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TAX & EXCHANGE CONTROL **ALERT**

IN THIS ISSUE >

Out-of-court settlements and VAT...don't settle for less

Parties to a legal dispute may often find themselves opting for an 'out-of-court' settlement as opposed to a protracted court battle where the outcome is uncertain and the legal costs high. On some level, an out-of-court settlement should represent a win for both parties. However, where the parties are VAT vendors, it is often the party receiving the settlement payment that is left with a slightly bitter taste in its mouth if VAT was not taken into consideration when agreeing on the settlement amount payable.

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Out-of-court settlements and VAT... don't settle for less

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Parties to a legal dispute may often find themselves opting for an 'out-of-court' settlement as opposed to a protracted court battle where the outcome is uncertain and the legal costs high. On some level, an out-of-court settlement should represent a win for both parties. However, where the parties are VAT vendors, it is often the party receiving the settlement payment that is left with a slightly bitter taste in its mouth if VAT was not taken into consideration when agreeing on the settlement amount payable.

VAT is levied on the value of the supply of goods or services by a vendor in the course or furtherance of an enterprise carried on by such vendor. VAT is therefore not a tax levied on receipts. The value to be placed on a supply is the amount of 'consideration' for such supply. The amount must therefore be received in respect of, in response to or for the inducement of the supply of goods or services for the amount to be subject to VAT. There must be a sufficient nexus between the supply and the payment for the payment to constitute consideration. It follows that where a settlement payment is made to a vendor, it must be determined whether the payment constitutes consideration for the supply of any goods or services by such vendor.

The term 'services' is broadly defined in the Value-Added Tax Act 89 of 1991 (VAT Act) to include 'anything done or to be done, including the surrendering of any right'. In this regard we note that in New Zealand, a forbearance to sue is regarded as being a supply of a service. The definition of 'services' as contained in the VAT Act therefore seems to be in line with the views taken by the New Zealand tax authorities. On the basis that the South African VAT system is modelled on that of New Zealand, we may rely thereon for guidance.

It follows that where a party to a dispute agrees to surrender its right to pursue legal action against another party in return for a settlement payment, that the settlement payment will constitute an identifiable payment that is reciprocal and directly linked to the surrendering party's right to pursue legal action against the counter-party. Where the surrendering of such right is made by a vendor in the course or furtherance of its enterprise, the settlement payment received will constitute consideration for the taxable supply of a service. The vendor receiving the settlement payment will accordingly be required to account for output tax thereon equal to the tax fraction ($^{15}/_{115}$) of the payment.

Out-of-court settlements and VAT... don't settle for less...*continued*

Where the settlement agreement does not stipulate whether the settlement payment is inclusive or exclusive of VAT, the settlement payment is deemed to be inclusive of VAT at the standard rate of 15% in terms of section 64 of the VAT Act.

In practice, and to the detriment of the vendor receiving a settlement payment, it seems that parties to an out-of-court settlement are often unaware of the VAT treatment of settlement payments, and as such do not factor in the VAT component when agreeing on a settlement amount or when drawing up the agreement in respect thereof. Where the settlement agreement does not stipulate whether the settlement payment is inclusive or exclusive of VAT, the settlement payment is deemed to be inclusive of VAT at the standard rate of 15% in terms of section 64 of the VAT Act. The supplying vendor, i.e. the recipient of the payment, will accordingly be required to account for VAT thereon and will not be able to recover the VAT amount from the other party in addition to the settlement payment already agreed to in terms of the settlement agreement. This is in line with the approach previously taken by our courts which have stated that the obligation to pay VAT in relation to a transaction on which VAT is payable is on the supplying vendor, and not on the recipient.

On the basis that the supplier, i.e. the vendor receiving the payment will be liable to account for VAT on the settlement payment received, such vendor will be required to issue a tax invoice to the other party reflecting the VAT included in the settlement amount. The party making the payment, being the recipient of the services, should then be entitled to claim an input tax deduction in respect of the VAT incurred to the extent that the payment was made in the course of its taxable enterprise activities. It follows that the party receiving the payment will be left out-of-pocket, whereas the party making the payment will benefit to the extent of the input tax deduction claimed.

By way of illustration, the effect of failing to allow for VAT in respect of an out-of-court settlement is as follows:

- Company X and Company B, both registered vendors, agree to enter into an out-of-court settlement in terms of which Company X agrees to make a settlement payment of R1 million to Company B in return for Company B agreeing to withdraw legal action against Company X.
- The agreement provides for a settlement payment of R1 million payable by Company X for Company B withdrawing its legal action, and in full and final settlement of any claims between the parties. The agreement is silent on VAT.
- On the basis that the settlement payment made to Company B is deemed to be inclusive of VAT, Company B will be required to account for output tax thereon to SARS in the amount of R130,434.78 (R1 million x ($^{15}/_{115}$)). The net amount received by Company B will thus only be R869,565.22 notwithstanding that it had agreed to settle for R1 million.
- Company X should be entitled to claim an input tax deduction in respect of the VAT portion of the payment amounting to R130,434.78, thus benefiting from the omission of the VAT treatment in the settlement agreement.

The above scenario should be distinguished from the scenario where a compensatory payment is made for losses or damages suffered by the claimant. The enquiry to determine whether VAT must be levied on compensation payments received is whether or not the payment is made for an underlying supply of goods or services.

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Out-of-court settlements and VAT... don't settle for less...*continued*

Vendors entering into out-of-court settlements, especially the vendor receiving payment of a settlement amount, are reminded of the importance of explicitly stating in the settlement agreement what the settlement payment is made for, and whether the settlement payment agreed upon is exclusive or inclusive of VAT, if VAT is payable.

Payments received as compensation for losses or damages suffered are generally not consideration for any services rendered and the payments are therefore not subject to VAT. These payments simply fall outside the scope of VAT.

Settlement agreements in terms of which compensation payments are made for losses or damages suffered may also provide for the payment to be made in full and final settlement of the claim. However, such a clause is included in the agreement to facilitate the settlement. The settlement payment is made to compensate the claimant for the losses or damages suffered, and no portion of the payment is made as consideration for the claimant foregoing its right to pursue legal action. In this scenario no VAT will be payable by the recipient of the compensation payment.

The VAT treatment of payments made under a settlement agreement turns on what the amount is paid in respect of. Compensatory payments made for losses or damages suffered will generally not be subject to VAT because they are not made for the supply of anything, whereas a settlement payment made to a vendor in return for agreeing to forego its right to pursue legal action in respect of an existing claim, will constitute consideration for a supply of services and will be subject to VAT.

If a settlement payment relates partly to a supply of services and partly to compensate a vendor for losses suffered, an appropriate apportionment of the payment will be required in terms of section 10(22) of the VAT Act. The portion of the payment relating to the losses suffered will not be subject to VAT whereas the portion of the payment received as consideration for the services rendered will attract VAT. It is therefore advisable that the settlement agreement clearly stipulates the settlement payment to be made for each part of the claim.

In view of the above, vendors entering into out-of-court settlements, especially the vendor receiving payment of a settlement amount, are reminded of the importance of explicitly stating in the settlement agreement what the settlement payment is made for, and whether the settlement payment agreed upon is exclusive or inclusive of VAT, if VAT is payable. If the settlement agreement is silent on VAT, the payment is deemed to be inclusive of VAT if it is made for services rendered. The vendor receiving such payment will accordingly be liable to account for output tax on the settlement amount equal to the tax fraction thereof, thus leaving the recipient out-of-pocket and ultimately having settled for less.

Varusha Moodaley

CDH
CLIFFE DEKKER HOFMEYR

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

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

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

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

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

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

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

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

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

Louise Kotze
Candidate Attorney
T +27 (0)11 562 1077
E louise.Kotze@cdhlegal.com

BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 1 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.

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

STELLENBOSCH
14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com