

TAX AND EXCHANGE CONTROL ALERT

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An input tax deduction may be claimed when VAT is incurred on goods and services acquired for the purpose of consumption, use or supply in the course of making taxable supplies.

The entitlement of a vendor to claim input tax deductions in respect of expenses incurred is generally not disputed where a vendor makes wholly taxable supplies. VAT is therefore generally not considered to be a large component of a business's cost base as most VAT registered businesses will be entitled to claim a credit or refund of VAT paid to the extent that they conduct an enterprise that makes taxable supplies.

There has, however, been a great deal of controversy and uncertainty surrounding the claiming of VAT input credits, particularly where mixed taxable and non-taxable supplies are made, and also in the context of expenses relating to corporate actions. This uncertainty regarding the deductibility of input tax credits in certain instances has created a VAT risk for many vendors. This article will briefly provide an overview of the differing views held by the courts and the South African Revenue Service (SARS), and in so doing, will highlight the relevant considerations when determining whether the VAT incurred for purposes of certain corporate actions may qualify as an input tax deduction.

In *Income Tax Case No. 1744 65 SATC 154* (ITC 1744), the appellant, a manufacturer of steel shipping containers, employed the services of a company specialising in the venture capital markets to undertake two share placings, so as to raise capital to manufacture containers. The appellant claimed the VAT incurred on the company's fees as an input tax deduction on the basis that it would not have been in a position

to manufacture the shipping containers had it not raised the capital. The appellant argued that the services were therefore acquired for the purpose of consumption, use or supply in the course of making taxable supplies. The court, however, found against the appellant, and, relying on a judgment of the European Court of Justice handed down in 1995, held that a direct and immediate link is required between the incurral of the service and the making of taxable supplies. The court held that the immediate purpose of incurring the expense was to make an exempt supply, being the issue of the shares, and regarded the ultimate purpose as irrelevant.

In the subsequent case of *Commissioner for SARS v De Beers* [2012] ZASCA 103 (12 June 2012), which was heard by the Supreme Court of Appeal (SCA), the respondent, De Beers Consolidated Mines Ltd (DBCM), required the services of independent financial advisors to consult and advise its board on whether a proposed restructuring transaction to be entered into was fair and reasonable. DBCM was legally obliged to acquire the independent financial advisor services in order to protect the rights and interest of independent DBCM unit holders. DBCM claimed input tax deductions in respect of the services acquired which claim was then rejected by SARS.

The Tax Court, which first heard the matter, found in favour of DBCM and dispelled the reasoning in *ITC 1744* by favouring a more generous commercial

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approach, requiring that there only be 'some link' and not a 'direct link' to the expense incurred and the making of taxable supplies before a deduction can be made. The decision of the Tax Court was, however, set aside when the case was taken on appeal to the SCA. The SCA in the *De Beers* case adopted a more restrictive approach to the allowing of VAT input credits, and in applying the 'direct and immediate link' test, dismissed the contention that where a vendor wholly carries on taxable activities, that all its expenses, including expenses relating to corporate actions that may arise, are attributable to such taxable activities. The SCA in the *De Beers* case chose to follow a restrictive approach in keeping with earlier European Union judgments, and with *ITC 1744*, despite the fact that subsequent judgments handed down by the European Court of Justice have since developed along different lines.

The definition of input tax as set out in s1 of the Value-Added Tax Act, No 89 of 1991 (VAT Act) requires that goods or services must be acquired for the purpose of consumption, use or supply in the course of making taxable supplies. Various South African judgments dealing with the phrase "in the course of" indicate that in order to claim an input tax deduction, there must be some relationship between the consumption or use of the services or goods and the making of taxable supplies. These judgments have not required a direct or immediate link as required by the Tax Court in *ITC 1744*, and subsequently by the SCA in the *De Beers* case.

South Africa does not have a 'direct link' requirement. Our requirement is that goods or services must have been acquired for the "purpose of consumption, use or supply in the course of making taxable supplies". It is also important to note that the legislature did not use the phrase "directly in connection with" (as is the case in s11(2)(l) of the VAT Act for example), which would have required a close and uninterrupted relationship.

Developments in the European Union in cases such as *Kretztechnik AG v Finanzamt Case C-465/03 2005* and *Skatteverket v AB SKF Case C-29/08 2008* also evidence a shift from the restrictive application of the direct and immediate link test to a more generous approach requiring only that there be a link to the overall business activities of a taxpayer. From the *De Beers* judgment, it is clear that South African courts disregard the developments in other jurisdictions.

The *De Beers* judgment, having established certain guidelines and principles regarding the claiming of input tax for VAT purposes, seems to have left us with more questions than answers, leaving taxpayers to now have to defend input tax deductions on costs that they were not required to defend before.

Even though the *De Beers* judgment casts light on the South African approach to the deductibility of input tax, the debate surrounding this issue remains very much alive. The SCA in *De Beers* declined to follow certain international precedents that have developed, and are continuing

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to develop, along more generous lines and it therefore seems that both SARS and the South African courts will continue to follow a more restrictive approach going forward.

Although overturned by the SCA, the judgment of the Tax Court in the *De Beers* case not only took into account international developments, but was also more aligned with the actual wording used in the VAT Act, thus giving effect to the neutrality principle of VAT.

It is submitted that the approach adopted by the SCA in the *De Beers* judgment conflicts with the neutrality principle of VAT, and it is expected that the application of the approach taken by the SCA, will result in businesses carrying a VAT cost for legitimate business expenses incurred in the course of their taxable activities, albeit

not directly and immediately linked thereto. The question of whether a vendor will be entitled to claim input tax deductions in respect of expenses incurred relating to corporate actions will therefore need to be carefully considered on a case by case basis, and in the context of its enterprise activities.

As mentioned above, the SCA in the *De Beers* case dismissed the contention that where a vendor carries on wholly taxable activities, that all its expenses are attributable to such taxable activities. This approach seems to be overly restrictive and it is likely that the principles adopted by the SCA in the *De Beers* case will be challenged by many South African vendors in future.

Varusha Moodaley

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CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.



This week's selected highlights in the Customs and Excise environment since our last instalment:

1. Schedule 1 Part 1 to the Act is amended to the effect that the rate of duty for "cane or beet sugar and chemically pure sucrose, in solid form" of heading 17.01 is reduced from 63,63 c/kg to a free rate of duty.
2. Draft Amendments relating to Excise in the Customs & Excise Act, No 91 of 1964 (Act):
 - 2.1 Rule 19A3.01 – Storage of fermented ethyl alcohol in a licenced special storage warehouse for supply to rebate users;
 - 2.2 Schedule 6:
 - 2.2.1 Insertion of rebate items 621.23, 621.25, 621.27, 621.29, 621.33, 621.35 and 621.37 to provide for the movement of alcohol derived from the process of extraction;
 - 2.2.2 Insertion of rebate items 620.18 and 620.20 to provide for the production of fermented ethyl alcohol by-product and the substitution of 620.19 and 620.21 to include the manufacture of non-alcoholic beverages by a process of extraction;
 - 2.2.3 Substitution of 619.07 to include the manufacture of non-alcoholic beverages by a process of extraction and the insertion of 619.09 to provide for the production of fermented ethyl alcohol by-product;
 - 2.3 The Explanatory Note issued by SARS provides as follows:

New technologies in the alcoholic beverages sector allow for the extraction of alcohol from beverages of a fermented origin. The current rules provide for the application of such fermented ethyl alcohol in primary or secondary spirits manufacturing, the denaturing thereof for rebated use or the export thereof. This proposed rule amendment will in addition provide for the storage of such fermented ethyl alcohol in a licenced special storage warehouse for the un-denatured supply thereof to registered rebate users. The draft rule amendment must be read together with the proposed rebate amendments

The rebate item numbers 619.07, 620.19 and 620.21 have been amended to include wine, other fermented beverages and beer that have undergone a

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process of extracting the alcohol, to manufacture non-alcoholic beverages.

Rebate items 621.23, 621.25, 621.33, 621.35 have been created to provide for the fermented ethyl alcohol by-product derived from the extraction process to be moved to primary (VMP) or secondary (VMS) warehouse to undergo any further processing.

In addition rebate 621.27, 621.29, 621.37, 621.39 is also created to provide for the fermented ethyl alcohol by-product derived from the extraction process to be moved to a special storage warehouse for the un-denatured supply thereof to registered rebate users or export.

3. In Schedule 2 to the Act, anti-dumping item 215.02/7312.10.90/04.08 [providing for "Ropes and cables, of iron or steel, not electrically insulated, of a diameter exceeding 32 mm (excluding that of wire of stainless steel, that of wire plated, coated or clad with copper and that identifiable as conveyor belt cord) ..."] is amended by substituting "96%" with "93%" in the "Rate of anti-dumping duty" column (of the English Notice) with retrospective effect from 17 June 2016;
4. The 2017 Draft Taxation Laws Amendment Bill and 2017 Draft Tax Administration Laws Amendment Bill, as they relate to Customs & Excise, make provision for the following (not an exhaustive list):

4.1 Proposed amendments to the Act:

- 4.1.1 The continuation of certain amendments of Schedules to the Act.
- 4.1.2 Amendment to s4 to update the list of government entities that are allowed access to SARS's trade statistics and the conditions for the sharing of such information.
- 4.1.3 Amendments to s19A and s20 are proposed to facilitate the required warehousing reforms relating to licensed storage warehousing in the liquid fuels industry.
- 4.1.4 Amendments to s21A:
 - 4.1.4.1 clarifies the cessation of liability for duty on imported goods used in the manufacture or production of other goods by a Customs Controlled Area (CCA) enterprise. In other words, liability ceases if it can be proved that the goods have been used in the manufacturing or production of goods by the CCA enterprise and that those goods have been removed to other licensed or registered premises

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for manufacture or production of any other goods by the licensee or registrant of such premises in accordance with any relevant provision of the Act; and

4.1.4.2 makes provision for the assumption of the liability for duty that ceased as contemplated in paragraph 4.1.4.1 above.

4.1.5 Amendment to s54C to refine the description of those other provisions of the Act that also apply with any necessary changes as the context may require to the environmental levy. The revised wording clarifies that the scope of this section is limited to those provisions that govern the administration of excisable goods.

4.1.6 Amendment to s75: In the 2015 Budget Review, it was announced that a comprehensive review of the administration of the diesel refund system would take place, which requires the delinking thereof from the VAT system. The 2017 Budget Review set out the legislative amendments

contained in this proposal that will facilitate these reforms. Further amendments to the Schedules and Rules of the Act will be developed following public consultations to implement the outcome of the review.

4.2 It is also proposed that the the Customs Duty Act, No 30 of 2014 (Duty Act), the Customs Control Act, No 31 of 2014 (Control Act) and the Customs and Excise Amendment Act, 2014 will be amended. All amendments are not dealt with hereunder. However, the following proposals are of particular interest:

4.2.1 Deferments under the Act will lapse upon commencement of the Duty Act. However, current deferment holders will be given an opportunity to re-apply under the Duty Act before commencement thereof.

4.2.2 The Commissioner will be enabled to exercise certain powers in terms of the Duty Act and the Control Act before commencement thereof. The reason is to effectively implement these Acts, which include appointment of officers, delegation of powers, submission of applications (licensing, registration, etc.) before due date, etc.

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