Dear Sir/Madam

CALL FOR COMMENT: DRAFT VAT INTERPRETATION NOTE ON SECTION 8(25) OF THE ACT (DRAFT IN)

We refer to the above-mentioned call for comment. Set out below please find SAICA VAT-sub-committee’s (a sub-committee of SAICA’s National Tax Committee) submission.

General comment
The introduction to the Draft IN indicates that it deals with sections 8(25), 9, 10 and 18 of the VAT Act. This could be somewhat misleading. The original primary need for the interpretation note was to clarify the deductibility of VAT incurred on expenses in the formation process of the new merged entities. Virtually all examples deal with the application of section 18 change-in-use principles which create the impression that the Draft IN deals comprehensively with section 18 of the Act. We put forward for your consideration that you refer to sections 9, 10 and 18 “to the extent that it impacts on the application of section 8(25).”

The Draft IN does not appropriately address the fact that section 8(25) only applies to the extent that the relevant Income Tax provision applies. In other words, certain assets and liabilities are excluded and these must be considered separately. Consequently, one first needs to consider supplies covered by section 8(25) and thereafter it must be determined whether the remaining supplies are sufficient to constitute an enterprise as a going concern, i.e. 11(1)(e). If section 11(1)(e) does not apply, it must be determined whether the remaining supplies are subject to VAT at 14%, or are exempt from VAT.

The application of section 8(25) may in certain circumstances disadvantage the vendor (i.e. without 8(25) the vendor may have supplied his enterprise as a going concern). To treat vendors (whether in a group of companies or not) equally, the vendors should be able to elect whether section 8(25) should apply. For this purpose we suggest a legislative amendment similar to the Income Tax Act election, i.e. 8(25) will apply unless the vendor elects it not to apply. Alternatively, SARS should consider the granting of a section 72 directive to this effect.
Deductibility of input tax
The meeting held between National Treasury, SARS and various other stakeholders on the interpretational difficulties with section 8(25) of the VAT Act dealt almost exclusively with the deductibility/recoverability of VAT incurred on costs incurred in the formation of the new merged entities. These transactions are often highly complex and the categories of costs incurred are vast and varied. The recoverability of VAT incurred on the various categories of expenses is often an important element in the overall business decision whether or not to proceed with the restructuring.

Paragraph 4.2 of the Draft IN deals with this issue. The Draft IN uses phrases like “where the conditions of deductibility are met”, “do not necessarily result in the denial of input tax …” and “does not prime facie indicate that the VAT incurred does not qualify as ‘input tax’ as defined.”. We submit that the use of the above terms does not assist with creating the clarity that is required for section 8(25) restructurings. It should be avoided where possible.

The test established in the Draft IN to determine deductibility is “to determine whether the supplying vendor and purchasing vendor would have been entitled to input tax had this transaction not fallen within the ambit of section 8(25)”. In our opinion this general test does not do justice to the potential complexity of the nature of many of these transactions. For example, at the most basic level, the test requires that the VAT incurred must have been deductible by “the supplying vendor and the purchasing vendor”. Clearly in practice only one of the vendors would be entitled to an input tax.

At a more complex level, a share-for-share swop may be a supply of an equity security for VAT purposes (being an exempt supply), but the underlying purpose of the transaction may be to combine production capacity and other synergies resulting in increased volumes of taxable supplies by the merged entities. If regard is exclusively had to the legal form of the transaction (being a supply of shares), no input tax deductions are allowable. If regard is however had to the substance of the transaction, the answer may be different.

We therefore recommend that the interpretation note deals with the application of the “substance versus form” doctrine as far as the application of section 8(25) is concerned. We are of the opinion that a deviation from the general rules is warranted due to the extraordinary nature of these transaction types.

We also recommend that a detailed example be inserted in the Draft IN dealing with each potential category of reorganisation and the treatment of VAT incurred on expenses unique to that category of restructure.

Other specific comments

Paragraph 2 on page 1 of the Draft IN
Does “relief in respect of transactions between group companies” apply to all on-going transactions, for example section 45 intra-group supplies of assets and stock?
Paragraph 4.3 on page 4 of the Draft IN
The issues raised in this paragraph are not limited to partnerships. It applies equally to bodies of persons requiring separate registration for VAT purposes. Where the re-organization involves a body of persons, section 8(25) can never apply. This is evident from the fact that since 8(25) is linked to Income Tax and for Income Tax purposes it will always be the underlying partners/members making the supply and not the body of persons, as is the case from a VAT perspective.

Paragraph 4.4 – Section 18
With reference to the last two subparagraphs contained in paragraph 4.4 of the Draft IN, we respectively do not agree with the application of the apportionment ratio as noted. Further clarification is needed and we propose that examples be included.

First paragraph on page 5 of the Draft IN
This paragraph seems to suggest that the recipient is, by implication, obliged to immediately start applying the supplier's apportionment ratio in circumstances where the recipient was not formerly required to apportion input tax but the supplier was. This can create an enormous cash flow disadvantage, especially since the recipient may have conducted a wholly taxable enterprise before acquiring a further enterprise to be used wholly for taxable purposes.

Paragraph 4.5 – General
The fourth sub-paragraph states that "(N)ote that the responsibilities imposed by the VAT Act on the selling vendor before the transactions contemplated in section 8(25) will pass to the acquiring vendor. This implies that SARS will hold the acquiring vendor liable for non-compliance of the selling vendor before the transaction contemplated in section 8(25)". We do not agree with this statement and are of the opinion that it can only apply in respect of the specific transaction.

Last two paragraphs under paragraph 4.5 on page 5 of the Draft IN
This interpretation clearly creates major financial and legal risks for the recipient. It must be remembered that 8(25) does not apply to a whole enterprise as a going concern, but only to identified assets to which the relevant Income Tax relief provisions apply. Consequently we fail to see the basis upon which the entire enterprise can be transferred to the recipient.

Section 18 examples

Example 1
Facts regarding Company C are contradicting. It states that Company C lets both commercial and residential properties. However, the 2 properties it owns are both for wholly taxable purposes. Also, the answer provided does not deal with the apportionment adjustment to be made.

Example 2
The proposed answer does not address the question posed, i.e. whether VAT is deductible on legal costs incurred? Also, it must be borne in mind that if the transaction was not done in terms of section 8(25) it would in all probability have been a fully taxable going concern (0%) and the VAT on costs would have been fully recoverable.
Example 3
What if the cost is borne by Company B? Further, the issuing of shares in this example effectively merely serves as a method of payment. Had payment been made by cheque, any VAT paid on bank charges would have been recoverable on the basis that goods/services, i.e. enterprise, was acquired for purposes of making taxable supplies.

Example seven
The last paragraph deals with penalties and interest in the case of non-compliance. We do not believe that this reference is necessary within the context of the example and Draft IN in general. We recommend that it be deleted, being out of context.

Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully

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The South African Institute of Chartered Accountants