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TAX AND EXCHANGE CONTROL ALERT

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In October 2015, the OECD BEPS Action 4 Report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Report) was released setting out a common approach to address BEPS involving interest and payments economically equivalent to interest.

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CARS, TAXABLE SUPPLIES AND INPUT VAT – WHAT SAYS THE LAW?

The Tax Court had to determine whether input tax could be claimed by the taxpayer, a close corporation which carried on business in the courier industry, on the purchase of a vehicle that it used to make taxable supplies.

In our current day and age where convenience is key, it is common for businesses to deliver purchased goods to their clients. For such businesses, especially those who specialise in providing delivery and logistical services, it is important to note the applicable VAT considerations when purchasing a vehicle. In *RTCC v Commissioner for the South African Revenue Service* (VAT 1345) [2016] ZATC 5 (28 July 2016), the Tax Court had to determine whether input tax could be claimed by the taxpayer, a close corporation which carried on business in the courier industry, on the purchase of a vehicle that it used to make taxable supplies.

Section 1 of the VAT Act contains a broad definition of "motor car", but for purposes of this discussion it is only relevant that a "motor car" includes a "motor vehicle of the kind normally used on public roads, which has three or more wheels and is constructed or converted wholly or mainly for the carriage of passengers".

Facts

While conducting an audit of the taxpayer's tax affairs, the South African Revenue Service (SARS) found that the taxpayer claimed input tax in respect of the acquisition of a 2007 Mercedes Benz 115 CDI Crew Cab vehicle (Vehicle), on the basis that the Vehicle was acquired for the purpose of making taxable supplies. SARS disallowed the claim as it considered the Vehicle to be a "motor car" as defined in s1 of the VAT Act, No 89 of 1991 (VAT Act). The taxpayer objected to SARS's assessment, alleging that it used the Vehicle solely in the courier business to deliver packages and not to transport passengers. SARS disallowed the objection and the taxpayer's subsequent appeal to the Tax Board was also unsuccessful. The taxpayer then appealed to the Tax Court in terms of s115 of the Tax Administration Act, No 28 of 2011 (TAA).

Judgment

The Tax Court firstly referred to s17(2)(c) of the VAT Act, which states that a VAT vendor may not claim an input tax deduction in respect of the supply of a "motor car", on which output tax was levied. Section 1 of the VAT Act contains a broad definition of "motor car", but for purposes of this discussion it is only relevant that a "motor car" includes a "motor vehicle of the kind normally used on public roads, which has three or more wheels and is constructed or converted wholly or mainly for the carriage of passengers". On the facts, the only issue was whether the Vehicle was constructed or converted wholly or mainly for the carriage of passengers.

Firstly, the Tax Court considered the meaning of the word "mainly". It referred to the decision in ITC 1596 (1995) 57 SATC 341 (T), where that court held that "mainly" refers to a measure of more than 50% and that an objective test must be applied to make this determination. Importantly, the court in ITC 1596 stated that the total construction, assembly, appearance, and space or surface of the vehicle must be taken into account to determine whether the vehicle is constructed mainly, ie more than 50%, for the carriage of passengers. This test was also approved in ITC 1693 62 SATC 518.

In the current case, the taxpayer argued that the characteristics of the Vehicle showed that it was constructed mainly for the transportation of goods. It argued that the floor area of the Vehicle should not be the test to determine whether it was mainly used to carry passengers,

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IN82 states that if the vendor subsequently converts the vehicle so that it no longer constitutes a "motor car", the vendor will be entitled to deduct input tax on the original or initial purchase price of the converted vehicle.

but rather the load capacity of the Vehicle which in this instance was weighted towards the carriage of goods. It argued that the Vehicle's second row of seats were used to load goods for carriage, but SARS disputed this and argued that the Vehicle was constructed mainly for the carriage of passengers.

In assessing the parties' arguments, the Tax Court referred to the judgment in ITC 1596, but held that it should be read with SARS Interpretation Note 82 (IN82). According to IN82, when applying the objective test, one must determine whether the passenger area or dedicated loading space is longer and that an area comprising fold-up seats should be regarded as a space for passengers. In applying the objective test, the court considered the diagrams and dimensions of the Vehicle as well as photographs of the Vehicle. These diagrams showed that the length of the Vehicle's passenger space constituted 65% of the Vehicle's total length, excluding the engine area. The floor area of the passenger space also constituted 65% of the Vehicle's floor area. The Tax Court rejected the taxpayer's argument that the driver's seat should be excluded from the calculation of the floor area comprising passenger space and endorsed the approach set out in IN82.

Interestingly, the court also remarked on s12 and s125 of the TAA which deals with the issue of legal representation before the Tax Court. In terms of s125, SARS may be represented in an appeal by a senior official referred to in s12. Section 12 states that the senior official must be an admitted advocate or attorney in order to represent SARS at the hearing. The same does not apply to the taxpayer, who may represent herself or may be represented by her representative, which may be a layperson with no understanding of the law or court process. According to the Tax Court, this provision may lead to an imbalance as to the equality of arms and creates a gap in the law which needs to be addressed by the relevant authorities "to ensure that the representatives have some expertise in the field of tax law".

Comment

Although the principles in the *RTCC* decision are well established in our law, it serves as a reminder to taxpayers whose business involves the making of taxable supplies and who are vendors in terms of the VAT Act, to ensure that they are able to claim an input tax deduction on motor vehicles purchased for their business. The failure of the taxpayer to claim such an input tax deduction will have a detrimental impact on the cash flow of a business, especially in the short term, depending on the category of vendors in which the taxpayer falls in terms of s27 of the VAT Act. If, for example, the taxpayer is a category A or B vendor, it will have to pay VAT to SARS every two months. However, there is a solution for a vendor who realises after the fact that it has purchased a vehicle on which it cannot claim an input tax deduction: IN82 states in paragraph 3.6.2 that under such circumstances, if the vendor subsequently converts the vehicle so that it no longer constitutes a "motor car", the vendor will be entitled to deduct input tax on the original or initial purchase price of the converted vehicle. IN82 further states that the vendor would most likely also be able to claim input VAT on the conversion costs provided the vehicle is used, consumed or supplied in the making of taxable supplies.

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BEPS INVOLVING INTEREST IN THE BANKING AND INSURANCE SECTORS

International debt shifting is rife, with multinational groups leveraging greater debt in subsidiaries located in high tax jurisdictions, thereby reducing their international tax incidence.

In October 2015, the OECD BEPS Action 4 Report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (Report) was released setting out a common approach to address BEPS involving interest and payments economically equivalent to interest. The Report included a 'fixed ratio rule' which limits an entity's net interest deductions to a set percentage of its tax earnings before interest, taxes, depreciation and amortisation (tax EBITDA) and a 'group ratio rule' which permits an entity to claim higher net interest deductions, based on the financial ratio of its worldwide group.

The Report's recommended approach to address these BEPS risks is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its tax EBITDA.

To elaborate briefly, BEPS Action 4 emphasises the need to address BEPS through the use of deductible payments such as interest (particularly related and/or connected party interest) and other financial payments economically equivalent to interest. The use of deductible payments such as interest to achieve inter-jurisdictional profit shifting is one of the simplest and most effective weapons in the international tax planning armoury. Multinational groups take advantage of the heterogeneity of tax deduction rules by reallocating debt to high tax jurisdictions. International debt shifting is rife, with multinational groups leveraging greater debt in subsidiaries located in high tax jurisdictions, thereby reducing their international tax incidence. Accordingly the leverage of a multinational group is acutely sensitive to a jurisdiction's tax rate, and fiscal authorities are confronted with ever diminishing corporate tax receipts from multinationals that employ excessively high leverage and concomitant interest deductions. Further, research indicates that developing countries are more susceptible to the adverse impact of debt shifting than developed countries.

The mobility and fungibility of money facilitates the easy intra-group manipulation of the combination of debt and equity. It is due to the above stated facts that BEPS Action 4 emphasises the need to address BEPS through the use of such deductible payments, which practice has the potential to facilitate double non-taxation in both inbound and outbound investment scenarios.

In the main, BEPS risks arise within the context of interest deductibility in three scenarios:

- multinational groups placing higher levels of third-party debt in high tax jurisdictions;
- multinationals using intra-group loans to generate interest deductions in excess of the relevant group's actual third-party interest expenditure; and
- multinationals using third-party or intra-group financing to generate tax exempt income.

As stated above, the Report's recommended approach to address these BEPS risks is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its tax EBITDA. As a minimum this ratio should be applied to all entities within a multinational group. To ensure that countries apply a benchmark fixed ratio that is low enough to combat BEPS, while

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The Report identifies banks and insurance companies as presenting unique issues that are not present in other sectors.

recognising that jurisdictions are not all in the same position from a leveraging or economic perspective, the recommended approach includes a band of possible ratios ranging from 10% to 30%. The Report also includes factors to be taken into consideration by a country when determining the appropriate benchmark fixed ratio. Factors which may lead a country to consider applying a higher benchmark fixed ratio rule include circumstances where the jurisdiction in question:

- operates the benchmark fixed ratio in isolation as opposed to in conjunction with a group ratio rule;
- does not permit the carry forward of unused interest or the carry back of disallowed interest expenditure;
- applies other targeted rules that specifically address BEPS risks as envisaged under Action 4;
- has higher interest rates relative to other countries (as does South Africa); or
- is required to apply the same treatment to different types of entities which are considered legally comparable even if those entities pose varying levels of BEPS risks (eg in the EU where legal requirements prescribe parity of treatment for legally comparable entities).

The Report also proposes the introduction of a group ratio rule in conjunction with the fixed ratio rule to allow an entity within a highly leveraged multinational group to deduct net interest expenditure in excess of the amount permitted under the fixed ratio rule, based on the relevant financial ratio of its worldwide group. In effect the group ratio rule entitles an entity to deduct net interest expenditure up to the net third-party interest expenditure/EBITDA ratio of its group. The OECD issued a further Public Discussion Draft: BEPS Action 4 – Elements of the Design and Operation of the Group Ratio Rule on 11 July 2016, calling for responses by 16 August 2016. We await the outcome in due course.

On 28 July 2016 the OECD released a further Public Discussion Draft: BEPS Action 4 – Approaches to Address BEPS involving Interest in the Banking and Insurance Sectors (Discussion Draft), which is the core focus of this article.

To contextualise the Discussion Draft, we need to review the Report's treatment of the banking and insurance sectors. The Report acknowledges that certain sectors, due to their uniqueness, require dedicated scrutiny, hence the release of the Discussion Draft since the Report provides that countries may exclude entities in banking and insurance groups, and regulated banks and insurance companies in non-financial groups from the ambit of the fixed ratio rule and the group ratio rule.

The Report identifies banks and insurance companies as presenting unique issues that are not present in other sectors. Interest expenditure is typically the largest cost on a bank's income statement. As such any rule limiting the deductibility of gross interest expenditure will have a significant impact on a bank's business model. Generally for insurance companies, interest expenditure will be considerably less, the largest costs on insurance companies' income statements being

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The Report concludes that a specific rule would have to be designed to manage the BEPS risks presented by banks and insurance companies.

policy benefits and claims. Banks and insurance companies both provide debt finance to groups in other sectors, either as lenders or investors in corporate bonds. As such they will generally be recipients of net interest income. A rule which caps net interest expenditure will not bear directly upon banks or insurance companies, although such a provision could limit the deduction of net interest expenditure in other group entities.

The Report observes further that the role interest performs in the banking and insurance sectors, differs from its role in other sectors. The nexus between interest expenditure and a bank's or an insurance company's income-generating capacity is much stronger than in other sectors. Financial sector businesses are generally subject to strict regulations which impose limitations on their capital structure and their ability to place debt in certain group entities. Basel III introduced a risk mitigation leverage ratio in 2011 to constrain leverage in the banking sector. In addition banks are subject to commercial constraints from credit rating agencies. The Report concludes that a specific rule would have to be designed to manage the BEPS risks presented by banks and insurance companies. One possibility the Report proposes, would entail focussing on the net interest expenditure attributable to regulatory capital instruments which perform a role comparable with debt in other sectors. A group-wide interest allocation rule could be formulated to limit a group's total net deductions on its regulatory capital to the amount of interest expenditure incurred on such instruments to third parties. The interest cap could be allocated within a group in accordance with regulatory requirements. Alternatively if existing regulatory requirements are found to limit excessive leveraging in groups, the Report suggests a best practice approach to hone in on a group's interest expenditure incurred other than in respect of its regulatory capital. This the Report observes, may require targeted rules to address risks presented by specific transactions.

The Discussion Draft does not change any of the conclusions agreed in the Report, but provides a more detailed consideration of the BEPS risks banks and insurance companies pose, as well as the BEPS risks posed by entities in a group with a bank or an insurance company, such as holding companies, group service companies and companies engaged in non-regulated financial or non-financial activities.

The Discussion Draft notes the significant differences between the business models, structures, financing and regulation of banking and insurance groups. Consequently it does not propose or anticipate that a country will apply equivalent interest deductibility limitations, if appropriate, to both groups.

While performing preparatory work on the Discussion Draft, several jurisdictions identified financing structures employed by banking and insurance groups which pose Action 4-type BEPS risks. The main BEPS risks involving interest were found to include:

- banks or insurance companies and entities in a group with a bank or an insurance company, using third-party or intra-group interest to fund equity investments which generate income which is either tax exempt or taxable at preferential rates; and

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The Discussion Draft finds that the risk of BEPS involving excessive interest deductions is generally posed by entities in a group with a bank or an insurance company, rather than by banks or insurance companies themselves.

- entities in a group with a bank or an insurance company incurring excessive third-party or intra-group interest expenditure, which may be deductible against taxable interest income in the bank or insurance company within the group.

The Discussion Draft finds that the risk of BEPS involving excessive interest deductions is generally posed by entities in a group with a bank or an insurance company, rather than by banks or insurance companies themselves. The Discussion Draft postulates that this may be due, at least in part, to the regulatory capital rules which require minimum amounts of equity to be held and restrict the amount of leverage in a single regulated entity. Although the regulatory capital rules are intended to ensure that the leverage of a bank or an insurance company doesn't render it capitally inadequate in the face of financial or economic shocks; it may be that the rules serve a dual purpose by producing an appropriate outcome from a tax perspective too.

Accordingly, for banks and insurance companies, a limited BEPS risk has been identified in the Discussion Draft.

For other entities in a banking or an insurance group, the Discussion Draft identifies a greater BEPS risk and recommends that countries consider applying the fixed ratio rule and group ratio rule to these entities, duly modified as appropriate in the specific circumstances. In each case, flexibility is provided for a jurisdiction to take cognisance of the particular features of its tax law and policy.

The Committee on Fiscal Affairs (CFA) has called upon interested parties to submit comments on the Discussion Draft by 8 September 2016. We await the release of the CFA's final report in due course.

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