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The deductibility of VAT on payments made under loan cover: SCA judgment in *CSARS v Capitec*

The Supreme Court of Appeal (SCA) handed down judgment on 21 June 2022 in the case of *Commissioner for the South African Revenue Service v Capitec Bank Ltd* (94/2021) [2022] ZASCA 97. The judgment raises questions regarding the interpretation and application of the Value-Added Tax Act 89 of 1991 (VAT Act) particularly the deduction of value-added tax (VAT) where goods or services are supplied for no consideration.

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THE FACTS AND ISSUE IN DISPUTE

Capitec Bank Ltd (Capitec) provides free loan cover to clients with unsecured loans, in the event of death or retrenchment. Capitec insured its risks in relation to its unsecured loans with third party insurers. As consideration for the provision of credit, Capitec charged a once-off initiation fee, monthly service fees and interest, all within the maximum limits provided for in the National Credit Act 34 of 2005 (NCA).

During November 2014 to November 2015, Capitec made payments in terms of the loan cover provided and made a deduction in terms of section 16(3)(c) of the VAT Act of R71,5 million, being the tax fraction of the amounts paid under the loan cover.

The South African Revenue Service (SARS) disallowed the deduction and contended that the payments made by Capitec did not qualify for a deduction under section 16(3)(c) because the supply of the loan cover did not constitute a "*taxable supply*" in that (i) the loan cover was provided for no consideration, and (ii) alternatively, the loan cover was provided in respect of an exempt supply.

The matter was first heard by the Tax Court where Sievers AJ found in favour of Capitec and held that the loan cover was provided in the course and furtherance of Capitec's taxable enterprise. Regarding SARS' alternative argument, the Tax Court held that the provision of credit cannot be artificially broken down into the provision of credit on the one side (which is VAT exempt) and a separate transaction in relation to the initiation fee and service fees (which are taxable), and that the loan cover promotes the entire enterprise of Capitec, which includes the making of taxable supplies.

The SCA overturned the judgment of the Tax Court and held that because the provision of credit is an exempt financial service, the loan cover was supplied in the course of making an exempt supply and no VAT was therefore deductible by Capitec.

THE RELEVANT VAT PRINCIPLES

Section 16(3)(c) of the VAT Act provides for a deduction of an amount equal to the tax fraction of any payment made to indemnify another person in terms of any contract of insurance, but only if the contract of insurance is a taxable supply.

A "*taxable supply*" is defined in section 1(1) to mean any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a). Section 7(1)(a) provides, as far as is relevant, that subject to the exemptions provided for in the VAT Act, VAT is levied on the supply by any vendor of goods or services supplied in the course or furtherance of any enterprise carried on by the vendor.

"*Enterprise*" is defined to mean, in the case of any vendor, any enterprise or activity which is carried on continuously or regularly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration. Proviso (v) to the definition of

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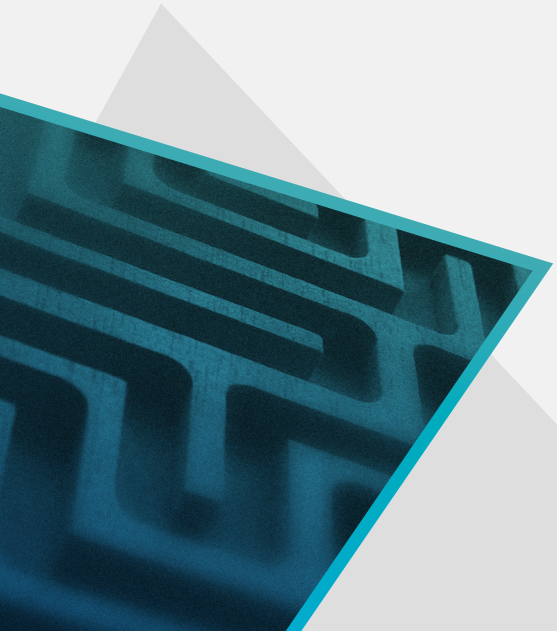

"enterprise" excludes from the definition any activity to the extent to which it involves the making of exempt supplies.

The term *"insurance"* is defined to mean insurance or guarantee against loss, damage, injury or risk of any kind whatever, whether pursuant to any contract or law, and *"contract of insurance"* includes a policy of insurance or an insurance cover but excludes a life insurance policy.

APPLICATION OF THE VAT PRINCIPLES

The VAT system operates on the basis that where a person carries on an enterprise, they must register as a vendor if the value of taxable supplies made in the course of that enterprise during any 12-month period exceeds the VAT registration threshold. Once registered for VAT, the vendor must account for VAT at the relevant rate on all supplies made in the course or furtherance of that enterprise, unless those supplies are specifically exempt from VAT. The VAT must be accounted for on the value of the supply as determined in section 10 of the VAT Act. The vendor may then deduct VAT incurred on goods or services acquired or imported for the purpose of consumption, use or supply in the course of making those taxable supplies. Where the goods or services are acquired partly for making taxable supplies, the VAT may be deducted only to that extent. In addition, a vendor may make the deductions as provided for in sections 16(3)(c) to 16(3)(o), where applicable.

Capitec supplies a service comprising of the provision of credit on a continuous and regular basis to its customers for a consideration. The consideration is charged in the form of interest, initiation fees and service fees. Although the provision of credit is exempt from VAT in terms of section 2(1)(f) read with section 12(a), in terms of the proviso to section 2(1), the provision of credit is a taxable supply to the extent that the consideration is any fee.

Capitec therefore carries on an enterprise involving the provision of credit to the extent that it charges fees as a consideration. It is this enterprise which requires Capitec to be registered for VAT, and all supplies made in the course or furtherance of this enterprise are subject to VAT under section 7(1)(a).

The provision of loan cover comprises the *"supply"* of a *"service"* and *"insurance"* within the defined meaning of these terms. Consequently, the provision of the loan cover by Capitec, a registered vendor, not being an exempt supply in terms of section 12, is a *"taxable supply"* if it is supplied in the course or furtherance of Capitec's enterprise. It should then follow that Capitec qualifies for a deduction for payments

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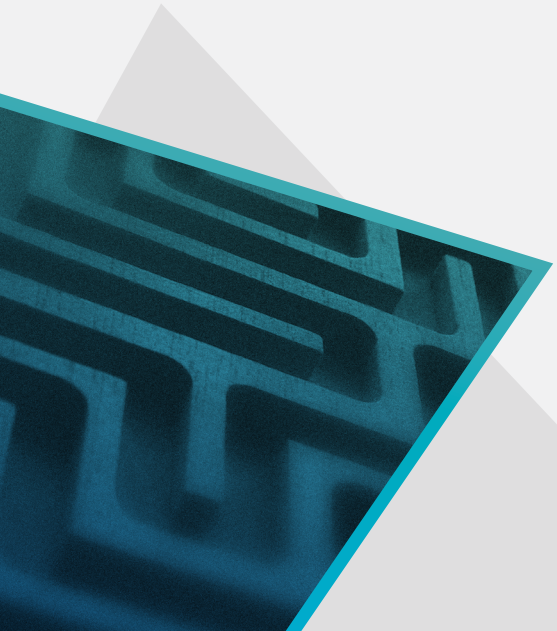

made under that insurance in terms of section 16(3)(c). However, if the loan cover is not provided in the course or furtherance of Capitec's taxable enterprise, then no deduction may be made because the loan cover is then not a taxable supply.

DISCUSSION AND ANALYSIS OF THE JUDGMENT

The SCA agreed with counsel acting for Capitec that there is a direct link between the supply of the loan cover and the provision of credit, but stated that it could not be ignored that Capitec is in the business of providing credit and not in the business of providing insurance. This is despite the VAT status of a supply of insurance not being determined by the status of the supplier, but rather by whether the supply is made by a vendor in the course or furtherance of an enterprise, and if it is exempt under section 12. The subject matter of an insurance policy also does not determine its VAT status. The supply of insurance remains taxable even if zero-rated goods (such as fuel) or the loss of money are covered.

The SCA relied on the judgment in *Commissioner for the South African Revenue Service v Tourvest Financial Services* (Pty) Ltd [2021] (5) SA 86 (SCA) where it was held that even if some taxable fees are earned for a financial service, it does not convert what is in the main an exempt supply into a taxable supply. Based on this finding in the *Tourvest* case, the SCA stated that the fact that fees charged by Capitec for its services of providing credit carry VAT, does not mean that the activity of supplying credit loses its exempt nature.

However, in the *Tourvest* case the SCA held (correctly, in our view) that the proviso to section 2(1) creates a mixed supply out of an identified activity, rather than causing the activity to lose its exempt status in its entirety. Accordingly, the activity involving the provision of credit for which fees and interest are charged as considerations comprises a mixed supply. The extent to which credit is provided on a continuous or regular basis for any fee, comprises an "*enterprise*", and if supplied by a registered vendor, the fees are subject to VAT under section 7(1)(a). It is only to the extent that the credit is provided for a consideration other than for a fee (i.e. interest), that it is excluded from an enterprise by virtue of proviso (v) to the definition of "*enterprise*".

The SCA stated that the fees charged for the provision of credit, if not paid immediately, become capitalised and are added to the outstanding loan, which render them exempt. If the debit order is returned unpaid, Capitec automatically extends additional credit to the borrower in the amount of the unpaid instalment, which is a separate supply of credit. The SCA ruled that because the loan cover relates exclusively to this supply of VAT exempt credit, the loan cover is supplied in the course of an exempt supply.

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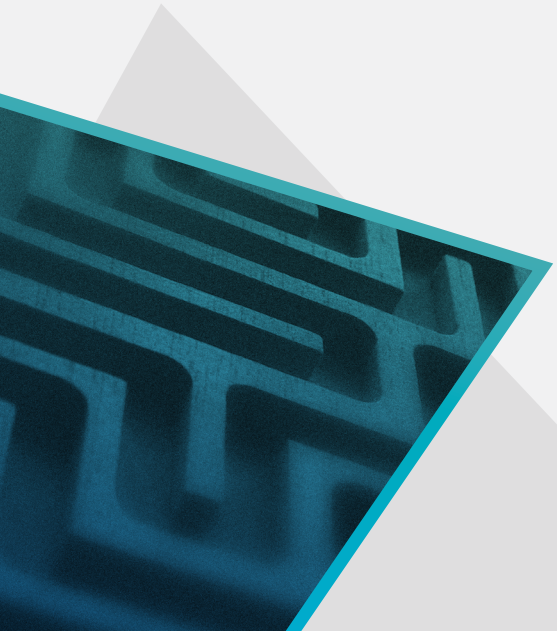

The SCA does not seem to have considered its judgment in *Standard Bank of SA Ltd v Oneanate Investments* (Pty) Ltd (in liquidation) [1998] 1 All SA 413 (A) where it ruled that the amounts debited to a customer's account do not lose their character. Accordingly, where the outstanding balance on a customer's account is made up of separate debit transactions, each debit entry retains its own identity and origin. In addition, section 126(3) of the NCA requires that payments made by a debtor should firstly be appropriated to unpaid interest charges, secondly to fees or charges, and lastly to the principal debt. This also applies to payments of overdue amounts. For VAT purposes, the provision of credit falls within section 2(1)(f) of the VAT Act if money is provided to another person who agrees to pay in the future sums exceeding the money provided. When a debtor defaults, there is no agreement entered into in terms of which the outstanding amount is advanced under a new loan. The amounts outstanding (including the fees) remain payable under the original loan agreement, and each amount outstanding retains its character.

A further question is whether the fact that Capitec provided the loan cover for no consideration resulted in it not being a supply made in the course or furtherance of an enterprise. The activity comprising the provision of credit is, in terms of the *Tourvest* judgment, a mixed supply which comprises an enterprise to the extent that fees are charged. The provision of credit for which interest is charged can therefore not be split from the provision of credit for which fees are charged as consideration. It is one and the same supply, and comprises an enterprise where fees are charged. The question is whether Capitec provided the loan cover in the course or furtherance of this enterprise, albeit for no consideration.

The Australian Tax Office stated that the phrase "*in the course or furtherance*" is broad enough to cover any supplies made in connection with an enterprise. An act done for the purpose or object of furthering an enterprise, or achieving its goals, is a furtherance of an enterprise. The same interpretation should also find application in a South African context.

The Tax Court held, based on the evidence, that the loan cover gives Capitec a competitive and marketing advantage to generate fees. The SCA agreed that there is a direct link between the supply of the loan cover and the provision of credit. If the provision of credit for a fee comprises an enterprise, and the loan cover promoted that enterprise, then it should follow that the loan cover was supplied in the course and furtherance of the enterprise, as per the Tax Court's finding. The supply is then a "*taxable supply*", subject to tax in terms of section 7(1)(a) at the value thereof, which is nil in terms of section 10(23) if supplied for no consideration. However, the SCA held

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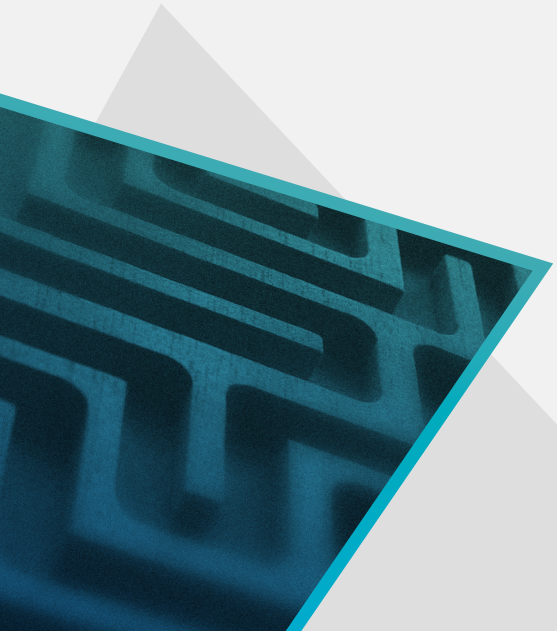

that because the provision of credit is an exempt financial service, the loan cover was supplied exclusively in the course of making an exempt supply and the VAT was therefore not deductible by Capitec.

ADDITIONAL CONSIDERATIONS

The SCA disagreed with counsel for Capitec that VAT apportionment provided for in section 17(1) does not apply to section 16(3)(c), because section 16(3) is made subject to section 17. However, one should appreciate that section 17 only deals with permissible deductions in respect of "*input tax*" which is a defined term, meaning "*VAT charged under section 7 and payable under that section by a supplier of goods or services made to the vendor*". A deduction provided for under section 16(3)(c) does not comprise "*input tax*" as defined and is therefore not subject to apportionment under section 17(1). It should then follow that if an indemnity payment is made under a contract of insurance which comprises a taxable supply, the total payment qualifies for a deduction, otherwise no deduction may be made.

The SCA stated that in terms of section 8(8) Capitec was required to pay output tax on the payment it received under the insurance policies with its insurer and stated that the deduction made under section 16(3)(c) immediately reversed that output tax, which skewed Capitec's books. However, if the loan cover was provided in the course of an exempt supply, as ruled by the SCA, then Capitec should arguably not be liable for output tax on the insurance payments received from its insurers. This is because section 8(8) only applies to the extent that the payments relate to a loss incurred in the course of carrying on an enterprise, which the SCA held was not the case. Capitec is therefore left in the position that it paid VAT on the indemnity payments received from its insurers for which it was not liable and is unlikely to recover the VAT overpaid if the tax periods have prescribed.

IMPLICATIONS OF THE JUDGMENT

The entities that will likely be most impacted by the judgment are financial institutions and providers of loans who also provide loan cover, whether or not for a consideration. They will have to carefully review the VAT status of the loan cover provided and their entitlement to deduct VAT, not only on payments made under the loan cover but also generally on goods and services acquired for their loan businesses, including premiums paid to insurers. These entities should also reconsider the VAT status of indemnity payments received from insurers in relation to their loan business.

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