be accessed up to one quarter by people aged 45 to 49; those in the 50 to 59 age bracket up to half their lifetime limit and for those aged 60 to 65 three quarters of their lifetime limit. People of 65 could invest the full R500,000 into the tax free account. Government would then look to phase out the interest income tax exemption over a transition period.

Alastair Morphet

TAX CONSIDERATIONS FOR NON-RESIDENT INDIVIDUALS RENDERING SERVICES IN SOUTH AFRICA

The rendering of services by non-resident individuals carries with it unique tax considerations.

In most cases an individual will have to register for income tax and submit tax returns on an annual basis. Also, various hurdles may have to be negotiated, such as determining the source of the income, determining whether the provisions of a relevant Double Tax Agreement (DTA), and determining whether an employees' tax withholding obligation exists.

For purposes of this article, the focus is on an individual that has been seconded by a foreign employer to render services in South Africa. In essence, the tax considerations of the non-resident individual will be analysed as well as the position of the home and host country employer in relation to the deduction of employees' tax.

Liability to tax in South Africa

In general a 'resident', as defined in s1 of the Income Tax Act (Act), is taxed on his worldwide income, irrespective of where the income is earned. On the other hand, non-residents are only taxed on income from a South African source, subject to the application of a relevant DTA. An important aspect to take note of is that the source of income must not be confused with the place of payment – the place where a non-resident's net income after tax is deposited (ie an offshore account) does not affect the potential liability to tax in South Africa.

The term 'source' is not separately defined in the Act, which is probably due to the fact that it would be impossible for the legislature to define the source of all types of income which a taxpayer may earn. Therefore, in determining the source of a receipt or accrual, it is necessary to consider court decisions on the subject, however, it is important to keep in mind that the determination of source is a factual question that must be determined in light of all the surrounding circumstances. In the case of services rendered in an employment context, it is a generally accepted principle that the source of income would be the place where the activity leading to the generation of income is physically being conducted (see CIR v Nell 24 SATC 261).

Where services are rendered within an employment context, as would be the case with a secondment, South Africa will, in principle, be able to tax the non-resident individual's remuneration. However, where the non-resident individual is resident in a country with which South Africa has concluded a DTA, the taxing rights may be limited, provided certain requirements are met.

Limitation of taxing rights under a DTA

As stated before, South Africa's taxing rights may be limited under a relevant DTA, notwithstanding the fact that the non-resident individual's remuneration is from, or deemed to be from, a local source. The basis on which South Africa's taxing rights are limited is however dependent on the wording and structure of the relevant DTA. Where a secondment is contemplated, it is critical for all parties involved to obtain professional advice regarding the interpretation and application of any relevant DTA.

The general rule applied in DTA's based on the Organisation for Economic Co-operation and Development's Model Tax Convention (OECD MTC), is that remuneration derived by a resident of a Contracting State (the home country) in respect of employment, shall be taxable only in that State, unless the employment is exercised in the other Contracting State (the host country). The OECD MTC goes further to state that if the employment is exercised in the other State (the host country), then that other State (the host country) may tax the remuneration, but only so much that is derived therefrom. What this means, potentially, is that both States (home and host country) will have the right to tax the remuneration and no State has the sole taxing right. The aforementioned problem generally occurs where the country in which the individual is resident taxes income on a worldwide basis as opposed to a source basis of taxation in the country where the services are actually rendered.

The OECD MTC, on which most of South Africa's DTA's are based, contains an exception to the general rule described above. Under the exception to the general rule, the host country's taxing rights (in this case South Africa) over remuneration are limited where all three requirements below, as discussed below, are met. Where all three requirements below are met, the sole taxing rights on the non-resident's remuneration will be with the home country, despite the fact a portion of the income will be from a South African source:

Requirement 1 – the non-resident individual must <u>not</u> be present in South Africa for more than 183 days in any 12 month period.

Requirement 2 – the remuneration of the non-resident individual is paid by, or on behalf of, an employer that is not resident in South Africa.

Requirement 3 – the cost of the non-resident individual's remuneration is not borne by a permanent establishment of the non-resident (home country) employer in South Africa.

Where any one of the requirements is not satisfied, then South Africa will have taxing rights over the non-resident individual's remuneration, but only on so much that is from, or deemed to be from a South African source this would require the individual to register as a taxpayer and submit an annual income tax return if the remuneration exceeds R120,000 per annum (as currently gazetted).

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Obligation to withhold employees' tax

Once it has been determined that the non-resident individual is subject to income tax in South Africa by virtue of the source rules and the relevant DTA does not limit South Africa' taxing rights, then, a further enquiry is necessary to determine whether an employees' tax withholding obligation is present for the home or host country employer.

The Fourth Schedule to the Act determines the circumstances under which employees' tax must be withheld. Paragraph 2(1) of the Fourth Schedule to the Act provides that an employer who is a resident or representative employer in the case of a non-resident and who pays or becomes liable to pay any amount by way of remuneration to any employee, will be required to deduct employees' tax in respect of the normal tax liability of that employee.

In general, the home country employer will not be regarded as a resident employer in South Africa by virtue of the fact that it is incorporated offshore or has its place of effective management outside South Africa. The aspect that would most likely trigger an employees' tax withholding obligation in South Africa for the host country is where a 'representative employer' is present. A 'representative employer', in the case of an employer who is not resident, means any resident agent of that non-resident employer having the authority to pay remuneration. Where, for example, the cost of the non-resident individual's remuneration is carried in South Africa by way of some inter-group arrangement, it is likely that an employees' tax withholding obligation will arise. Each case must however be tested against its own facts and circumstances.

Conclusion

Given the complex local tax environment, coupled with the specialist approach required in relation to DTA interpretation, it is important for home and host country employers to evaluate their anticipated secondments carefully.

Ruaan van Eeden

TRANSFER PRICING: JUDGMENT OF THE SUPREME COURT OF CANADA IN THE GLAXOSMITHKLINE CASE

The Supreme Court of Canada gave judgment on 18 October 2012 in the matter between GlaxoSmithKline (Glaxo Canada) and the Canadian Revenue Authorities dealing with the transfer pricing arrangement between Glaxo Canada and related non-resident companies.

By way of background, Glaxo Canada entered into a licence agreement that conferred rights and benefits onto it. In addition, it also entered into a supply agreement that established the transfer prices of ranitidine, an active pharmaceutical ingredient in the brand name anti-ulcer drug Zantac. Among others, it was indicated that one should consider the combined effect of the licence and supply agreements in order to establish an appropriate transfer pricing relationship. The reason for this conclusion was that Glaxo Canada was at least paying for some of the rights and benefits under the licence agreement as part of the purchase prices for ranitidine. One could therefore not ignore the existence of the licence agreement and the payments made thereunder.

In establishing an appropriate benchmark, the Court indicated that one should firstly have regard to the words and provisions of the statute. The relevant Canadian statute required a court to determine whether the relevant price paid by Glaxo Canada was greater than the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length. It was indicated that the OECD Guidelines do not form part of the statute, even though they suggest a number of methods that can be used to determine whether the prices paid were consistent with parties dealing at arm's length.

The Court indicated that the starting point to determine whether the parties acted at arm's length is that one should have regard to the economically relevant characteristics of the arm's length and non-arm's length circumstances to ensure that they are sufficiently comparable. If there are no related transactions or where the related transactions do not impact on the reasonableness of the prices paid, one should adopt a transaction by transaction approach. Even in such instance, one may have to consider other transactions that may impact on the ultimate arm's length relationship. One should consider the relevant circumstances as opposed to merely using comparables that do not take into account the economic circumstances of the relationship between the parties. It was indicated that the circumstances will include agreements that may confer rights and benefits to the payor over and above the purchase of property in circumstances where those other agreements may be linked to the agreement in terms of which the goods may be acquired.

The Court emphasised that transfer pricing is not an exact science and that it is 'highly unlikely' that comparisons will yield identical circumstances. A court must thus exercise its best informed judgment in establishing an acceptable arm's length price. This issue is especially relevant in circumstances where SARS often approaches a transfer pricing matter as if it is an exact science and as if there is only one transfer price. The Court specifically rejected such an approach. It was indicated that some leeway must be allowed in the determination of a reasonable amount. As long as a transfer price falls within such range, the relevant requirements of transfer pricing would be satisfied. It is only if it is not within that range that a court could select a point within a range it considers reasonable in the circumstances based on an average, median, mode or other appropriate statistical measure.

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The following additional guidelines were indicated in establishing an arm's length relationship:

- One should consider the respective roles and functions of the parties and transfer pricing should not result in a misallocation of earnings that fails to take account of the relevant functions and resources and risks inherent in each role that is played.
- Prices should be determined having regard to the independent interests of each party.
- In the specific instance it was indicated that arm's length distributions have found it in their interests to acquire the ranitidine from a GlaxoSmithKline group supplier rather than from generic resources.

Even though the judgment of the Supreme Court of Canada can thus be welcomed from a taxpayer's perspective, the one important issue to be appreciated is the fact that the cross-appeal of Glaxo Canada was also dismissed. Even though the approach of the Tax Court was thus not accepted by the Supreme Court of Canada, it was found that Glaxo Canada could not on that basis alone argue that it has 'demolished' the assumptions of the Canadian Revenue Authorities. The fact that the approach of the Revenue Authorities was thus incorrect, did not imply that Glaxo Canada 'demolished' the approach concerned. An inappropriate comparator therefore does not save the day for the taxpayer. One should appreciate that the burden of proof is then still upon the taxpayer, which makes it very difficult for the taxpayer. In the circumstances concerned the matter was referred back to the Tax Court to determine an appropriate price. The parties will thus have to spar another round in the Tax Court in order to determine what is in fact an appropriate price even though the Court found that the comparators and approach of the Canadian Revenue Authorities was not appropriate.

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