# Tax & Exchange Control

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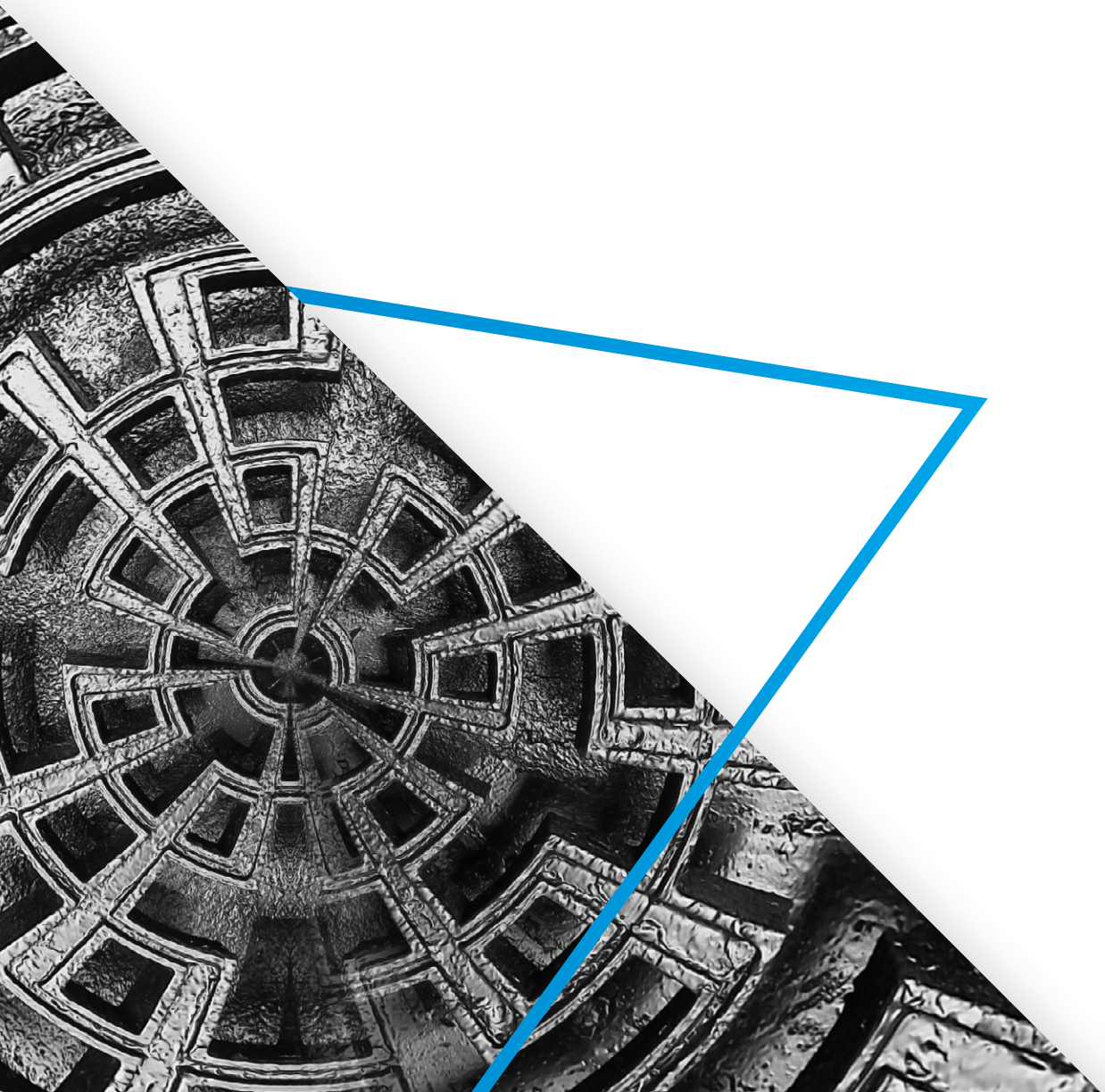

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TAX & EXCHANGE CONTROL ALERT

# VAT complexity or clarity: The Constitutional Court's judgment in the Capitec Bank case

**The deduction of value-added tax (VAT) is a fundamental principle of the operation of the VAT system. If a vendor who makes taxable supplies is denied the right to deduct VAT, then it distorts the operation of the VAT system and results in a cascading of the tax.**

The Constitutional Court handed down its judgment on 12 April 2024 in the VAT appeal by Capitec Bank (Capitec) against a judgment of the Supreme Court of Appeal (SCA), where the SCA previously held that Capitec was not entitled to any VAT deduction in respect of payments made under loan cover which Capitec provided to customers for no consideration. Our detailed analysis and comment on the SCA's judgment can be accessed here.

Although the Constitutional Court judgment does not result in a substantial win for Capitec, it addresses and clarifies various important VAT principles. It is invigorating to see a judgment, which was penned by Justice Rogers, that provides such clarity on various complex VAT principles in the context of the operation of the VAT system.

## The issue in dispute

Capitec provides unsecured loans to its clients in return for which it receives interest, service fees, and a once-off initiation fee. The interest is exempt from VAT, whereas the fees are subject to VAT. To make its credit offering more attractive, Capitec provides free loan cover to clients with unsecured loans, in the event of their death or retrenchment.

Capitec sought to deduct VAT on the payments it made to cover the outstanding loans of clients who were retrenched or who passed away. Capitec made the deduction in terms of section 16(3)(c) of the Value Added Tax Act 89 of 1991 (VAT Act) on the basis that the loan cover comprised "*insurance*" as defined in the VAT Act, and that the insurance cover comprised a taxable supply.

The South African Revenue Service (SARS) disallowed the deduction and contended that the payments made by Capitec did not qualify for a deduction under section 16(3)(c) because the supply of the loan cover did not constitute a "*taxable supply*". This was on the basis that the loan cover was provided for no consideration, or alternatively, the loan cover was provided in respect of an exempt supply, being the provision of credit.

The Tax Court originally found in favour of Capitec and held that the loan cover was provided in the course and furtherance of Capitec's taxable enterprise and that the loan cover promoted the entire enterprise of Capitec, which included the making of taxable supplies.

The SCA overturned the Tax Court's judgment and essentially held that because the provision of credit is an exempt financial service, the loan cover was supplied in the course of making an exempt supply and no VAT was therefore deductible by Capitec.

Capitec then lodged an appeal with the Constitutional Court. The Constitutional Court considered and clarified several important principles.

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## Supply for no consideration

The Constitutional Court recognised that the definition of "*enterprise*" in the VAT Act requires a regular or continuous activity involving the supply of goods or services for consideration. However, the court stated that the definition does not require that **all** goods or services supplied in the course of that activity must be supplied for consideration.

The Constitutional Court clarified that contrary to the SCA's view, the provisions of section 10(23) of the VAT Act were applicable in Capitec's circumstances. Section 10(23) provides that where a supply is made for no consideration, the value of the supply is deemed to be nil. It agreed with the SCA that section 10(23) cannot convert a non-taxable supply into a taxable supply, but section 10(23) makes it clear that any supply, whether taxable or non-taxable, may be a supply for no consideration, in which case it is assigned a value of nil.

The Constitutional Court explained that, where an enterprise sells goods for consideration and provides a free item to customers as a marketing ploy, it is still important to classify the item as a taxable supply to enable the vendor to deduct VAT thereon as input tax.

Relying on the UK case of *Revenue and Customs v Tesco Freetime Ltd* [2019] UKUT 18 (TCC); [2019] STC 1188, the court held that Capitec's supply of the loan cover was not disqualified from being a "*taxable supply*" merely because it was supplied free of charge and that the SCA erred in finding otherwise.

## Exempt supply

The SCA held that the provision of credit by Capitec was an exempt financial service, that only a minor component of its business generated taxable fees, and that the loan cover was supplied in the course of making an exempt supply.

The Constitutional Court stated that, to determine whether the loan cover was an exempt, taxable, or mixed supply, the purpose of Capitec's provision of the loan cover to its borrowers was important. The evidence by Capitec that the free loan cover was provided because it made Capitec's loan offering to unsecured borrowers more attractive, was undisputed and accepted. The free loan cover advanced Capitec's business of lending money to unsecured borrowers, from which it earned exempt interest and taxable fees.

The Constitutional Court held that the loan cover was a mixed supply made in the course and furtherance of Capitec's exempt activity of lending money for interest and its enterprise activity of lending money for fees. The court confirmed that the provision of credit is a single activity and that in terms of the proviso to section 2(1) the activity has two components, the one being an exempt activity and the other an "*enterprise*" activity.

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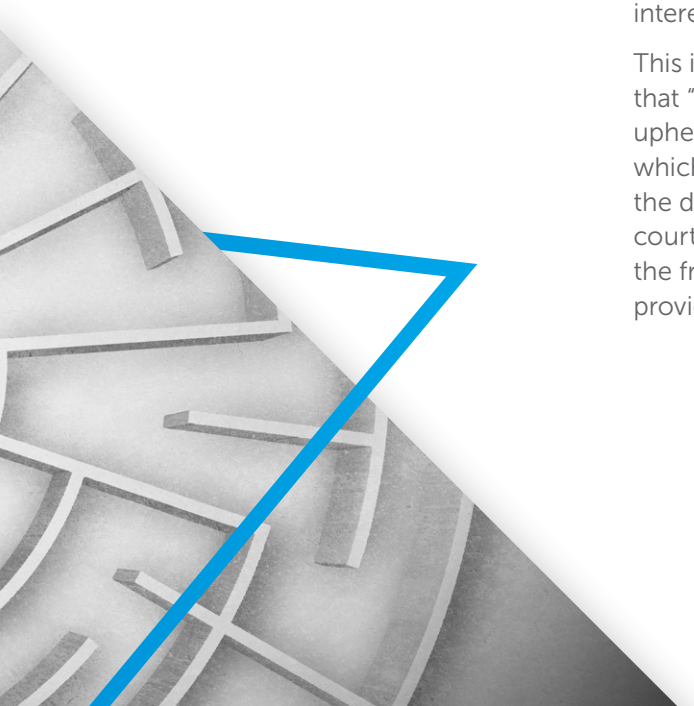

## Nature of outstanding debt

The SCA stated in its judgment that the fees charged for the provision of credit, if not paid immediately, become capitalised and are then added to the outstanding loan, which renders them exempt. If a debit order was returned unpaid, Capitec automatically extended additional credit to the borrower in the amount of the unpaid instalment, which was a separate supply of credit. It is on this basis that the SCA ruled that because the loan cover related exclusively to this additional supply of VAT-exempt credit, the loan cover was supplied in the course of an exempt supply.

However, the Constitutional Court confirmed the judgment in *Standard Bank of SA Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* [1998] 1 All SA 413 (A) (14 November 1997) where the SCA ruled that the amounts debited to a customer's account do not lose their character as capital, interest and fees.

This is important because, had the judgment of the SCA that *"new"* credit was provided when a debtor defaults been upheld, no relief would then be claimable on the fees on which VAT was accounted for, when the fee component of the debt was written off as irrecoverable. In any event, the court held that the benefit that the borrower obtained from the free cover was not relevant, but rather why Capitec provided the free loan cover.

## Extent of a permitted deduction

The VAT system operates on the basis that where a vendor makes taxable supplies, the vendor is entitled to deduct the total amount of VAT incurred on goods or services acquired for use, consumption, or supply in the course of making such taxable supplies. Where a vendor makes both taxable and exempt supplies, the vendor is only entitled to deduct VAT to the extent that the vendor makes taxable supplies.

The Constitutional Court took a practical approach in this case. It stated that there are four possible outcomes where the loan cover, being the supply of a contract of insurance, comprises a mixed supply made in the course or furtherance simultaneously of an exempt activity and an *"enterprise"* activity:

- the vendor is entitled to a full deduction of the tax fraction of the payments made;
- the vendor is not entitled to any deduction;
- a portion of the tax fraction of the payments made may be deducted in terms of section 17(1); or
- the vendor may deduct a portion of the tax fraction of the payments made, invoking an apportionment implicit in section 16(3)(c) in the context of the scheme of the VAT Act as a whole.

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The Constitutional Court stated that because the enterprise activity of Capitec (being the fee-earning component) was only 5% to 13% of the whole, the rest being exempt from VAT, it would disturb the operation of the VAT system to allow Capitec a full deduction of the tax fraction of the payments made. The same would apply if no deduction was allowed. Importantly, in this regard, the court stated that SARS, as an organ of the state subject to the Constitution, should not seek to exact tax that is not due and payable.

Although the application of section 17(1) would have yielded the desired result, section 17(1) only applies to "*input tax*" whereas a deduction under section 16(3)(c) is not "*input tax*" as defined. Accordingly, the VAT legislation does not allow for an apportionment under section 17(1) for payments made as contemplated by section 16(3)(c).

In considering certain income tax authorities, including *Commissioner for Inland Revenue v Rand Selections Corporation Ltd* [1956] (3) SA 124 (A) and *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* [1983] (3) SA 935(A), the Constitutional Court held that apportionment in the context of section 16(3)(c) is mandated. Furthermore, Capitec should not be penalised for the fact that it did not plead apportionment in its appeal in the Tax Court.

## The judgment

The Constitutional Court held that Capitec was entitled to a deduction of a portion of the tax fraction of the payments made under the loan cover provided, to the extent that it related to the fee-earning enterprise activities of Capitec. The matter was referred back to SARS to determine an appropriate apportionment method to be applied.

## Comments

Although the judgment is not the outcome that Capitec sought, the allowing of a VAT deduction to the extent that Capitec makes taxable supplies is in accordance with the operation of the VAT system and cannot be faulted. The effort that the Constitutional Court made to clarify and apply complex VAT principles in the context of the VAT Act is refreshing, and we hope that SARS and our lower courts will follow suit.

**Gerhard Badenhorst**

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