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TAX & EXCHANGE CONTROL **ALERT**

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CLIFFE DEKKER HOFMEYR

Venture capital companies and trades in respect of immovable property

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In terms of section 12J of the Income Tax Act 58 of 1962 (Act), put simply, a person who invests in an approved "venture capital company" may claim an immediate income tax deduction equal to the amount invested (subject to limitations).

A "venture capital company" will only be approved as such if, among other requirements, the sole object of the company is the management of investments in companies that are "qualifying companies".

A company is not a "qualifying company" if, among other requirements, it carries on any "impermissible trade".

Among other things, "any trade carried on in respect of immovable property, other than a trade carried on as an hotel keeper" is an "impermissible trade".

What does the phrase "in respect of immovable property" mean in this context?

The phrase "in respect of" has on a number of occasions been interpreted to the effect that it denotes a direct or causal relationship. So, in the present case, a trade would only be an "impermissible trade" if there is a direct or causal relationship between the trade, on the one hand, and immovable property, on the other hand.

SARS has issued a document titled Draft Guide on Venture Capital Companies (Draft Guide).

In the Draft Guide, SARS refers to a number of cases and states the following (at page 11):

> *The conclusion of these cases is that, bearing in mind that section 12J is an incentive and that there was a clear intention that the incentive should not be extended to trades in specified industries, the term "in respect of" must be widely interpreted in the context of section 12J along the lines of "in connection with" and "in relation to". Notwithstanding the wide interpretation, there are situations in which the connection with a listed item will be considered too remote to result in it falling within the ambit of "in respect of"... (Footnotes omitted.)*

It does not necessarily follow from the fact that section 12J of the Act is an incentive provision that the words "in respect of" should be given a wide meaning. The stated purpose of the introduction of the venture capital company regime is to provide a tax incentive to assist small and medium-sized businesses with the challenges they face when they try to raise equity financing (see page 66 of *Explanatory Memorandum on the Revenue Laws Amendment Bill*, 2008 [W.P.2 – '08] which accompanied the legislation that introduced section 12J into the Act). One could just as easily argue that, because the provision creates an incentive, the words "in respect of" should be given a restrictive meaning so that more, rather than less, trades will qualify under the regime.

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Venture capital companies and trades in respect of immovable property*...continued*

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In SARS' view, the following are impermissible trades (Draft Guide at page 12):

- Letting of immovable property.
- Refurbishment or development of immovable property.
- Trading in immovable property.

As to trades in relation to immovable property that SARS does *not* see as being impermissible trades, SARS states the following at page 12 of the Draft Guide:

> *Arguably a person carrying on the trade of a plumber or electrician fixing the plumbing or electrical equipment in a building is conducting a trade in respect of immovable property because plumbing and electrical installations in a building are part of the immovable property. However, taking the purpose and context of the section into account and the work that the plumber or electrician does in conducting the repairs, it is considered that this interpretation would be too restrictive and unintended and should not be adopted. (Footnotes omitted.)*

On 6 June 2017, SARS issued Binding Private Ruling: BPR 274 (BPR 274). One of the issues that was considered in BPR 274 was whether a company which was to provide and maintain solar facilities at the site of its customer was carrying on an impermissible trade. All of the assets provided by the company, including solar panels, transmission cables and other related facilities, would have been owned by the company and supplied to the customer in terms of an operating lease. SARS ruled that, despite the fact that solar panels – once installed – may technically become part of the relevant immovable property, the solar panels were movable assets and that, accordingly, the company would not be carrying on an impermissible trade, ie a trade in respect of immovable property.

Most recently, SARS issued Binding Private Ruling: BPR 333. In that matter, the operating company would undertake farming operations consisting of planting, growing, harvesting, packing, transportation and distribution of blueberries. Vacant land required to undertake the farming operations would either be purchased or leased by the operating company. Upon securing the land, the farming operations would be established which would include fencing,

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Venture capital companies and trades in respect of immovable property...*continued*

While SARS takes the view that, technically, the phrase "in respect of immovable property" should be given a wide meaning, in practice it appears as if SARS is interpreting the phrase more restrictively.

netting, a drip irrigation system, cold rooms, equipment and the planting of the blueberry bushes. SARS ruled that the farming of blueberries by the operating company would not constitute a trade in respect of immovable property and, accordingly, did not constitute an impermissible trade.

So, while SARS takes the view that, technically, the phrase "in respect of immovable property" should be given a wide meaning, in practice it appears as if SARS is interpreting the phrase more restrictively. It seems as if SARS accepts that in cases where there is no direct link between a person's business and the immovable property there is no "impermissible trade".

One could thus argue, based on the guidance and recent rulings issued by SARS, that venture capital companies who invest in the following companies would potentially meet the requirements of section 12J of the Act:

- Contractors supplying services in relation to immovable property, eg plumbers, electricians, building contractors, quantity surveyors, and security companies. (As to building contractors, see the case of *Moodley v Estate Agents Board* [1982] 2 All SA 259 (D).)
- Companies engaged in the installation of certain solar power equipment.
- Farmers.

If a person is in doubt, however, as to whether a company carries on an "impermissible trade" or not, it should preferably approach SARS for a ruling.

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VAT apportionment: An unintended penalty?

> The issue under consideration was whether proviso (iii) [to section 17] prohibits SARS from granting a ruling to apply an appropriate apportionment ruling retrospectively to prior financial years...

The stated policy of the South African Revenue Service (SARS) not to make value-added tax (VAT) apportionment rulings effective retrospectively to prior financial years has been questioned on several occasions. The matter was recently considered by the Tax Court in the case of *Taxpayer v Commissioner for the South African Revenue Service* (VAT2063) [2019] ZATC 2 (15 November 2019) where the Tax Court found in favour of SARS.

The taxpayer in this case provides money-transfer services within Africa, mobile phone credit and *bureau de change* services. The taxpayer therefore makes both taxable and exempt supplies for VAT purposes and is thus required to apportion the VAT it incurs on its expenses between taxable and exempt supplies.

The taxpayer apportioned the VAT on its expenses but did not have prior written approval for the apportionment method it applied. The taxpayer then applied in its 2017 financial year to SARS for approval to apply an appropriate apportionment method. SARS issued a binding private ruling to the taxpayer in which it approved the application of a transaction count-based (TCB) method. The ruling was made effective from 1 March 2016, being the commencement of the financial year in which the taxpayer applied for the ruling.

The taxpayer requested SARS to make the ruling effective retrospectively to 1 February 2014, which request SARS refused. The taxpayer appealed to the Tax Court against the decision of SARS. The Tax Court found in favour of SARS on the basis that the standard turnover-based method (STB) as set out in Binding General Ruling 16 (BGR 16) was the only ratio applicable to the taxpayer until SARS issued the binding private ruling, and that proviso (iii) to section 17(1) of the Value-Added Tax Act 89 of 1991 (VAT Act) expressly precluded SARS from issuing a ruling that had effect prior to 1 March 2016.

Proviso (iii) to section 17(1) provides that where a method for determining an apportionment ratio has been approved by the Commissioner, that method may only be changed with effect from a future tax period, or from another date which the Commissioner considers equitable, but such other date must be within the taxpayer's year of assessment for income tax purposes.

The issue under consideration was whether proviso (iii) prohibits SARS from granting a ruling to apply an appropriate apportionment ruling retrospectively to prior financial years, or whether a taxpayer is, in the absence of a specific ruling, compelled to apply the STB method for those years even if it does not yield a ratio which fairly represents the extent to which the taxpayer applied its resources for making taxable supplies.

The Constitutional Court in *Metcash Trading Ltd v Commissioner for South African Revenue Service & Another* 63 SATC 13, stated that to evaluate the cogency of a constitutional challenge of certain provisions of the VAT Act, one must have some understanding of the

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VAT apportionment: An unintended penalty?...*continued*

The Tax Court effectively ruled that the taxpayer was required to apply the STB method in prior financial years even though it had no resemblance to the extent to which the taxpayer actually applied its resources for making taxable supplies.

VAT system, which is sophisticated, and its provisions are numerous and complex. It stated further that the VAT Act is interlarded with many terms of art, some of which are defined, and others bear a special meaning in their context. It is considered that the same approach should be followed in considering the context and purpose of the VAT Act and determining the application of its provisions.

A fundamental and important feature of a VAT system, unlike any other tax, is the entitlement to deduct VAT incurred on expenses from the VAT charged on the supply of goods or services, to determine the VAT payable on the "value added" by the taxpayer in each tax period. Where a deduction is not granted, it impacts on pricing, distorts consumer and producer choices and has a cascading effect (tax is levied on tax). One of the reasons why South Africa replaced its sales tax system with VAT was to eliminate these distortions and the cascading effect of the sales tax system, which did not allow for deductions.

The right to deduct VAT is however limited to the extent that a vendor acquires goods or services for the purpose of consumption, use or supply in the course of making taxable supplies. Where a vendor makes both taxable and exempt supplies, the VAT may only be deducted to the extent that expenses are fairly attributable to making taxable supplies.

Section 17(1) of the VAT Act provides that the extent to which VAT is deductible in these circumstances, is determined by the Commissioner in terms of a binding general ruling or a binding private (or class) ruling. The extent to which the deduction may be made must be determined by the Commissioner on a fair and reasonable basis which fairly represents the application of goods or services for making taxable supplies.

SARS issued BGR 16 in terms of section 17(1), which prescribes the application of a turnover-based method of apportionment. A taxpayer may apply this method without any specific prior written approval by the Commissioner, on the condition that it may only be used if it is fair and reasonable. If it is not fair and reasonable, BGR 16 requires that the taxpayer must apply to SARS to use an alternative method.

A turnover-based method such as the STB method as prescribed by BGR 16 will only yield a fair and reasonable result if there is a constant relationship between every output transaction (taxable or exempt) and the VAT incurred on expenses. It also assumes that the profit margin of taxable and exempt transactions is substantially the same. In practice, this will hardly ever be the case. The only real advantage of a turnover-based method is that it is simple to calculate (K Zacharopoulos, *Value-Added Tax: The Partial Exemption Regime*).

It was common cause in Case No VAT 2063 that the STB method as prescribed by BGR 16 did not yield a fair and reasonable apportionment ratio, and that the TCB method was a suitable or appropriate apportionment method for the taxpayer's enterprise. Yet the Tax Court effectively ruled that the taxpayer was required to apply the STB method in prior financial

VAT apportionment: An unintended penalty?*...continued*

A taxpayer should not be required to pay substantially more VAT than what is properly levied in terms of the VAT Act, simply because of an omission to timeously apply for approval to apply an appropriate apportionment method.

years even though it had no resemblance to the extent to which the taxpayer actually applied its resources for making taxable supplies. The Tax Court's decision was based on its interpretation of proviso (iii) to section 17(1).

With reference to proviso (iii) to section 17(1), the Tax Court stated that it cannot be that a vendor who is enjoined to apply to use an alternative method, but fails or refuses to do so, should be placed in the same position as a vendor who applies timeously. However, one of the generally accepted principles of VAT policy is that it must ensure neutrality, i.e. that taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Proviso (iii) to section 17(1) applies where a taxpayer applies an approved apportionment method, and then seeks to change such an approved method. Once an appropriate apportionment method has been determined and approved, the taxpayer should apply such method consistently from year to year. Where circumstances change which warrant the application of a different, more appropriate method, then the new method may only be applied from a current date or from the commencement of the current financial year, whichever is equitable. Proviso (iii) does not seem to find application where a taxpayer has never previously applied any apportionment method or has applied an unapproved apportionment method.

The STB method is rarely representative of the extent to which a taxpayer applies its resources for making taxable supplies. Requiring a taxpayer to apply an inappropriate apportionment method seems to be contrary to the overall construct and mechanism of the VAT Act. A taxpayer should not be required to pay substantially more VAT than what is properly levied in terms of the VAT Act, simply because of an omission to timeously apply for approval to apply an appropriate apportionment method. Section 17(1) and proviso (iii) are not intended to serve as penalty provisions.

The application of an apportionment method which does not fairly reflect the extent to which a taxpayer actually applies its resources for making taxable supplies, impacts on the neutrality principle, on pricing and has a cascading effect, which are all best avoided under a VAT system. To avoid a similar situation, taxpayers who make both taxable and exempt supplies are best advised to apply timeously for prior approval to apply an appropriate apportionment method.

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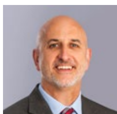

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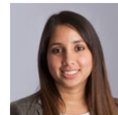

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