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EXCHANGE CONTROL
TAX COMPLIANCE STATUS

DEDUCTIONS AND ALLOWANCES
FUTURE EXPENDITURE CONTRACTS: LOYALTY CARDS

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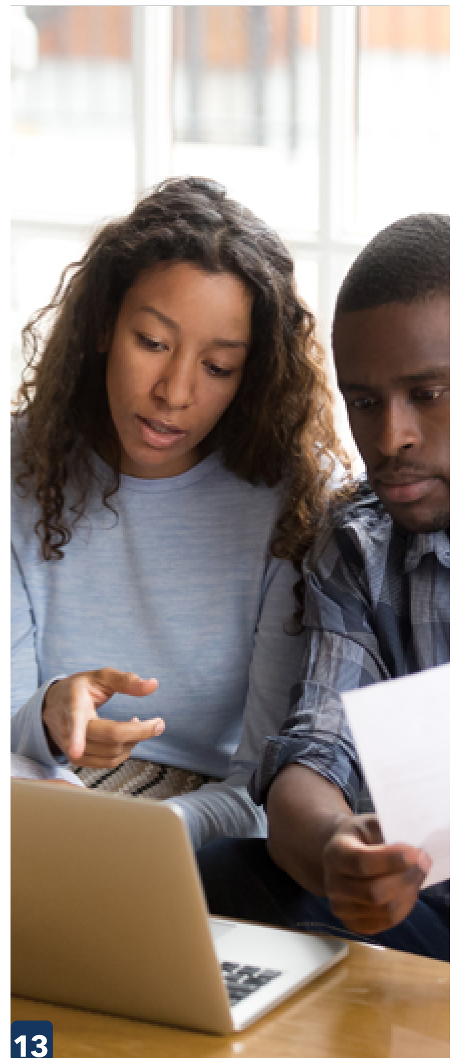

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Mr KG Karro (Chairman), Mr MA Khan, Prof KI Mitchell, Prof JJ Roeleveld, Prof PG Surtees, Mr Z Mabhoza, Ms MC Foster

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FUTURE EXPENDITURE CONTRACTS: LOYALTY CARDS

On 3 December 2019 the Supreme Court of Appeal delivered its judgment in the matter of CSARS v Clicks Retailers (Pty) Ltd*, [2019] (not yet reported). In doing so it reversed the decision of the tax court and disallowed the taxpayer's claim for an allowance under section 24C of the Income Tax Act, 1962 (the Act), in respect of its customer loyalty programme.*

The taxpayer operates a loyalty programme known as Clicks ClubCard. Membership is voluntary and in no way limits the freedom of customers to shop wherever they choose. When a customer presents a membership card when making a purchase, one loyalty point is earned and recorded in the records of Clicks for every R10 spent. At quarterly intervals, a customer who has accumulated at least 100 points is awarded a voucher for R10 for each 100 points. Vouchers may not be exchanged for cash, but may be redeemed against the cost of subsequent purchases.

During the 2009 year of assessment, the taxpayer claimed an allowance of about R44 million to be deducted from its gross income, calculated on the basis of the cost of sales to the taxpayer in honouring vouchers that the taxpayer expected customers to redeem in the following tax year. SARS disallowed the claim and rejected the taxpayer's objection to the disallowance.

The taxpayer succeeded on appeal to the tax court, for the following reasons:

(a) it was artificial and factually incorrect to regard the taxpayer's expenditure as arising from a different contract from the first purchase and sale contract that had occasioned the customer's acquisition of the points;

(b) the first purchase and sale agreement triggered both the earning of income by Clicks and an obligation on the taxpayer to incur future expenditure; and

(c) the obligation to incur future expenditure was therefore incurred under the same contract from which the income was earned and the requirements of section 24C were met.

Section 24C provided in 2009 that, for the allowance for future expenditure to apply, SARS must be satisfied that:

1. an amount of expenditure "*will be incurred*" after the end of the year;

2. the amount will be incurred (i) in a manner that the amount will be deductible in a subsequent year of assessment; or (ii) in respect of the acquisition of an asset in respect of which any deduction will be admissible under the Act;

3. the income of a taxpayer in any year of assessment includes or consists of "*an amount received by or accrued to him in terms of any contract*", and that all or part of the amount will be used to finance future expenditure which the taxpayer will incur "*in the performance of his obligations under such contract*".

Section 24C in 2009 also provided that, for the allowance for future expenditure to apply, the allowance must be added back to income in the following year of assessment.

The most recent decision on section 24C was *CSARS v Big G Restaurants (Pty) Ltd,* 2018 *(Big G)*, in which the court held that the income and the expenditure must arise from the same contract. It does not avail the taxpayer if two contracts are "*inextricably linked*". The operative concept is "contract", not "scheme" or "transaction".

SARS contended that there were at least three contracts: the ClubCard contract, which was issued free of charge and gave rise to no income in the taxpayer's hands; the first contract of purchase and sale, when the customer bought merchandise from the taxpayer and triggered the award of points under the ClubCard contract; and the second contract of purchase and sale, when the customer bought merchandise and was entitled to redeem the voucher. The points awarded arose from the ClubCard contract. So, the probable future expenditure arose from the points awarded under the ClubCard contract.

The taxpayer contended that the only issue for determination was whether or not the first contract of purchase imposed an obligation on the taxpayer, as the tax court had found. There was, according to the taxpayer, a "direct and immediate connection" between each qualifying contract of sale and the obligation on the taxpayer to issue rewards to the customer. The ClubCard contract itself did not create or impose on the taxpayer any exigible obligation to grant any rewards on the taxpayer. The conclusion of a qualifying purchase not only brought into existence an exigible obligation on the taxpayer to issue rewards, but also determined the content of that obligation, with reference to the value of the qualifying purchase. It followed that the "same contract" requirement was met.

The court stated that the ClubCard contract establishes the right of the customer to receive points and then vouchers redeemable against subsequent purchases. This was how the taxpayer described the position in its reply to the SARS enquiry. When it came to the objection, however, the taxpayer shifted its ground. It continued to say that the expenditure was incurred in performing its obligations under the loyalty programme, but started to equivocate regarding the relationship between this and the contracts that generated the rewards. It stated that—

> there is no separate contract of purchase and sale relating to the goods purchased – the customer's presentation of the ClubCard when paying at the till-point being inextricably interwoven with and an integral part of each purchase and sale of goods transaction entered into by the ClubCard customer.

It seems that *Big G* and now the present matter have confirmed a strict interpretation of section 24C, where different contracts cannot be bundled together and treated as one.

The phrase "inextricably interwoven with" was the kiss of death for the taxpayer. The court referred to the decision in *Big G*, where the SCA had rejected this concept in relation to section 24C. The income from the first sale contract would be used to finance the acquisition of stock for future sales, thus enabling the taxpayer to meet its obligations under the second sale. The contract that created the right to income was the first sale. The contract that obliged the taxpayer to honour the vouchers was not the first sale, nor the second sale, but the ClubCard contract, a different contract from either of the sale contracts.

The taxpayer's argument had as its object the reduction of the contractual relationship with a customer to a single qualifying contract of sale, which is both income-earning and obligation-imposing, because the taxpayer is obliged to award points to the customer. This argument ignored the reality of the arrangement, in which three contracts are operative under the loyalty plan. Consequently, the taxpayer did not have access to the section 24C allowance.

After the unanimous decision of the court, delivered by Dlodlo JA, Wallis JA, the author of the definitive judgment on interpretation in *Natal Joint Municipal Pension Fund v Endumeni Municipality*, 2012, dealt with the decision in *Big G*, to show, according to the learned judge, why the outcome of Big G's current appeal to the Constitutional Court would not affect the present judgment. In section 24C there is a clear link between "a contract" and "such contract". It was this link that had been fatal to the taxpayers in both cases. In doing so he, not surprisingly, applied the principles he had summarised in *Natal Joint Municipal Pension Fund*, by considering the reason for the introduction of section 24C in 1980. This was to provide relief to taxpayers who in the ordinary course of their operations would be required to make provision for replacement of machinery and equipment in order to keep their operations up to date. The learned judge referred to situations where construction companies receive upfront payments from clients to enable them to obtain the necessary equipment and materials to commence a contract.

In the case of businesses such as Big G, sensible management would in any event dictate that the external appearance in internal décor be regularly refurbished, regardless of whether or not the undertaking was operating under a franchise agreement. To allow a provision for such future expenditure would be to permit the deduction of expenses before they had been incurred, which would offer taxpayers a means of manipulating the timing of tax payments. The SCA had found in *Big G* that the sale of meals and the expenditure incurred on refurbishment arose from two different contracts. And this was the same argument that applied in the present matter. When a customer buys goods from the taxpayer and leaves the shop, that is the end of the transaction. It is only later, when the customer returns to the shop and makes another purchase, that the loyalty points awarded in terms of the ClubCard contract, and based on the value of the first transaction, come into operation. And the taxpayer's obligation under the second transaction arises only from the need to acquire the goods necessary to conclude the second sale contract. If one views the matter from the perspective that the loyalty programme is merely an undertaking to offer the customer a discount on the next purchase, that hardly qualifies as expenditure contemplated under section 24C. It seems that *Big G* and now the present matter have confirmed a strict interpretation of section 24C, where different contracts cannot be bundled together and treated as one.

Prof Peter Surtees

Act sections:

- Income Tax Act 58 of 1962: section 24C.

Cases:

- *CSARS v Clicks Retailers (Pty) Ltd* Case No 58/2019;
- *CSARS v Big G Restaurants (Pty) Ltd* [2018] 81 SATC 185 SCA;
- *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] ZASCA 13.

Tags: gross income; contractual relationship.

COMMERCIAL BUILDINGS: SECTION 13*QUIN* OF THE INCOME TAX ACT

On 28 June 2019, the tax court (sitting in Johannesburg) handed down judgment in the matter of XYZ CC v The Commissioner for the South African Revenue Service*, 2019 (as yet unreported), in which it had to decide whether the appellant (the taxpayer) was entitled to claim a commercial building allowance in terms of section 13*quin* of the Income Tax Act, 1962 (the Act). The tax court also had to decide whether certain interest imposed should be remitted.*

FACTS

The taxpayer bought commercial property in August 2001 from which it currently earns rental income and between 2007 and 2012 it made improvements to the property. The taxpayer did not claim the commercial building allowance in terms of section 13*quin* of the Act between the 2007 and 2012 years of assessment, but in the 2014 year of assessment it claimed the section 13*quin* allowance for all of these years of assessment. SARS disallowed the allowance claimed for the 2007 to 2012 years of assessment by issuing an additional assessment, against which the taxpayer appealed. It was not in dispute that, in principle, the taxpayer was entitled to claim the section 13*quin* allowance.

RELEVANT LEGAL PROVISION AND ISSUE IN DISPUTE

Section 13*quin*(3) of the Act states the following:

> Where any building or improvement in respect of which any deduction is claimed in terms of this section was during any previous financial year brought into use for the first time by the taxpayer for the purposes of any trade carried on by such taxpayer, the receipts and accruals of which were not included in the income of such taxpayer during such year, any deduction which could have been allowed in terms of this section during such year or any subsequent year in which such asset was used by the taxpayer shall for the purposes of this section be deemed to have been allowed during such previous year or years as if the receipts and accruals of such trade had been included in the income of such taxpayer.

Assuming a taxpayer meets all the requirements of section 13*quin*, the provision allows a taxpayer to claim an allowance of 5% of the cost to the taxpayer of any new and unused building owned by the taxpayer or on any new and unused improvement to a building owned by the taxpayer, in a particular year of assessment.

In the current matter, the tax court had to decide whether, based on section 13*quin*(3), the taxpayer could claim the allowance for the 2007 to 2012 years of assessment, in the 2014 year of assessment.

ARGUMENTS RAISED BY THE PARTIES

The taxpayer's key arguments were the following:

- The taxpayer "did not claim the commercial building allowance provided for by section 13*quin*…between the periods 2007 and 2012 and was therefore entitled to claim same together with the 2013 [year of] assessment in the 2014 year of assessment".
- The taxpayer did not claim the allowance in those years as it was not properly advised by its former accountant;
- SARS will not be prejudiced if it were to allow the taxpayer to claim the allowance as argued for as it will recoup the allowances when the taxpayer sells the property;
- The purpose of introducing section 13*quin* was to put a taxpayer in the same position as other taxpayers who benefit from allowances granted for movable assets;
- Section 13*quin*(3) is ambiguous and therefore needs to be interpreted in favour of the taxpayer; and
- On a proper interpretation of section 13*quin*(3), a taxpayer is entitled to claim allowances for the previous years of assessment relating to the building or improvements as provided for in section 13*quin*.

The tax court held that it is trite that section 13*quin* of the Act was introduced to provide for capital allowances in respect of immovable property depending on the use of the property.

SARS' key arguments were the following:

- The taxpayer failed to provide any evidence that section 13*quin*(3) is ambiguous and therefore the Taxpayer could not invoke the *contra fiscum* rule;

  When considering the provisions of section 13*quin*, it is impermissible for the taxpayer to claim a lump sum of the improvements for the 2008 to 2012 years of assessment and the building allowance for the 2013 year of assessment, in the 2014 year of assessment;
- It is clear from section 13*quin*(3) that the allowance could not be claimed because, if the receipts and accruals of the taxpayer are not included in its income, the allowance is nonetheless deemed to have been claimed and allowed; and
- The deeming provision merely provides a taxpayer who qualifies to apply the allowances as and when it has to recoup it in terms of section 8(4) of the Act, but does not grant an automatic right to a taxpayer to deduct the previous years' allowances in a subsequent year of assessment.

JUDGMENT

The tax court held that it is trite that section 13*quin* of the Act was introduced to provide for capital allowances in respect of immovable property depending on the use of the property. It explained that the section provides for an allowance in respect of commercial buildings that are owned by a taxpayer and used solely for a taxpayer's trade.

The tax court held that it could not agree with the taxpayer's contentions and that the provisions of section 13*quin*(3) are clear and need not be interpreted further than the words in the provision itself. According to the tax court:

> "…it is clear that if the receipts and accruals were not included in the income of the Taxpayer during the previous year of assessment, any deduction which would have been allowed in terms of section 13*quin* during that year shall be deemed to have been allowed in that year."

The tax court then referred to the Supreme Court of Appeal's judgment in *Novartis v Maphil*, 2015, where it deals with the principles of interpretation and held that the taxpayer had failed to demonstrate that section 13*quin*(3) is ambiguous. With reference to the definition of "year of assessment" in section 1(1) and case law, it held that in light of the taxpayer's failure to claim the building allowances in the 2007 to 2012 years of assessment, section 13*quin*(3) deems the allowance as having been claimed and allowed as a deduction for the past years of assessment. Furthermore, the tax court stated that it "*…does not make any business sense for the appellant [Taxpayer] to claim a lump sum after having incurred the expenses over a period of 5 years.*" In its view, section 13*quin*(3) was inserted to "*…prevent taxpayers from delaying in applying for these deductions and to avoid unnecessary cash flow problems.*"

The tax court therefore disallowed the taxpayer's appeal in respect of section 13*quin*. It also disallowed the taxpayer's appeal against the imposition of interest.

The judgment serves as a warning to taxpayers in the commercial property industry to ensure that they claim the section 13*quin* allowance correctly.

COMMENT

The judgment serves as a warning to taxpayers in the commercial property industry to ensure that they claim the section 13*quin* allowance correctly. However, it is slightly disappointing that the tax court did not analyse the deeming provision in a bit more detail before coming to its conclusion. It would also have been helpful if it discussed the principles of the *contra fiscum* rule in more detail. Presumably it did not do so, as it found the provision was clear and easy to interpret. It is also noteworthy that SARS Interpretation Note 107 only dedicates a few paragraphs to section 13*quin*(3).

Cliffe Dekker Hofmeyr

Act sections:

- Income Tax Act 58 of 1962: sections 1(1) (definition of "year of assessment"), 8(4) & 13*quin*.

Other documents:

- SARS Interpretation Note 107.

Cases:

- *XYZ CC v The Commissioner for the South African Revenue Service* Case No: IT14434/2019;
- *Novartis v Maphil* (20229/2014) [2015] ZASCA 111.

Tags: additional assessment; *contra fiscum* rule.

TAX COMPLIANCE STATUS

Recently, the South African Revenue Service (SARS) announced that it would no longer be issuing printed tax clearance certificates (TCCs). The announcement was not unexpected as SARS had already indicated in 2015 when the tax compliance status (TCS) system was implemented, that it would cease issuing printed TCCs at a future date.

From a practical perspective, SARS' announcement regarding TCCs does not change a lot. Prior to SARS ceasing to issue TCCs, a taxpayer applying to confirm its TCS would be issued with a letter confirming its TCS as compliant, including a pin that could be provided to third parties to verify this, and a TCC. From now on, only the letter confirming the taxpayer's TCS as compliant will be issued and third parties will have to verify that a taxpayer's TCS is compliant by using the pin provided.

EFFECT OF THE CHANGE REGARDING TCCS ON EXCHANGE CONTROL ISSUES

Pursuant to SARS' decision regarding TCCs, the South African Reserve Bank's Financial Surveillance Department (FinSurv) issued Circular 23/2019 and Circular 24/2019 on 12 November 2019. These circulars deal with, among other things, the effect of the announcement regarding TCCs on individuals who wish to emigrate for exchange control purposes or who wish to transfer funds abroad, using their foreign investment allowance (FIA).

In Circular 23/2019, FinSurv announced several changes, including the following, which are reflected in the amended version of the Currency and Exchanges Manual for Authorised Dealers (AD Manual):

- Section B.2(B)(i)(d) of the AD Manual, which deals with the FIA and previously made reference to the TCC, now states that when an authorised dealer allows a taxpayer to transfer funds abroad using her FIA, the authorised dealer must use the TCS PIN to verify the taxpayer's TCS via SARS eFiling prior to effecting any transfers. Authorised dealers must ensure that the amount to be transferred does not exceed the amount approved by SARS. Authorised dealers should note that the TCS can expire and should authorised dealers find that the TCS PIN has indeed expired, then the authorised dealer must insist on a new TCS PIN to verify the taxpayer's tax compliance status;

Hopefully, the transition from using the TCC to using the TCS PIN will be seamless and will not cause any delays to the process of transferring funds abroad using one's FIA or when emigrating for tax and exchange control purposes.

- Section B.2(B)(i)(m) of the AD Manual, which deals with applications by individuals to invest in excess of the annual FIA limit of R10 million abroad in a calendar year, now states that authorised dealers must use the TCS PIN to verify the taxpayer's TCS via SARS eFiling prior to effecting any transfers. Authorised dealers should note that the TCS PIN can expire and should authorised dealers find that the TCS PIN has indeed expired, then the authorised dealer must insist on a new TCS PIN to verify the taxpayer's compliance; and

- Section B.4(G)(i)(d) of the AD Manual, which deals with the use of the FIA in the case of a South African resident temporarily abroad, states substantially the same as section B.2(B)(i)(d) of the AD Manual, referred to above.

In Circular 24/2019, FinSurv announced further changes, including the following, which are reflected in the amended version of the AD Manual:

- Section B.2(J)(i)(b) of the AD Manual, which deals with emigration by individuals for exchange control purposes and previously made reference to the TCC, now states that all emigration applications must be accompanied by a duly completed Form MP 336(b) signed by the applicant, together with a printed TCS verification result obtained via the SARS TCS system reflecting the compliance status of the applicant(s) including a breakdown of the remaining capital assets held in South Africa. All subsequent transfers by emigrants will depend on the current TCS at the date and time the TCS PIN is used. A TCS PIN will be issued where the remaining value of the assets on emigration are above the limits outlined in subsection B.2(J)(ii)(a) of the AD Manual and a TCS PIN Good Standing will be issued where the remaining value of the assets on emigration are within the limits outlined in subsection B.2(J)(ii)(a);

- Sections B.2(J)(v)(a)(hh) and B.2(J)(v)(a)(ii) of the AD Manual, which deal with the transfer of an individual's assets abroad pursuant to an individual's emigration for exchange control purposes, also now refer to providing the TCS information to the authorised dealer instead of a TCC; and

- A new provision, namely section B.2(J)(v)(a)(ll), which also deals with emigration and which states that pursuant to a person's emigration, all previously undeclared assets, excluding where the assets represent an inheritance and/or insurance policies, must be referred to SARS for a tax directive. Subsequently, an application must be submitted to FinSurv accompanied by a printed TCS verification result obtained via the TCS system reflecting the compliance status of the applicant(s) including the value of the capital assets declared to and approved for transfer by SARS.

OBSERVATION

Individuals who wish to make use of the FIA or who wish to emigrate for exchange control purposes in future, should take note of the changes in the AD Manual and that TCCs will no longer be issued or provided. Hopefully, the transition from using the TCC to using the TCS PIN will be seamless and will not cause any delays to the process of transferring funds abroad using one's FIA or when emigrating for tax and exchange control purposes.

Cliffe Dekker Hofmeyr

Other documents:

- Circulars 23/2019 & 24/2019 (issued by SARB's Surveillance Department on 12 November 2019);
- Currency and Exchanges Manual for Authorised Dealers (AD Manual);
- Form MP 336(b) (form to accompany all emigration applications).

Tags: tax clearance certificates; tax compliance status; foreign investment allowance; exchange control.

INTEREST RATES

Tax and VAT – interest rate decreases

The SARS interest rates have been decreased as detailed below. It is important to remember that interest and penalties paid to SARS are not deductible expenses for income tax purposes. On the other hand, interest received from SARS is fully taxable (after deducting the current initial exemption of R23 800 per annum (R34 500 if you are 65 or older) for all local interest income earned by natural persons).

- **INCOME TAX, PROVISIONAL TAX, DIVIDENDS TAX, ETC**

Payable to SARS on short payments of all such taxes (other than VAT): 9.75% per annum from 1 May 2020 (was 10% per annum with effect from 1 November 2019).

Payable by SARS on refunds of tax (where interest is applicable): 5.75% per annum from 1 May 2020 (was 6% per annum with effect from 1 November 2019).

If the refund is made after a successful tax appeal or where the appeal is conceded by SARS, the interest rate is 9.75% per annum from 1 May 2020 (was 10% per annum from 1 November 2019).

- **VAT**

Payable to SARS on late payments: 9.75% per annum from 1 May 2020 (was 10% per annum from 1 November 2019).

Payable by SARS on VAT refunds after prescribed period: 9.75% per annum from 1 May 2020 (was 10% per annum from 1 November 2019).

- **FRINGE BENEFITS**

Official interest rate for loans to employees below which a deemed fringe benefit arises: 7.25% per annum from 1 February 2020 (was 7.50% per annum from 1 August 2019). See below for details.

- **DIVIDENDS TAX**

Official interest rate for loans (designated in rands) to shareholders below which the interest on such loans can be deemed to be dividends on which dividends tax is payable: 7.25% per annum from 1 February 2020 (was 7.50% per annum from 1 August 2019). See below for details.

- **DONATIONS TAX**

Loans to trusts by natural connected persons with interest charged at rates below the official rate create a donation subject to donations tax at 20%.

- **PENALTIES**

The amount of penalties for late payments (where applicable) are substantial (at least 10%) and are in addition to interest charged.

FRINGE BENEFITS, LOANS, DONATIONS TAX AND DIVIDENDS TAX – INTEREST RATES

- If inadequate interest is charged to an employee (including working directors) on loans (other than for the purpose of furthering his own studies) in excess of R3 000 from his employer (or associated institution), tax on the fringe benefit may be payable.

  Unless interest is charged at the "official" rate or greater, the employee is deemed to have received a taxable fringe benefit calculated as being the difference between the interest actually charged and interest calculated at the "official" rate.

  For employees' tax purposes, the tax deduction must be made whenever interest is payable; if not regularly, then on a monthly basis for monthly paid employees, weekly for weekly paid employees, etc.

- Subject to a number of exceptions, distributions of income and capital gains from a company / close corporation are normally subject to dividends tax at the flat rate of 20%. Loans or advances to or for the benefit of a shareholder / member will be deemed to be dividends but only to the extent that interest at less than the "official" rate (or market-related rate in the case of foreign currency loans) is payable on the loan, or fringe benefits tax is payable on an interest-free (or subsidised interest) loan to an employee.

  It is not the amount of the loan but the interest reduction which is deemed to be a dividend. Low-interest loans are accordingly subject to dividends tax payable by the company and only in respect of the interest benefit.

- Loans to trusts by natural connected persons with interest charged below the official rate create a donation subject to donations tax at 20%.

- With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%. For foreign currency loans, the rate is the equivalent of the foreign "repo rate" plus 1%. The South African repo rate is currently 6.25% per annum.

With effect from 1 March 2011, the official rate has been defined as the rate of interest equal to the South African "repo rate" plus 1%.

THE "OFFICIAL" RATE OF INTEREST OVER THE PAST FIVE YEARS

With effect from		*Rate per annum*
1 August 2015	–	7.00%
1 December 2015	–	7.25%
1 February 2016	–	7.75%
1 April 2016	–	8.00%
1 August 2017	–	7.75%
1 April 2018	–	7.50%
1 December 2018	–	7.75%
1 August 2019	–	7.50%
1 February 2020	–	7.25%

Kent Karro

Editorial note: Further interest rate reductions will be published in future editions.

Tags: deductible expenses; natural connected persons; taxable fringe benefit; low-interest loans; repo rate.

SETTLEMENT AGREEMENTS

Parties to a legal dispute may often find themselves opting for an "out-of-court" settlement as opposed to a protracted court battle where the outcome is uncertain and the legal costs high. On some level, an out-of-court settlement should represent a win for both parties. However, where the parties are VAT vendors, it is often the party receiving the settlement payment that is left with a slightly bitter taste in its mouth if VAT was not taken into consideration when agreeing on the settlement amount payable.

VAT is levied on the value of the supply of goods or services by a vendor in the course or furtherance of an enterprise carried on by such vendor. VAT is therefore not a tax levied on receipts. The value to be placed on a supply is the amount of "consideration" for such supply. The amount must therefore be received in respect of, in response to, or for the inducement of the supply of goods or services for the amount to be subject to VAT. There must be a sufficient nexus between the supply and the payment for the payment to constitute consideration. It follows that where a settlement payment is made to a vendor, it must be determined whether the payment constitutes consideration for the supply of any goods or services by such vendor.

The term "services" is broadly defined in the Value-Added Tax Act, 1991 (the VAT Act), to include '"anything done or to be done, including the surrendering of any right". In this regard we note that in New Zealand, a forbearance to sue is regarded as being a supply of a service. The definition of "services" as contained in the VAT Act therefore seems to be in line with the views taken by the New Zealand tax authorities. On the basis that the South African VAT system is modelled on that of New Zealand, we may rely thereon for guidance.

It follows that, where a party to a dispute agrees to surrender its right to pursue legal action against the other party in return for a settlement payment, the settlement payment will constitute an identifiable payment that is reciprocal and directly linked to the surrendering party's right to pursue legal action against the counter-party. Where the surrendering of such right is made by a vendor in the course or furtherance of its enterprise, the settlement payment received will constitute consideration for the taxable supply of a service. The vendor receiving the settlement payment will accordingly be required to account for output tax thereon equal to the tax fraction (15/115) of the payment.

In practice, and to the detriment of the vendor receiving a settlement payment, it seems that parties to an out-of-court settlement are often unaware of the VAT treatment of settlement payments, and as such do not factor in the VAT component when agreeing on a settlement amount or when drawing up the agreement in respect thereof. Where the settlement agreement does not stipulate whether the settlement payment is inclusive or exclusive of VAT, the settlement payment is deemed to be inclusive of VAT at the standard rate of 15% in terms of section 64 of the VAT Act. The supplying vendor, ie the recipient of the payment, will accordingly be required to account for VAT thereon and will not be able to recover the VAT amount from the other party in addition to the settlement payment already agreed to in terms of the settlement agreement. This is in line with the approach previously taken by our courts which have stated that the obligation to pay VAT in relation to a transaction on which VAT is payable is on the supplying vendor, and not on the recipient.

On the basis that the supplier, ie the vendor receiving the payment, will be liable to account for VAT on the settlement payment received, such vendor will be required to issue a tax invoice to the other party reflecting the VAT included in the settlement amount. The party making the payment, being the recipient of the services, should then be entitled to claim an input tax deduction in respect of the VAT incurred to the extent that the payment was made in the course of its taxable enterprise activities. It follows that the party receiving the payment will be left out-of-pocket, whereas the party making the payment will benefit to the extent of the input tax deduction claimed.

In practice, and to the detriment of the vendor receiving a settlement payment, it seems that parties to an out-of-court settlement are often unaware of the VAT treatment of settlement payments, and as such do not factor in the VAT component when agreeing on a settlement amount or when drawing up the agreement in respect thereof.

By way of illustration, the effect of failing to allow for VAT in respect of an out-of-court settlement is as follows:

- Company X and Company B, both registered vendors, agree to enter into an out-of-court settlement in terms of which Company X agrees to make a settlement payment of R1 million to Company B in return for Company B agreeing to withdraw legal action against Company X.
- The agreement provides for a settlement payment of R1 million payable by Company X for Company B withdrawing its legal action, and in full and final settlement of any claims between the parties. The agreement is silent on VAT.
- On the basis that the settlement payment made to Company B is deemed to be inclusive of VAT, Company B will be required to account for output tax thereon to SARS in the amount of R130,434.78 (R1 million x (15/115)). The net amount received by Company B will thus only be R869,565.22 notwithstanding that it had agreed to settle for R1 million.
- Company X should be entitled to claim an input tax deduction in respect of the VAT portion of the payment amounting to R130,434.78, thus benefiting from the failure to deal with VAT in the settlement agreement.

Vendors entering into out-of-court settlements, especially the vendor receiving payment of a settlement amount, are reminded of the importance of explicitly stating in the settlement agreement what the settlement payment is made for, and whether the settlement payment agreed upon is exclusive or inclusive of VAT.

The above scenario should be distinguished from the scenario where a compensatory payment is made for losses or damages suffered by the claimant. The enquiry to determine whether VAT must be levied on compensation payments received is whether or not the payment is made for an underlying supply of goods or services. Payments received as compensation for losses or damages suffered are generally not considered as being for any services rendered and the payments are therefore not subject to VAT. These payments simply fall outside the scope of VAT.

Settlement agreements in terms of which compensation payments are made for losses or damages suffered may also provide for the payment to be made in full and final settlement of the claim. However, such a clause is included in the agreement to facilitate the settlement. The settlement payment is made to compensate the claimant for the losses or damages suffered, and no portion of the payment is made as consideration for the claimant foregoing its right to pursue legal action. In this scenario no VAT will be payable by the recipient of the compensation payment.

The VAT treatment of payments made under a settlement agreement turns on the question as to the reason for the payment of the amount. Compensatory payments made for losses or damages suffered will generally not be subject to VAT because they are not made for the supply of anything, whereas a settlement payment made to a vendor in return for agreeing to forego its right to pursue legal action in respect of an existing claim, will constitute consideration for a supply of services and will be subject to VAT.

If a settlement payment relates partly to a supply of services and partly to compensate a vendor for losses suffered, an appropriate apportionment of the payment will be required in terms of section 10(22) of the VAT Act. The portion of the payment relating to the losses suffered will not be subject to VAT whereas the portion of the payment received as consideration for the services rendered will attract VAT. It is therefore advisable that the settlement agreement clearly stipulates the settlement payment to be made for each part of the claim.

In view of the above, vendors entering into out-of-court settlements, especially the vendor receiving payment of a settlement amount, are reminded of the importance of explicitly stating in the settlement agreement what the settlement payment is made for, and whether the settlement payment agreed upon is exclusive or inclusive of VAT. If the settlement agreement is silent on VAT, the payment is deemed to be inclusive of VAT if it is made for services rendered. The vendor receiving such payment will accordingly be liable to account for output tax on the settlement amount equal to the tax fraction thereof, thus leaving the recipient out-of-pocket and ultimately having settled for less.

Cliffe Dekker Hofmeyr

Acts:

- Value-Added Tax Act 89 of 1991: sections 1(1) (definition of "services"), 10(22) & 64.

Tags: out-of-court settlement; supply of goods or services; output tax.

TRADING IN RESPECT OF IMMOVABLE PROPERTY

In terms of section 12J of the Income Tax Act 58 of 1962 (the Act), a person who invests in an approved "venture capital company" may claim an immediate income tax deduction equal to the amount invested (subject to limitations).

A "venture capital company" will only be approved as such if, among other requirements, the sole object of the company is the management of investments in companies that are "qualifying companies".

A company is not a "qualifying company" if, among other requirements, it carries on any "impermissible trade".

Among other things, "any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper" is an "impermissible trade".

What does the phrase "in respect of immovable property" mean in this context?

The phrase "in respect of" has on a number of occasions been interpreted to the effect that it denotes a direct or causal relationship. So, in the present case, a trade would only be an "impermissible trade" if there is a direct or causal relationship between the trade, on the one hand, and immovable property, on the other hand.

On 19 February 2020, SARS issued a Guide on Venture Capital Companies (the Guide).

In the Guide, SARS refers to a number of cases and states the following (on page 13):

> Taking the principles from these cases into account and bearing in mind that section 12J is an incentive and that there was a clear intention that the incentive should not be extended to trades in specified industries, the term "in respect of" must be widely interpreted in the context of section 12J along the lines of "in connection with" and "in relation to". Notwithstanding the wide interpretation, there are situations in which the connection with a listed item will be considered too remote to result in it falling within the ambit of "in respect of"... (Footnotes omitted.)

It does not necessarily follow from the fact that section 12J of the Act is an incentive provision that the words "in respect of" should be given a wide meaning. The stated purpose of the introduction of the venture capital company regime is to provide a tax incentive

to assist small and medium-sized businesses with the challenges they face when they try to raise equity financing (see page 66 of *Explanatory Memorandum on the Revenue Laws Amendment Bill*, 2008 [W.P.2 – '08], which accompanied the legislation that introduced section 12J into the Act). One could just as easily argue that, because the provision creates an incentive, the words "in respect of" should be given a restrictive meaning so that more, rather than fewer, trades will qualify under the regime.

SARS does not provide a list of trades "in respect of immovable property" that will constitute an "impermissible trade".

As to trades in relation to immovable property that SARS does not see as being impermissible trades, SARS states the following at page 15 of the Guide:

> Arguably a person carrying on the trade of a plumber or electrician fixing the plumbing or electrical equipment in a building is conducting a trade in respect of immovable property because plumbing and electrical installations in a building are part of the immovable property. However, taking the purpose and context of the section into account and the work that the plumber or electrician does in conducting the repairs, it is considered that this interpretation would be too restrictive and unintended and should not be adopted. (Footnotes omitted.)

On 6 June 2017, SARS issued Binding Private Ruling 274 (BPR 274). One of the issues considered in BPR 274 was whether a company, which was to provide and maintain solar facilities at the site of its customer, was carrying on an impermissible trade. All of the assets provided by the company, including solar panels, transmission cables and other related facilities, would have been owned by the company and supplied to the customer in terms of an operating lease. SARS ruled that despite the fact that solar panels, once installed, may technically become part of the relevant immovable property, the solar panels were movable assets and that, accordingly, the company would not be carrying on an impermissible trade, ie a trade in respect of immovable property.

Most recently, SARS issued Binding Private Ruling 333. In that matter, the operating company would undertake farming operations consisting of planting, growing, harvesting, packing, transportation and distribution of blueberries. Vacant land required to undertake the farming operations would either be purchased or leased by the operating company. Upon securing the land, the farming operations would be established which would include fencing, netting, a drip irrigation system, cold rooms, equipment and the planting of the blueberry bushes. SARS ruled that the farming of blueberries by the operating company would not constitute a trade in respect of immovable property and, accordingly, did not constitute an impermissible trade.

If a person is in doubt, however, as to whether a company carries on an "impermissible trade" or not, it should preferably approach SARS for a ruling.

So, while SARS takes the view that, technically, the phrase "in respect of immovable property" should be given a wide meaning, in practice it appears as if SARS is interpreting the phrase more restrictively. It seems as if SARS accepts that in cases where there is no direct link between a person's business and the immovable property there is no "impermissible trade".

One could thus argue, based on the guidance and recent rulings issued by SARS, that venture capital companies who invest in the following companies would potentially meet the requirements of section 12J of the Act:

- Contractors supplying services in relation to immovable property, ie plumbers, electricians, building contractors, quantity surveyors, and security companies. (As to building contractors, see the case of *Moodley v Estate Agents Board*, 1982.)
- Companies engaged in the installation of certain solar power equipment.
- Farmers.

If a person is in doubt, however, as to whether a company carries on an "impermissible trade" or not, it should preferably approach SARS for a ruling.

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Editorial comment: Published SARS rulings are necessarily redacted summaries of the facts and circumstances. Consequently, they and articles discussing them should be treated with care and not simply relied on as they appear. Furthermore, a *binding private ruling* has a binding effect *between SARS and the applicant only*, and is published for general information. It does not constitute a practice generally prevailing. A third party may not rely upon a binding private ruling under any circumstances. In addition, published binding private rulings may not be cited in any dispute with SARS, other than a dispute involving the applicant or any co-applicant(s) identified therein.

Acts:

- Income Tax Act 58 of 1962: section 12J.

Other documents:

- Guide on Venture Capital Companies (issued by SARS on 19 February 2020);
- *Explanatory Memorandum on the Revenue Laws Amendment Bill*, 2008 [W.P.2 – '08];
- Binding Private Rulings 274 & 333.

Cases:

- *Moodley v Estate Agents Board* [1982] 2 All SA 259 (D).

Tags: income tax deduction; immovable property.