

The deductibility of value added tax on costs incurred to raise share capital: A critical analysis of the *ITC 1744* case

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OPSOMMING

Die aftrekbaarheid van belasting op toegevoegde waarde op kostes aangegaan om aandele uit te reik: 'n Kritiese ontleding van die *ITC 1744*-saak

Maatskappye gaan dikwels wesenlike kostes aan by die uitreik van aandele om bedrywigheede te finansier. Tans voer die Suid-Afrikaanse Inkomstediens (SAID) aan dat belasting op toegevoegde waarde (BTW) aangegaan op aandeeluitreikingskoste nie aftrekbaar is nie. Hierdie siening is gebaseer op die *ITC 1744*-saak. Die uitspraak in die *ITC 1744*-saak is gebaseer op die mening uitgespreek in 'n Europese hofsak wat in 1994 beslis is. Sedertdien het die *European Court of Justice* (ECJ) in 'n aantal sake die aftrekbaarheid van BTW op aandeeluitreikingskoste oorweeg en beslis dat insetbelasting in sekere gevalle aftrekbaar sal wees. In hierdie artikel word die vraag gestel of argumente soortgelyk aan die argumente gevolg deur die ECJ in Suid-Afrika aangevoer kan word. Gebaseer op die ontleding van die argumente in die ECJ-beslissings, binne die konteks van die Suid-Afrikaanse wetgewing, word aangevoer dat daar gebiedende gronde bestaan om in Suid-Afrika te argumenteer dat 'n aandeeluitreiking nie 'n lewering daarstel nie en dat aandeeluitreikingskoste as 'n algemene bokoste beskou kan word. Hierdie argumente kan die SAID aanmoedig om die siening wat tans gehuldig word by die aftrekbaarheid van BTW op aandeeluitreikingskoste in Suid-Afrika, te hersien.

1 Introduction

It is at the heart of any business to raise capital to start up or expand its activities.¹ In doing so, several types of costs, such as share transfer secretarial charges, legal fees, fees payable to merchant bankers and specialist consultants, as well as listing fees, may be incurred, often in

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1 Du Toit *et al Corporate Finance: A South African Perspective* (2010) 336.

significant amounts,² especially in the private equity industry.³ Value added tax (VAT) is levied on the supply of these services.⁴ The level of share issue costs is significantly affected by the deductibility (or not) of the VAT paid on the share issue costs incurred by the entity issuing the shares⁵ and can become an important factor in determining how and how much finance will be raised.⁶

During 2002, in the case of *ITC 1744*,⁷ it was held that a company cannot deduct the VAT paid on share issue costs, even if such costs are incurred to raise finance for a new business venture that would ultimately entail the making of taxable supplies.⁸

This view was based on the principles of the judgment of the European Court of Justice (ECJ) in the case of *BLP Group Plc v Commissioner of Customs and Excise*.⁹ in which it was held that the deductibility of the VAT paid on an expense depends on the existence of a direct and immediate link between an expense and a taxable supply.¹⁰ Even though the South African Revenue Service (SARS) is not bound to follow a decision of the Tax Court,¹¹ the view expressed in *ITC 1744* is favourable to SARS and is currently the only case law providing guidance on the matter in South Africa. The current SARS policy in respect of the deductibility of VAT on share issue costs is therefore based on the *ITC 1744* case.¹²

The *BLP Group Plc* judgment was laid down in 1994. Subsequently a number of judgments in respect of share issue costs have been delivered

2 For example, a placement fee of 20 per cent of the proceeds received from the share issue was incurred in the case of *ITC 1744* 65 SATC 154 for a placement of shares in the venture capital market.

3 Gasparotto "Achieving clarity on VAT for holding companies" (2008) *International Tax Review* March 2008.

4 VAT is levied on the supply of these services in terms of s 7(1)(a) Value Added Tax Act 89 of 1991 (the VAT Act). The proviso to s 2(1) specifically excludes activities relating to the issue of shares from the definition of financial services to the extent that it attracts a fee, commission, merchant's discount or similar charge. These financial services are therefore not exempt from VAT in terms of s 12.

5 For example, share issue costs of R114 (including VAT) are reduced to R100 if input tax can be deducted. If input tax cannot be deducted this cost remains at R114. The deductibility of input tax therefore reduces the cost to the company paying the share issue costs by 12.28 per cent (calculated as R14/R114).

6 Firer *et al* *Fundamentals of Corporate Finance* (2004) 505.

7 65 SATC 154.

8 *Idem* 158.

9 European Court Reports PI-0983 ("*BLP Group Plc* case").

10 *ITC 1744* 158.

11 De Koker *Silke on South African Income Tax* (2010) § 25.4.

12 Badenhorst *et al* *Ensign* (2010) February 2010, available at <http://www.ens.co.za/newsletter/briefs/taxFeb10entitlement.html> (accessed 2010-11-20); Silver "Share transactions - A VAT chance?" *Deloitte Tax News* 2 2010, (<http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/Tax%20News%20of%202010.pdf> (accessed 2010-11-20);

by the ECJ. These judgments have changed the view in Europe¹³ on the deductibility of VAT on share issue costs.¹⁴ As reliance was previously placed on the views of the ECJ in *ITC 1744*, it is submitted that the reasoning followed by the ECJ may provide compelling arguments to reconsider the position in South Africa.

The objective of this article is to analyse the views expressed in respect of the deductibility of VAT on share issue costs in the judgments of the ECJ subsequent to the *BLP Group Plc* case in order to determine whether compelling grounds exist to advance similar arguments in the South African context. If such grounds exist, it may provide a basis to reconsider the position in South Africa that is based on the judgment in *ITC 1744*.

In light of the object of the article the analysis commences in section 2 with a discussion of the *ITC 1744* judgment, followed by an investigation into the relevant ECJ case law in section 3. The possibility of following similar arguments to those of the ECJ in the South African context is considered in section 4.

2 The *ITC 1744* Case

In *ITC 1744* the Cape Tax Court was presented with an appeal by a company that was incorporated to exploit a patent to manufacture steel shipping containers suitable for road freight. In order to raise finance to commence its activities the vendor employed a specialist in the venture capital market to place its shares in the market. The company paid the specialist a placement fee equal to 20 per cent of the capital raised for the services provided. The specialist levied VAT on the supply of these services.¹⁵

The question before the court was whether the company was allowed to deduct the VAT on the placement fee paid to the specialist. In answering this question, the court had to consider the definition of "input tax" in section 1 of the VAT Act, which determines that where a vendor is concerned

'input tax' means –

Schneider "Tax authorities adopt more practical approach for financial services" *KPMG Global Indirect Taxes* (2009); PricewaterhouseCoopers "Holding company expenses - Have you over-claimed input VAT?" *VAT Alert* (2009) 2009-11-05.

13 The views expressed in the judgments were in terms of the Sixth Council Directive 77/388/EEC of 1977-05-12 on the harmonisation of member states' laws relating to turnover taxes - Common system of value added tax: uniform basis of assessment *Official Journal L 145 13/06/1977 P 0001 - 0040* (hereinafter referred to as the "Sixth Directive"), the statute that governs VAT in the European Community.

14 Stewart & Bernier "Deductibility of VAT on the cost of issuing new shares" *International Tax Review* September 2004.

15 *ITC 1744* 156.

- (a) tax charged ... 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* ...¹⁶ (own emphasis).

The company contended that although issuing its shares is an exempt supply of a financial service,¹⁷ the connection between the issuing of shares to raise finance and its business of making taxable supplies (to manufacture and sell containers) was sufficiently close to justify the deductibility of input tax on the placement fee. It argued in favour of this contention that the company would not have been able to manufacture and supply the containers in the absence of this service and the consequent failure to raise finance.¹⁸

However, Conradie J did not agree with this view. In arriving at his judgment he relied on the *BLP Group Plc* case and supported this by a reference to *Customs and Excise Commissioners v UBAF Bank Ltd.*¹⁹

The issue considered in the *BLP Group Plc* case was whether VAT on professional fees paid to merchant bankers, who advised on the disposal of shares held in a subsidiary, would be deductible. The purpose of the disposal of the shares, according to *BLP Group Plc*, was to raise funding to settle debts that arose from its taxable transactions. The legislation relating to the deduction of input tax relevant in this case stated:²⁰

[I]n so far as goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct ...

- (a) VAT due or paid ... in respect of goods or services supplied or to be supplied to him by another taxable person. (own emphasis)

The ECJ ruled that a direct and immediate link was required between the professional fees paid in respect of the shares disposed of by *BLP Group Plc* and its taxable transactions to be able to deduct input tax on the transactions. The court was of the opinion that there was a direct and immediate link between the professional fees incurred and the disposal (transfer) of shares, an exempt supply; and further that the ultimate purpose of the taxable person, in this case to raise funding to settle debts arising from taxable transactions, was not relevant when considering the deductibility of the input tax.²¹

16 Definition of input tax in s 1 VAT Act.

17 This view of the company was based on the assumption that the issue of shares is an exempt supply in terms of s 12(a) & s 2(1)(d) VAT Act. This assumption proved to be contentious in the ECJ cases discussed in Part 3 of this article.

18 *ITC 1744* 156.

19 1996 STC 372 (hereinafter referred to as the "*UBAF Bank case*").

20 Article 17(2) of the Sixth Directive.

21 *ITC 1744* 158.

In support of the "direct and immediate link" test, Conradie J referred to the *UBAF Bank* case²² where a company incurred fees for advisory services related to the acquisition of shares in three subsidiaries. The purpose of acquiring the subsidiaries was to strip the existing leasing businesses out of them to enable the taxpayer to expand its existing leasing business. In this case the judge concluded that there was a direct and immediate link between the fees incurred and the taxpayer's existing leasing business, and applied the "direct and immediate link" test in favour of the taxpayer.²³

Relying on the "direct and immediate link" test laid down by the European courts in the cases discussed above, Conradie J held that a direct and immediate link existed between the share issue costs incurred by the appealing taxpayer in *ITC 1744* and the issue of the shares that was not part of the taxpayer's business of manufacturing and selling containers, but rather an exempt supply in his view.²⁴

3 Views of the European Court of Justice

The judgment in *ITC 1744* relied on two cases, neither of which involved share issue costs. In relying on these cases it is submitted that Conradie J was of the opinion that the principles established in these cases may similarly be applied to share issue costs. Views expressed by the ECJ on the deductibility of VAT on share issue costs since 2000 differ from those in *ITC 1744*. This raises the question whether the principles from the *BLP Group Plc* and *UBAF Bank* cases, which dealt with a sale of previously issued shares and an acquisition of shares respectively, could similarly be applied when new shares are issued. The relevant ECJ cases and the fundamental principles laid down in each case are considered next.

3 1 *Cibo Participants SA v Directeur Régional des Impôts de Nord-Pas-de-Calais*

In *Cibo Participants SA v Directeur régional des impôts de Nord-Pas-de-Calais*,²⁵ *Cibo Participants SA* ("Cibo") acquired shares in three subsidiary companies. It incurred various costs in respect of acquiring these shares, including fees to perform an audit on the companies acquired, negotiation fees, and fees for tax and legal assistance. Cibo deducted the input tax on these costs, but the deduction was disallowed by the tax authorities on the grounds that the costs were incurred to

22 *Supra*.

23 *ITC 1744* 158.

24 *ITC 1744* 158. The ECJ judgments subsequent to the *BLP Group Plc* case established the principle that issuing shares is not a supply and can therefore not be exempted. This casts some doubt on whether Conradie J's view that the principles laid down in respect of the transfer of shares could similarly be applied in the context of share issues was appropriate.

25 ECJ Case C-16/00 (hereinafter referred to as the "*Cibo* case").

acquire shares and receive dividends that are exempt and non-taxable transactions.²⁶

Despite the fact that the matter at issue concerned share acquisition costs, as opposed to share issue costs, the judgment laid down principles later applied by the ECJ in matters concerning the issue of shares.²⁷ The first question confronting the court was whether Cibo's acquisition of the shares would result in a taxable transaction.²⁸ In terms of article 4(2) of the Sixth Directive²⁹ a prerequisite for a transaction to be taxable is that it must be an economic activity performed by a taxable person. The court held that earning dividends was not an economic activity since the receipt of dividends from the subsidiaries did not in itself constitute consideration in exchange for a supply of goods or services by Cibo.³⁰ It was further held that in this case the object of Cibo's acquisition of shares in the subsidiaries was to become involved in the management of these subsidiaries in exchange for a management service fee. This involvement was regarded as an economic activity, which meant that Cibo was conducting economic activities (transactions) that were subject to VAT (i.e. taxable transactions).³¹

The second question considered by the court was whether Cibo was entitled to deduct input tax on the advisory fees.³² As the input tax system was designed to relieve the burden of VAT payable by a trader on taxable activities, the court held that expenditure incurred must be linked to the output activity (supply) in order to apply the "direct and immediate link" test laid down in the *BLP Group Plc* case.³³ The nature of the output activity (supply) to which the expenditure is linked determines whether the input tax on the expenditure can be deducted.³⁴ As the dividends earned did not constitute consideration for a supply, the cost to acquire the shares in the subsidiaries could not be linked to this transaction or a specific supply. Instead it was held that the expenditure should be viewed as a general cost of performing all the entity's supplies. This implied that the expense had a direct and immediate link with the business as a

26 *Cibo* case § 9.

27 Refer to the discussion of the *Cibo* case in the *KapHag* case below.

28 *Cibo* case § 14.

29 Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value-added tax: uniform basis of assessment.

30 *Cibo* case § 41. A similar view was put forward with reference to the South African context by Connell "Holding Companies to account: The expense apportionment conundrum" 2004 *SALJ* 117.

31 *Cibo* case 26 § 22.

32 *Idem* § 24.

33 *Idem* § 27 & § 29.

34 *Idem* § 31.

whole; hence the deductibility of input tax depended on the nature of the activities (supplies) of the entity's business.³⁵

The principle that emerged from this case was that expenditure had to be linked to activities or supplies when applying the "direct and immediate link" test. If expenditure cannot be linked to a specific economic activity or supply, it has to be viewed as a general cost that benefits the business as a whole (i.e. all the supplies made by the business).

3 2 *KapHag Renditefonds v Finanzamt Charlottenburg*

In *KapHag Renditefonds v Finanzamt Charlottenburg*,³⁶ KapHag Renditefonds ("KapHag") was a partnership, established under the German civil law to acquire a development right to land on which it intended to erect buildings to lease out and manage. In November 1991 a new partner contributed an amount of capital to the KapHag partnership. Legal fees, on which VAT was levied, were incurred to facilitate admission of the new partner. KapHag deducted the input tax on these fees, but the tax authorities disallowed the deduction.³⁷

The question posed to the ECJ in this case was whether admission of a new partner in exchange for a contribution by the partner was a supply rendered by the partnership.³⁸ It was held that the partnership did not supply any goods or services to the new partner. This view was based on the argument that the partner had merely been provided with the expectation of sharing in future partnership profits in virtue of owning a share of the partnership's assets by the existing owners of the partnership. As a result the acquisition of the new partner's share of the partnership's assets was not a supply rendered by the partnership.³⁹ As no goods or services had been supplied to the new partner (no economic activity), the contribution made by the new partner did not constitute a consideration for something supplied to him/her by the partnership. Instead the contribution represented the performance of an obligation towards the object of the partnership.⁴⁰ The admission of the new partner did therefore not fall within the ambit of the VAT system.⁴¹ The court held that exemption of a supply under article 13B(d)(5) could not be applied since no supply had been made.⁴²

The main principle laid down in this case was that the admission of a new partner did not amount to a supply of a good or service by the

35 *Idem* § 33.

36 ECJ Case C-442/01 (hereinafter referred to as the "*KapHag* case").

37 *Idem* § 12–15.

38 *Idem* § 22.

39 *Idem* § 24 & § 42.

40 *Idem* 34 § 25.

41 *Idem* 34 § 41.

42 Article 13B(d)(5) of the Sixth Directive exempts "transactions, including negotiation, excluding management and safekeeping, in shares, interests in companies and associations, debentures and other securities" from VAT.

partnership, hence the transaction did not fall within the ambit of the VAT system and therefore could not be exempt from VAT. Following this judgment, the question arose whether this same principle could be applied to share issues. The application of this principle in the context of a company issuing shares was tested in *Kretztechnik AG v Finanzamt Linz*,⁴³ which is discussed below.

3 3 *Kretztechnik AG v Finanzamt Linz*

As this was the first case dealing with share issue costs, it is of particular importance to the objective of this article, namely to analyse the VAT treatment of share issue costs. *Kretztechnik AG* (hereafter "Kretztechnik"), a company incorporated in Austria, was involved in the development and production of medical equipment. The company was listed on the Frankfurt stock exchange with a view to raising capital in order to expand its activities. Expenditure was incurred by Kretztechnik to be admitted to the stock exchange. As in the *Cibo* and *KapHag* cases, Kretztechnik claimed a deduction for input tax on the expense but was denied this deduction by the tax authorities on grounds that the share issue cost related directly and immediately to a share issue which is an exempt transaction.⁴⁴ At this point it is worth noting that the judgment by Conrardie J in *ITC 1744* was based on the same ground.⁴⁵

The two questions posed to the court in respect of the share issue costs have been addressed in different contexts (disposal and acquisition of shares as well as the admission of a partner to a partnership) in the *BLP Group Plc*, *Cibo* and *KapHag* cases. The first question to consider was whether the issuing of shares constitutes a supply of services.⁴⁶ The court concluded that similar to the admission of a new partner in the *KapHag* case, no service is supplied by a company when it issues shares in exchange for the share issue price. It was held that the company does not supply a service as it does not transfer any existing rights or any portion of the company's property to the new shareholder. On the contrary, the judge was of the view that the company was the acquiring party in this transaction since it acquired new capital and did not supply any goods or services in exchange. As there was no supply, the transaction was not an economic activity and therefore not within the scope of the VAT system.⁴⁷ It was submitted that if the issue of shares is not an exempt supply, the exempt-supply rule for share transactions in article 13(5)(d) of the Sixth Directive would be confined to the economic activities involving the acquisition and disposal (supplying) of previously issued shares.⁴⁸

43 ECJ Case C-465/03 (hereinafter referred to as the "*Kretztechnik* case").

44 *Idem* § 12–14.

45 *Firer et al* 158.

46 *Kretztechnik* case § 15.

47 *Idem* § 24–28.

48 *Idem* § 20.

The second question was whether Kretztechnik was allowed to claim an input tax deduction on a supply of services to it that related to issuing shares, a transaction which the court found not to constitute a supply in answering the first question. As in the *Cibo* case, this question was considered in view of the neutrality objective of the VAT system. The principle laid down in the *Cibo* case was applied to achieve this neutrality, and it was held accordingly that the "direct and immediate link" test only applied where a link existed between expenditure incurred by the entity concerned and supplies made by that entity. If the expenditure could not be linked to a specific supply, it followed that it had to be viewed as a general cost that benefited the business as a whole. The deductibility of input tax on the expenditure then depended on the nature of the activities of the business as a whole (taxable or non-taxable).⁴⁹ Given that the issue of shares was not considered a supply by the court, the share issue costs could not be attributed to this activity or supply and therefore formed part of the general costs of the business. If the business activities financed by the share issue included any non-taxable transactions, input tax could be deducted only to the extent of the entity's taxable transactions.⁵⁰

The *Kretztechnik* case established and confirmed two principles relating to share issue costs. Firstly, it was confirmed that as with the admission of a new partner, a share issue does not constitute a supply. Secondly, in applying the "direct and immediate link" test share issue costs should not be linked directly and immediately to the issuing of shares, as this is not a supply, but should rather be treated as a general cost of the business as a whole.

The application of the *Kretztechnik* judgment and the apportionment of the deductible input tax were illustrated in *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG v Finanzamt Göttingen*⁵¹ discussed below.

49 *Idem* § 36.

50 *Idem* § 38.

51 ECJ Case C-437/06 (hereinafter referred to as the "*Securenta* case").

3 4 *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG, as the Legal Successor of Göttinger Vermögensanlagen AG v Finanzamt Göttingen*

Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG ("Securenta") is a company that is involved in the following activities:

- (a) Acquisition, management and disposal of real estate (taxable supply);
- (b) Acquisition and disposal of securities (exempt supply); and
- (c) Holding of financial investments (not an economic activity and therefore not relating to a taxable transaction).

In 1994 the company paid fees to arrange the issuing of new shares and to admit new silent partners into the business. Securenta claimed a deduction for the full input tax on these fees, relying on the judgment in the *Cibo* case to claim that a general benefit accrued to its business from the finance raised.⁵²

In delivering its judgment the court accepted *Securenta's* argument that the issuing of shares did not constitute a supply, confirming the views in the *KapHag* and *Kretztechnik* cases.⁵³ Relying *inter alia* on the *Cibo* case, it further confirmed that the share issue costs incurred in the case under review were part of the general costs of the business as a whole.⁵⁴ The question considered by the court in this case was whether *Securenta* was entitled to deduct the full input tax on this general cost or not.⁵⁵ As in the *Cibo* and *Kretztechnik* cases, it was held that with a view to the neutrality objective of the VAT system the input tax could only be deducted to the extent that the supplies made by the business as a whole resulted in taxable transactions.⁵⁶ *Securenta* was therefore only entitled to claim a deduction of input tax on the share issue costs to the extent that such costs were attributable to its taxable activity of dealing in real estate.⁵⁷

The *Securenta* case confirmed the principles of the *Kretztechnik* case in respect of the nature of a share issue and also illustrated how the "direct and immediate link" test should be applied to share issue costs that are considered to be general costs. In the four cases discussed up to this point the underlying transactions (admission of a partner and the issue of shares) were not regarded as constituting a supply. The last case, *Skatteverket v AB SKF*,⁵⁸ illustrates the application of the principles laid down by the judgments discussed above where the transaction at issue constitutes a supply. This judgment is of particular importance in this

52 *Idem* § 13.

53 *Idem* § 28.

54 *Idem* § 29.

55 *Idem* § 17.

56 *Idem* § 25.

57 *Idem* 49 § 31.

58 ECJ Case C-29/08 (hereinafter referred to as the "*SKF* case").

article as it considered the same type of transaction as the *BLP Group Plc* case following the *Kretztechnik* judgment.

3 5 *Skatteverket v AB SKF*

AB SKF (hereinafter "*SKF*") is a company that holds investments in subsidiaries and is involved in the management of these subsidiaries. The company disposed of its investment in two of its subsidiaries and therefore ceased to provide management services to these former subsidiaries. According to *SKF* it disposed of its investments in the subsidiaries to raise funding for its other business activities (which only involved taxable transactions). *SKF* therefore deducted the full input tax on the services provided to it in respect of the disposal of shares. The tax authorities disallowed this input tax deduction.⁵⁹

The court held, as it had in the *Cibo* and *Kretztechnik* cases, that the output transaction relating to the services rendered to *SKF* had to be identified. The services were supplied to *SKF* in respect of the disposal of shares. Unlike the issuing of new shares, the disposal or transfer of previously issued shares held as an investment constitutes a supply. This supply is an economic activity that is an exempt transaction in terms of article 13(5)(d) of the Sixth Directive. It was held that the input tax on the services provided could therefore not be deducted as input tax to the extent that the services resulted directly and immediately in an exempt transaction.⁶⁰ However, the court did leave room for *SKF* to argue that the services were provided to obtain funding for the business as a whole and that a portion of the expense could therefore be regarded as a general cost to the business.⁶¹

The view held in respect of the deductibility of VAT on costs incurred to transfer existing shares in this judgment was consistent with that in the *BLP Group Plc* judgment and therefore confirmed that this view was upheld by the ECJ. The *SKF* case did, however, highlight that a distinction has to be made between share issues and the transfer of previously issued shares as the nature of the transactions differ.

3 6 Concluding Thoughts on the ECJ Views

From the ECJ cases discussed, it can be concluded that it was established in European case law that the issuing of an entity's own shares does not constitute an economic activity or a supply of a service.⁶² This must be distinguished from the transfer of previously issued shares held for trading purposes or as an investment, which is an exempt supply within the scope of the European VAT system.⁶³ Secondly, the principle was established that in order to apply the "direct and immediate link" test laid

59 *Idem* § 20–24.

60 *Idem* 56 § 73.

61 *Idem* 56 § 73.

62 Illustrated by the *KapHag*, *Kretztechnik* and *Securenta* cases.

63 Illustrated in the *SKF* case.

down in the *BLP Group Plc* case, expenditure must be attributable to supplies or economic activities to achieve VAT neutrality.⁶⁴ The deductibility of the input tax on the expense will depend on the nature of these supplies or activities. If the expense cannot be linked to a specific supply or activity, which will be the case when share issue costs are incurred, it should be viewed as a general cost that benefits the entity's business.⁶⁵

As the objective of the article is to establish whether similar arguments can be followed in respect of the deductibility of input tax on share issue costs in South Africa, the next part of this article comprises a critical analysis of the relevant requirements in the South African context.

4 Critical Analysis of the ECJ arguments in the South African Context

When considering whether similar arguments to those followed in the ECJ judgments may be plausible in the South African context, this must be approached with caution as differences may exist between the basis of the European VAT system and that obtaining in South Africa.⁶⁶ One view may be that the ECJ's reasoning could provide an indication of the appropriate input tax treatment of share issue costs in South Africa given that the European VAT system was consulted during the development of the South African VAT system⁶⁷ and *ITC 1744* was premised extensively on the ECJ's views in the *BLP Group Plc* case. However, differences may exist between the South African and European VAT systems, as the VAT Act was ultimately modelled on the New Zealand Goods and Services Tax (GST) legislation⁶⁸ and not the European VAT system. The appropriateness of the arguments followed by the ECJ in the South African context must therefore be considered in light of any differences between the VAT Act and the Sixth Directive, as well as the views in New Zealand on the matters contemplated.

This part of the article provides a critical analysis of the requirements of the VAT Act to establish whether the arguments followed by the ECJ in respect of share issue costs could be advanced in the South African context. This analysis considers the possibility of advancing similar argument based on the two main grounds of the ECJ for allowing a deduction of input tax on share issue costs.

64 Held in the *Cibo* case, and applied in the *Kretztechnik*, *Securenta* and *SKF* cases.

65 Illustrated in the *Kretztechnik* case and applied in the *Securenta* case.

66 De Koker § 25.4. In the case of ITC 1853 *The Taxpayer* (2011) 135 (ITC 1853 case) it was reiterated that it should be considered whether arguments followed in other jurisdictions were decided under comparable VAT or GST legislation if similar arguments are put forward in the South African VAT context.

67 Myburgh & Schneider *Managing VAT* (2007) 3.

68 Schenk & Oldman *Value Added Tax: A comparative approach* (2007) 112.

The ECJ's first ground for deducting input tax on share issue costs was that the issuing of an entity's own shares was not a supply and could therefore not be an exempt supply.⁶⁹ The question whether the issuing of an entity's shares is a transaction that falls within or is deemed to fall within the scope of the VAT Act in the South African context is considered next.

4 1 Is the Issuing of an Entity's Shares a Transaction that falls within or is deemed to fall within the Parameters of the VAT Act?

Section 7(1)(a) of the VAT Act, which imposes VAT on a transaction, must be consulted to answer this question. This section reads as follows:

Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax –

(a) on the *supply* by any vendor of *goods or services* supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him ...⁷⁰ (own emphasis).

The emphasis added indicates that the requirements of section 7(1)(a) only apply when goods or services are supplied. The introduction to section 7(1)(a) further exempts certain transactions from VAT. It is submitted that section 12 can, however, only exempt a transaction if it would have been subject to VAT in terms of section 7(1)(a) prior to the application of section 12 (i.e. it constitutes a supply of goods or services).

In terms of article 2(1) of the Sixth Directive VAT is imposed in Europe on the supply of goods or services by a taxable person. It is therefore submitted that the requirements of the VAT Act and the Sixth Directive are similar in that a supply of goods or services must take place for VAT to be imposed on a transaction.

In the *KapHag* and *Kretztechnik* cases it was held that the issuing of a company's own shares did not constitute a supply under the Sixth Directive, as the new shareholders (or partners) merely received a prospect of sharing in the profits of the company (or partnership) in exchange for their contributions. In other words, the company (or partnership) did not give anything up or provide anything to the new shareholders (partners). On the contrary, the judge concluded that the company acquired something (capital) as opposed to relinquishing something when shares were issued in the *Kretztechnik* case. As no supply was made by the company, the contribution paid by the new shareholder could not be viewed as consideration received. For a similar argument to be advanced in the South African context it is of critical importance to determine whether the term "supply" has a similar

⁶⁹ Refer to the *Kretztechnik* & *Securenta* cases.

⁷⁰ S 7(1)(a) VAT Act.

meaning in terms of the VAT Act as the meaning given to this word by the ECJ and the Sixth Directive.⁷¹

The term "supply" is defined in the VAT Act to include:

a performance in terms of a sale, rental agreement, installment credit agreement and *all other forms of supply*, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected.⁷² (own emphasis).

As this definition is not exhaustive and includes a reference to "all other forms of supply", the specific nature of a supply in the context of the matter under review remains an open question. To explore the meaning of the phrase "all other forms of supply", the ordinary meaning of the term "supply" as well as the meaning of the term "supply" as provided in case law will be considered. As the New Zealand GST Act⁷³ contains a similar reference to "all forms of supply" in section 5(1), guidance on the meaning of "supply" from New Zealand case law will be taken into account.

A dictionary definition often provides a court with insight into the ordinary meaning of words in a statute.⁷⁴ "Supply" is defined in the Oxford Advanced Learner's Dictionary as "*to make available* for use or *to provide* something to someone ..." (own emphasis), and in the Cambridge Dictionary as "*to provide* something that is wanted or needed ..." (own emphasis). Similarly, it is defined in the Merriam-Webster dictionary as "*to provide ... , to make available, to satisfy ... or to furnish*" (own emphasis). These definitions of "supply" as a verb indicate an act whereby the supplier gives something to another person.

It is submitted that the ordinary meaning of the term "supply" supports the *Kretztechnik* argument that a share issue is not a supply if the view is taken that a company does not provide or give up anything when it issues its own shares. However, case law that may extend the meaning of the word "supply" beyond its ordinary meaning for the purposes of the VAT Act must be considered. In the case of *Shell's Annandale Farm (Pty) Ltd v CSARS*⁷⁵ it was held that a supply can only take place in the form of an act or action performed by a supplier in order to accomplish a supply. However, the judge did not expand on the nature of the act required. In the judgment pronounced in the case of *National Educare Forum v CSARS*⁷⁶ it was concluded that the action referred to in the Shell's Annandale Farm case included an act where something was

71 As the object of the article is to consider the deductibility of VAT incurred on share issue costs, the discussion will be limited to an analysis of the nature of share issues in South Africa. Hence, the nature of admission of a partner into a partnership will not be considered in the South African context.

72 Definition of supply in s 1 VAT Act.

73 Goods & Services Tax Act 41 of 1985 ("GST Act").

74 *Blue Circle Cement Ltd v CIR* 1984 2 SA 764 (A).

75 62 SATC 97 ("Shell's Annandale case").

76 2002 3 SA 111 (Tk HC).

provided or delivered. It is submitted that this definition of "supply" does not extend the meaning of the term beyond its ordinary meaning.

In the context of the New Zealand GST system, where the term "supply" is not defined, the courts had a similar view to the two South African cases mentioned when the word "supply" was interpreted to mean "furnished with or provided to".⁷⁷ As the courts in New Zealand held the view that contractual rights and obligations often determine whether a "supply" has been made,⁷⁸ case law dealing with such rights and obligations may also provide useful insight to the meaning of "supply". In contexts other than VAT where these rights and obligations have been considered, the term "supply" has been interpreted to mean "to give something".⁷⁹ Despite the fact that it has been submitted that the use of the phrase "all forms of supply" includes a broad range of activities related to the term "supply", New Zealand courts have held the view that this wide interpretation should not result in a transaction where an amount is received but where something has not been provided to or furnished to the counterparty by the recipient of the amount being included in the meaning of "supply".⁸⁰ Trombitas⁸¹ argues that, based on the case law in New Zealand, grounds exist to support the views in the *Kretztechnik* case that a share issue does not constitute a supply in New Zealand.

It is worth noting that in the United Kingdom case of *Trinity Mirror Plc (formerly Mirror Group Newspapers Ltd) v Customs and Excise Commissioner*⁸² it was held that the issuing of a company's own shares constituted a supply within the ordinary meaning of the word. However, subsequent to the *Kretztechnik* judgment Her Majesty's Revenue and Customs (HMRC) announced that this view was incorrect and afforded taxpayers the opportunity to claim input tax on past share issue costs for a period of three years prior to the announcement.⁸³

Lastly, the term "consideration" is defined in the VAT Act as "a payment in respect of, in response to, or for the inducement of a supply of goods or services".⁸⁴ If no goods or services are supplied, an amount received would not meet the definition of consideration. It can therefore be concluded that the mere fact that an amount has been received does not necessarily mean that a supply has taken place for the purposes of the VAT Act. Based on this argument it is submitted that this definition

77 *Databank Systems Ltd v CIR* [1987] NZLR 312 (HC).

78 *Rotorua Regional Airport Ltd v CIR* (2010) 24 NZTC 23, 979 (HC).

79 *Pacific Tawling Ltd & Anor v Chief Executive of the Ministries of Fisheries & Anor* (1999) 2 NZLR 388.

80 *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 (CA).

81 Trombitas "GST Fundamentals: Supply and out-of-scope transactions" in *Taxation issues: Existing and emerging* (ed Maples & Sawyer) (2011).

82 2001 STC 192 (Ct. App. 2001)(UK).

83 *HMRC Business Brief* 12/2005 (2005-06-15).

84 Definition of supply in s 1 VAT Act.

therefore also does not widen the meaning of "supply" in the context of the VAT Act to include any transaction where the taxpayer receives an amount.

Based on the conventional meaning of "supply" in the context of the general discipline, specific definitions in the VAT Act, as well as interpretations of the concept of supply according to VAT case law, an action where something is given up, provided, made available or delivered is required for a transaction to constitute a supply. If this line of reasoning is followed, grounds may exist to advance a similar argument to that of the ECJ, namely that the issuing of shares is not a form of supply as the company does not provide, furnish or give something to the new shareholder, in the South African context. This argument may, however, be nullified if the specific transaction of issuing a company's shares is explicitly deemed to be a supply in terms of the VAT Act.

Three provisions have to be considered to determine whether a share issue is explicitly deemed to be a supply in terms of the VAT Act. Firstly, as stated earlier, the definition of a supply does not explicitly include a transaction whereby shares are issued. Secondly, the meaning of an exempt supply and the exemption provision must be considered. An exempt supply is defined as "*a supply* that is exempt from tax under section 12" (own emphasis).⁸⁵ This definition presupposes that there is a supply. The exemption provision in section 12 states that:

[T]he *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 a rate of zero per cent under section 11.⁸⁶ (own emphasis).

It is submitted that this provision only applies when a supply has been made and does not deem the issue of shares to be a supply if it would not be a supply otherwise. Lastly, the definition of a financial service includes "the *activities* which are *deemed* by section 2 to be *financial services*" (own emphasis).⁸⁷ Section 2 deems "the issue, allotment or transfer of ownership of an equity security or a participatory security" to be a financial service.⁸⁸ One argument would be that the wording of section 2 only determines the nature of activities that are regarded to be financial services, and does not deem a transaction that would not be a supply otherwise to become a supply. On the other hand, it could be argued that the definition of a financial service would not have included the issue of an equity security if it was the intention of the legislator that this transaction was not a supply. The criticism against the latter argument is

85 Definition of exempt supply in s 1 VAT Act.

86 s 12(a) VAT Act.

87 Definition of financial service in s 1 VAT Act.

88 s 2(1)(d) VAT Act.

that this view is merely based on speculation about the intention of the legislator and could be an instance in the South African tax legislation where a provision or definition refers to items that do not fall within the scope of such a provision or definition.⁸⁹ Such a view would have been justified if the definition of the VAT Act explicitly defined a financial service to be a supply,⁹⁰ as it is done in the Australian legislation.⁹¹ Based on the three provisions considered above, it is submitted that no provision in the VAT Act explicitly deems the issue of an entity's own shares to be a supply.

Based on the discussion above, grounds may exist to conclude that there appears to be no significant differences in the meaning of the word "supply" between the European and South African VAT systems in the context of share issues. It is submitted that arguments similar to those of the ECJ may be advanced in respect of the meaning of "supply" in the South African context in respect of the issuing of shares. These arguments provide support for the view that the issue of shares will not constitute a supply in South Africa, in which case it follows that the issue of shares cannot be an exempt supply. This view contradicts that expressed by Conradie J in *ITC 1744*, namely that the issue of shares is an exempt supply. As illustrated in the *SKF* case, a transaction involving a transfer of existing shares, which is a supply that can be exempt, differs in nature from that involving the issuing of shares, which is not a supply. It appears as if this distinction may not have been made when the *ITC 1744* case was concluded.

In light of the arguments submitted above grounds exist to contend that a share issue is not a supply in the South African context. In determining whether the reasoning of the ECJ in respect of the deductibility of input tax on share issue costs may be appropriate in the South African context, the analysis continues by considering the requirements of the VAT Act as regards the deduction of input tax.

89 There have been instances where provisions in South African tax legislation have been drafted to specifically refer to an item, while that item was not within the scope of the provision. An example of such drafting was s 64B(5)(c) of the Income Tax Act 58 of 1962 that, prior to the amendment by the Revenue Laws Amendment Act 74 of 2002, exempted liquidation dividends declared from profits of a capital nature from STC. In terms of paragraph (a) of the definition of a dividend, liquidation distributions made from profits of a capital nature were specifically excluded from a dividend as defined. S 64B(5)(c) therefore exempted a transaction that was never a dividend from STC, a tax that was only levied when a dividend was present.

90 This is the reason provided by the Australian tax authorities for viewing the issue of shares as a supply (Evans "Capital raising costs – the wrong side of the mirror?" 2007 *The Tax Specialist* 126).

91 The Australian Goods and Services tax system [A New Tax System (Goods and Service Tax) Act (1999)] uses the words "financial supplies" as opposed to "financial services" in the South African legislation. The definition of financial supplies states any provision of an interest in an equity as a form of property is a financial supply.

5 Input Tax Deduction Requirements

The second ground of the ECJ's argument was that expenditure had to be linked to supplies (whether taxable or not) in order to apply the "direct and immediate link" test laid down in the *BLP Group Plc* case when determining whether input tax can be deducted or not. If this test was applied, share issue costs had to be viewed as a general cost that benefited all the supplies made by the business.⁹² It is therefore important to investigate whether, in terms of the provisions of the VAT Act, share issue costs can be regarded as general costs that benefit the business as a whole of the entity incurring the costs. In order to broach this question the definition of input tax and the provisions of section 17(1) of the VAT Act must be considered. In terms of the VAT Act input tax:

in relation to a vendor, means –

- (a) tax charged under section 7 and payable in terms of that section by – ...
- (ii) 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.⁹³ (own emphasis).

Provided that a vendor has obtained the necessary documentation,⁹⁴ the VAT payable by the vendor for a VAT period may be reduced by the input tax in respect of the supply of goods and services to the vendor during the relevant period.⁹⁵ However, this reduction is subject to section 17 which, consistent with the definition of input tax, states that a vendor can only deduct input tax to the extent that the goods or services supplied to the vendor are consumed, used or supplied in the course of making taxable supplies.⁹⁶ A core requirement of both the definition of input tax and section 17(1) is therefore that input tax can only be deducted to the extent that the goods or services concerned are acquired by the vendor for the purposes of consumption, use or supply in the course of producing taxable supplies.

Article 17(2) of the Sixth Directive that allows for a deduction in respect of input tax, provides that

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:

92 Refer to the *Cibo*, *Kretztechnik* and *Securenta* cases.

93 Definition of input tax in s 1 VAT Act.

94 s 16(2) VAT Act.

95 s 16(3)(a)(i) VAT Act.

96 s 17(1) VAT Act.

(a) Value Added Tax due or paid in respect of goods or services supplied or to be supplied to him by another taxable person.⁹⁷ (own emphasis).

The requirement of the Sixth Directive that corresponds with the determination "for the purpose of consumption, use or supply in the course of making taxable supplies" contained in the VAT Act reads: "in so far as goods and services are used for the purposes of his taxable transactions". Both requirements only allow a deduction of input tax if the expenditure relates to taxable supplies (the VAT Act) or taxable transactions (Sixth Directive). The question to consider at this point, is therefore whether taxable supplies are different from taxable transactions. The latter are economic activities (the supply of goods or services) that are subject to VAT.⁹⁸ A taxable supply is defined as "any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a), including tax chargeable at a rate of zero per cent under section 11".⁹⁹ Both terms refer to transactions where goods or services supplied are subject to VAT and exclude exempt supplies. It is therefore submitted that there is no significant difference between the meaning of "taxable supplies" and "taxable transactions".

In light of the above analysis, it is submitted that there is no significant difference between the requirements respectively imposed on input tax deductions in South Africa and in the European Union that could impede the application of the arguments in the ECJ judgments in South Africa. It would therefore be appropriate to use the "direct and immediate link" test to apply the provisions of the VAT Act. Conradie J signaled concurrence with this view by applying the principle from the *BLP Group Plc* case in *ITC 1744*.¹⁰⁰

Similarly, Davis J relied on the views expressed in the *SKF* case, in which the "direct and immediate link" test was applied, when he considered the deductibility of input tax incurred on overhead costs in the South African VAT context in *ITC 1853*. It is submitted that case law dealing with input tax deductions in New Zealand's GST Act may not necessarily be relevant to the discussion as the requirements to deduct input tax differ from those in the VAT Act and the Sixth Directive.¹⁰¹

97 Art 17(2) Sixth Directive.

98 Article 2(1) Sixth Directive.

99 Definition of taxable supply in s 1 VAT Act.

100 *Ibid.* 7 at 157.

101 In terms of s 3A(1) New Zealand GST Act input tax is defined as "tax charged under s 8(1) on the supply of goods and services made to that person, being goods and services acquired for the *principal* purpose of making taxable supplies" (own emphasis). Neither the VAT Act nor the Sixth Directive requires goods or services to have been acquired for the *principal* purpose of making taxable supplies in order to be able to deduct input tax. It is submitted that this requirement may impact significantly on whether a direct link is required between the goods or services acquired and the input tax incurred, as was illustrated by the judgment in the case of the *CIR v Trustees in the Mangaheia Trust and Trustees in the Te Mata Property* (2009) 24 NZTC 23 711.

Based on the above discussion, it is submitted that grounds exist to argue that where expenditure cannot be linked to a specific supply, the "direct and immediate link" test should be applied in South Africa by linking the expenditure incurred to the supplies of the business as a whole, similar to the application of this test in Europe. Given the arguments advanced in support of the view that a share issue is not a supply, grounds may exist to view share issue costs as a general cost that benefits the business as a whole in South Africa. Input tax on this share issue costs would then be deductible to the extent that the business makes taxable supplies.

6 Conclusion and Summary

In *ITC 1744* it was held that VAT levied on costs incurred to issue shares in a company was not deductible when the share issue costs were incurred to raise finance for the business of manufacturing and supplying containers because there was no "direct and immediate link" between the taxable supplies that the company was going to make and the funding obtained. It was held that such a direct and immediate link did exist between the expenditure and the issue of shares, which Conradie J considered to be an exempt supply. The requirement of a direct and immediate link to the entity's taxable supplies was based on the ECJ judgment pronounced in 1994 in the *BLP Group Plc case*.

Subsequent to the *BLP Group Plc case*, a number of ECJ judgments were instrumental in changing the view in Europe on the deductibility of input tax on share issue costs. An important principle was laid down in the *KapHag* and *Kretztechnik* cases where it was held that the issuing of an entity's own shares did not constitute a supply of goods or services. Proceeding from this principle, it was held in the *Cibo* and *Kretztechnik* cases that when determining whether input tax on share issue costs would be deductible, such costs should be viewed as general costs that benefit the business as a whole as it cannot be directly and immediately linked to a transaction that is not a supply.

As *ITC 1744* is only a Tax Court judgment, it is not binding on the high court or the supreme court of appeal.¹⁰² Given the grounds on which the ECJ allowed the deduction of input tax on share issue costs in certain instances in Europe and the arguments in favour of following a similar line of reasoning in South Africa put forward in this article, the time may have come for taxpayers in South Africa to challenge the current SARS policy.

102 De Koker § 25.4.