

REPUBLIC OF SOUTH AFRICA



**IN THE TAX COURT OF SOUTH AFRICA
(HELD AT CAPE TOWN)**

CASE NO: VAT 1904

- (1) REPORTABLE: YES/NO
(2) OF INTEREST TO OTHER JUDGES: YES/NO
(3) REVISED.

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DATE

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SIGNATURE

In the matter between:

ABC BANK LIMITED

Appellant

and

**THE COMMISSIONER FOR THE
SOUTH AFRICAN REVENUE SERVICE**

Respondent

Date of hearing: 21 August 2020

Date of judgment: 26 November 2020

J U D G M E N T

SIEVERS AJ

INTRODUCTION

[1] The appellant is ABC Bank Limited (“ABC”), a registered bank which conducts business with regard to both transactional banking (including savings accounts and credit card facilities) and unsecured lending. ABC appeals against the additional VAT assessment raised by the respondent (“SARS”) against its November 2017 VAT return in which ABC claimed an input tax deduction in terms of section 16(3)(c) of the Value-Added Tax Act 89 of 1991 (“the VAT Act”).

[2] The input tax deduction claimed relates to ABC’s unsecured lending business. The standard form loan agreements with the bank’s customers contained a contractual provision that ABC would, on their retrenchment or death, settle their outstanding loans up to a specified amount. During the VAT period from November 2014 to November 2015 ABC made payments in this regard totalling R582 383 753,66. The tax fraction of this amount, being R71 520 811,85, was claimed as a deduction.

[3] On 15 February 2018, SARS issued an assessment in terms of which it disallowed the input tax deduction claimed and levied a 10% late payment penalty for the resultant understatement of ABC’s VAT liability.

[4] In terms of Rule 34, promulgated under section 103 of the Tax Administration Act 28 of 2011 (“the TAA”), the issues in an appeal to the tax court are those contained in the statement of the grounds of assessment and opposing the appeal, read with the statement of the grounds of appeal and the reply, if any, to the grounds of appeal.

[5] In its statement of grounds of assessment and for opposing the appeal SARS contends that the loan cover payments do not qualify for an input tax deduction in terms of section 16(3)(c) of the VAT Act because the supply of the loan cover did not constitute a “taxable supply” in that:

- (1) the loan cover was provided for no “consideration” and accordingly the supply of the loan cover had no “value”, and
- (2) the loan cover constituted, alternatively was in respect of, an exempt supply.

[6] The above accordingly constitutes the issues to be decided in the appeal.

[7] A further issue is whether the 10% penalty imposed in terms of section 39(1) of the VAT Act should be remitted pursuant to section 217(3) of the TAA.

[8] Neither party seeks a costs order nor were any circumstances advanced as envisaged by section 130 of the TAA.

SECTION 16(3)(c)

[9] Section 16 (3)(c) permits the deduction of an amount equal to the tax fraction of any payment made by the vendor to indemnify another person in terms of any contract of insurance provided that the supply of that contract of insurance is a taxable supply.¹

[10] A taxable supply is defined in section 1 as the supply of goods or services chargeable with tax under provision 7(1)(a), including tax chargeable at 0% under section 11.²

[11] Section 7(1)(a) provides for VAT to be levied and paid on the supply of goods or services by any vendor in the course or furtherance of any enterprise carried on by him.

[12] An enterprise is defined in section 1 as an activity carried on by any vendor continuously or regularly in the course or furtherance of which goods or services are supplied to another person for a consideration, whether or not for profit.³

[13] “Consideration”, is defined as any payment made, whether in money or otherwise, in respect of the supply of any goods or services by that person or any other person.⁴

¹ Section 16(3) Subject to the provisions of subsection (2) of this section and the provisions of section 15 and 17, the amount of tax payable in respect of a tax period shall be calculated by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period, as determined under subsection (4) and the amounts (if any) received by the vendor during that period by way of refunds of tax charged under section 7(1)(b) and (c) and 7(3)(a), the following amounts namely—

(c) an amount equal to the tax fraction of any payment made during the tax period by the vendor to indemnify another person in terms of any contract of insurance: Provided that this paragraph—

(i) shall only apply where the supply of that contract of insurance is a taxable supply or where the supply of that contract of insurance would have been a taxable supply if the time of performance of that supply had been on or after the commencement date;

² “**Taxable supply**” means any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent under section 11;

³ “**Enterprise**” means—

(a) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods, or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club.

⁴ “**Consideration**”, in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax) whether in money or otherwise, or any act of forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain: ...

[14] The following facts are not in dispute:

- (1) ABC paid out loan cover in the amount of R582 383 753,66 during the tax periods in question and the tax fraction of the total payments made is R71 520 811,85.
- (2) The standard written loan agreement between ABC and its clients includes an undertaking in clause 13 that for loans of 6 months or more, if the customer dies or is retrenched, the amount owing to ABC would be covered to a maximum of R264 000,00, save that if the customer was retrenched within 3 months from taking the loan only half of the amount owing will be covered.
- (3) The agreement stated that ABC did not charge any fees for the loan cover.
- (4) The agreement recorded the costs of credit as being the initiation fee charged upfront, the monthly services fee, included in the instalment, and interest. Both the initiation fee and monthly service fee included 14% VAT.
- (5) The loan cover which ABC afforded its clients was a discreet contractual obligation and that there was no nexus between such clients and the insurer with whom ABC concluded a contract of insurance to protect itself against the portion of the loss to which it was now exposed in respect of such clients.

[15] The issue in dispute is whether the supply of the loan cover is a “taxable supply” as required by the proviso (i) to section 16(3)(c). In its Rule 31 statement, SARS denied that the supply is a taxable supply for the two reasons set out in paragraph 5 above.

[16] The definition of what constitutes a taxable supply does not contain a requirement for there to be a consideration. It does however require the supply of services is chargeable with tax under provision 7(1)(a), including tax chargeable at 0% under section 11.

[17] Section 7(1)(a) provides for VAT to be levied on the supply by any vendor during the course or furtherance by an enterprise carried on by him. The definition of enterprise requires that services be supplied to another person for a consideration, whether or not for profit.

[18] In the present matter ABC provides a loan to its customers. In respect of such loan the customers pay an initiation fee, service fees and interest. The initiation and services fees include VAT.

[19] This while the written loan contract expressly states that ABC does not charge any fees for the loan cover it does set out the statutory service fees charged. These service fees are defined in section 1 of the National Credit Act 34 of 2005 (“the NCA”) as being a fee that may be charged periodically by a credit provider in connection with the routine administration cost of maintaining a credit agreement.

[20] Regulation 44(3) to the NCA provides that:

“the service fee covers the cost of administering a credit agreement which is the operational cost of the credit provider such as rent, labour, communication, banking, processing of repayments and any other costs related to the administration of a credit agreement.”

[21] Thus whilst ABC makes no separate and distinct charge for the loan cover the cost of such cover to ABC is at least in part recovered through service fees which provide for its operational costs. These fees constitute consideration for the cover provided.

[22] ABC's unsecured lending business is thus an enterprise as defined and as required by section 7(1)(a) of the VAT Act. VAT is levied on the initiation fee and service fee by ABC, and this is during the course of furtherance of its unsecured lending business.

[23] The fact that the supply of the loan cover is not charged for in a separate fee would not disqualify it from being a taxable supply. In this regard SARS Interpretation Note 70 dated 14 March 2013 (entitled “Supplies Made for No Consideration”) provides in paragraph 5.2.2:

“the effect is that VAT incurred on marketing efforts, including certain promotional supplies made for no consideration, may be deducted if the expenses can be directly attributed to specific taxable supplies made for a consideration, or generally, for the purpose of promoting the vendors other taxable products offerings.”

[24] Before the commencement of the National Credit Act 34 of 2005 (“the NCA”) ABC's loan products fell within the exemption levels of the Usury Act and it charged a single all-inclusive interest rate for the provision of credit to clients. The NCA introduced restrictions on charges for credit by limiting the allowable charges to interest, an initiation fee and a service fee, each subject to a statutory cap.

[25] ABC followed this model and charged a combination of interest, an initiation fee and a monthly service fee to its clients making it commercially feasible to offer small amounts of credit. Subject to the limits on revenue imposed by the NCA, ABC sought to ensure that its total costs, risks and profit aspirations were covered by its total loan revenue, made up of interest and fees. The portion of the total loan revenue arising from fees would be relatively higher as the loan period decreased. ABC had a policy of charging the maximum permissible initiation and service fees on all loans and would offer discounts to clients by reducing interest rates, rather than to lower the fees charged.

[26] The main risk ABC faced in the unsecured lending business was credit risk, being the risk of non-payment by loan clients. While some of the causes of this risk were within the client's control, others, such as death and retrenchment were not. On death and retrenchment the option of attempting to pursue the retrenched client, or the client deceased's estate, for unpaid sums was unattractive as it might not realise any proceeds. It would furthermore be disadvantageous to the client in a time of distress. The undertaking not to pursue the client in the event of death or retrenchment made in the standard form loan agreement accordingly gave ABC both a competitive advantage and a marketing benefit.

[27] ABC's management accountant, Mr X testified that whilst ABC did not levy a separate charge for the loan cover, ABC absorbed the costs associated with providing the loan cover as part and partial of its overall costs of providing credit.

[28] A client would however only receive the loan cover against the obligation to pay fees and interest and it was only against this consideration that the client would obtain the benefit. The loan cover was accordingly not purely gratuitous, but linked to the provision of credit which enabled ABC to generate its loan revenue from fees and interest. Accordingly the loan cover is thus for a consideration. The supply of the loan cover was made in the course and furtherance of an "enterprise" that involved the making of taxable supplies.

[29] It is clear that the provision of the loan cover is made during the process of, and in order to, advance ABC's lending business. ABC makes taxable supplies for a consideration in the context of that lending business. That consideration takes the form of fees which are a key component on the income side of the business model. As the loan cover gives ABC a competitive and marketing advantage to generate fees, the loan cover was therefore supplied in the course and furtherance of making taxable supplies.

EXEMPT SUPPLY

[30] The second basis of disallowance was that the supply of the loan cover constituted, alternatively was in respect of, an exempt supply.⁵ Proviso (v) to the definition of enterprise provides that any activity, to the extent to which it involves the making of exempt supplies, shall not be deemed to be the carrying on of an enterprise.⁶

⁵ (v) any activity shall to the extent to which it involves the making of exempt supplies not be deemed to be the carrying on of an enterprise;

⁶ **Section 12. Exempt supplies.**—The supply of any of the following goods or services shall be exempt from the tax imposed under section 7(1)(a):

(a) The supply of any financial services, but excluding the supply of financial services which, but for this paragraph, would be charged with tax at the rate of zero percent under section 11;

[31] Section 12(a) of the VAT Act treats the supply of financial services as an exempt supply. Section 2 of the VAT Act defines financial services as including (in 2(1)(f)) the provision of credit where the lender will repay in the future an amount exceeding the amount of the credit advanced. Interest on a loan is accordingly exempt. A proviso to the definition of financial services in section 2 provides that the exemption shall not apply to the extent that the consideration payable in respect thereof is any fee. The exemption does accordingly not apply to the initiation fee and the monthly service fees.

[32] The basis for the argument advanced by SARS is that the loan cover advanced or was supplied in the course and furtherance of the making of an exclusively exempt supply. This is premised upon it being accepted that one can separate the provision of credit from the provision of services in relation to the initiation fee and the provision of monthly services in respect of the service fee, and that the supply of loan cover is exclusively made in the course and furtherance of the exempt provision of credit.

[33] In *Commissioner, SARS v Capstone 556 (Pty) Ltd* 2016 (4) SA 341 (SCA) in para [34] the court held that:

“if the receipt or accrual arises from a detailed commercial transaction the transaction must be considered in its entirety from its commercial perspective and not be broken into component parts or subjected to narrow legalistic scrutiny.”

Applying this ratio in the present matter and adopting a commercial approach towards the analysis of ABC’s unsecured lending business it is clear that one is dealing with the provision of credit to clients which cannot artificially be broken down into the provision of credit on one hand and other distinct separate transactions in relation to the initiation fee and service fee.

[34] The clients contract for and receive no benefit over and above the loan itself, apart from the loan cover. Where no loan is advanced, no initiation fee is payable and no service fee is levied. Furthermore, as set out above in section 1 of NCA both “initiation fee” and “service fee” are defined (with Regulation 44(3)) by reference to the types of costs incurred by the vendor and not by reference to any particular service supplied to the customer. This is emphasized by the inclusion in the NCA of interest, initiation fee and the service fee, as sub-components under the heading “costs of credit” in section 101 thereof. The fee income, which is charged over and above interest in terms of a loan agreement, is part of the consideration payable for the provision of credit.

[35] The loan cover promotes and is made in the course and furtherance of an enterprise that includes the making of taxable supplies. These fees are a key component on the income side of ABC’s business model. It would be uncommercial and inconsistent with X’s evidence in this regard to accept that the loan cover exclusively advances an exempt supply.

[36] The clients contracted to get a loan and not for other separate distinct services. The taxable fees recover costs to the bank and not services to the client. The NCA includes these with interest as being "costs of credit". All three are the consideration paid for credit.

[37] As the supply of loan cover advances the entire business of advancing credit and this includes a taxable supply, the loan cover advances a taxable supply for consideration.

[38] The requirements of section 16(3)(c) are thus satisfied and ABC qualifies for the deduction provided for therein.

CONCLUSION

[39] The assessment thus falls to be set aside and as a result the penalty imposed also falls away.

[40] It is accordingly ordered that:

- (1) the appeal is upheld;
- (2) it is directed that appellant (ABC) was entitled to deduct the amount of R71 520 811,85 from its output tax in November 2017 by virtue of section 16(3)(c) of the VAT Act;
- (3) the additional assessment for the November 2017 tax period is set aside;
- (4) respondent shall refund to appellant the sum of R71 520 811,85 together with interest at the prescribed rate from date of payment to date of refund.

SIEVERS AJ
JUDGE OF THE HIGH COURT

Assessors: ADV J HAMMON-UNGERER
 MR E GOUWS