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TAX ALERT

CONCESSIONARY TAX RATE ACCORDED TO SMALL BUSINESS CORPORATIONS – WHEN DO YOU QUALIFY?

Section 12E of the Income Tax Act, No 58 of 1962 (Act) provides for a beneficial tax dispensation for small business corporations, subject to certain requirements being complied with. Specifically, s12E(4)(a) of the Act defines a small business corporation and deals comprehensively with what should be construed as a small business corporation before a corporate entity can qualify for the concessionary tax rates.

A recent case in which the application of s12E was dealt with is the case of *TML Consultancy Services CC v The Commissioner, case no 12860,* handed down by the Tax Court on 22 June 2012. By way of a general background, this case concerned the appellant who submitted its tax returns for the 2005 and 2006 years of assessment on the basis that it was a small business corporation in terms of s12E of the Act. Accordingly the Appellant was assessed for the 2005 and 2006 tax years as a small business corporation.

However, in 2007, the Commissioner for the South African Revenue Service (SARS) issued additional assessments for the 2005 and 2006 tax years on the basis that the appellant was a company who rendered a personal service and as such did not qualify as a small business corporation. As a result the appellant lost out on the concessionary tax rate accorded to small business corporations.

In August 2007, the appellant filed objections to the additional assessments on the grounds that SARS had not provided the appellant with any reasons for the additional assessments. SARS subsequently responded with a letter stating that the appellant rendered a personal service as contemplated by s12E(4)(d) and derived more than 20% of its receipts and accruals from the provision of that service and from investment income, as prescribed by s12E(4)(a)(iii) of the Act. Consequently, it was not eligible for the concessionary tax rates applicable to small business corporations.

Subsequently, the appellant lodged an appeal against the decision of SARS to the South Gauteng Tax Court (Court) pursuant to the provisions of s83A(13) of the Act. Essentially, the crisp issue before the Court was whether the appellant qualified to be categorised as a small business corporation, as contemplated in s12E(4)(a) of the Act or whether the appellant was barred from such categorisation on the grounds that s12(4)(a)(iii) read with s12(4)(d), operate against such categorisation.

Based on the facts above, the Court held that "in deciding whether the appellant qualified as a small business corporation or not, the enquiry must of necessity be directed at the following:

- What is the meaning of the words "consulting, broking and management" and do any of the above terms describe any part of the appellant's activities?
- If the appellant does in fact provide any of the personal services referred to in s12E(4)(d) of the Act, is any specific income generated by a person who is a member of the company and, if so, does such income collectively with any investment income, exceed 20% of the appellant's receipts and accruals and capital gains?"

In deciding on the first leg of the enquiry, the Tax Court referred to SARS' Interpretation Note No 9, where it was stated that "the definition of "Personal Service" is very broad and does not define the meaning of each activity. It is therefore necessary to analyse each activity within it's ordinary meaning separately".

Based on the facts of the case and the ordinary interpretation of the term 'consulting' as well as the overall nature of the appellant's business, the Court concluded that the appellant in this case is not involved in the business of consulting, broking or management as used in s12E(4)(d) of the Act.

Therefore, SARS' contention that the appellant rendered a "personal service" as contemplated in s12E of the Act cannot succeed.

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Insofar as the second part of the enquiry is concerned the Court held that based on the overall activities of the appellant, providing the consultancy services to its clients is an incidental part of the services provided and that no income is directly attributable from that specific type of activity. Furthermore, the Court stated that "the appellant's contention that the amount, if any, earned from that particular activity could not exceed 5% of the total income derived by the appellant, is not far-fetched".

Accordingly, the Court found that SARS was incorrect in deciding that the appellant was a personal service provider, as defined in s12E of the Act as the nature of its business activities do not constitute a personal service. Furthermore, even if the revenue earned was directly attributable to the consultancy services provided by the appellant to its clients, this revenue did not exceed the prescribed amount.

On this basis, the Court ordered SARS to withdraw the revised assessments for the 2005 and 2006 years of assessment, and to issue revised assessments for the aforementioned years of assessment in terms of which the appellant is taxed as a small business corporation in terms of s12E of the Act.

Nicole Paulsen

THERE BE DRAGONS: THE VAT IMPLICATIONS ARISING FROM THE DE BEERS SCA JUDGMENT

On a more careful reading of the Supreme Court of Appeal (SCA) judgment, there are certainly some serious repercussions that can arise and impact on the vendor and its enterprise to the extent that the costs incurred by the business do not form part of the 'enterprise' and 'taxable supplies' as defined below.

The issues arising from this judgment should be analysed after compartmentalising them into certain costs, that a normal enterprise, or in this case a listed company whose enterprise comprised the mining, buying and selling of diamonds can incur and where the input tax claimed for VAT purposes will be denied.

For ease of reference, we will deal with the finding of each of the costs (being the direct costs, overhead costs, shareholder costs and subsidiary costs) as they were dealt with in the majority judgment written by Southwood AJA (Leach JA and Maclaren AJA concurring) (majority judgment) and the minority judgment written by Navsa and van Heerden JJA (minority judgment).

The Relevant provisions of the VAT Act 89 of 1991 (Act)

It is useful to set out those sections of the Act around which the judgment turned.

Enterprise

A vendor will only be regarded as making taxable supplies if it can be said that the supply was made in the course or furtherance of its 'enterprise'.

'Enterprise' is defined, *inter alia*, 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) .....
> ii) any activity shall be the extent to which it involves the making of exempt supplies not be deemed to be the carrying on of an enterprise;"

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."

Analysis of expenditure incurred by a company and its ability to claim input tax for VAT purposes

What is clear from both the majority and minority judgment relating to direct costs is that the expenditure would only be allowed as a deduction for input tax to the extent that those costs can be said to have been directly linked to the enterprise.

In other words the VAT incurred in respect of services or goods acquired by the vendor must have been:

> "…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 are acquired by the vendor such purpose…"

continued

What can be a major concern arising out of this judgment and going forward, is the potential for the South African Revenue Service (SARS) to issue revised assessments based on this judgement. I have no doubt this will ensure a few restless nights of worry and concern.

General overhead costs such as audit fees and legal fees will generally not raise too much of an issue to the extent that the costs are close enough to the core of the business of the enterprise. It would be wise to consider each expense on the grounds of whether it would be deemed a normal overhead cost of operating the enterprise.

In the writer's view, an interesting issue was the manner in which the majority judgment dealt with the issue of complying with statutory obligations and in particular shareholder costs.

In paragraph 53 of the majority judgment it is stated that:

> "the question is whether NMR's services were acquired for the purpose of making 'taxable supplies' in that 'enterprise'" and further "…DBCM acquired NMR's services because DBCM was the target of a takeover by parties to whom it was related and DBCM's board had a duty to report to independent unit holders as to whether the consortium's offer was fair and reasonable…Such services were not acquired to enable DBCM to *enhance* its VAT 'enterprise' of mining, marketing and selling diamonds. The 'enterprise' was not in the least *affected* by whether or not DBCM acquired NMR's services. They were also not acquired in the ordinary course of DBCM's 'enterprise' as *part of its overhead expenditure* as argued by DBCM. They were supplied to enable DBCM's board to comply with its legal obligations." (*our emphasis*).

It was argued by De Beers Consolidated Mines Limited (DBCM) that as a listed company it was obliged to engage in various forms of activities in relations to its shareholders and that these supplies formed an integral part of the enterprise, for example, publication of announcements in the press, publication of circulars and distribution of dividends. These supplies are generally made for no consideration and the question that arises was whether the VAT paid on these inputs could be held to be acquired for the purpose of making taxable supplies in the course and furtherance of the company's enterprise.

The majority judgment took a rather narrow interpretation of 'enterprise' in disallowing the claim for services of NM Rothschild and Sons Ltd (NMR). They held that the services by NMR did not add to the company's enterprise of mining, buying and selling diamonds. They held that the statutory costs incurred related to the obligations to the shareholders. The enterprise of mining, selling and buying diamonds needs to be distinguished from the statutory obligations imposed on a company.

If one considers the wording of paragraph 53 of the majority judgment it can be argued that to the extent a company does not comply with the onerous statutory regulations imposed on it that it will not be able to continue. When dealing with shareholder costs, we believe that there is an argument that to the extent that those costs incurred affect the interest of the company as opposed to the interest of the shareholder, which does not affect the enterprise, it is deductible.

To expand further on this line of thinking, the extent that shareholder costs are costs that are in the interest of the company, those can *affect* the enterprise so that these costs could be allowed as a deduction-compliance with statutory obligations. The issuing of shares for instance will not be allowed as a deduction.

To the extent that the shareholder costs are costs that are in the interest of the shareholder, we are of the view based on both the majority and minority judgment that these costs will not be allowed as a deduction. They do not enhance the VAT enterprise. The costs that we are referring to are those incurred such as JSE listing fees, publication of annual reports and shareholder communications, which are in the interest of the shareholders.

In other words, to the extent that the expenditure relates to a shareholder activity, the costs cannot be said to relate to the making of any taxable supplies by the vendor in the course or furtherance of its mining 'enterprise'. Put differently, these shareholder activities, while crucial from not only a legal perspective but a commercial one, do not relate to or enhance the vendor's on-going diamond activities.

It was accepted that although DBCM acted under a legal obligation in providing advice to its shareholders in relation to the proposed restructuring, those activities were not sufficiently linked to its 'usual' taxable supplies of mining, selling and buying diamonds for the foreign services to fall outside the scope of 'imported services' or for the VAT incurred in respect of those local services to constitute 'input tax'.

It is evident that any subsidiary costs relating to the enterprise will not be allowed as a deduction.

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