28 May 2021

To: The South African Revenue Service
Lehae La SARS
299 Bronkhorst Street
PRETORIA
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Via email: SARS - policycomments@sars.gov.za

RE: SAIT COMMENTS ON DRAFT INTERPRETATION NOTE: DEDUCTION OF MEDICAL LUMP SUM PAYMENTS

Dear Colleagues,

We appreciated the invitation to comment on the draft interpretation note (draft IN), which deals with the tax treatment of deductions of medical lump sum payments made to a former employee, their dependents or to an insurer, as outlined in section 12M of the Income Tax Act, No. 58 of 1962 (the Act).

Our comments are set out below for your consideration.

1. Structure and approach of the draft IN

The draft IN provides guidance on the interpretation and application of section 12M of the Act, which relates to the deductibility of a lump sum amount paid by a taxpayer to or in respect of a former employee or dependents of that former employee for purposes of covering post-retirement medical benefits.

At a substantive policy level, we are in general agreement with the interpretation note and we believe that it is a fairly open interpretation note. We also find the plethora of examples immensely helpful. Provided below are our comments highlighting a few key issues.

2. Background

With reference to the following sentence:
"Previously the tax treatment of a lump sum paid by a taxpayer to cancel the obligation to provide for the post-retirement medical benefits of a former employee was uncertain and arguably not deductible."

To our knowledge, the argument was accepted during various Advance Tax Rulings that preceded the introduction of section 12M into the Act, that the type of expense described above, qualified for a section 11(a) tax deduction read with section 23(g) of the Act. The obstacle towards claiming the deduction was not the deductibility as such, but rather the timing thereof since SARS at that point raised the application of section 23H(1)(b)(ii) of the Act.

To our recollection, the introduction of section 12M was to address the concern about the timing of the deduction as a result of the possible application of section 23H. The sentence quoted above seems to imply that the deductibility was at issue.

In our view, should the sentence remain as is, it would create the impression that similar transactions that do not 100% fall within the ambit of section 12M, would not generate a tax deduction. We do not believe this to be the case, and recommend that the background be clarified.

3. Noted exclusions on the purpose of the draft IN

At the outset the draft IN states that the income tax implications of the benefit to the former employee are not considered in the draft IN. Given the substantial amounts that are typically involved in a transaction that gives rise to a section 12M deduction, we believe that the consideration of the income tax implications for the employee should also be considered in detail.

We recommend that this should be considered in the draft IN.

4. Market value of incorporeal assets paid as an amount to a former employee

As outlined in the draft IN, we agree that an amount paid to a former employee for purposes of covering post-retirement medical benefits may take many forms, *inter alia* incorporeal forms. In this regard, we welcome the extensive case law references that the draft IN contains that make explains that necessity for incorporeal assets to be valued or to have a value attached thereto. The draft IN further states that the question regarding whether an amount (in the form of incorporeal assets) is a question that should be determined on an objective basis. Given that the attribution of market value may fluctuate over a period of time, we are interested to know when SARS would determine the market value of an incorporeal asset.

The following questions come to mind:

- Would the incorporeal asset be valued at the date that the lump sum is paid to the employee; or
- Will the incorporeal asset be valued at the date upon which the employer claims the section 12M deduction?

As this is not clear in the draft IN, we recommend that the finalised version of the draft IN clearly outline the way in which SARS intends to deal with the determination of market value in relation to incorporeal assets that are given to an employee in view of a lump sum.

5. Person to whom the lump sum payment is made

Often, a taxpayer could decide to pay a lump sum over to an employee by way making two lump sum payments, i.e., one made directly to the former employee or dependants (under section 12M(2)(a) of the Act) and a second to the insurer (under section 12M(2)(b) of the Act). We believe that both of these payments will fall within the ambit of section 12M of the Act, and we therefore recommend that the draft IN include reference to this type of occurrence which often happens in practice.

The draft IN states that the lump sum must be paid to:
"any former employee who retired from the taxpayer's employment on the grounds of old age…"

The above wording in the Draft IN does not appear to cover instances where a taxpayer's employment policy allows for early retirement. As this is fairly common in practice, we recommend that a specific reference be added to the draft IN to clarify that early retirement in terms of a taxpayer's employment policy would qualify as "on grounds of old age" for purposes of qualifying for a deduction in terms of section 12M of the Act.

6. Miscellaneous

We set out below our additional considerations regarding specific wording in the draft IN that we recommend should be considered prior to the finalisation of the draft IN.

5.1 Paragraph 2

"Depending on the facts, the taxpayer may shift their contractual responsibility to provide post-retirement medical benefits to the insurer, former employee or dependant."

We recommend that the word "shift" (as underlined) should be replaced with the word "transfer".

6.2 Paragraph 4.1

Paragraph 4.1 refers to the term "medical scheme fund". We recommend that the term "medical scheme fund" should cross-refer to paragraph 5 of the draft IN, where the meaning of this term is explained.

6.3 Paragraph 4.2.5(a)

"The definition of "employee" as contained in the Fourth Schedule to the Act, which is applicable when determining the employees' tax to be deducted or withheld by an employer, is wider than the general definition applicable for the purpose of section 12M."

Given that there is no "general definition" applicable for purposes of section 12M of the Act, we recommend that this sentence should rather refer to the common law meaning of an "employee" and include applicable case law.

6.4 Paragraph 4.2.5(b)

This paragraph addresses the meaning of the term "retire". More specifically, the draft IN refers to *"rules and regulations that govern retirement at a particular taxpayer"* and also to *"policies and procedures specifying the circumstances under which an employee may qualify for retirement on the grounds of ill-health or infirmity"*.

We recommend that these statements be clarified. As opposed to referring to regulations, we recommend that these paragraphs should refer to the employee benefit policies of the employer with regard to retirement and the rules of any applicable retirement fund.

Additionally, in Example 4, it is stated that early retirement at 60 years is not considered to be retirement due to old age. However, this depends on the facts. For example, if the rules of the applicable retirement fund allow for early retirement (i.e., after age 55 and before "normal retirement age" as defined in the rules of the fund), that should still constitute retirement due to old age for purposes of section 12M of the Act on the basis that the employee's retirement is causally linked to the age of the employee. We are of the view that early retirement from a specified age in terms of the rules of an applicable retirement fund still constitutes retirement for this purpose. We recommend that this scenario be considered in further detail.

6.5 Paragraph 5

In this paragraph that deals with contributions made to a medical scheme or fund, the draft IN states the following:

"The taxpayer has the obligation to determine whether the legislation governing such foreign scheme is similar to the Medical Schemes Act."

In this regard, section 6A(2)(a)(ii) of the Medical Scheme Act, No. 131 of 1998 (the Medical Scheme Act) refers 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 wording suggests that the taxpayer is not required to determine whether the foreign legislation is similar to the Medical Schemes Act. It simply requires the taxpayer to confirm that the fund is registered as a medical scheme in such other country.

Therefore, the taxpayer should not be placed under any obligation in this respect. We therefore recommend that this interpretation be reversed.

6.6 Paragraph 6

In the result of example 6, the following wording is used:

"Should Employee J survive beyond the age of 75 years, the mortality risk will be assumed by Company Z".

However, in the facts of the example, the example states that Company Z retains a contingent liability for post-retirement medical aid contributions in the event that Employee J survives beyond the age of 75 years. The Company does not assume that mortality risk only if Employee J lives longer than age 75.

We recommend that this example be clarified accordingly.

Additionally, in its guidance as to the meaning of “connected person” in the context of the proviso to section 12M of the Act, the draft IN states the following:

“*In the event that the taxpayer, or any connected person in relation to the taxpayer (being the insurer or someone other than the insurer), retains or has any actual or contingent obligation to cover any future medical aid cost of a former employee or dependants of a former employee as specified in 4.2.5.(c) the taxpayer would not be entitled to a deduction under section 12M*”

The wording above is not exactly articulated in the proviso in section 12M of the Act and appears to have been specifically added to include the insurer contemplated in section 12M(2)(b) of the Act within the ambit of the exclusion.

We believe that the words “retains or has” cannot be read into the section as the section only uses the word “retains”. There appears to be a discrepancy in the wording in this regard and recommend that this be rectified prior to the finalisation of the draft IN.

6.7 Paragraph 7

We recommend that the meaning of the reference to a “specified” medical scheme and a “specified” medical scheme fund should be clarified.

7. Conclusion

In conclusion, SAIT welcomes the opportunity to comment on this draft IN prior to the finalisation thereof. We would welcome further engagement.

Yours faithfully,

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