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TAX & EXCHANGE CONTROL ALERT

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The case of *Kangra Group (Pty) Ltd v Commissioner for SARS* (Case number A20/18) was recently heard by the full bench of the Western Cape division of the High Court.

Facts and background

The salient facts were relatively simple: The taxpayer, Kangra Group (Pty) Ltd (Taxpayer) was a coal mining company linked to the well-known entrepreneur and philanthropist, Mr Graham Beck. It supplied coal to AMCI under a set of agreements. The price of the coal was fixed under the contract at about US$25 per ton. During the term of the contract, the price of coal in the international market increased considerably to about US$40 per ton.

The Taxpayer unilaterally decided to stop supplying coal to AMCI at the fixed price, and to start supplying coal to third parties at the higher price. AMCI instituted arbitration proceedings against the Taxpayer and the parties eventually settled. The Taxpayer conceded AMCI's claim and agreed that it would pay AMCI an amount of R90 million. It is important to appreciate that during the relevant period, Kangra Group's coal business was spun off from the Kangra Group to another entity, namely Kangra Coal (Pty) Ltd (Kangra Coal) for the purpose of facilitating a black economic empowerment transaction with a chosen partner.

One of the key facts before the court was that Mr Beck concluded the settlement agreement on behalf of the Kangra Group (ie the Taxpayer) and the representative from AMCI relating to the Kangra Group's (and/or Kangra Coal) obligations of supplying coal to AMCI. On that basis, the Taxpayer sought to deduct the settlement amount for income tax purposes in terms of the general deduction provision in s11(a) of the Income Tax Act, No 58 of 1962 (Act).

That provision reads as follows:

> 11. General deductions allowed in determination of taxable income
>
> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived:
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature…"

Historically, taxpayers have inevitably succeeded and failed in claiming expenses akin to damages and compensation pursuant to three issues, including:

1. whether the expenses were incurred for the purposes of conducting the taxpayer's trade;

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2. if so, whether such expenses were incurred in the production of income; and
3. thirdly, whether such expenses incurred were of a revenue or capital nature (if the answers to the above two queries were in the affirmative).

Findings of the High Court

In *Kangra Group v C:SARS*, Gamble J focused on, amongst others, the second enquiry which was neatly summarised in one of the leading cases on whether expenses are incurred in the production of income, namely *Port Elizabeth Electric Tramway Co Limited v CIR 8* SATC 13, in which Watermeyer AJP (as he then was) dealt with the issue as follows:

> Income is produced by the performance of a series of acts and attendant upon them are expenses. Such expenses are deductible expenses provided they are so closely linked to such acts as to be regarded as part of the cost of performing them.
>
> A little reflection will show that two questions arise (a) whether the act to which the expenditure is attached is performed in the production of income and (b) whether the expenditure is linked to it closely enough.

In *Kangra Group v C:SARS*, Gamble J thus set out the crux of the matter at paragraph [27]:

> In the result it was incumbent on the taxpayer to establish before the Tax Court that the conclusion of the settlement agreement with AMCI was linked "distinctly and directly" with the actual earning of income by the Group before it could qualify as a deduction. To put it differently, it may be asked whether the taxpayer proved that such income as was produced by repudiating the supply agreements with AMCI, was received by the Group (or accrued to it) as a consequence of such repudiation.

Furthermore, the court at paragraph [47] surmised that the settlement agreement was the price that was paid for the opportunity to earn additional income from selling coal at US$40 rather than US$25/ton, that amounted to a return of more than 60% over what would have been received had the coal been sold to AMCI. Gamble J held that the question that had to thus be determined by the court was two-fold: Whether the payment of contractual damages such as that incurred by the Group in settling the arbitration claim be termed expenditure in terms of s11(a) of the Act? And, if so, did such expenditure result in the Taxpayer earning income?

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The court found that the payment did not constitute "expenditure" for purposes of the general deduction formula and in doing so, applied, among other things, the relevant principles enunciated in the leading cases on damages and compensation.

The court found that the payment did not constitute "expenditure" for purposes of the general deduction formula and in doing so, applied, among other things, the relevant principles enunciated in the leading cases on damages and compensation, including P*E Tramway as well as Joffe & Co (Pty) Ltd v CIR 13* SATC 354 where it was established that damages had to be a necessary concomitant of the taxpayer's trade. The court in *Kangra Group v C:SARS* held as follows:

> It may well be that an incident of trading in coal is the breaching of a contract of sale. For example, there may be a breakdown in the railway system resulting in the load not reaching the port on time and the supplier may have to face a damages claim from the buyer arising out of non-delivery. But that is a wholly different situation to one where the supplier wantonly breaches its obligations in order to secure a more lucrative contract elsewhere.

Notwithstanding the court's conclusion at paragraph [55] that the Taxpayer's payment of R90m in settlement of the claim in arbitration did not constitute "expenditure" as contemplated under s11*(a)*, Gamble J nevertheless, (out of caution), also considered and held that in any event such "expenditure" was not incurred in the production of income. Paragraph [58] of the judgment summarises Gamble J's conclusion concisely as follows:

> It is evident, furthermore, that any income associated with the alleged expenditure actually accrued to the benefit of Kangra Coal. That was the entity which reflected a substantial increase in turnover for the fiscal years in question and that entity has already rendered its tax returns and claimed all related expenditure for those years. Mr. Beck's decision to claim the deduction, not on behalf of Kangra Coal but the Group, seems rather to have been influenced by a number of other developments.

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It is clear that before a taxpayer calculatedly breaches an agreement, it should carefully consider the incidence of tax.

The further developments referred to by Gamble J were threefold, including that Mr Beck no longer had control of Kangra Coal at the time the relevant deduction was claimed, that the terms of the sale of the coal business agreement provided that Kangra Group was only liable for contingent liabilities which existed at the time of the sale, and all other liabilities had been transferred to Kangra Coal and that Mr Beck's decision to vest the claim in the Kangra Group (as opposed to Kangra Coal) was therefore a strategic one at the end of the day.

On that basis Gamble J dismissed the appeal of the Taxpayer given that it had not discharged the onus of establishing that it was entitled to claim the general deduction contended for. It is interesting to speculate whether the court may have reached a different conclusion to the extent that the deduction was claimed in Kangra Coal itself as opposed to Kangra Group. There may have been an argument for the taxpayer in that instance given the closer connection between the expenditure and the income earned, however, one may well have also encountered further difficulty proving that the expenditure was of a revenue nature given that the settlement agreement arguably enabled the taxpayer to increase its income earning capacity by selling coal at a higher price to other third party customers.

In conclusion, it is clear that before a taxpayer calculatedly breaches an agreement, it should carefully consider the incidence of tax.

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VAT ON COMMERCIAL AND RESIDENTIAL ACCOMMODATION: LODGING, LEASING OR RENTING?

The distinction between commercial accommodation and a dwelling is essential, because the supply of commercial accommodation is subject to VAT at the standard rate, whereas the letting and hiring of a dwelling is exempt from VAT.

The Value-Added Tax Act, No 89 of 1991 (VAT Act) contemplates the supply of two types of residential accommodation, ie the supply of "commercial accommodation" and "dwellings". The distinction between commercial accommodation and a dwelling is essential, because the supply of commercial accommodation is subject to VAT at the standard rate, whereas the letting and hiring of a dwelling is exempt from VAT. In addition, where commercial accommodation is supplied together with domestic goods or services (furniture, water, electricity cleaning, maintenance, etc.) for periods longer than 28 days for an all-inclusive charge, VAT is only payable on 60% of such charge. It is unfortunately not always clear as to whether the accommodation provided comprises "commercial accommodation" or "dwellings".

The difficulty in determining what comprises "commercial accommodation" has been highlighted in the case of Respublica (Pty) Ltd.

The definition of "commercial accommodation" in the VAT Act contemplates the supply of lodging, or board and lodging, together with domestic goods or services in any residential establishment which is regularly and systematically supplied, but excludes a "dwelling" supplied in terms of an agreement for the letting and hiring thereof.

A "dwelling" on the other hand is defined as any building or structure used predominantly as a place of residence or abode of a natural person, including fixtures and fittings, but it excludes the supply of "commercial accommodation".

It is not always clear as to whether the supply of accommodation in a residential establishment comprises "commercial accommodation", and the South African Revenue Service (SARS) also refuses to issue rulings to confirm whether or not a supply of accommodation comprises "commercial accommodation". The difficulty in determining what comprises "commercial accommodation" has been highlighted in the case of *Respublica (Pty) Ltd (Respublica)*. *Respublica* owned a residential property which comprised of a number of furnished units specifically developed for student accommodation. *Respublica* entered into a five-year lease with a university for the sole purpose of accommodating the university's students. *Respublica* also supplied domestic goods and services, ie water, electricity, maintenance, cleaning and laundry services. The university paid an all-inclusive rental per bed per month. The students were required to vacate the units during university holiday periods.

Respublica approached the High Court for a declaratory order after it could not reach consensus with SARS as to whether the accommodation provided under these terms comprised "commercial accommodation", subject to VAT at 60% of the all-inclusive rental. It was accepted that the accommodation provided did not comprise "dwellings", and it was common cause that *Respublica* provided domestic goods and services.

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The SCA held that the accommodation provided by Respublica does not comprise "commercial accommodation".

SARS contended that "commercial accommodation" contemplates the supply of lodging. Since only natural persons can be lodgers, the university, being the lessee, was not capable of lodging and was merely a tenant. SARS further argued that there was no contractual relationship between *Respublica* and the students.

Respublica contended that the property was let to the university for the sole purpose of supplying accommodation to the students. *Respublica* was responsible for managing the property and the students and to enforce the house rules which the students were required to adhere to, and it supplied the domestic goods and services directly to the students, who were the recipients of its supplies.

The High Court delivered judgment on 29 February 2016 and found in favour of *Respublica*. The High Court was of the view that the words used in the definition of "commercial accommodation" must be read in conjunction with the purpose of which the property was let to the university. It also agreed with *Respublica* that a *nexus* between the lessor and the end user is not a requirement for the supply of commercial accommodation.

SARS appealed directly to the Supreme Court of Appeal (SCA) against the High Court judgment. In its judgment delivered on 12 September 2018, the SCA reversed the order of the High Court, and held that the accommodation provided by *Respublica* does not comprise "commercial accommodation". The SCA held that the decisive question is whether *Respublica* can be said to have provided lodging. By its nature, the university is incapable of living in accommodation, and can therefore not be a lodger. The SCA held further that there was no contractual relationship between *Respublica* and the students for the provision of the accommodation. The SCA was of the view that the VAT consequences of a supply must be assessed by reference, first and foremost, to the contractual arrangements under which the supply is made.

Based on the facts, the SCA held that two distinct relationships were contemplated. The first being between *Respublica* and the university, and the second between the university and the student. The supply by *Respublica* was therefore neither "commercial accommodation" nor a "dwelling", but was considered to be the supply of a building under a lease, subject to VAT at the standard rate.

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

Mark Linington has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2017.

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Suppliers of student accommodation should therefore carefully consider the terms of the agreements and their contracting parties in view of the SCA judgment.

If the VAT status of the supply must be assessed by the contractual arrangements under which the supply is made as held by the SCA, then the supply of accommodation to the students under an agreement with the students directly, as opposed to an agreement with the university, will qualify as "commercial accommodation".

A landlord supplying student accommodation could find itself in a situation that it has a lease with a university for half of the number of beds in the building, and the other half is supplied to students under agreements entered into with the students directly. In terms of the SCA judgment, the rentals charged to the university are subject to VAT at the full standard rate, whereas the rentals charged to the students qualify as "commercial accommodation" at the reduced rate.

Suppliers of student accommodation should therefore carefully consider the terms of the agreements and their contracting parties in view of the SCA judgment.

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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.

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