

15 JUNE 2018

TAX & EXCHANGE CONTROL ALERT

IN THIS
ISSUE

THE CAPITAL V REVENUE QUESTION IN
THE CONTEXT OF GOVERNMENT GRANTS:
THE SCA DECIDES IN FAVOUR OF THE
MOTOR MANUFACTURING INDUSTRY

In the recent case of *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service* 80 SATC 179, the age-old question of whether a receipt is capital or revenue in nature was addressed by the Supreme Court of Appeal (SCA), in the context of government grants paid to motor vehicle manufacturers.

THE CAPITAL V REVENUE QUESTION IN THE CONTEXT OF GOVERNMENT GRANTS: THE SCA DECIDES IN FAVOUR OF THE MOTOR MANUFACTURING INDUSTRY

One of the objectives of the MIDP was the rationalisation of the motor car models being produced.

The Taxpayer participated in the PAA scheme and received certificates for the 2008 to 2010 years of assessment.



In the recent case of *Volkswagen South Africa (Pty) Ltd v Commissioner for South African Revenue Service 80 SATC 179*, the age-old question of whether a receipt is capital or revenue in nature was addressed by the Supreme Court of Appeal (SCA), in the context of government grants paid to motor vehicle manufacturers.

Background and relevant facts

In order to ensure the South African motor manufacturing industry remained internationally competitive, the South African Government initiated a motor industry development program (MIDP) in 1995. One of the objectives of the MIDP was the rationalisation of the motor car models being produced. In other words, the program sought to reduce the number of models being produced to improve performance and save costs. The rationalisation required plant and machinery upgrades and technology enhancements (both of which involved substantial capital outlay) and as such, the Board on Tariffs and Trade recommended the introduction of a Productive Asset Allowance (PAA). The PAA, which was provided in the form of a PAA certificate, was available to those manufacturers that invested a certain minimum value in productive assets for the manufacture and assembly of light motor vehicles. The certificate provided for a rebate on customs duty for certain categories of motor vehicles, which was to be calculated as a percentage of the value of the productive assets approved by the Director-General: Trade and Industry. As such, manufacturers that participated in the PAA scheme were reimbursed for an amount up to 20% of the capital expenditure incurred in the rationalisation

process by setting the rebate off against the customs duty the manufacturer was liable to pay on the importation of vehicles to be sold in South Africa.

Volkswagen South Africa (Pty) Ltd (Taxpayer), is a motor manufacturer involved in the manufacture and sale of motor vehicles, including the importation and exportation thereof. The Taxpayer participated in the PAA scheme and received certificates for the 2008 to 2010 years of assessment, which rebate amounts were reflected in its income tax returns as accruals of a capital nature. The South African Revenue Service (SARS) rejected these amounts as being capital in nature and issued assessments on the basis that these amounts were revenue in nature. The Tax Court confirmed SARS's assessments, which decision the Taxpayer appealed against.

Legal principles considered by the SCA

The pivotal question, in this case, was whether the PAA certificates constituted receipts or accruals which were capital or revenue in nature.

Despite the myriad of court decisions regarding the determination of whether an accrual or receipt is capital or revenue in nature (and the numerous guidelines that accompanied them), there are no set rules that can be applied to make this determination. Various cases have

THE CAPITAL V REVENUE QUESTION IN THE CONTEXT OF GOVERNMENT GRANTS: THE SCA DECIDES IN FAVOUR OF THE MOTOR MANUFACTURING INDUSTRY

CONTINUED

Interpretation Note 59 issued by SARS on 10 December 2010 (IN59) also gives an indication of which receipts or accruals of government grants will be considered as capital in nature and which will be revenue in nature.



reiterated that regard must always be had to whether the accrual arose from the realisation of a capital asset or whether it was received in pursuance of a profit-making scheme. Despite these guidelines, the courts have also stated that commercial and good sense must always be the overarching basis on which such a determination must be made.

Interpretation Note 59 issued by SARS on 10 December 2010 (IN59) also gives an indication of which receipts or accruals of government grants will be considered as capital in nature and which will be revenue in nature. Most relevant to this matter is paragraph 3.2.3, which states the following :

'A government grant will be of a revenue nature in the hands of a person carrying on trading operations if it is a trading receipt. A grant is a trading receipt if its receipt is a normal incident of a person's trading operations. The nature of the grant received and the relationship which exists between the grant received and the recipient's activities needs to be examined.

A government grant will be a trading receipt when it is paid in order to assist in meeting a person's trading obligations or in order to assist in carrying on trading operations. A grant of this nature results in trading receipts being supplemented and accordingly is itself a trading receipt.

By contrast, any amount received or accrued for the purpose of:

- *establishing an income-earning structure, or*
- *compensation for the surrender of such a structure, is of a capital nature.'*

IN59 suggests that SARS regards the purpose of a government grant of utmost importance in determining whether such grant is capital or revenue in nature.

Judgment

The Taxpayer contended that the matter could be decided by answering two questions, these being:

1. What was the real and basic cause of the accrual (i.e. in respect of what activity was the grant made); and
2. Whether the abovementioned cause was more closely associated with the equipment of the taxpayer's income-producing machinery (which would make it capital in nature) or with its income-earning operations (which would make it revenue in nature).

The court considered this approach and found it to be appropriate considering the nature of the matter.

SARS contended that the PAA certificates could only be redeemed by the payment of customs duties and therefore only accrued once the motors had been imported. As such, they were so closely connected to the income producing activities of the Taxpayer that they were revenue in nature. The SCA disregarded this contention and held that the PAA certificates did not accrue only once the imports had been made but immediately after they had been issued to the Taxpayer. It found that the PAA certificates were issued to compensate manufacturers for at least a portion of the capital expenditure incurred in pursuance of the rationalisation of motor vehicle models and that this clearly distinguished them as capital in nature. The SCA added that the inability to trade the PAA certificates was a further indication of the capital nature thereof.

THE CAPITAL V REVENUE QUESTION IN THE CONTEXT OF GOVERNMENT GRANTS: THE SCA DECIDES IN FAVOUR OF THE MOTOR MANUFACTURING INDUSTRY

CONTINUED

The fact that the grants were paid in the form of rebates does not change the capital nature of the benefit received by the Taxpayer.



It was held that the capital investment made by motor manufacturers was at the centre of the PAA scheme and that without these capital investments, no certificates would have been issued. Furthermore, if the grants had been paid in cash, there would have been no dispute regarding the capital nature thereof. As such, the fact that the grants were paid in the form of rebates does not change the capital nature of the benefit received by the Taxpayer.

The SCA concluded that the PAA certificates were in no way received as part of a scheme of profit making and reimbursed the Taxpayer in respect of a percentage of its capital expenditure. The SCA, therefore, upheld the appeal and declared that the PAA certificates were capital in nature.

Comment

The case raises a number of interesting issues. Firstly, it is submitted that the SCA applied the principles regarding the classification of the accruals correctly,

by determining that the PAA certificates were capital in nature. The SCA's reliance on the contents of IN59 is interesting. In our Tax and Exchange Control Alert of 4 May 2018, we referred to the Constitutional Court's decision in *Marshall NO and Others v Commissioner for SARS* (CCT208/17) [2018] ZACC 11 (25 April 2018) where it was held that it would only be justified to rely on an interpretation note, if it reflected a practice of an impartial application of a custom recognised by all concerned. Despite the Constitutional Court's judgment that followed the SCA judgment, It could be argued that the principles in IN59 regarding the classification of government grants could be relied on, as the principles appear to be consistent with the established principles laid down in South African jurisprudence regarding the determination of an amount as capital or revenue in nature.

Louis Botha and Louise Kotze



OUR TEAM

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



Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com



Mark Linington
Private Equity Sector Head
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com



Jerome Brink
Senior Associate
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com



Gerhard Badenhorst
Director
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com



Candice Gibson
Senior Associate
T +27 (0)11 562 1602
E candice.gibson@cdhlegal.com



Petr Erasmus
Director
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com



Gigi Nyanin
Senior Associate
T +27 (0)11 562 1120
E gigi.nyanin@cdhlegal.com



Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com



Varusha Moodaley
Senior Associate
T +27 (0)21 481 6392
E varusha.moodaley@cdhlegal.com



Heinrich Louw
Director
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com



Louis Botha
Associate
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com



Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@cdhlegal.com



Mareli Treurnicht
Director
T +27 (0)11 562 1103
E mareli.treurnicht@cdhlegal.com

BBBEE STATUS: LEVEL TWO CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 2 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

This information is published for general information purposes and is not intended to constitute legal advice. Specialist legal advice should always be sought in relation to any particular situation. Cliffe Dekker Hofmeyr will accept no responsibility for any actions taken or not taken on the basis of this publication.

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@cdhlegal.com

CAPE TOWN

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@cdhlegal.com

©2018 2451/JUNE

