DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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VAT CONSIDERATIONS IN RELATION TO THE DISPOSAL OF LEASED COMMERCIAL PROPERTY

Subject to various conditions being met, an enterprise (or part of it capable of separate operation), that is disposed of as a going concern to a registered vendor, may be subject to Value-Added Tax (VAT) at the zero rate. Where leased commercial property is being disposed of as a going concern, particular care must be taken by the person making the supply to ensure that the correct VAT rate is applied.

For purposes of this article we will briefly discuss two scenarios:

- The disposal of a commercial letting enterprise by a vendor (fixed property together with lease agreements); and
- The disposal of a commercial property by a vendor to its only tenant that will continue the letting enterprise.

The zero rating provisions for the disposal of an enterprise as a going concern are contained in s11(1)(e) of the Value-Added Tax Act, No 89 of 1991 (VAT Act), read with Interpretation Note 57 (IN57). Essentially, for a disposal to qualify for the zero rate of VAT, the following requirements must be met:

- The parties must agree in writing that the enterprise is disposed of as a going concern.
- The supplier and recipient must be registered vendors.
- The supply must be of an enterprise or part of an enterprise capable of separate operation.
- The supplier and the recipient must, at the time of concluding the agreement, agree in writing that the enterprise (or part thereof) will be an income earning activity on transfer.
- The assets necessary for the carrying on of the enterprise must be disposed of.
- The supplier and the recipient must agree in writing that the consideration for the supply is inclusive of tax at the rate of 0%.

For purposes of discussing the two scenarios above, the focus will be on the transfer of assets necessary for the carrying on of the enterprise, in other words, what would be required to zero rate a transaction with reference to commercial letting enterprises.

In terms of IN57, the view of the South African Revenue Service (SARS) is that the mere transfer of an asset is not enough to fall within the zero rating provisions of s11(1)(e) of the VAT Act. More specifically, in relation to the disposal of a commercial letting enterprise, it is SARS' view that the fixed property must be disposed of, together with the lease agreement in order to fall within the zero rating provisions. The aforementioned disposals of commercial letting enterprises must also pass the additional test relating to level of occupancy. SARS' view is that an occupancy level of at least 50% is required, which is consistent with the approach followed in other jurisdictions, such as New Zealand. The 50% occupancy level is however not set in stone,

continued

IN THIS ISSUE

as one would need to consider the current market conditions in which the disposal is made. One may face a scenario, in an economic slowdown that occupancy rates of less than 50% may be acceptable – it should therefore not be a hindrance in applying the zero rate of VAT in such a scenario.

In practice, it is not uncommon for a tenant (being the only tenant) to enter into an agreement for the purchase of commercial property from its current owner. SARS' view, in the aforementioned scenario, is that this type of transaction does not constitute the disposal of a going concern for purposes of the s11(1)(e) of the VAT Act. In VAT Guide 409 for Fixed Property and Construction various income activities are listed that would not qualify as the transfer of an income earning activity – more specifically it is SARS' view that where a lease is extinguished where a commercial property is sold to a tenant, it does not constitute the sale of a going concern. In other words, it is SARS' view that not all the assets, that is fixed property including lease, have been transferred as part of the enterprise disposal.

A slightly more complex situation arises where a lessee has entered into a sub-letting arrangement and intends to purchase the commercial property outright from the current owner. The lessee technically (but not in a legal sense) steps into the shoes of the owner upon the transfer of the commercial property and will continue the letting enterprise and make taxable supplies subject to VAT at the standard rate. Even though a commercial letting enterprise appears to continue unhindered where the lessee now becomes the outright owner, it is debatable whether the zero rating will apply to the disposal of the property. An argument that counts against zero rating this type of transaction is that the lease between the owner and the lessee terminates on disposal and that the sub-letting agreements, which the lessee has in place with its tenants, do not form part of the assets necessary for the carrying on of the lessor's enterprise. In such a scenario the standard rate would likely apply to the disposal, however, the recipient would be able to claim input tax where the property will be used in the course of making taxable supplies.

As can be gleaned from above, when parties are concluding agreements for the transfer of a commercial letting enterprise as a going concern and applying the zero rating provisions, there are various factors that need to be taken into account from a VAT perspective. The dragon is in the detail.

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SARS' PREFERENCE ON BUSINESS RESCUE

An important judgment was handed down in the Western Cape High Court on 31 October 2012. This was in the matter of ***Commissioner: SARS v Mark Beginsel NO and Others***. Readers will no doubt be aware of SARS' statutory preference legislated in Section 99 of the Insolvency Act, No 24 of 1936. The fact that SARS is a preferred creditor in a winding up has often gutted the estate leaving pennies for the concurrent creditors.

Accordingly, it was with interest that the legal community waited to see what SARS' position would be where a company sought business rescue in terms of s128 of the Companies Act, No 71 of 2008. In this matter that came before Fourie J, the business rescue practitioners had sought an extension for the submission of their proposed business rescue plan, but at the meeting of creditors SARS had insisted that it should be ranked as a preferent creditor and that the business rescue practitioners should accordingly take into account SARS' attitude based on the additional weight it would carry as a creditor. The business rescue practitioners refused to do this saying that they had taken senior counsel's advice to the effect that the classification of creditors in the Insolvency Act was not applicable to Chapter 6 of the Companies Act, which contains no statutory preferences such as are found in s96 to s102 of the Insolvency Act.

SARS applied to Court for an order declaring unlawful and invalid the decision taken at the meeting of creditors to approve the business rescue plan. Moreover, they sought to interdict the business rescue practitioners from distributing any monies of the company pursuant to the business rescue plan. Following from this the Court was asked to declare that the business rescue practitioners must put the company into liquidation.

The legal issue really turned on the interpretation of s145(4)(a) and (b) of the Companies Act, which stipulates that in respect of any decision, secured or unsecured creditors would have a voting interest equal to the value of their claim in the company, and that a concurrent creditor who would be subordinated in a liquidation has a voting interest independently and expertly appraised equal to the amount which they could reasonably expect to receive in

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a liquidation. SARS' argument was that its status as a preferent creditor under s99 of the Insolvency Act meant that its claims would rank ahead of ordinary concurrent creditors under s103 of the Insolvency Act. As such it is an unsecured creditor in s145 and had a voting interest at the creditors meeting equal to the value of its claim against the company. SARS' argument was that ordinary concurrent creditors under s103 are included in the class of concurrent creditors who would be subordinated in a liquidation. Essentially SARS was looking to be considered to be a preferent unsecured creditor under s145(4)(a) of the Companies Act, and to have a voting interest equal to the value of its claim. The remainder of the non preferent concurrent creditors, would have been disenfranchised concurrent creditors in terms of the provisions of s145(4)(b). In such an event the vote of SARS would have carried the day and the business rescue plan would have been rejected at the meeting, contrary to the wishes of the majority of the company's creditors.

The judge's view was that SARS' construction was not only contrary to the ordinary grammatical meaning of the words, but also led to an illogical result that failed to balance the rights and interests of the relevant stakeholders. The judge's view was that no statutory preferences were created in Chapter 6 of the Companies Act, and if the intention of the legislature had been to confer such a preference on SARS in business rescue proceedings, it would have made such intention clear. No trace of such an intention could be found in the Act. On the reading of the judge, and having regard to the purpose of business rescue proceedings, only one conclusion was justified, namely that SARS is not by virtue of its preferent status in s99 of the Insolvency Act a preferent creditor for the purposes of business rescue proceedings. The judge referred to Mars' Law of Insolvency and to Henochsberg on the Companies Act, concerning the notion of a preferent creditor whose claim is not secured, but who ranks above the claims of concurrent creditors. These are those who have the statutory preferences in s96 to s102 of the Insolvency Act. The judge considered at length the argument put forward by Henochsberg which was the same interpretation as that put forward by SARS. The judge noted that Henochsberg accepted that this interpretation that a concurrent creditor who would be subordinated in a liquidation in terms of s145(4)(b) of the Companies Act would be grossly unfair to the concurrent creditors. Fourie J said that in his mind the ordinary meaning of the concept of subordination, meant that a creditor's claim that was subject to a subordination or back ranking agreement, was what is being considered in sub paragraph (b). The judge said that in his view s144(2) of the Companies Act did not lend any support for the interpretation contended for by Henochsberg.

Accordingly, SARS would enjoy no greater voting interest than the other concurrent creditors of the company with the result that there is no basis on which to impeach the voting procedure that had been followed by the business rescue practitioners.

In the writer's view the provisions of the Companies Act are most likely to be amended.

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