REPORTABLE

IN THE INCOME TAX SPECIAL COURT

HELD AT CAPE TOWN

Case No.: VAT 91

The Honourable Mr Justice J A Conradie	President
Mr G N Krone	Accountant Member
Mr T I Potgieter	Commercial Member

In the matter between:

XYZ LIMITED **Appellant**

and

THE COMMISSIONER FOR THE

SOUTH AFRICAN REVENUE SERVICE **Respondent**

(Heard in Cape Town on 27 February 2002)

JUDGMENT

25 March 2002

CONRADIE, J:

The Appellant is a vendor registered under the provisions of the Value Added Tax Act 89 of 1991 ('the Act'). It was incorporated to exploit a patent for the

manufacture of steel shipping containers suitable for road freight. For manufacturing the containers the Appellant needed capital. It set abut raising the capital by employing the services of PV (Pty) Ltd ('PV'), a company specialising in the venture capital market.

In the tax year in question PV undertook two share placings for the Appellant, the first during January 1998 of 6 000 000 shares at 60c each and another for the same number of shares and at the same price between April and July of the same year.

PV received as remuneration for its services altogether 20% of the capital raised. It paid over to the Commissioner for the South African Revenue Service ('the Commissioner') and in turn recovered from the Appellant value-added tax ('VAT') on its remuneration. VAT was payable in terms of s 7 of the Act because PV was a vendor making taxable supplies.

The Appellant's role in the quest for capital was limited to the allotment and issue of shares in itself to investors recruited by PV. The allotment, issue and transfer of ownership of equity securities are in terms of s 2(1) of the Act deemed to be financial services. The supply of financial services is under s 12 of the Act exempt from tax levied under s 7(1)(a). An exempt trader pays VAT on his purchases but is unable to claim his input tax liability as a credit against his tax liability on sales as he cannot impose VAT on his exempt sales. All this is common cause.

When the Appellant nevertheless claimed from the Commissioner the VAT which it had paid to PV, the Commissioner in rejecting the claim relied on the definition of 'input tax' in s 1 of the Act. 'Input tax' is defined to be–

> '(a) tax charged under section 7 and payable in terms of that section by-
>
> (i) a supplier on the supply of goods or services made by that supplier to the vendor;
>
> … where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services concerned are acquired by the vendor for such purpose;'

Section 17(1) of the Act reinforces the definition by providing that where services are obtained by a vendor partly for use or supply in the course of making taxable supplies and partly for another purpose, input tax is claimable only in respect of supplies by the vendor which are taxable. Indeed, proviso (v) to the definition of 'enterprise' in s 1 of the Act makes it clear that a vendor who makes exempt supplies does not even, in relation to such supplies, carry on an 'enterprise'. He is in the position of an (unregistered) end-user. This is the person who ultimately pays the tax; for although it is called a value added tax, VAT is really a consumption tax: its effect on a vendor is neutral except if that vendor makes exempt supplies. To the extent that he does so, his activities do not amount to the carrying on of an 'enterprise' and he falls outside the tax net.

The Appellant's case is that although the supply of financial services is exempt from VAT its claim for input tax should in this case, exceptionally, be allowed because of the close connection between the sale of the shares and the shipping containers manufactured by it (which would not have been manufactured if the capital had not been raised by PV) and which were, of course, supplies subject to VAT. This, argued Mr V for the Appellant, brought the VAT paid on the services acquired by the Appellant from PV within the definition of input tax in s 1; the services were, he contended, 'acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies … '

The difficulty with Mr V's submission is that although the raising of the capital might have been indispensable to the making of the taxable supplies, one would, if he were right, have to interpret the expression 'in the course of the making of taxable supplies to accommodate the remuneration paid for the raising of the Appellant's capital. The raising of capital seems rather to be preparatory to the making of the taxable supplies. It does not seem to me that one can reasonably say that PV's services were acquired in the course of manufacturing the shipping containers. Capital goods such as machinery bought with the raised capital can be said to have been acquired in the course of making taxable supplies. But there the connection is closer. And it is the closeness of the connection that counts.

BLP Group plc v Commissioners of Customs and Excise (European Court Reports page 1-0983) was a case referred to the European Court of Justice for

a preliminary ruling on the interpretation, *inter alia*, of article 17 of the European Community's Sixth Directive on the harmonisation of the laws of the member states relating to turnover taxes.

The relevant paragraphs of article 17 read as follows:

> '[2 In so far as goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:
>
> (a) VAT due or paid… in respect of goods or services supplied or to be supplied to him by another taxable person;
>
> [3 Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:
>
> (a) transactions relating to the economic activities… carried out in another country, which would be deductible if they had been performed within the territory of the country;
>
> (b) transactions which are exempt…
>
> (c) any of the transactions exempt when the customer is established outside the Community or when those

> transactions are directly linked with goods to be exported to a country outside the Community.'

BLP Group plc was a management holding company which disposed of shares in a subsidiary. The sale of shares was an exempt transaction in terms of the VAT legislation. It sought to deduct as input tax VAT paid on professional services supplied by merchant bankers, solicitors and accountants in connection with the sale on the basis that the purpose of the sale was to pay off debts that had arisen directly from its taxable transactions. The European Court of Justice held that where a taxable person uses services for an exempt transaction, he is not entitled to deduct the input tax paid even if the ultimate purpose of the transaction is the making of taxable supplies.

Despite the difference in wording between article 17 of the Sixth Directive and s 7 of the Act I consider the decision to be helpful. The expression in s 7(1)(a) ' … in the course or furtherance of any enterprise carried on by him… 'is certainly no wider and is probably narrower than the expression 'for the purposes of his taxable transactions' in article 17. The principle is that where goods or services are used for an exempt supply it is not legitimate for the taxpayer to look through that supply to an ultimate purpose of carrying out taxable supplies. The European Court of Justice motivated its decision by saying-

> '19 Paragraph 5 lays down the rules applicable to the right to deduct VAT where the VAT relates to goods or services used by the taxable person "both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible and for transactions in respect of which value added tax is not

> deductible". The use in that provision of the words "for transactions" shows that to give the right to deduct under paragraph 2 the goods and services in question must have a direct and immediate link with the taxable transactions and that the ultimate aim pursued by the taxable person is irrelevant in this respect.'

Similar propositions to those advanced before me were put forward in the case of *Customs and Excise Commissioners v UBAF Bank Ltd* [1995] STC 250 heard first in the Queen's Bench Division and later before the Civil Division of the Court of Appeal. The decision on appeal is reported in *Simon's Tax Cases*, [1996] STC 372. The Respondent bank carried on an equipment leasing business. In order to extend this business, it acquired three leasing companies. It did so by buying their shares and thereafter buying the business of each; this meant that the companies were left dormant. In making the acquisitions the Respondent paid certain fees to its solicitors and to a company called Cipher Resources Ltd. The commissioners contended that the Respondent had incurred the fees in acquiring additional subsidiary companies and not in making taxable supplies of leasing services: there was therefore no sufficient or direct link between the fees paid for the services of Cipher Resources and the solicitors and the taxable supplies. The court of appeal held that there was. In distinguishing the decision in *BLP Group plc* (supra) Neill L J said this:

> "In the present case there was no intervening supply by UBAF between the acquisition of the shares and the businesses and the subsequent use of the acquired assets in the making of taxable supplies. The tribunal considered the evidence and came to the conclusion… that the transactions… ' were intended

to, and did, enable the Bank so add substantially to its own existing leasing business and, in VAT terms, to make taxable supplies of leasing'. It seems to me that this was a finding of fact that there was a direct link between the acquisitions and the making of the taxable supplies. It is true that the assets acquired were not physical assets but the assets clearly included rights under the existing leases between the three companies and their lessees."

Mr V did not argue that a direct and immediate link between the services of PV and the making of the taxable supplies was not required. His argument was that there *was* such a link since the capital raised was used for the running of the Appellant's business. For the reasons given above, this contention fails.

The appeal is dismissed. The Commissioner's assessments are confirmed.

_____Signed_____

CONRADIE, J

This judgment is reportable

Mr R V, instructed by Hofmeyr Herbstein & Gihwala Inc. of P O Box 1221, Cape Town appeared on behalf of the Appellant.

Mr L Connell represented the Commissioner for the South African Revenue Service.