

## VAT LIABILITY FOR FICTITIOUS SUPPLIES

*XYZ CC v The Commissioner for South African Revenue Service*

In the recent decision of *XYZ CC v The Commissioner for South African Revenue Service*, the Tax Court was required to determine whether XYZ CC (taxpayer) should be exonerated from its tax liabilities on the basis that unfair and dishonest practices by external third parties, carried out in a secretive way in order to trick the taxpayer, led to the taxpayer incurring the liability.

By way of a general background, a certain Mr A was approached by external third parties, who proposed that he establish a close corporation (the taxpayer) with the business of supplying seafood products. In turn, the third parties gave an undertaking to Mr A that they would order supplies from the taxpayer. Based on this agreement, the taxpayer was duly incorporated with Mr A being the sole member, and the taxpayer subsequently registered as a VAT vendor with SARS. Subsequent to this, the third parties again approached Mr A and asked him to issue fictitious invoices in the name of the taxpayer as it was needed in order to raise a loan for the purpose of purchasing stock for their business. The third parties gave a further undertaking that they would take care of any tax consequences that may arise from the issuing of the fictitious tax invoices. Mr A duly agreed to this and issued three tax invoices detailing the nature of the fictitious supplies allegedly made. The amounts reflected on the tax invoices were inclusive of VAT and were paid by the third parties bank, being the amount of the loan to the tax payer. Also, as agreed, Mr A caused the amounts to be paid from the taxpayer to the third parties, after which the third parties absconded.

Accordingly and in terms of s15(1) of the VAT Act, No 89 of 1991 (Act), a taxpayer has to account for the VAT on the issuing of an invoice unless it had been granted permission to account for VAT on a payment basis. In this case, the taxpayer had failed to account for VAT and rendered a nil VAT return for the relevant VAT periods.

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As a result of the taxpayer's failure to account for VAT, SARS raised additional assessments in 2005 in terms of s31 of the Act. Further, in terms of section 60 of the Act, SARS imposed 200% additional tax against the taxpayer. The taxpayer objected to the additional assessment and the punitive levies on the basis that Mr A was not aware of the fact that the agreement between himself and the third party was entered into for some nefarious purpose and further, it was argued that Mr A did not wilfully issue the fictitious tax invoices in the name of the taxpayer but rather issued the tax invoices under duress.

Accordingly, the issue for consideration before the Tax Court was (i) the credibility of Mr A's explanation for engaging in the fraudulent action; and (ii) if it is found that Mr A's explanation was credible, whether the taxpayer would be exonerated from liability. In answering these questions, the Court held that:

- Given the accounting background of Mr A, it is arguable that he was well acquainted with and understood the provisions of the Act. Therefore, there exists no logical explanation as to why Mr A would have participated in the fraud gratuitously and in the process expose himself to criminal and punitive assessments, unless he participated in the fraud for his own gain.

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- Although Mr A argued that he engaged in the fraudulent activity under circumstances of duress, technically Mr A could have avoided this fraudulent activity by (i) withholding the VAT and duly paying it over to SARS; or (ii) reversing the invoices by issuing credit notes to the third party in term of s21 of the Act.

In light of this, the Tax Court dismissed the appeal of the taxpayer on two grounds. The first was that Mr A did not provide a credible account of the circumstances under which he had submitted the fraudulent tax invoices, and thereafter a nil VAT return. The second was that irrespective of Mr A's explanation, the taxpayer (and Mr A being the sole member) was patently liable in terms of the provisions of the Act for the VAT as well as the punitive levies.

## VAT 101- THE DRACONIAN PROVISIONS

Given the complexity and ever changing tax legislation in South Africa it is useful to take a step back to basics, especially in a VAT context, which will always be a favourite area for SARS to investigate.

The VAT Act, No 89 of 1991 (Act) provides for the imposition of VAT in respect of the supply of goods and services and on the importation of goods and services. Persons who make taxable supplies in the course or furtherance of an enterprise conducted wholly or partly in South Africa are required to register as vendors, provided the minimum turnover threshold is reached. Vendors collect output VAT from their customers and claim credits for input VAT paid by them. The difference between output VAT and input VAT is either paid to or refundable by SARS.

VAT is generally levied at the standard rate of 14% at each stage within the distribution chain, although certain supplies are subject to VAT at a rate of 0% (referred to as 'zero-rated' supplies) that are still taxable. Other supplies are exempt, such as financial services. The benefit of providing taxable supplies is that a vendor can claim an input tax credit associated with the rendering of the taxable supplies.

In terms of s23 of the Act, a person (that includes a natural person, company, etc) is required to register as a vendor if it carries on an enterprise and the total value of taxable supplies during the last 12 months exceeds R1 million, or if at the commencement of any month there are reasonable grounds for believing that the total value of taxable supplies in the next 12 months, will exceed R1 million.

The decision by the Tax Court in this case is indicative of the fact that in determining the tax liability of a party, SARS will not concern itself with skulduggery among the parties to a transaction. The consequence is that SARS will apply black letter law in determining tax liability without considering the wider facts such as fictitious supplies.

*Nicole Paulsen*

## Enterprise

Before a person (or company) can register as a vendor, the person (or company) would need to carry on an enterprise. An 'enterprise' is defined as any activity that is carried on continuously or regularly, or partly in South Africa in the course or furtherance of which goods and services are supplied to any other person for a consideration whether or not for profit. What needs to be understood in a South African VAT context is that a 'vendor' is merely a collection agent for SARS and cannot lay claim to nor own any VAT collected on SARS' behalf.

'Enterprise' is defined, among other things, as follows:

"...in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club...

Provided that —

- (i) ...
- (v) any activity shall to the extent to which it involves the making of exempt supplies not be deemed to be the carrying on of an enterprise;

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## The supply

Section 12 of the Act deals with exemptions and provides, among other things, that:

"The supply of any of the following goods or services shall be exempt from the tax imposed under s7(1)(a):

(a) the supply of any financial services, but excluding the supply of financial services which, but for this paragraph, would be charged with tax at the rate of zero per cent under s11".

Accordingly, in terms of the Act, any supply of financial services, which is zero rated in terms of s11, is not exempt but is treated as a zero-rated supply.

In terms of s2 of the Act, the following activities are, among other things, deemed to be 'financial services': "the issue, allotment or transfer of ownership of an equity security or a participatory security" (S2(1)(d) of the Act)

In terms of s2(2)(iv) of the Act, an 'equity security' means "any interest in or right to a share in the capital of a juristic person ...".

'Output tax' is defined in section 1 of the Act as: "in relation to any vendor, means the tax charged under s7(1)(a) in respect of the supply of goods and services by that vendor".

Section 7(1)(a) of the Act levies VAT as follows: "on the supply by any vendor of goods or services supplied by him... in the course or furtherance of any enterprise carried on by him".

A 'taxable supply' is in turn defined as: "any supply of goods or services which is chargeable with tax under the provisions of s7(1)(a), including tax chargeable at the rate of zero per cent under s11".

Once a person is registered for VAT, that person has to account for output tax on all taxable supplies of goods and services. Taxable supplies consist of standard rated and zero rated supplies while other supplies are exempt, such as financial services.

## Input tax

'Input tax' is defined in s1 of the Act as:

"tax charged... on the supply of goods or services made... to the vendor... where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of s17) that the goods or services concerned are acquired by the vendor for such purpose".

An input tax deduction is granted to a vendor where the goods or services were acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies. The benefit of providing taxable supplies is that a vendor can claim an input tax credit associated with the rendering of the taxable supplies by him.

Vendors need to constantly review the VAT obligations imposed on them as part of a prudent tax risk management framework to keep pace with the ever changing South African tax landscape.

*Carmen Moss-Holdstock*

## CONTACT US

For more information about our Tax practice and services, please contact:



**Emil Brincker**  
Director  
National Practice Head  
T +27 (0)11 562 1063  
E [emil.brincker@dclacdh.com](mailto:emil.brincker@dclacdh.com)



**Alastair Morphet**  
Director  
T +27 (0)11 562 1391  
E [alastair.morphet@dclacdh.com](mailto:alastair.morphet@dclacdh.com)



**Andrew Seaber**  
Senior Associate  
T +27 (0)11 562 1768  
E [andrew.seaber@dclacdh.com](mailto:andrew.seaber@dclacdh.com)



**Ben Strauss**  
Director  
T +27 (0)21 405 6063  
E [ben.strauss@dclacdh.co](mailto:ben.strauss@dclacdh.co)



**Heinrich Louw**  
Associate  
T +27 (0)11 562 1085  
E [heinrich.louw@dclacdh.com](mailto:heinrich.louw@dclacdh.com)



**Johan van der Walt**  
Director  
T +27 (0)11 562 1177  
E [johan.vanderwalt@dclacdh.com](mailto:johan.vanderwalt@dclacdh.com)



**Tessmerica Moodley**  
Associate  
T +27 (0)21 481 6397  
E [tessmerica.moodley@dclacdh.com](mailto:tessmerica.moodley@dclacdh.com)



**Ruaan van Eeden**  
Director  
T +27 (0)11 562 1086  
E [ruaan.vaneeden@dclacdh.com](mailto:ruaan.vaneeden@dclacdh.com)



**Carmen Moss-Holdstock**  
Associate  
T +27 (0)11 562 1614  
E [carmen.moss-holdstock@dclacdh.com](mailto:carmen.moss-holdstock@dclacdh.com)

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### BBBEE STATUS: LEVEL THREE CONTRIBUTOR

#### JOHANNESBURG

1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa  
Dx 154 Randburg and Dx 42 Johannesburg  
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E [jhb@dclacdh.com](mailto:jhb@dclacdh.com)

#### CAPETOWN

11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa  
Dx 5 Cape Town  
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E [ctn@dclacdh.com](mailto:ctn@dclacdh.com)

[www.cliffedekkerhofmeyr.com](http://www.cliffedekkerhofmeyr.com)

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