MERCHANT CASH ADVANCES – INVESTIGATING THE TAXATION CONSEQUENCES IN SOUTH AFRICA

by

Eduard Kilian

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Supervisor: Mr R Nel

Faculty of Economic and Management Sciences

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SUMMARY

Since the recent credit crisis in 2008, innovative lending products have emerged to address the need for enterprises to maintain and improve their cash flows. One such product is the merchant cash advance (MCA). This form of finance is related to debt factoring and is essentially the business equivalent of a payday loan. In its most common form, a lump sum payment is made to a business in exchange for an agreed upon percentage of future credit and/or debit card receivables. A percentage of the merchant's daily credit or debit card receivables is retained, either directly from the processor that clears and settles the credit or debit card payment or via a debit order from the merchant's bank account, until the obligation has been met. The future receivables are purchased at a discount and a processing fee is also charged.

Many merchant cash advance service providers (MCASP) structure their business in such a way that it resembles traditional debt factoring. In this manner, MCASPs endeavour to distinguish their product offering from traditional loans, in an effort to elude legislation that would affect loans, for example the limiting of interest rates charged.

There is however currently a lack of definitive guidance on the taxation consequences from the perspective of the merchant utilising the product and the MCASP providing it. The purpose of this research is to investigate the taxation consequences of MCA transactions in South Africa in an attempt to provide such guidance.

The key issue for consideration affecting the taxation consequences of MCAs is the classification of these transactions as either a form of debt factoring or as loans. The research considers and suggests the appropriate classification of these transactions. The taxation treatment is then considered based on this classification from the perspective the merchant utilising the product and the MCASP providing the product. Taxation issues investigated, include the income tax treatment of the discounting cost as "interest", the availability of deductions allowed by the Income Tax Act and the Value-Added Tax consequences.

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OPSOMMING

Sedert die onlangse kredietkrisis in 2008 het innoverende leningsprodukte na vore gekom om te voorsien in die vraag van ondernemings om hul kontantvloei te handhaaf en verbeter. Een van hierdie produkte is die handelaarskontantvoorskot (HKV). Hierdie vorm van finansiering is verwant aan skuldfaktorering en is basies die besigheidsekwivalent van ‘n betaaldaglening. In die mees algemene vorm, word ‘n enkelbdragbetaling aan ‘n besigheid gemaak in ruil vir ‘n voorafbepaalde persentasie van die toekomstige krediet- en/of debietkaartdebiteure. ’n Persentasie van die handelaar se daagliske krediet- of debietkaart debiteure word teruggehou totdat die skuld afgelos is. Invordering vind plaas direk vanaf die verwerker wat die krediet- of debietkaartbetaling goedkeur en betaal, of deur middel van ‘n debietorder direk vanaf die handelaar se bankrekening. Die toekomstige debiteure word teen ‘n diskonto aangekoop en ‘n verwerkingsfooi kan ook gehef word.

Baie handelaarskontantvoorskot-diensverskaffers (HKVD) struktureer hul besighede op so ‘n wyse dat dit soos tradisionele skuldfaktorering voorkom. Op hierdie manier beoog HKVD’s om hul produk van tradisionele lenings te onderskei, met die doel om wetgewing vry te spring wat lenings sou beïnvloed, byvoorbeeld beperkings op rentekoerse gehef.

Daar is egter tans ‘n tekort aan beslissende leiding, wat die belastinggevolge betref, uit die perspektief van die handelaar wat die produk benut en die HKVD wat dit verskaf. Die doel van hierdie navorsing is om te ondersoek wat die belastinggevolge van HKV’e in Suid-Afrika is in ‘n poging om hierdie leiding te verskaf.

Die kernaangeleentheid vir oorweging wat die belastinghantering affekteer, is die klassifisering van HKV-transaksies as ‘n vorm van skuldfaktorering of as lenings. Hierdie navorsing skenk oorweging aan hierdie transaksies en stel ‘n toepaslike klassifikasie voor. Die belastinghantering word dan oorweeg, gebaseer op hierdie klassifikasie uit die perskeptief van die handelaar wat die produk benut en die HKVD wat die produk verskaf. Belastingaangeleenthede wat ondersoek word, sluit die inkomstebelastinghantering van die diskonto gehef as “rente” in, die beskikbaarheid van aftrekkings toegelaat kragtens die Inkomstebelastingwet en die gevolge vir Belasting op Toegevoegde Waarde.

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LIST OF ABBREVIATIONS

During this study, the abbreviations listed below were used.

Abbreviation	Meaning
Act	Income Tax Act No.58 of 1962
VAT	Value-Added Tax
MCA	Merchant Cash Advance
MCASP	Merchant Cash Advance Service Provider
NCA	National Credit Act No. 34 of 2005
SCI	Statement of Comprehensive Income
SFP	Statement of Financial Position

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CHAPTER 1: INTRODUCTION

1.1 Background

Cash is a commodity that is in increasingly short supply in today's business world. Businesses, especially start-up or small and medium-sized enterprises often have to rely on their debtors to settle their debts timeously to maintain a positive cash flow. Traditional forms of finance for these enterprises, such as term loans and overdraft facilities, are often insufficient to sustain the business in the long run (Philippou, 2008). These enterprises have been compelled to look at different and innovative ways of maintaining and improving their operating cash flow (Van der Walt, 2009). Cash-strapped and start-up businesses require access to settlement period ‘bridging’ finance to enable them to meet overheads, honour creditor repayments and take advantage of beneficial market conditions (The Banking Association of South Africa, 2009).

One of these alternatives is debt factoring. Debt factoring is the assignment of debts for consideration. The debt is sold to the debt factor for a price that is less than the face value of the debt, referred to as a discount (Bloomsbury, 2013).

Within this context in the current market conditions, debtor or invoice financing facilities provide an extremely viable option in terms of accessing working capital. Cash advances are granted against funding already secured (a company’s debtor book or, for the smaller business, a single invoice). Advances of up to 80% of its total value are granted, with the only security required being creditworthy debtors and a clear credit record. The concerns associated with slow or non-paying debtors, which includes defaulting on credit and loan repayment terms, are thereby eliminated. Debt factoring is therefore no longer viewed as an alternative finance of last resort (The Banking Association of South Africa, 2009).

A more recent development, increasing in popularity since the recent credit crisis in 2008, is the merchant cash advance (MCA). The MCA is a lending product related to debt factoring that has been available since at least 2001 (Farrel, 2008). This form of finance is essentially the business equivalent of a payday loan (Bennet, 2008). In its most common form, a lump sum payment is made to a business in exchange for an agreed upon

percentage of future credit and/or debit card receivables (Tozzi, 2009). A percentage of the client's daily credit or debit card sales is retained, either directly from the processor that clears and settles the credit or debit card payment or via a debit order from the client's bank account, until the obligation has been met. The merchant cash advance service provider (MCASP) often forms a partnership with card-payment processors to enable them to collect payments directly from the client's point of sales terminal. In common with standard debt factoring transactions, a discount, as well as a processing fee, is charged (Loten, 2011).

MCAs differ from debt factoring due to the fact that debt factoring involves existing debt (i.e. goods have already been sold by the merchant to the customers), while merchant advances are based on future credit and debit card sales, i.e. the merchant is yet to sell goods to the customers. With debt factoring, an existing debt is sold to the factor, while with MCAs the merchant sells its future receivables. At the time of sale of the future receivables, there is therefore no right to payment by any specified customer, for any specified product or price. The risk of non-payment has also not shifted to the MCASP, as repayment is collected from funds actually transmitted to the merchant, from customers that pay for the goods or services delivered (Weston, 2012).

Many MCASPs structure their business in a way which resembles traditional debt factoring. For example, transactions are often designed to be purchases and sales of future receivables between a MCASP and a merchant (Weston, 2012). In this manner MCASPs endeavour to distinguish their product offering from traditional loans. MCASPs therefore claim that they are not bound by legislation that would affect loans, for example the limiting of interest rates (Farrel, 2008). MCAs can therefore be expensive compared with interest on a traditional bank loan, ranging from 10% to 100% effective interest (Bennet, 2008). In the Unites States of America, as these transactions are therefore distinguished from traditional financial services, there are few regulations governing these entities and oversight of this industry falls primarily to the courts (Bennet, 2008). In a South African context, the classification of a MCA as a loan could affect protection granted to the consumer, for example under the National Credit Act No. 34 of 2005 (NCA). As in the United Sates, the classification of these transactions as loans will also impact on possible protection granted to clients of these products in terms of common law, i.e. the argument that these transactions are usurious and therefore unlawful (Weston,

2012). It will also have a significant impact on how these transactions are treated from a taxation perspective.

Regardless of the potential for unscrupulous business practices due to the lack of regulation, MCAs are feasible alternatives for retail businesses that do not qualify for bank loans (Bennet, 2008). As there is typically no set period for repayment of the advance, the repayment rises and falls with a company's sales. These advances therefore tend to appeal to businesses with a high volume of daily credit and debit card sales, such as retailers and restaurants (Loten, 2011).

There are now more than 50 companies in the United States of America issuing cash advances to small businesses (Bennet, 2008). According to Shield Funding (2012) in excess of $750 million was advanced during 2011. The product is now well established in Canada, Hong Kong, the United Kingdom and Australia (Anderson, 2011). There are still relatively few MCASPs in South Africa. Retail Capital Proprietary Limited, Merchant Capital Proprietary Limited and Everest Merchant Funding Proprietary Limited are examples of companies specialising in offering MCAs. As an indication of the extent of the industry in South Africa, Retail Capital Proprietary Limited, launched during 2011, has already processed more than R60 million in advances (Hubbard, 2012).

1.2 Research problem

The purpose of this research is to investigate the taxation consequences of MCAs in South Africa. A lack of definitive guidance on the taxation consequences currently exists from the perspective of the MCASPs providing the product or the merchant utilising it.

One of the predominant factors attracting companies to provide MCA services is the fact that it could be argued that these transactions are not loans. The argument here is that the MCASP simply purchases future credit or debit card receivables at a discounted rate, i.e. no loan is granted (Tozzi, 2009). If the purchase of future receivables can therefore be distinguished from the granting of a loan, this will have an impact on the taxation treatment of these transactions in terms of the Income Tax Act No.58 of 1962 (the “Act”).

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Uncertainty also exists whether these transactions are merely another form of debt factoring (Weston, 2012). Clarity is therefore required regarding the exact nature of a MCA from a South African tax perspective.

In order to provide guidance on the taxation consequences, the following aspects relating to MCAs also requires investigation:

- Is the merchant able to deduct the cost of obtaining a MCA from income?
- Is the provision of a MCA a taxable supply in terms of the Value-Added Tax Act?
- Is the MCA provider entitled to a bad debt deduction and/or allowance with regards to the amount advanced?
- What are the possible capital gains tax consequences of MCAs?

MCASPs and the merchants utilising these products currently have no guidance on how to treat these transactions from a taxation perspective.

1.3 Research objective

The purpose of this research is to investigate the taxation consequences of MCAs in an attempt to provide guidance to existing and potential providers and users of this product.

The objective will be addressed as follows:

- ***Investigating the classification of MCAs***
  The classification of MCAs will impact the taxation treatment of these transactions. Two alternative classifications will be considered:

  - *MCAs as a form of traditional debt factoring*
    The nature of MCAs will be scrutinised to determine whether these transactions are merely a form of debt factoring. A comparison between MCAs and traditional debt factoring will be performed to identify similarities and/or differences. Relevant sections of the Act and case law will be used to support this conclusion.

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- *Classification of MCAs as loans*

  The nature of MCAs will be analysed to determine whether they can be classified as loans. The legal elements that constitute a loan will be investigated and a comparison will be made between MCAs and loans. Guidance that exists in the Act, the Value-Added Tax (VAT) Act and relevant case law will be examined to conclude on the classification.

- ***Investigating the taxation treatment based on the classification of MCAs***

  Once an appropriate classification for MCAs has been suggested, the taxation treatment will be considered, based on this assessment. The taxation implications will be elucidated from the following two perspectives:

  - *Income tax treatment from the perspective of the MCASP*

    The taxation consequences from the perspective of the MCASP will be considered. The key aspect to consider will be whether the discounting fee will be taxed as "interest" in accordance with the Act. VAT implications will also be considered, as well as other deductions allowed by the Act, such as the bad debt deduction and allowance.

  - *Income tax treatment from the perspective of the merchant*

    The taxation consequences for merchants obtaining MCAs will be assessed. It will be investigated whether merchants will be able to deduct the discount incurred or the processing fee from income.

The objective of the research will be to develop a summary that could provide guidance regarding the taxation consequences of MCA transactions.

1.4 Rationale for research

MCAs is a very recent addition to the South African financial services market and, there is significant risk of MCASPs and merchants treating these transactions incorrectly from a taxation perspective. For the suppliers of MCAs, the research could provide guidance regarding the taxation consequences of cash advanced from an Income Tax and VAT perspective. Furthermore, merchants utilising MCAs could obtain clarity regarding the possible tax benefits (or lack thereof) based on the guidance provided by this study.

1.5 Research methodology

In this study, the historic method was the chosen research methodology. A literature review was performed with the purpose of ascertaining the classification of MCAs (as merely a form of debt factoring or loan or neither) and the subsequent investigation of the taxation consequences based on the classification.

Literature from South African sources served as a point of departure and includes legislation, case law and popular academic publications. The literature was also supplemented with reference to literature from international sources and case law where no specific guidance could be identified in the literature from South African sources. The investigation relied on the SUNSearch databases in the identification of literature from business, economic or tax journals, giving preference to peer-reviewed academic articles. The following key words were applied in conducting searches: 'debt'; 'debt factoring'; 'discount; 'financial services'; 'interest'; 'loans'; 'merchant cash advance'; 'sale of debt'; and 'sale of future receivables'. The results were then prioritised to focus on the most recent literature and scrutinized for literature containing findings considered relevant to this study. In order to ensure completeness, Google Scholar has also been applied (again using the key words listed above) in identifying potentially useful literature not initially identified during the searches on the SUNSearch databases.

1.6 Overview of chapters

The course of the study will be as follows:

In Chapter 2 an investigation of the various types of MCA transactions will be performed. The key question that will be investigated is whether a MCA can be classified as a form of debt factoring, or the alternative, as a loan. The impact of the various elements or clauses in a MCA transaction, that will impact the classification, will be investigated. In considering the appropriate classification, reference will also be made to the accounting treatment of these transactions. The similarities and / or differences between MCAs, debt factoring and loans will be investigated and an appropriate classification suggested.

In Chapter 3 the income tax consequences of MCAs will be investigated under the following headings:

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- ***Impact on merchants***

  The taxation consequences for merchants obtaining MCAs will be assessed. The implications of the cession of future receivables on the merchant and the ability to deduct the discounting cost or processing fee from income will be investigated.

- ***Impact on MCASPs***

  The taxation consequences from the perspective of the MCASP will be considered. The key aspect to consider will be whether the discounting fee will be taxed as "interest" in accordance with the Act. The ability of the MCASP to claim a bad debt deduction and/or allowance will also be scrutinised.

- ***Capital gains tax consequences***

  The potential capital gains tax consequences of MCA agreements will be considered.

In Chapter 4 the possible VAT consequences of a MCA taxable in terms of the VAT Act will be investigated. The definition of a "financial service" in the VAT Act will be investigated to determine whether MCAs fall within this definition. Arguments for and against defining MCAs as a "financial service" will be considered.

In Chapter 5 a summary of the conclusions reached and the various matters to consider when determining how MCAs are treated for tax purposes will be provided. The purpose of the summary will be to provide a meaningful comparison to traditional debt factoring transactions and loans.

1.7 Limitation of scope of the study

The research is limited to investigating how MCAs are taxed in South Africa from an Income Tax and VAT perspective. This will include the potential capital gains tax consequences. Other taxes, such as donations tax, will not be considered, as the taxation consequences on the MCA transaction, if any, are evident, based on current legislation. The consequences of other South African legislation, such as the NCA, on MCAs will not be considered. For practical purposes the scope of this study will also not consider possible cross-border MCA agreements. Both parties (MCASPs and merchants) will therefore be deemed to be residents for the purposes of this study.

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CHAPTER 2: CLASSIFICATION OF MCAS

MCA agreements can traditionally be classified in two ways: *bona fide* loans or the purchase of future credit and/or debit card receivables (Weston, 2012). The latter classification appears to represent a form of debt factoring. The key question that must be answered to determine an appropriate classification is whether a debt or asset is sold or ceded by the merchant to the MCASP, or whether the MCA agreement is merely a loan for which the repayment of the debt is determined with reference to the future sales of the merchant.

To enable a meaningful classification of a MCA transaction to be made, the steps or elements that comprise debt factoring, a loan and a MCA transaction must be identified and described. These steps or elements must then be compared for each of the three types of transactions to identify similarities and/or differences. To obtain a better understanding of the MCA transaction, a detailed analysis of the accounting entries of debt factoring, loans and MCA transactions will be considered and a comparison performed. Finally, guidance to assist in classifying MCA transactions contained in the Act and other legislation in South Africa will be analysed. This detailed analysis can then be used as a basis for an appropriate classification.

2.1 Background to MCA transactions

The MCA is a lending product that at appears to be related to traditional debt factoring. There are different variations to the product with varying terms and conditions, but many MCASPs structure their transactions in such a manner that they resemble traditional debt factoring (Weston, 2012). A cash advance is provided to a merchant that accepts credit and/or debit card payments. The advance provided is described to be a purchase of the future receivables generated by the credit and/or debit card sales volume that the merchant will generate. Repayment of the advance is based on the merchant's sales volume. An agreed upon percentage of the merchant's daily credit and/or debit card sales is retained until the obligation has been met, usually between six to eight months (Risk and Fraud Management Committee of the Electronic Transactions Association, 2008). Furthermore, most MCASPs also do not require any collateral, as this type of funding is not regarded as a loan (Merchant Resources International Inc., 2013).

In the event that the merchant obtaining the advance goes out of business and the MCASP will not be able to recover the full advance or a portion thereof, it would bear the loss (Tozzi, 2009). MCAs are therefore concluded on a non-recourse basis, unless the agreement between the parties stipulates different (Loten, 2011). Although no collateral is required in terms of MCA agreements, a personal guarantee against fraud is however typically required (Consus Group, 2004). This personal guarantee stipulates the performance of a number of covenants contained in the MCA agreement. Examples of these covenants are (Consus Group, 2004):

- that the merchant will conduct its business consistent with past practice;
- the merchant will exclusively use an agreed upon card processor for the processing of all its credit and debit card transactions;
- the merchant will not to take any action to discourage the use of credit or debit cards or to permit any event to occur which could have an adverse effect on its use; and
- the merchant will not sell, dispose of, convey or otherwise transfer its business or assets without the express prior written consent of the MCASP.

The basic elements of a MCA transaction are therefore the provision of a sum of money to the merchant by the MCASP and the collection of a percentage of the future credit and/or debit card receivables by the MCASP from the merchant (Tozzi, 2009).

The MCASP provides or advances a sum of money to the merchant, the purchase price (First Data, 2012), in return for the future debt ceded to the MCASP. The purchase price therefore represents the selling price for an interest in the future credit and/or debit card receivables of the merchant. The value of the future debt purchased by the MCASP is referred to as the purchased amount (First Data, 2012). The purchased amount is the total amount that must be collected by the merchant on behalf of the MCASP and therefore represents the value of the future debt purchased.

The MCASP collects a percentage of the future sales receipts of the merchant. This purchased percentage (First Data, 2102) is the percentage of the daily credit and/or debit card sales that must be remitted to the MCASP via the collection methods elucidated below to remit the purchased amount. The purchased percentage of the future credit

and/or debit cards receivables is collected and remitted to the MCASP until the purchased amount has been settled.

The MCASP collects payment via three methods (Nectar Cash-flow Advances, 2012):

- ***Split withholding***
  The credit and/or debit card processing company (for example VISA or MasterCard) automatically splits the payment between the merchant and the MCASP. The split is based on a percentage contractually agreed upon between the merchant and the MCASP. MCASPs often form a partnership with card-payment processors to enable them to collect payments directly from the client's point of sales terminal (Loten, 2011).

- ***Trust account withholding***
  Credit and/or debit card payments are deposited into a bank account controlled by the MCASP. The contractually agreed percentage of the payments received is deducted by the MCASP and the balance is remitted to the merchant.

- ***Debit order***
  The MCASP is notified of the quantum of credit and/or debit card payments and collects the agreed upon percentage of the payments received directly from the merchant's bank account.

Similar to traditional debt factoring transactions, a discount and a processing fee is charged (Loten, 2011). The discount represents the difference between the amount of future credit and/or debit card receivables purchased and the amount of cash advanced to the merchant, while the processing fee represents a fee for collecting the amounts due to the MCASP and arranging the agreement (First Data, 2012).

The accounting treatment of MCA transactions will now be considered as the next step in considering the appropriate classification of the MCA transaction.

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2.2 Accounting treatment of a MCA transaction

In *Case no 11345*, an unreported judgment by the Johannesburg Income Tax Special Court on 4 July 2008, Boruchowitz, J. points out at 88 that when analysing a transaction from an accounting perspective, the purpose of accounting is to give a fair reflection of the taxpayer's financial position at the end of the financial year. When analysing a transaction from a taxation perspective, the purpose is to establish the basis on which the taxpayer's liability for income tax has to be determined in accordance with the provisions of the Act. The tax treatment therefore has no necessary connection with the accounting treatment. In *Stellenbosch Farmers' Winery (Pty) Ltd v CSARS* 2012 (5) SA 363 (SCA), Kroon AJA commented at 373: "... accounting practice cannot override the correct interpretation of the provisions of the Act and their application to the facts of the matter".

In *Sub-Nigel Ltd v Commissioner for Inland Revenue* 1948 (4) SA 580 (A) Centlivres JA at 588 points out when examining the deductibility of an expenditure that the court is not concerned with what may be “considered proper from an accountant's point of view or from the view of the prudent trader”. He further points out that the court must merely determine what is permissible according to the language of the Act.

The accounting treatment of a MCA transaction will therefore not prescribe the most appropriate taxation treatment. It can however assist in classifying the transaction for the purpose of identifying the nature of the transaction and will therefore subsequently be considered.

IFRS 9 *Financial Instruments* outlines the accounting requirements to derecognise the transfer of financial assets such as credit or debit receivables (International Accounting Services Board, 2013). According to IFRS 9 paragraph 3.2.3, a financial asset is derecognised by an entity when it transfers the financial asset to a new recipient. To account for the transfer, i.e. to derecognise the asset from an accounting perspective, the entity must transfer the contractual rights to receive the cash flows of the financial asset, or it retains the contractual rights to receive the cash flows, but assumes a contractual obligation to pay the cash flows to one or more recipients.

The merchant retains the contractual rights to receive the cash flows related to credit or debit sales from the credit or debit card processor, but is obligated to pay the cash flows generated via credit or debit card sales to the MCASP in terms of the MCA agreement. IFRS 9 further stipulates that if the agreement that obligates the entity to pay the cash flows to the new recipient meets all of the three following criteria, the entity or merchant must derecognise the financial asset:

- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. The merchant only remits amounts to the MCASP when credit and debit sales are performed and collected (Elixir Financial, 2103). This requirement is therefore met.

- The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows. This requirement is also met as the MCA agreement prohibits the sale of the future receivables to any other MCASP (Elixir Financial, 2013).

- The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. As explained above, the merchant remits the cash flows to the MCASP via split withholding, trust account withholding or debit order. These methods of collections are all designed to ensure the MCASP can collect the funds efficiently and quickly. The agreement may stipulate that collection is to take place on a daily basis (Elixir Financial, 2013). IFRS 9 further stipulates that the entity is not entitled to reinvest such cash flows, except for in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients. It is submitted that as collection is made daily, MCA agreements obligate the merchant to remit collected amounts to the MCASP without delay and any potential interest that may arise between collection and remittance to the MCASP is insignificant.

Based on the consideration in this study, when applying IFRS principles to determine an appropriate accounting treatment for the MCA transaction, the transaction can be classified as a sale of a future receivable.

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To obtain a better understanding of a MCA transaction, a detailed analysis of the accounting entries are required. An example will be used for this purpose:

Details of transaction:

- A merchant enters into a MCA transaction with a MCASP for an advance of 100,000.
- The MCASP acquires a financial asset which is a contractual right to receive cash from the merchant in accordance with IFRS 9 *Financial Instruments* (International Accounting Services Board, 2013).
- In accordance with the agreement the MCASP can collect 5% of the daily credit and debit card sales of the merchant until it has collected 130,000.
- A processing fee of 1,000 is charged by the MCASP for the cost of processing, preparation and completion of documents.

2.2.1 Accounting entries in the ledger of the merchant

The merchant recognises the cash received from the MCASP. As an asset is sold, a loss is recorded on the sale (representing the discount earned by the MCASP). A liability is recognised as the merchant is liable towards the MCASP to settle the purchased percentage of future receivables.

Table 1: Recognition of the receivables purchased in the ledger of the merchant

	Account		**Dr**	**Cr**
Dr	Bank	SFP	100,000	
Dr	Loss on sale of future receivables	SCI	30,000	
Dr	Unearned processing fee	SCI	1,000	
Cr	Liability towards MCASP	SFP		131,000
Recognising the cash received from the MCASP and the liability towards the MCASP.				

Source: Murray, 2011.

As future sales are recorded, the percentage of the future sales as stipulated in the contract is withheld and paid over the MCASP. Assuming the merchant generates 1,000 of sales, the MCASP will withhold 50 (5% of the sales).

Table 2: Recognition of sales and percentage due to the MCASP

	Account		**Dr**	**Cr**
Dr	Credit / debit card receivable	SFP	1,000	
Cr	Sales	SCI		1,000
Dr	Liability towards MCASP	SFP	50	
Dr	Cash received	SFP	950	
Cr	Credit / debit card receivable	SFP		1,000
Recognising credit / debit card sales, receipt of receivables and amount withheld by the MCASP.				

Source: Murray, 2011.

2.2.2 Accounting entries in the ledger of the MCASP

A literature study did not reveal any specific guidance on how to account for MCA in the accounts of the MCASP. Applying these principles to the example MCA transaction above, the suggested accounting entries will be considered.

The MCASP accounts for the payment of the advance to the merchant. A receivable is recognised for the future receivables that must be withheld from the future sales of the merchant. The discount earned is recognised as deferred income.

Table 3: Recognition of the advance to the merchant and unearned discount

	Account		Dr	Cr
Dr	Receivable from merchant	SFP	131,000	
Cr	Unearned discount	SFP		30,000
Cr	Processing fee	SCI		1,000
Cr	Bank	SFP		100,000
Recognising the payment of the advance to the merchant and the unearned discount.				

Source: Compiled by the author based on literature reviewed.

The processing fee is charged for collecting the amounts due to the MCASP and for arranging the agreement (First Data, 2012). In accordance with IAS 18 *Revenue,* the MCASP will therefore recognise the processing fee as arising from the provision of a service with reference to its stage of completion.

Assuming the merchant generates sales of 1,000 the MCASP would withhold 50 (5% of sales amount withheld). The MCASP earns a discount of 30% of the amount advanced (130,000 of receivables purchased for advance of 100,000). The unearned discount is therefore recognised as sales are generated by the merchant and withheld by the MCASP (30,000/130,000 x 50).

Table 4: Recognition of the sales made by the merchant

	Account		**Dr**	**Cr**
Dr	Bank	SFP	50	
Dr	Receivable from merchant	SFP		50
Dr	Unearned discount	SFP	11.5	
Cr	Discount earned	SCI		11.5
Recognising the receipt of 50 from sales made by the merchant, representing discount of 11.5 earned.				

Source: Compiled by the author based on literature reviewed.

2.3 Background to debt factoring transactions

The merchant cash advance transaction can be classified as either a form of debt factoring or a loan. The elements or steps involved in entering into a debt factoring transaction or the granting of a loan must therefore be compared to that of a MCA to enable a meaningful classification to be made.

The United States English translation of the Oxford English Dictionary defines a “factor” as “a company that buys a manufacturer’s invoices at a discount and takes responsibility for collecting the payments due on them” (Oxford University Press, 2012). Factoring is a form of financing whereby merchants sell their existing accounts receivable at a discount in return for immediate cash. An interest charge is not explicit in the factoring agreement, but

a discounting fee is however charged. The factor assumes the title to the accounts receivables purchased. The factor therefore collects monies due to him on to same terms as were granted by the merchant to his customers. A service or processing fee may also be charged.

Factoring involves three parties:

- the factor, a financial institution;
- the merchant providing goods and services to customers and the seller of the accounts receivable and
- the customers, which represent the accounts receivables due to the merchant for goods and services purchased.

Factoring can be performed on either a non-recourse or recourse basis. With non-recourse factoring, in addition to assuming the title to the accounts receivables purchased, the factor assumes the credit risk of non-payment of the accounts receivable purchased. In the event of default, the factor therefore does not have a claim against the merchant selling the accounts receivable for account payment deficiency. Most factoring transactions are performed on a non-recourse basis.

With recourse factoring, the factor can claim for account payment deficiency from the merchant. The factor only suffers losses if the accounts receivables purchased defaults and the merchant is unable to satisfy the factor's claim. Recourse factoring may be perceived from a technical perspective to be a form of credit.

Factoring may also be performed on either a notification or non-notification basis. This means that customers may (or may not) be notified that their accounts payable due to a merchant have been sold.

Factors also typically provide ancillary services to merchants: credit and collection services. The credit and collection functions related to the accounts receivables are therefore effectively outsourced to the factor. Credit services relate to the credit assessment of a merchant's customers whose accounts receivables will be sold to the factor. Collection services relate to the collection of delinquent accounts and would include contacting customers to notify them of overdue payments, collection activities and legal action.

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Factoring is therefore an integrated financial solution that includes a financing, credit risk mitigation, accounting and collection service (Ernst and Young, 2009).

2.4 Accounting treatment of debt factoring

With non-recourse debt factoring, the transferred assets can be derecognised from the seller's financial statements and recognised in the financial statements of the factor as the risks connected with the transferred assets are held by the factor or buyer. This is due to the fact that the transaction is recognised as a sale of receivables, as control is transferred from the seller to the buyer (International Accounting Services Board, 2013).

In the following example, the accounting entries to account for a non-recourse transaction can be illustrated as follows:

<u>Details of transaction:</u>

- A merchant enters into a debt factoring arrangement with a debt factor for a debt of 100,000 due in three months.
- The debt factor has a financial asset which is a contractual right to receive cash from the debtor in accordance with IFRS 9 *Financial Instruments* (International Accounting Services Board, 2013).
- The debt factor funds 80% of the amount (80,000) upfront and is still liable to refund 15% (15,000) upon payment by the debtor to the merchant.
- The debt factor will administer and recover the debt on behalf of the merchant for which the debt factor will hold back 5% of the debt (5,000) as a fee.

2.4.1 Accounting entries in the ledger of the merchant

The merchant recognises the cash received from the debt factor and the refund due upon collection of the debtor by the debt factor as follows:

Table 5: Recognition of the receivables purchased in the ledger of the merchant

	Account		Dr	Cr
Dr	Bank	SFP	80,000	
Dr	Processing fee	SCI	5,000	
Dr	Refund due from debt factor	SFP	15,000	
Cr	Receivables	SFP		100,000
Recognising the sale of the receivable to the debt factor.				

Source: Van der Walt, 2009.

2.4.2 Accounting entries in the ledger of the debt factor

The debt factor recognises the cash advanced to the merchant and the refund due upon collection of the debtor as follows:

Table 6: Recognition of cash advanced in the ledger of the debt factor

	Account		Dr	Cr
Dr	Factoring debtor	SFP	100,000	
Cr	Bank	SFP		80,000
Cr	Refund obligation	SFP		15,000
Cr	Unearned finance charges	SFP		5,000
Recognising the right to receive cash from the debtor, payment of advance to the merchant, refund obligation held as security and unearned finance charges in accordance with IFRS 9.				

Source: Van der Walt, 2009.

Revenue on this transaction is recognised in terms of IAS 18 *Revenue* (International Accounting Services Board, 2013) which provides for three categories of revenue recognition, i.e. the sale of goods, the rendering of a service and interest on use by others

of entity assets. The debt factor grants the merchant the use of its cash for a limited period as the debt factor will collect the debt when due. Revenue therefore falls within the interest category. IAS 18 requires that revenue that falls within this category should be recognised on the effective interest method. The unearned finance charges are unwound over the three month period and recognised as income in the form of interest. The interest on the transaction is recognised with the following journal:

Table 7: Recognition of interest over the period of agreement

Period		**Account**		**Dr**	**Cr**
Month 1	Dr	Unearned finance charges	SFP	1,667	
	Cr	Interest received	SCI		1,667
Month 2	Dr	Unearned finance charges	SFP	1,667	
	Cr	Interest received	SCI		1,667
Month 3	Dr	Unearned finance charges	SFP	1,667	
	Cr	Interest received	SCI		1,667
Recognising effective interest over the period of the transaction in accordance with IAS 18.					

Source: Van der Walt, 2009.

Included in the transaction was the requirement of the debt factor to administer and collect the debt. A portion of the 5% fee therefore consists of a charge for this service and should be allocated towards this service. The debt factor will therefore recognise this portion in accordance with IAS 18 *Revenue* as arising from the provision of a service with reference to its stage of completion.

After three months the interest (or discount) of 5,000 is fully recognised and the debtor settles his account and pays the debt factor the full value outstanding. The debt factor refunds the 15% withheld as security, completing the transaction. The entries can be illustrated as follows:

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Table 8: Recognition of receipt of payment and payment of refund obligation

	Account		Dr	Cr
Dr	Bank	SFP	100,000	
Cr	Factoring debtor	SFP		100,000
Dr	Refund obligation	SFP	15,000	
Cr	Bank	SFP		15,000

Source: Van der Walt, 2009.

With recourse factoring, the factor or buyer only recognises the amount paid to the assignor of the debt as an advance payment. Interest is accounted for in a similar manner as with recourse factoring over the period of the agreement. The seller recognises the advance received as a loan with receivables as collateral. The receivables are not recognised as truly sold (Ernst and Young, 2009).

2.5 Comparison between MCAs and debt factoring

With debt factoring and MCAs, cash is advanced to the merchant when the transaction is concluded. The factor and the MCASP do not advance 100% of the value of the current or future receivables purchased, but advances a lower percentage. With debt factoring, the discount rate is between 1.0% to 2.0% above the prime overdraft rate (Invoice Factoring, 2010). In the case of MCAs, the discount rate is typically in excess of 25% (Bennett and Tiku, 2008).

Many MCASPs structure their business in a way which resembles traditional factoring (Weston, 2012). The agreement with the merchant is specifically referred to as a “purchase and sale for future receivables agreement” as opposed to a loan agreement (First Data, 2012).

Ancillary services are not typically provided by the MCASP to the merchant as is the case in factoring agreements as the customer/merchant relationship is not in existence at the time of sale.

2.5.1 Comparison of accounting entries

From the perspective of the merchant that obtains the funding, the predominant difference in accounting for the MCA or the debt factoring transaction is that the merchant would account for a liability towards the MCASP when the MCA is obtained. When the debt factoring transaction is concluded, the merchant would de-recognise an existing receivable. The merchant obtains the MCA for receivables that do not yet exist, and therefore owes an amount to the MCASP until sufficient sales are concluded, and therefore receivables generated, to settle this liability.

From the perspective of the MCASP or the debt factor the predominant difference is that the receivable recognised by the MCASP is a liability due by the merchant, whilst the debt factor recognises a liability due by a third party. The MCASP purchases an asset that must still be brought into existence, therefore a liability is present until the sales made by the merchant bring receivables into existence. This also affects the recognition of the discount or interest: with a debt factoring transaction the discount or unearned finance charges are recognised by the debt factor from the date the transaction is concluded until the repayment date of the debt sold (factored). With the MCA transaction, the discount is recognised as income only when the merchant performs sales and receivables are generated. The processing fee charged by the MCASP and the service fee charged by the debt factor is earned as the services are delivered over the lifetime of the contract.

2.5.2 Basic elements of a MCA transaction compared to debtor factoring

To classify the MCA transaction as a form of debt factoring, each of the elements or steps followed to perform a MCA transaction must be compared to the steps or elements involved in a debt factoring transaction.

The basic elements of a MCA transaction are:

- *Sale of debt.* The future debt is sold by a merchant to a MCASP;
- *Sum of money transferred.* The MCASP provides a sum of money to the merchant in return for the future debt purchased, referred to as the selling price of the future debt; and
- *Collection of debt* (the MCASP collects a percentage of the future sales of the merchant (Tozzi, 2009).

Sale of debt

The first element of a debt factoring transaction is the sale of debt, i.e. a debt is sold by a merchant to a debt factor. The sale is affected by a sales agreement. For a contract to be a sale agreement, the essential requirements are that the parties have the intention agree or appear to agree that the seller will make something available to the buyer in return for the payment price (Kerr *et al.*, 2010:1).

In *Syfrets Bond Participation Bond Managers Ltd v CSARS* 63 SATC 1, guidelines were provided to apply when identifying the sale of a financial asset as a true "sale". The first requirement of a sale is an identifiable commodity or merchandise. Secondly, a price or reward must be specified. Marais JA further clarifies that factoring transactions in which debts are sold at a discount to their face value are sales and not loans. The identifiable commodity is the debt due to the seller by a third party and a price is specified - the discounted face value of the debt.

With debt factoring and MCA agreements, the identifiable commodity is the recorded debt. The predominant difference between MCAs and traditional debt factoring is due to the fact that factoring involves existing debt (i.e. goods have already been sold by the merchant to the customers), while merchant advances are based on future debit and credit card sales, i.e. the merchant is yet to sell goods to the customers. Debt factoring involves the sale of an existing debt to the factor, while with MCAs the merchant effectively sells its future receivables. When the transaction is concluded, there is therefore no right to receive payment from any specified customer, for any specified product or price, as the receivable or asset being sold does not exist at time of sale (Bennett and Tiku, 2008).

With debt factoring and MCA transactions, the sale of the existing or future debt is affected via a cession of debt. In *First National Bank of SA Ltd v Lynn NO & others* 1996 (2) SA 339 (A), Joubert JA describes cession as an act of transfer whereby rights in a movable incorporeal thing is transferred from the cedent to the cessionary. It functions in the same manner in which rights in a movable corporeal thing are transferred via physical delivery. As mentioned above, a sales agreement is required as a cause or reason for the cedent's intention to transfer the right and the cessionary's intention to become the holder of the right appears or can be inferred. The cedent is divested of the right and it vests in the cessionary.

Joubert JA further clarifies the elements of a cession as follows:

- the act of transfer;
- the subject matter is a right; and
- the transfer is affected by an agreement between the cedent and the cessionary.

Based on the consideration in this study, the MCA agreement includes all these elements as the right, and title in the future receivables of the merchant is transferred by an agreement.

The sale of a thing that is yet to come into existence is referred to as an *emptio rei speratae* (Kerr et al., 2010:14). Joubert JA in *First National Bank of SA Ltd v Lynn NO & others* 1996 (2) SA 339 (A) further refers to Van Bynkershoek (1673-1743) Observationes Tumultuariae vol 3 obs 2448 that determined that a non-existent right of action or a non-existent debt can never in law be transferred as the subject-matter of a cession. However, Joubert JA does confirm his agreement with the principle that the parties may reach an agreement to cede and transfer a future or contingent right of action, or a future or conditional debt. When the debt comes into existence and accrues or becomes due and payable, it will be transferred to the cessionary. If the debt never comes into existence, it will be a non-existing right of action or a non-existent debt which cannot be the subject-matter of a cession. In *Taxpayer v Commissioner of Taxes, Botswana* 43 SATC 118, 1980 (BCA) it was also confirmed that in the Roman Dutch law, future rights can be effectively ceded, thereby divesting the cedent of such rights and vesting them in the cessionary.

Future rights can therefore be transferred and the first element involved in a MCA transaction, i.e. the cession of debt, will therefore be similar to debt factoring for the purposes of classifying the transaction as a sale of debt.

Sum of money transferred

The MCASP provides a sum of money to the merchant in return for the future debt purchased, referred to as the selling price of the future debt. The second requirement enunciated by Marais JA in *Syfrets Bond Participation Bond Managers Ltd v CSARS* 63 SATC 1 is that a price or reward must be specified for the debt purchased to be classified as a sale. MCA agreements specify a “purchase price”, i.e. the selling price for the future debt sold. This requirement is also met and the nature of the MCA and debt factoring agreement is therefore similar.

Collection of debt

The MCASP collects a percentage of the future sales of the merchant (Tozzi, 2009). Debt factoring may involve the collection of debt from the customers of the merchant or directly from the merchant (Ernst and Young, 2009). With MCA agreements, the MCASP collects monies due directly from the merchant (Nectar Cash-flow Advances, 2012). A collection process is therefore present with both transactions and it can therefore be argued that they are similar in nature.

2.6 Background to loans

One of the predominant factors attracting companies to provide MCA services is the fact that they argue that these transactions are not loans. Based on an investigation of the accounting treatment of MCAs (refer Table 1) the initial recognition also resembles that of a loan with the recognition of a liability, juxtaposed to debt factoring where no liability is initially recognised (refer Table 5). The argument here is that the merchant factor simply purchases future credit card receivable at a discounted rate, i.e. no loan is granted. These companies therefore claim that they are not bound by usury laws that would limit interest rates (Tozzi, 2009). If the purchase of future receivables is therefore a loan, this will also have an impact on its taxation in terms of the Act.

The definition of a “loan” is not defined in the Income Tax Act. The Oxford English Dictionary defines a "loan" as (Oxford University Press, 2012): “a thing that is borrowed, especially a sum of money that is expected to be paid back with interest.”

Furthermore, the Act does not include a definition of a loan, but includes a definition of a “financial instrument” that is defined by section 1 of the Income Tax Act as follows:
“(a) a loan, advance, debt, bond, debenture… or a similar instrument”; and
(e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset;

The definition contained in paragraph (e) is a broad definition and while it can be accepted that the MCA is a “financial arrangement”, as it refers to finance being provided by a MCASP to a merchant, it must be explored whether this arrangement is based on the time value of money or the cash flow of an asset. This section is now followed by a comparison between MCA agreements and loans.

2.7 Comparison between MCA agreements and loans

The two key characteristics of a loan according to this definition contained in the Oxford English Dictionary are: (i) that something is borrowed, and (ii) that this “thing” must be repaid with “interest”.

Something is borrowed

The Merriam-Webster (2013) dictionary highlights the fact that the ownership of the “thing” borrowed in terms of a loan will be temporary.

It is submitted that as the merchant cedes the right and title of the future receivables to the MCASP, the ownership of the “thing” or future receivable is not temporary and the MCA therefore differs from a loan in this regard. In *ITC 968* (1962) 24 SATC 726(F) the court determined that the transaction of discounting the promissory notes was legally a sale of the notes and not a loan. The MCASP purchases receivables payable by the credit or debit card processor to the merchant when credit or debit cards sales are made. In common with non-recourse debt factoring agreements, the MCASP does however grant the merchant the use of its funds until sales are made by the merchant to enable receivables to come into existence. Until these sales are therefore made, the merchant has the use of funds obtained from the MCASP. Based on the MCA agreement, the MCASP does not advance funds in order to lend money to the merchant, but performs an outright purchase of future receivables for which payment by the merchant is delayed as it depends on sales that must still occur (First Data, 2012). It is submitted that the advance is not merely a loan for which repayment of the debt is determined with regards to future sales.

Interest

“Interest” is defined in section 24J of the Act and the common-law meaning of interest has also been explored in different court cases.

Section 24J of the Income Tax Act further determines that “interest” includes the “gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement and the amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as

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represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled".

In *ITC 1496* 53 SATC 229(T) at 248, reference is made to Halsbury's Laws of England 4 ed Vol 32 para 106, which defines interest as "the return of compensation for the use of retention by one person, of a sum of money belonging to or owed to another". In *ITC 1496* 53 SATC 229 at 249, "interest" was defined as "expenditure to compensate a lender for the time period during which the money is lent to a second party."

A traditional loan means that interest is charged as compensation for the use of the lender's money. MCA agreements do not refer to interest being charged. According to First Data (2012) in a typical MCA agreement, the merchant further agrees to remit to the factor an amount in excess of the "selling price" of the future receivables to the factor. This excess payment present in MCA agreements may represent "interest". In *ITC 1587* 57 SATC 97 the discount fee charged by a debt factor was determined to constitute or to be akin to "interest".

Section 24J(1) of the Income tax Act defines "interest" to include the "gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement". The compensation the MCASP receives for entering into a transaction with the merchant is in reality a "discount" – this is the difference between the purchased amount and the purchase price.

"Discount" is defined in The Concise Oxford Dictionary to mean "a deduction from the amount of a bill of exchange etc. by a person who gives value for it before it is due". The transferor (cedent) of a debt security incurs discounting cost in order to receive payment of existing or future debts by third parties, from the transferee (cessionary). The profit of the MCASP or the debt factor is therefore compensation for providing funding to the merchant and is thus a form of discount.

It is consequently submitted that section 24J will apply to the MCA transaction as the difference between the purchase price and the purchased amounts, represents a discount payable in terms of a financial arrangement.

In addition to that fact that interest is charged on loans, Goldin (2007) highlights that the other main differences between a MCA transaction and a traditional loan is that it has no fixed period for repayment, there are no fixed monthly instalments and the MCASP has no recourse towards the merchant. Each of these elements listed by Goldin (2007) is further discussed:

- ***Fixed time period***

  A traditional loan generally has a fixed repayment term. MCA agreements remain in force until the purchased amount has been collected. Depending on the volume of sales at the merchant made via credit or debit cards, the period it will take for the MCASP to collect the purchased amount varies. MCA agreements generally do not include a reference to a set repayment period.

- ***Fixed monthly payment***

  A traditional loan with a fixed interest rate stipulates a fixed amount or instalment that must be repaid every month. For traditional loans with variable interest rates, the instalment will vary to the extent that the interest rate, to which the agreement is linked, for example the prime interest rate, varies. MCA agreements do not stipulate a fixed amount that must be collected, as the amount that must be repaid by the merchant to the MCASP is a percentage of the sales volume of the merchant. The repayment amount is therefore dependent on the economic activity of the merchant, unlike a loan for which the prepayment amount is not influenced by the sales of the borrower.

- ***Recourse***

  There is no recourse in the case of a MCA, should the merchant legitimately go out of business. With traditional loans, collateral is typically provided.

The MCA agreement therefore differs from a traditional loan, in that ownership of a financial asset is transferred, as opposed to money being borrowed when a loan is granted. A discount is charged on MCA agreements, while interest is charged on loans. The absence of interest in MCAs also highlights the fact that terms common to loans, such as a fixed time period and fixed monthly payment or instalment, are not present.

2.8 Conclusion on classification of MCAs

The typical MCA agreement stipulates that, against payment of an amount, the right, title and interest arising from payments by the merchant's customers using credit and debit cards up to a specified amount is transferred to the MCASP (First Data, 2012). An amount is therefore expected to be paid back to the MCASP, which satisfies the principle that money is simply borrowed from the MCASP. The MCA agreement does however specifically refer to the money being provided as a purchase amount relating to a financial asset, i.e. the merchant's future receivables that are sold. There is however a difference between an amount borrowed in the form of a loan, and the outright sale and purchase of the future receivables. The intention of the parties to the agreement will determine whether the transaction is classified as a loan or the sale of an asset (Risk and Fraud Management Committee of the Electronic Transactions Association, 2008).

Based on the analysis performed and a comparison of product features as summarised in Table 9, it is submitted that the typical MCA agreement is not a loan agreement from a common law perspective as there are significant differences between these agreements. The most significant of these differences are that a transfer in ownership of a financial asset is present in a MCA agreement, whilst with a traditional loan the lender borrows funds from the lender. The MCA agreement does not stipulate an interest rate, but may refer to a discount rate and these agreements are also granted without recourse.

MCA agreements may however by classified as a "financial instrument" and "instrument" as defined by the Act, which will have implications with regards to capital gains tax and the application of section 24J respectively. It is held that a MCA agreement is a specialised form of debt factoring. A sale of an asset has therefore occurred as opposed to a loan being granted. The income tax and value-added tax implications will therefore be analysed, based on this classification. It is however important to note that certain sections of the Income Tax Act and VAT Act may still apply to MCA transactions if the definitions contained in these acts apply to these transactions. Based on the consideration in this study it is submitted that section 24J of the Act applies to the discount contained in MCA transactions.

Table 9: Comparison between product features of a MCA and debt factoring

Product features	**Merchant credit advance**	**Debt factoring**	**Loan**
Existence of debt of underlying customers of merchant	Debt and customer do not exist at time of sale	Debt and customer exist at time of sale	Funds advanced to merchant at commencement of agreement
Nature of agreement	Referred to as purchase and sale agreement	Non-recourse factoring: Purchase and sale agreement Recourse factoring: Loan agreement	Loan agreement
Advancement of funds	Funds advanced to merchant at commencement of agreement	Funds advanced to merchant at commencement of agreement	Funds advanced to merchant at commencement of agreement
Credit risk: risk of non-payment	Risk of non-payment remains with MCASP. MCA agreement may stipulate personal guarantee with regards to covenants.	Risk of non-payment with factor (non-recourse) or merchant (recourse)	Risk of non-payment with lender
Ancillary services	No ancillary services provided	Credit risk and collection services provided	No ancillary services provided

Transfer of ownership	Right, title and interest in *future* receivables transferred to MCASP	Right, title and interest in *existing* receivables transferred to factor	Amount borrowed by lender
Charging of discount	Purchase price less than purchased amount of future receivables	Advance less than 100% of the face value of receivable advanced	Not applicable
Charging of additional fee	MCASP may charge processing fees	Factor may charge service fees	Lender may charge initiation or monthly service fees
Parties involved	MCASP, merchant and customer	Factor, merchant and customer	Lender and merchant
Repayment period	No set repayment period	Repayment period based on terms provided to customers	Repayment period specified in loan agreement
Interest charged	No interest explicitly in agreement	No interest explicitly in agreement	Lender charges interest
Notification of customers	Customer not notified	Customer may be notified	Not applicable

Source: Compiled by author based on literature reviewed.

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CHAPTER 3: INCOME TAX CONSEQUENCES OF MCAS

In the Chapter 2 it was concluded that the MCA transaction is a specialised form of debt factoring. The income tax consequences from the perspective of the merchant obtaining the advance and the MCASP granting it, are considered in this chapter.

3.1 Income earned by the merchant

The merchant receives an advance, the MCA, from the MCASP. In terms section 1 of the Act, “gross income'” is the total amount received by or accrued to a taxpayer, in cash or otherwise, from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature.

The merchant sells, to the MCASP, an interest in its future credit and debit card receivables (First Funds, 2009). The advance the merchant receives is the selling price of the receivables sold. As the future receivables are generated via sales of the merchant, the merchant must cede or transfer a percentage of these receivables that are settled to the merchant as consideration for the selling price received. The advance received therefore represents the selling price of an asset, the future credit and debit card receivables. The MCA received is therefore of a capital nature and hence not included in “gross income”.

Furthermore, the merchant earns income when providing goods or services to its customers. Sales will be made that give rise to the credit or debit card receivables that are ceded to the MCASP. As discussed in Chapter 2 and as determined in *ITC 1378*, a contingent or future right or *spes* (in this case the future receivable) is capable of effective cession so as to vest the right in the cessionary. In accordance with the MCA agreement, the merchant cedes the future credit and debit card receivables to the MCASP (the cessionary), and not the future income generated by the merchant.

According to De Koker and Williams (2013), a cession of income will transfer the right of the cedent to the cessionary, if the cession is structured in such a way that the cedent has no right to claim the future income. De Koker and Williams (2013) further

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stipulate that the courts will examine the form and contents of the agreement of a cession in order to establish whether the cedent has divested himself of the right to claim the income, when that income will accrue in the future.

De Koker and Williams (2013) highlight that there is a difference between the disposal of income which has accrued to a person and the disposition of a *spes* or right to income. With an accrual there is an implication that a claim has already arisen. This unconditional right to income cannot be ceded so that the income is taxable in the hands of the cessionary. If an accrual has not yet occurred, the right to income is conditional and can be ceded to cause the resultant income to be taxable in the hands of the cessionary. In *Moodie v Commissioner for Inland Revenue, Transkei, and another; Commissioner for Inland Revenue, Transkei, and another v Moodie and another* 1993 (2) SA 501 (TkA), Goldin JA at 506 held that when a taxpayer disposes of or cedes his right to income after it has accrued to him, it remains part of his "gross income" and therefore taxable in his hands. If however he divests himself of his right to income before it accrues to him, such right to income accrues to the recipient. It must therefore be determined whether the income in question has accrued before or after the cession thereof. In determining this, the following cases are considered:

In *CIR v Witwatersrand Association of Racing Clubs* 1960 (3) SA 291 (A) (23 SATC 380) the taxpayer decided to organise a race meeting and to pay over the profits to two designated charities. As the association simply decided that it would pay any profits accrued to it to the charities, and no prior entitlement to the money by the charities existed, it was held that the proceeds of the race meeting accrued to the taxpayer as income, notwithstanding the fact that they had been paid over to the charities.

In *CSARS v Cape Consumers (Pty) Ltd* 1999 (4) SA 1213 (C), a buy-aid organisation was obliged, in terms of its articles of association, to credit the income earned to the Buyers' Reserve Fund, as in terms of the legal relationships between itself and its buyers, such monies were not for its own benefit but for the benefit of the buyers. It was therefore determined that there was no prior receipt or accrual of this income by the buy-aid organisation.

It is evident that a MCA and debt factoring differ in respect of whether *existing* receivables are transferred or *future* receivables are transferred (refer to Table 9). With traditional debt factoring, the debt already exists when it is factored, but with a MCA, the debt does not exist on the date the agreement is entered into. It therefore follows that with a MCA, the debt is ceded prior to an accrual (of the underlying sale which gives rise to it), which prompts consideration of the principle established in the supreme court case of *CIR v Witwatersrand Association of Racing Clubs* 23 SATC 380 1960 (3) SA 291 (A). It therefore needs to be considered whether the merchant would have to include the income ceded prior to accrual in "gross income". In determining the tax liability on the right to income ceded by the taxpayer, it is crucial to determine whether the right was ceded before or after it had accrued to the taxpayer - where cession of right to income, a cession in *securitatem debiti*, the cedent (taxpayer) retains dominium in right and such income is taxable in the cedent's (taxpayer's) hands (*Moodie v Commissioner for Inland Revenue, Transkei, and another; Commissioner for Inland Revenue, Transkei, and another v Moodie and another* 1993 (2) SA 501 (TkA)).

The typical MCA agreement (First Funds, 2009) specifically refers to the purchase and sale of *future receivables*. Applying the principles of *CSARS v Cape Consumers (Pty) Ltd* 1999 (4) SA 1213 (C) to the MCA, no legal or contractual right exists that transfers or cedes the right to income from the merchant to the MCASP. As was the situation in *CIR v Witwatersrand Association of Racing Clubs* 23 SATC 380 1960 (3) SA 291 (A), no prior entitlement by the MCASP to the sales income exists. The MCA agreement does not create a prior entitlement of the MCASP to the future sales generated by the merchant, but only to the receivables created by these sales. It is submitted, that although the MCA agreement is concluded before sales which bring the subject matter of the cession into existence, the cession applies only to the credit or debit card receivables that are created by the subsequent sale and not the sale itself. These receivables only come into existence after the merchant performed the sales, hence the income first accrues to the merchant, and thereafter a cession of a percentage of the receivables created, is affected. As was the case with *Moodie v Commissioner for Inland Revenue, Transkei, and another; Commissioner for Inland Revenue, Transkei, and another v Moodie and another*

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1993 (2) SA 501 (TkA), the merchant cedes the right to income after it has accrued to him.

The merchant will therefore still be taxed in accordance with section 1 of the Act after entering into a MCA agreement, as an amount accrues to the merchant.

3.2 Expenditure incurred by the merchant

As elucidated in section 2.2 “Accounting treatment of a MCA transaction”, the merchant incurs the following expenditure when entering into a MCA agreement:

- Processing fee, and
- Discount.

3.2.1 Processing fee

A processing fee is incurred by the merchant when the MCASP purchases the future receivables at a discount. The processing fee represents a fee charged by the MCASP to the merchant for collecting the amounts due to it and arranging the agreement (First Data, 2012). The merchant may be able to claim a deduction in terms of section 11(a). Section 11(a) allows the taxpayer to deduct from income expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

This expenditure is actually incurred as the merchant pays these fees over to the MCASP on a monthly basis or when the future receivables are sold by the merchant to the MCASP as stipulated in the MCA agreement. The key questions affecting the deductibility of this expenditure are, however, whether they are incurred in the production of income and whether the expenditure is of a capital nature.

The merchant cedes the future receivables (credit or debit card sales) related to the sale of its products or services. It does not trade in debt and is therefore not a moneylender and the debt sold may therefore represent capital assets in its hands. The proceeds of the debts may therefore be of a capital nature had they been paid to the taxpayer on their due dates (i.e. if the merchant collected the credit or debit card

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receivables for its own account). This factor does however not affect the deductibility of the nature of the loss sustained. This principle was established in *ITC 1628* 60 SATC 33 which related to the early discounting of the debts. Galgut J held that "even if it is to be assumed that the proceeds of the promissory notes might have been of a capital nature had they been paid to the taxpayer on their due dates, the losses that were sustained because of their early discounting were unrelated thereto and because they were intended to produce working capital, and because that is what the discounting of them achieved, they were instead related solely and only to the income earning activities of the taxpayer."

The purpose of obtaining the MCA is to obtain working capital for the business. The processing fee incurred is therefore incidental to the income producing activities of the merchant and as there is sufficient closeness of connection between the expenditure and the income-earning operations, the processing fee may be deducted from the merchant's income. It is therefore submitted that merchants that incur processing fees when entering into MCA agreements, may deduct this expenditure from income in terms of section 11(a).

3.2.2 Discount

Galgut J commented in *ITC 1628* 60 SATC 33 that "The loss resulting from a discount, which is called a factoring charge, is always allowed as a deduction". In *CSARS v Creative Productions* (Pty) Ltd [1999] 2 All SA 14 (N) (61 SATC 106), Levinsohn J upheld the decision of *ITC 1628* (60 SATC 33) that discounting charges incurred in discounting promissory notes obtained under an export scheme were properly deductible as expenditure incurred in the production of its income. The purpose in discounting the notes by the taxpayer was as in order to obtain working capital for its manufacturing business. The transaction was therefore determined to be no different in principle from other transactions intended to raise working capital, such as factoring and the raising of loans.

The following principles are laid down in this case: A distinction exists between money spent in creating or acquiring a source of profit and money spent in working the concern for present production of profits. Thus a distinction exists between

expenditure incurred in the operation of the concern as opposed to expenditure incurred in the acquisition of the means of the production, such as property and tools.

A distinction must be drawn between floating and fixed capital. Floating capital frequently changes its form from money to goods and vice versa, and where this is done for the purpose of making profit, the capital so employed, is floating capital. If the expenditure is part of the cost incidental to the performance of the income-producing operations as distinguished from the equipment of the income-producing machine, it is then revenue expenditure, even if it is paid in a lump sum.

In deciding how the expenditure should then be regarded, the closeness of the connection between the expenditure and the income-earning operations, having regard to both the purpose of the expenditure and what it actually effects, has to be assessed (*CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A)).

If the discount is therefore incurred with purpose of obtaining working capital for the business, it will be deductible in terms of section 11(a). In contrast, in *ITC 968* it was found that the promissory note concerned was discounted in order to access cash for purposes of making a capital investment. The discounting fee was therefore not allowed as a deduction.

Applying the principles laid down in *CSARS v Creative Productions* (Pty) Ltd [1999] 2 All SA 14 (N) (61 SATC 106) to the MCA transaction, the merchant incurs a discounting expenditure with the purpose to obtain working capital. According to Davis et al (2012), when trade debts are ceded with the purpose of financing trading activities, the difference between the face value of the debts and the purchase price, referred to as a discount, is akin to interest and is deemed to be sufficiently close to the income-earning operation in order to regard it as part of the cost thereof. The merchant will be regarded as the ‘issuer’ in respect of the interest for the purpose of section 24J(2) and thus qualify for a deduction in terms of the said section.

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3.3 Income earned by a MCASP

The MCASP earns the following income from the MCA transaction, which will be considered separately:

- Processing fee, and
- Discount.

3.3.1 Processing fee

The MCASP earns a processing fee for the preparation and completion of documents, the change associated with the banking infrastructure setup (The North American Merchant Advance Association (NAMAA), 2009) and the collection of amounts due (First Data, 2012). Some MCASPs may also charge a fee for a site visit if the value of the advance is above a certain amount (SBA Business Funding Inc., 2012).

In terms section 1 of the Income Tax Act, "gross income" is the total amount received by or accrued to a taxpayer, in cash or otherwise, from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature.

The total amount of the processing fee is stipulated in the MCA agreement and the processing fee is generally received by the MCASP upon payment of the advance to the merchant (Cash on Demand, 2011). *In Lategan v CIR 1926* CPD 209 at 204 Judge Watermeyer held that "accrued" means to "become entitled to". It is submitted that the processing fee accrues to the MCASP when the agreement is signed as the MCASP would become entitled to the fee on this date.

The processing fee will therefore be included in "gross income" if it is not of a capital nature. The processing fee received would be income in nature if received as part of a profit-making scheme. In *ITC 31* (1924) 2 SATC 52(C) it was determined that if debts are purchased and an amount is collected in excess of what was paid, it was done in the furtherance of the enterprise and is therefore income in nature. In *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A), the Appellate Division held that "… whether the receipts that flow from the carrying on of

a business are revenue still depends on whether the business was conducted with a profit-making purpose, i.e. as part of a profit-making venture or scheme." Therefore only if the purpose for the MCASP in purchasing the future receivables of the merchant is due to a scheme of profit-making, will the proceeds be income. By entering into the MCA agreement, it is the intention of the MCASP to make a profit, i.e. the purchased amount or amount collected by the MCASP over the lifetime of the agreement will be in excess of the purchased amount or receivables purchased. The processing fee is therefore not of a capital nature as it is proceeds earned from a scheme of profit-making.

The processing fee for the processing and arrangement of the MCA is therefore "gross income" as defined in section 1 of the Act.

3.3.2 Discount

The MCASP purchases the right, title and interest in and to the amount of the purchased amount, of the future receivables arising from payment by customers of the merchant using credit and debit cards (First Data, 2012). The MCASP only pays the merchant the purchase price, which is a lesser amount than the amount of the receivables purchased (being the discount concerned). This difference between the amount paid by the MCASP for the future receivables and the actual future receivables collected, represent a discount and would in terms of section 1 of the Act be included in income if not of a capital nature. As submitted above with regards to the processing fee charged by the MCASP, the discount is of an income nature as the purpose of the MCASP in entering into the MCA agreement is to earn a profit.

The MCASP will be regarded as the 'holder' for the purpose of section 24J(3) and therefore will be required to include interest in "gross income" if the arrangement represents an income instrument. In the event that the MCASP is not a company, it is therefore a requirement for section 24J(3) to be applied that the term will, or is reasonably likely to, exceed one year. If the MCASP is a company, the arrangement will represent an income instrument even if the expected term is less than one year. The MCASP typically tries to collect the advance within one year (Risk and Fraud Management Committee of the Electronic Transactions Association, 2008), but as

the MCASP has no fixed repayment term (Goldin, 2007), the purchased percentage of receivables may be collected over a longer period.

If it is assumed that the term of a MCA *does not exceed one year*, section 24J(3) would not apply, but the general inclusion in terms of “gross income”. The income in the form of the discount would be included in the “gross income” of the MCASP when it is received by or accrued to it. In *Lategan v CIR* 1926 CPD 203 and *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 A it was confirmed that an amount accrues to a taxpayer in the tax year that the taxpayer becomes *entitled* to it. The discount accrues to the MCASP when the MCA agreement is concluded, i.e. when an advance is made, the MCASP is entitled to the discount stipulated in the agreement and would therefore be included in its “gross income”.

If it is assumed that the term of a MCA *exceeds one year*, it is submitted that the difference between the purchase price and the purchased amounts, represents a discount payable in terms of a financial arrangement. Section 24J(1) defines “interest” to include the “gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement”. Section 24J(3) further prescribes that interest accrues on a day-to-day basis using a yield-to-maturity methodology (unless an alternative method has been used) and applies to all instruments as defined. This section provides that the holder of an instrument will be deemed to have accrued an amount of interest, which must be included in his “gross income”. The accrual amount to be included in “gross income” will be equal to the sum of all accrual amounts in relation to all accrual periods falling, whether in part or in whole, within such year of assessment in respect of such income instrument (Brand, 2010). In calculating the "accrual amount" of an instrument, the "yield to maturity" is applied to the "adjusted initial amount". The “adjusted initial amount” refers to a lesser amount that is used to perform the calculation, after taking into consideration payments between related parties (Dachs, 2010).

The "yield to maturity" is defined as, *inter alia*, the rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of any instrument in relation to a holder or an issuer, as the case may be, of

such instrument during the term of such instrument, equals the initial amount in relation to such holder or issuer of such instrument (Dachs, 2010).

A determination of the yield to maturity of the instrument is required in order to calculate the accrual amounts. The Taxation Laws Amendment Act, No. 24 of 2011 (the "Amendment Act") enacted changes to the Act specifically aimed at anti-avoidance mechanisms used by taxpayers to fall outside of the application of section 24J of the Act. The definition of "date of redemption" was amended.

The definition of "date of redemption" deals with two types of scenarios. Firstly it refers to instances where the terms of an instrument specifies a date on which all liability to pay all amounts in terms of that instrument will be discharged, and the date is specified in terms of the instrument. The terms must also not be subject to change, whether as a result of any right which is fixed or contingent of the holder of that instrument or otherwise. For such an instrument, the date of redemption will be regarded as the date specified in the terms of the instrument and the term of the instrument will end on such date.

If the terms of the instrument do not specify a date when all liabilities must be discharged or the date specified is subject to change, the date of redemption will be regarded as the date on which, on a balance of probabilities, all liability to pay all amounts in terms of that instrument, is likely to be discharged. The yield to maturity calculation for instruments with uncertain maturity dates will therefore be based on a date on which all liability to pay all amounts under the terms of the instrument is likely to occur, based on a balance of probabilities (Magolego, 2012).

According the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011, rights to renew or extend the period of the instrument must be taken into account to the extent that these rights will more likely than not be exercised, based on the balance of probabilities. The date of redemption may therefore change over time as facts and circumstances deviate from the initial estimate. Annual adjustments may therefore be required.

The term of an instrument with an uncertain date of redemption will be regarded as the period commencing on the date of issue or transfer of that instrument and ending on the date of redemption of that instrument as specified above (Magolego, 2012).

The MCA agreement does not include a specific repayment date (First Data, 2012). It is impossible to determine the exact date of redemption as the merchant continues to settle the factor or percentage of the receivables collected, until the original amount advanced plus the discounting profit has been settled. As section 24J defines the 'date of redemption' where the terms of that instrument do not specify a date, as the date on which, on a balance of probabilities, all liability to pay all amounts in terms of that instrument is likely to be discharged, it is submitted that the date of redemption can be based on volume of sales transactions of the merchant. When a MCASP provides an advance to a merchant, one of the key factors it considers, is the sales history of the merchant. The sales history is used to determine the quantum of the advance provided to the merchant. Applying the factor of future receivables that will be collected to the expected sales of the merchant from the date of inception of the agreement, a maturity date can therefore be calculated when, based on a balance of probabilities, the merchant advance is expected to be settled (Everest Merchant Funding (Pty) Ltd, 2011).

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3.4 Expenditure incurred by MCASP

The MCASP could incur the following expenditure in entering into a MCA transaction, which will be discussed subsequently:

- Purchase price of future receivables;
- Bad debt expenditure; and
- Doubtful debt allowance.

3.4.1 Purchase price of future receivables

The purchase price is the amount the MCASP pays to obtain the right, title and interest in the future receivables of the merchant. According to section 11(a) of the Act, the taxpayer may deduct from income expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

The future receivables purchased (or purchase price as stipulated in the MCA) will be deductible if actually incurred. In *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) the court held that money is not received nor does it accrue within the meaning either of the definition of "gross income" if it is borrowed. The MCASP purchases a financial asset, the right to receive future receivables, which is also an obligation to repay what has been received (the debt). The MCASP has therefore not incurred a loss or expenditure after the initial purchase price is advanced and no deduction from income is possible. This situation may however be different in the event of bad debts which will be investigated in the subsequent section.

3.4.2 Bad debt expenditure

MCA transactions are performed without recourse. It is therefore possible that a MCASP may purchase the future receivables of a merchant, but is unable to collect the purchased amount as stipulated in the MCA contract.

The MCASP may qualify for a bad debt expenditure deduction under section 11(a) or section 11(i) of the Act. The application of each of these sections will be considered.

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The specific deduction, section 11(i), would be considered as a starting point and if the MCASP does not meet the requirements of section 11(i), the requirements of section 11(a) would be considered.

Section 11(i)

Section 11(i) of the Act allows a taxpayer to deduct from income the amount of any debt due to the taxpayer, which during the year of assessment has become bad. The amount must have been included in the taxpayer's income in the current or previous years of assessment. If the advance provided by the MCASP becomes irrecoverable, the MCASP will not be able to claim a section 11(i) deduction in relation to any amount that was not included in its income.

The purchase price, i.e. the actual advance provided by the MCASP to the merchant that represents the price paid by the MCASP to purchase the future receivables, will never be included in income, therefore a section 11(i) deduction is not possible.

The processing fee charged by the MCASP will be included in income and a section 11(i) deduction is therefore possible in relation to the charge, if the MCASP is unable to collect this fee from the merchant.

The discount earned will be taxed in accordance with section 24J of the Act. It may therefore be possible to include an amount in the income of the MCASP, but which may subsequently not be recovered, i.e. it may become bad. This is due to the fact that section 24J requires the MCASP to calculate a maturity date of the MCA, based on a balance of probabilities of the period that the merchant advance is expected to be settled. The actual amount collected relating to a MCA granted may therefore be less than the discount included in income for tax purposes. It is therefore submitted that the MCASP may be able to claim a section 11(i) deduction relating to the discount included in income, but not collected.

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As submitted above, the only component which would not have been included in the income of the MCASP previously, would be the initial purchase price of the future receivables for which purpose the application of section 11(a) will subsequently be discussed.

Section 11(a) for portion of bad debt in respect of purchase price

If expenditure or a loss is incurred relating to irrecoverable debt advanced in the production of income and the expenditure or loss is not of a capital nature, a deduction in terms of section 11(a) of the Act may be possible.

The MCASP may actually incur a bad debt expenditure relating to the amount due to the MCASP if the MCASP is unable to collect the full amount or a portion thereof. Corbett AJA confirmed at 595 in *Stone v SIR* 1974 (3) SA 584 that the taxpayer in that case may have been eligible to deduct the loss of the loan capital by reason of it having become irrecoverable.

In *Port Elizabeth Electric Tramway Co v Commissioner for Internal Revenue* 1936 CPD 241, Judge Watermeyer held that if the act which entailed the expenditure was for the purpose of earning income, and the expenditure incurred is so closely connected to the act that it can be regarded as part of the cost of performing it, the expenditure will be incurred in the production of income. The purpose for the MCASP by providing MCAs is to earn income predominantly in the form of a discount earned when collecting the future receivables. It is therefore submitted that the expenditure related to the purchasing of the future receivables is in the production of income.

The next and last requirement would be to consider whether or not the expenditure is of a capital nature. It is SARS practice, substantiated by case law, that in circumstances in which it can be satisfactorily shown that it is the custom of trade or business of the taxpayer to make loans or advances to customers as an integral part of the business carried on, a deduction under section 11(a) is allowed with regards to losses suffered on irrecoverable loans. It must therefore be considered whether the future receivables purchased by the MCASP, based on the discussions contained in

Chapter 2, can be considered to be its floating or circulating capital and not its fixed capital.

Various cases have established that if a taxpayer is a “moneylender”, money will constitute its floating capital. Losses suffered with regards irrecoverable loans or advances provided by “moneylenders” will qualify for a deduction in terms of section 11(a). In *Stone v SIR 1974* (3) SA 584 at 595, Corbett AJA confirmed that when a taxpayer pursues the trade of a “moneylender”, money constitutes the trading stock of the taxpayer or its circulating capital. Corbett AJA further states, when referring to the decision that “moneylenders” can claim a section 11(a) deduction for bad debts: “… provided that the business is purely that of moneylender and the loans are not made in order to acquire an asset or advantage calculated to promote the interests and profits of some other business conducted by the taxpayer”. He also points out: “There is, however, in my view, no warrant for extending this principle to loans by persons who are not conducting a moneylending business”.

It therefore appears that Corbett AJA intended that a bad debt deduction in terms of section 11(a) should apply only if two requirements are met:

- it must be provided by a banker or “moneylender”; and
- it must be made in the course and for the purposes of the moneylending business, and not for the purpose of the advancement of another business conducted by the taxpayer.

The second requirement has been discussed above and concluded in the affirmative.

With regards to the first requirement, in *ITC 933* at 348, Van Winsen raises the following questions to determine whether a taxpayer is conducting the business of “moneylender”:

- whether there is any degree of continuity and system about the transactions;
- the frequency of turnover stipulated by the lender; and
- the rate of interest on the loans.

In *Solaglass Finance Company (Pty) Limited v Commissioner for Inland Revenue* 1991 (2) SA 257 (A), Friedman AJA stated at 271 that whether or not a taxpayer can be said to be carrying on the business of a "moneylender" or banker, is a question of fact to be decided in the light of the circumstances of the particular case. Friedman AJA lists the following guidelines to determine whether a taxpayer can be said to be carrying on the business of a "moneylender":

- "There must be an intention to lend to all and sundry provided they are, from his point of view, eligible;
- The lending must be done on a system or plan which discloses a degree of continuity in laying out and getting back the capital for further use and which involves a frequent turnover of the capital;
- The obtaining of security is a usual, though not essential, feature of a loan made in the course of a moneylending business;
- The fact that money has on several occasions been lent at remunerative rates of interest is not enough to show that the business of moneylending is being carried on. There must be a certain degree of continuity and system about the transactions; and
- The proportion of the income from loans to the total income: the smallness of the proportions cannot, however, be decisive if the other essential elements of a moneylending business exist."

It appears that the trade of a MCASP will qualify as being that of moneylending based on most of the criteria set by Van Winsen and Friedman. MCAs are offered to the general public and MCASPs do have a system or degree of continuity with regards to their transactions. MCASPs have standard sale and purchase agreements and it is the business objective of the MCASP to provide numerous advances. It is also submitted that Van Winsen refers at 348 to the fact that the "moneylender" must charge interest on its loans granted, i.e. loans are granted with the intention to earn income. MCA agreements contain a discount and a processing fee is charged. The MCASP therefore provides the advance with the intention of earning income.

In *Sentra-Oes Koöperatief Bpk v KBI* 57 SATC 109, a loss suffered on short-term bank deposits of working capital by an insurer, was determined not to be deductible,

as the insurer was determined not to be a "moneylender". From case law it appears that an entity that is not registered as a banking institution or credit provider will have difficulty in proving it is a "moneylender" (Clegg, 2013). In *Solaglass Finance Company (Pty) Ltd v Commissioner for Inland Revenue* 1991 (2) SA 257 (A), losses incurred by Solaglass on loans granted, were however allowed as a deduction, even though the company was not registered as a banking institution or credit provider and provided loans to group companies.

It has not been tested in our courts whether the business of granting MCAs is a form of moneylending or banking. It is submitted that although not tested in our courts, the business of a MCASP can be argued to be synonymous to that of a "moneylender" due to the fact that the MCASP treats money as floating or circulating capital. It is submitted that there is merit in the argument that although bad debt in respect of the purchase price in a MCA agreement is not deductible in terms of section 11(i), it could still be deductible under section 11(a).

Apart from actual bad debt incurred the MCASP may also have possible doubtful debt in respect of which section 11(j) will be subsequently considered.

3.4.3 Doubtful debt allowance

A MCASP may qualify for a doubtful debt allowance in terms of section 11(j) of the Act in respect of so much of any debts due to the MCASP as the Commissioner considers to be doubtful, if those debts would have been allowed as a deduction under any other provisions of the Act had they become bad. This may be the case if it is doubtful whether the MCASP may be able to collect the purchased amount from the merchant's future sales.

It has been submitted that the MCASP may qualify for a section 11(i) or 11(a) deduction in respect of MCAs that it is unable to collect. Section 11(j) may therefore apply, as the future receivables purchased by the MCASP, which are debts, would be deductible under section 11(i) or 11(a) of the Act if they become bad.

It is the practice of the Commissioner that the allowance is based on a list of doubtful debts (Davis, 2012). It is submitted that the MCASP would be able to provide such a list in relation to MCAs granted for which recovery is doubtful.

3.5 Capital gains tax consequences of MCAs

It was concluded above that the income earned by the MCASP from the MCA transaction is income in nature. The discount and processing fee earned by the MCASP is therefore included in its income in accordance with section 1(a) of the Act.

The conclusion reached with regards to the merchant utilising the product, was that it can deduct from income the discounting fee and the processing fee incurred when the entering into the MCA agreement.

According to the Eighth Schedule to the Act, capital gains tax is levied on the disposal of an asset for proceeds that exceed its base cost. The definition of an "asset" according to the Eighth Schedule is very wide and is defined as "property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum". The MCASP obtains a right to claim payment from the merchant with regards to the future credit or debit card sales made. As discussed in Chapter 2, future rights can be ceded and this right in the future receivable is therefore an incorporeal asset.

Paragraph 11 of the Eighth Schedule defines "disposals" as "any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset…". The cession of the future receivables by the merchant is therefore a disposal of a right.

The "base cost" of an asset is described in paragraph 20(1)(a) to include "the expenditure actually incurred in respect of the cost of acquisition or creation of that asset". The expenditure actually incurred in acquiring the right to claim payment is the amount advanced by the MCASP to the merchant plus any incidental costs, such

as the cost of drawing up the agreement. The base cost of the future receivables sold in the hands of the merchant is therefore the value of the credit or debit card sales.

From the above it is clear that a disposal of an asset has occurred when a merchant sells its future receivables to a MCASP when entering into a MCA agreement. The MCA agreement, in particular the element of the transaction that relates to the sale of the future receivables, may therefore have capital gains tax implications for the merchant. These potential capital gains tax consequences will now be investigated.

3.5.1 Capital gains tax consequences for the merchant

In principle, the sale of the future receivables by the merchant to the MCASP is a disposal of an asset upon which a capital gain, or in the case of MCA agreements, a capital loss, may be incurred. The Eighth Schedule applies to both capital assets and trading stock as the definition is very wide. It has however been concluded that the merchant will be able to deduct from income the expenditure incurred when entering into a MCA as it was entered into in order to obtain working capital for the business and there is therefore sufficient closeness of connection between the expenditure and the income-earning operations.

According to paragraph 20(3)(a) of the Eighth Schedule, the expenditure incurred by a person in respect of an asset must be reduced by any amount which was allowed as a deduction in determining the taxable income of that person. It is therefore submitted that the discount incurred by the merchant when obtaining a MCA will therefore be disregarded for capital gains tax purposes, as it has been allowed as a deduction from income.

If for example, a merchant sells future receivables with a base cost of 100,000 (i.e. the value of future sales will be 100,000) for 70,000, the MCASP will include the 30,000 discount in income in accordance with section 24J. The merchant will deduct the 30,000 discount from income and therefore in accordance with paragraph 20(3) of the Eighth Schedule, the discount incurred is excluded from the base cost of the

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future receivables. No capital gain or loss is therefore incurred by the merchant, as the proceeds and base cost of the asset sold is 70,000.

3.6 Conclusion

From an income tax perspective it is submitted that the MCA is a specialised form of debt factoring. The normal taxation implications will be similar to traditional debt factoring in that the party advancing the funds or purchasing the future receivables will treat as income any profit made when entering into the transaction. The party obtaining the advance can deduct from income the expenditure incurred, as the objective of the transaction is to obtain working capital.

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CHAPTER 4: VALUE-ADDED TAX CONSEQUENCES OF MCAS

4.1 Background

Apart from income tax consequences (as discussed in Chapter 3), a MCA may also have potential VAT consequences, which will be the subject of this chapter.

Regardless of the definitions contained in the VAT Act, a person will however only be liable for VAT if required to register in terms of section 23 of VAT Act. According to this section, every person who, at the end of any month, where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month, in the course of carrying on all enterprises, has exceeded R1 million or at the commencement of any month where there are reasonable grounds for believing that the total value of the taxable supplies to be made by that person in the period of 12 months, reckoned from the commencement of the said month, will exceed the abovementioned amount. This chapter assumes that the merchant and the MCASP are liable to register under section 23. The MCA transaction will therefore be deemed to have VAT implications for the purposes of this chapter.

A literature review revealed some guidance regarding the potential VAT treatment of MCAs. SARS issued General written ruling 212: "Discounting/factoring of debts - whether commission or service fee for discounting/factoring of debtors is taxable or exempt". This ruling specifically indicated that the service fee or commission charged by a debt factor on the provision of debt factoring services is an exempt service and therefore not subject to VAT. This ruling was however withdrawn, effective 1 October 2009.

The VAT treatment of MCAs would however depend on whether these transactions are regarded as debt factoring services. In Chapter 2 it was concluded that MCAs are a specialised form of debt factoring and not a loan.

The VAT consequences will now be considered from the perspective of the MCASP and the merchant respectively.

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4.2 VAT consequences of income earned by a MCASP

In terms of section 7 of the VAT Act 89 of 1991, the supply of goods or services by a vendor in the course or furtherance of any enterprise carried on by him, is subject to VAT at the standard rate, unless the supply is specifically exempt or zero-rated.

The mere receipt of money does not give rise to any obligation to account for VAT, unless that receipt represents the consideration for a taxable supply of goods or services. "Consideration" is defined in section 1 of the VAT Act as "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 or 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…". The MCASP would therefore be liable for VAT if there is a supply of services to the merchant when a MCA agreement is concluded. With reference to MCAs it will now be investigated whether it constitutes the supply of a service, and if this is indeed the case, whether this would qualify as a taxable supply or exempt service.

4.2.1 Advance provided to the merchant

The key feature of the MCA agreement is the purchase of the future receivables, which represent the advance provided to the merchant. It must therefore be investigated whether this purchase is the provision of a "service" as contemplated by the VAT Act. The definition of "services" in section 1 of the VAT Act means "anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage…".

In accordance with the MCA agreement, the MCASP agrees to purchase the future receivables of the merchant. For this to be a "service", it must be argued that this involves the MCASP "doing" something. The phrase "anything done or to be done" in the definition of "services" is very broad, and therefore almost all supplies which are not a supply of goods, is a supply of a service.

The initial advance itself would still constitute a “service” as it involves making available an advantage or surrender of a right, i.e. the cash amount advanced. It therefore needs to be established whether (or not) the service in advancing the initial amount could possibly constitute an exempt “financial service”.

On assumption that a service is supplied when a MCA is granted, the definition of “financial services” contained in section 2 of the VAT Act must be considered to determine whether such a supply could possibly be exempt from VAT. Any activity which falls within the ambit of the “financial services” definition will be exempt from VAT in terms of section 12(a) of the Act. Two sub-sections contained in section 2 could affect the classification of the MCA:

Sub-section 1(c) of the definition of “financial services” stipulates that “the issue, allotment, drawing, acceptance, endorsement or *transfer of ownership of a debt security*” is a “financial service”. In section 2.5.2, the cession of book debts was investigated and determined to be a form of transferring ownership in a moveable incorporeal thing, for example a debt. According to Botes and De Wet (2011) debt factoring is merely a form of cession. Existing book debts, i.e. debts which already exist, but are not claimable at the time of the transaction, are ceded by the client to the debt factor when a factoring transaction is concluded. The debt factoring transaction will therefore be classified as a “financial service” provided by the debt factor under sub-section 1(c).

MCA transactions do however relate to future debt, i.e. the debt is not in existence at the time of the transaction. Existing and future book debts may however be ceded. In *First National Bank of SA Ltd v Lynn NO & others* supra at 360B it was confirmed that existing and future book debts may be ceded. It is therefore submitted that the MCA transaction can be classified as the *transfer of ownership of a debt security* according to sub-section 1(c) of the definition of a “financial service”.

According to sub-section 1(f) of this definition, “the provision by any person of credit under an agreement by which money or money’s worth is provided by that person to another person who agrees to pay a sum or sums in the future exceeding in the aggregate the amount of such money or monies worth” is also a “financial service”.

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It can be argued that the merchant does not agree to pay the future amounts to the MCASP from the merchant’s own funds, but that the MCASP will receive money from the settlement of third party receivables. The transaction would therefore fall outside the sub-section 1(f) of the definition. The merchant does however discharge his obligation by ceding the future credit card receipts to the MCASP. This cession can therefore simply be argued as being another method of payment. Furthermore, the definition of “consideration” includes any payment made in money or otherwise, such as a cession, in this case. It is therefore also submitted that the MCA transaction can be classified as a “financial service” according to sub-section 1(f).

Based on the definition of a “financial service” contained in sub-sections 1(c) and 1(f), it is submitted that the provision of an advance made under a MCA is a “financial service” as defined. Next, the income earned by the provision of the advance by the MCASP, that is the processing fees and discount earned, will be considered.

4.2.2 Processing fee

In Chapter 3 the income tax consequences of the processing fee charged by the MCASP were investigated. This fee is charged for the preparation and completion of documents, the change associated with the banking infrastructure setup (The North American Merchant Advance Association (NAMAA), 2009), for a site visit if the value of the advance is above a certain amount (SBA Business Funding Inc., 2012) and the collecting of amounts due (First Data, 2012).

It is submitted that the processing fees charged by the MCASP would constitute the supply of services by the MCASP (if a VAT vendor) in the course or furtherance of its enterprise carried on by him, and is therefore subject to VAT at the standard rate. No exemptions apply. This is due to the fact that in accordance with the definition of “financial services” contained in section 2 of the VAT Act, to the extent that the consideration payable represents any fee, commission, merchant's discount or similar charge, excluding any discounting cost, the transfer of a debt security shall not be deemed to be a VAT exempt “financial service”. The processing fee is therefore expressly excluded from the definition of “financial services”, and is a

taxable supply for which the MCASP would have to issue a VAT invoice and the MCASP would therefore account for output VAT.

4.2.3 Discount

The cedent (the merchant) of a debt security incurs discounting cost in order to receive payment for existing or future debts by third parties, from the cessionary (the MCASP). Botes and De Wet (2011) suggest that the discount earned by a debt factor may be viewed as nothing more than a profit made on the purchase of receivables and not the rendering of a “service” as defined in the VAT Act to either the merchant or their future customers. As support for this view, the judgement in *Commissioner for South African Revenue Services v Cape Consumers (Pty) Ltd* 1999 (4) SA 1213 (C) can be applied to MCAs, which related to settlement discounts granted by suppliers of goods to Cape Consumers (a mutual buying organisation established for the benefit of its own clients). In this case the court had to determine whether settlement discounts granted by suppliers of goods to Cape Consumers were received as a result of the supply of goods or services by Cape Consumers. The court held that the factual position was that buyers agreed to pay to Cape Consumers the full purchase price and that the “so-called” discount merely represented the difference between the full cash price and the price which applied between Cape Consumers and the suppliers. The suppliers did not pay Cape Consumers any money, while Cape Consumers retained the excess of the price paid by the buyers to Cape Consumers over the amount payable by Cape Consumers to suppliers. The court held that this amount, the discount, constituted no more than a reduced purchase price gained as a result of prompt payment. The court concluded that nothing was done by Cape Consumers other than to pay the agreed amount to the suppliers. Such an arrangement was determined not to fall within the definition of “services” as defined in the Act and therefore did not attract VAT.

When applying these principles to the MCA agreement, it can therefore be argued that the additional amount which accrues to the MCASP as a result of retaining the difference between the purchase price of the future receivables and the face value of the receivables (the “discount”), is no more than a profit made on the purchase of

such receivables and not a "service" rendered to either the merchants or their customers.

If it is however accepted that the discount earned is a "service" as defined, discounting costs, in terms of section 2(1) of the VAT Act, are expressly excluded from charges that are consideration for taxable supplies: "…Provided that the activities contemplated in paragraphs (a), (b), (c), (d) and (f) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost." Discounting cost is therefore expressly excluded from the charges which are not consideration for financial services (in other words, discounting cost is excluded from the charges which are consideration for taxable supplies) and is therefore an exempt supply.

Section 2(1) does however stipulate that the charges will only be excluded (or included in the case of discounting costs) when referring to the activities listed in section 2(1). Botes and De Wet (2011) are further of the view that the "service" rendered by a factoring company when discounting book debts, is not a "financial service" in terms of section 2, as the service does not fall under any of the activities listed as "financial services". The transfer of the ownership of the debt security by the transferor, the merchant, to the transferee, the MCASP, is covered by section 2(1)(c). The consideration for this transfer of debt is the gross amount paid by the transferee or MCASP, for the debt, the purchased amount of debt. The MCASP would only pay the purchase price for the debt, the difference representing the discounting cost. This fee is not consideration for a supply contemplated in section 2(1)(c). Using this rationale, discounting costs may therefore be considered to be a taxable supply.

Based on the discussion above, the MCA agreement can be considered a "financial service" and accordingly any consideration which is received by the MCASP for such service would be exempt from VAT. Even if the rationale is applied that the service rendered by a factoring company or MCASP when discounting book debts, is not a "financial service" in terms of section 2, as the service does not fall under any of the activities listed as "financial services", applying the principles laid down in *Commissioner for South African Revenue Services v Cape Consumers (Pty) Ltd*

1999 (4) SA 1213 (C), it can be argued that the earning of a discount by the MCASP is not a "service" and therefore still not a taxable supply.

It is therefore submitted that, based on this analysis, there is no supply of services which would attract output VAT and therefore the amount of the discount which accrues to the MCASP is not taxable. The MCASP would therefore not account for output VAT nor would it be entitled or obliged to issue a tax invoice to the merchants with regards to the discounting fee charged.

4.3 VAT consequences of expenditure incurred by MCASP

4.3.1 Purchase price of future receivables

Based on discussions submitted under 4.2.1, the provision of the MCA by a MCASP is an exempt "financial service". The MCASP will therefore not be entitled to an input tax claim in relation to the purchase price of the receivables.

4.3.2 Bad debt expenditure and doubtful debt allowance

When a MCA transaction is concluded, the MCASP pays the purchase price for the purchased amount or face value of the future receivables. The MCASP may subsequently be unable to recover or collect the future receivables and may incur a write-off with regards to this amount or a portion thereof. It should therefore be determined whether (or not) the MCASP may claim input tax in accordance with section 22 of the VAT Act.

Section 22(1A) applies where a vendor has made a taxable supply for consideration in money, has furnished a return in respect of the tax period for which the output tax on the supply was payable and has transferred the accounts receivable relating to such taxable supply at face value to another vendor on a non-recourse basis. Section 22(1A) stipulates that if any amount of the face value (excluding any amount of finance charges or collection costs) of such accounts receivable has been written off as irrecoverable by the recipient vendor, the recipient vendor may make an input tax

deduction in terms of section 16(3) of an amount equal to the tax fraction of such face value (limited to the amount paid by the recipient in respect of such face value) written off by him.

It is submitted that the MCASP will not be entitled to an input tax claim under section 22(1A). Although MCA transactions are concluded on a non-recourse basis, when the MCA transaction is concluded the merchant would not have made a taxable supply or furnished a return in respect of the tax period for which the output tax on the supply was payable. The MCA transaction is based on future receivables, i.e. the sales which must still take place which will give rise to the receivables. Section 22(1A) specifically requires that the merchant must have made a taxable supply and furnished a return in respect thereof to enable the recipient vendor to utilise section 22(1A). The vendor will only make taxable supplies (and furnish returns in respect thereof) after the MCA agreement is concluded and transfer of the related receivable has taken place. The MCASP may therefore not claim input VAT on the eventual write-off in terms of section 22(1A) and this will also affect deductions for income tax purposes.

In Chapter 3 it was submitted that the MCASP would be able to deduct from income those debts written off as irrecoverable in accordance with section 11(a). Section 23C of the Income Tax Act stipulates that if the taxpayer is a vendor as defined in section 1 of the VAT Act and was entitled to a deduction of input tax in relation to the expenditure in question, the amount of such input tax shall be excluded from the expenditure incurred. As the MCASP would not be entitled to an input tax claim, it is therefore submitted that the MCASP would be able to include the VAT portion of the receivables written off (or partially written off) in the section 11(a) claim from income as this portion would represent expenditure actually incurred.

Section 22(1A) of the VAT Act further stipulates that if the recipient vendor recovers any amount with regards to the debt written off, the amount recovered shall be deemed to be a taxable supply in the same ratio as the amount of the irrecoverable debt recovered bears to the debt written off. As the MCASP cannot claim input tax in terms of section 22(1A), if the MCASP therefore recovers any amount with regards to the debt written off, the amount recovered shall be deemed to be income.

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4.4 VAT consequences of income earned by the merchant

In Chapter 3 it was argued that the sales made by the merchant are not affected by the MCA agreement and that the merchant is still liable for normal taxation on the income earned.

VAT is levied on the supply of goods or services by a vendor in the course or furtherance of any enterprise carried on by him. The sale of goods or services by the vendor will be in the course or furtherance of its enterprise and will therefore be subject to VAT at the standard rate. It is submitted that the VAT position of the merchant is not affected by entering into a MCA agreement with regards to sales made or services rendered. The merchant would still be liable to levy output tax in relation to these sales or services rendered.

4.5 VAT consequences of expenditure incurred by the merchant

4.5.1 Processing fee

The processing fees charged by the MCASP would constitute the supply of services by a vendor in the course or furtherance of its enterprise carried, and is therefore subject to VAT at the standard rate. As VAT will be levied on the processing fee in terms of section 7 of the VAT Act, the merchant will be entitled to claim input tax in relation the processing fees incurred.

4.5.2 Discount

The MCASP does not provide a taxable supply in rendering the service in terms of a MCA, or alternatively the provision of the MCA is an exempt supply as it is a “financial service” as defined. It therefore follows that the discount incurred by the merchant in partaking in a MCA transaction would not constitute “input tax” as defined in section 1 of the VAT Act. The merchant would therefore not be entitled to an input tax credit for the amount of the “discount” arising from the transfer of the future receivables to the MCASP.

4.6 Conclusion

The VAT consequences of the MCA agreement largely reflect similar consequences than traditional debt factoring. The implications for the MCASP and the merchant can best be summarised with the following example:

Details of transactions:

- A merchant enters into a MCA transaction with a MCASP for an advance of 100,000.
- In accordance with the agreement the MCASP can collect 5% of the daily credit and debit card sales of the merchant until it has collected 130,000.
- Discounting costs of the transaction is therefore 30,000 (the difference between 130,000 and 100,000).
- A processing fee of 1,000 (excluding VAT) is charged by the MCASP for the cost of processing, preparation and completion of documents.
- The merchant performs daily sales of 600,000 (including VAT).
- The MCASP only manages to collect 30,000 (600,000 x 5%) from the future credit and debit card sales of the merchant before it is liquidated.
- The MCASP therefore incurs a bad debt write-off of 100,000.
- The MCASP recovers 10,000 from the liquidator of the merchant as final payment of the merchant's debt.
- Assume a VAT rate of 14%.

VAT consequences:

- Output tax is accounted for by the merchant on sales made of 600,000, including VAT: 600,000 x 14/114 = R73,684.
- No output tax is accounted for by the merchant on the cession of the future receivables to the MCASP.
- No output tax is levied by MCASP with regards to the 30,000 discount charged, as this is represents an exempt supply.
- Output tax of 140 levied by the MCASP on the processing fee of 1,000 is charged, as this is a supply in the course or furtherance of its enterprise.

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The merchant may subsequently claim an input tax credit for the corresponding output tax levied by the MCASP.

- No output tax is levied by the MCASP on the receipt of the 30,000 collected. The amount is not received in respect of a taxable supply made by the MCASP, as the MCA can be considered to be a "financial service" and accordingly any consideration which is received by the MCASP for such service would be exempt from VAT.
- The MCASP paid 100,000 (the purchase price) for future receivables of 130,000 (purchased amount or face value). Only 30,000 was collected by the MCASP that consequently incurs a bad debt write-off of 100,000. The MCASP will not be able to claim input tax in accordance with section 22(1A).
- The MCASP recovers 10,000 of the 100,000 written off. The MCASP would not have levied any output tax on the initial recognition of the debt written off (the initial advance granted to the merchant), therefore would not be entitled to an input tax claim in accordance with section 22(1A).

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CHAPTER 5: CONCLUSION AND RECOMMENDATION

5.1 Conclusion

The examination of the classification of the MCA agreement revealed that this transaction is a specialised from of debt factoring as opposed to a loan agreement (despite the accounting treatment of MCA resembling that of a loan). In common with debt factoring, the MCA agreement is a mechanism to access funding. The key difference between debt factoring and MCA agreements is that the subject of debt factoring is current or existing debt, whereas the MCA agreement refers to receivables that must still come into existence. On further investigation it was established, under 2.5.2, that such a future rights can be ceded.

Based on an investigation of the income tax consequences it was determined that the merchant receiving the advance will be still be liable for income tax on the sales made that generate the future receivables that are the subject of the cession. Merchants are however able to deduct the discounting cost from their income. The MCASP will be liable for income tax on the discount earned and processing fees charged. The MCASP may then be entitled to deduct from income those expenditures actually incurred in producing income from the MCA, specifically bad debt expenditure in the event that the MCASP is unable to collect the purchased percentage of future receivables due to lack of sales by the merchant. The MCASP may also qualify for a section 11(j) doubtful debt allowance. Furthermore, although no interest is explicitly charged in most debt factoring and MCA transactions, the study revealed that section 24J applies to MCAs, as the charging of a discount is implicit to the MCA agreement.

Based on an investigation of the VAT consequences, it was determined that the supply of the MCA by the MCASP is an exempt supply as it is a “financial service”, as defined. The charging of the processing fee for the collection of the future receivable or administration of the agreement is specifically excluded from the definition of “financial services” and is therefore a taxable supply by the MCASP. The discount earned by the MCASP is also an exempt supply. With regards to irrecoverable debt, the MCASP that provides MCAs is at a disadvantage from a cash flow perspective if

compared to traditional debt factoring, as no input tax may be claimed on irrecoverable debt incurred after the transfer of the future receivable to the MCASP. The amount of input tax that cannot be claimed, can however be claimed as a deduction from income, hence the lesser cash flow benefit.

A summary of the taxation consequences is provided in Table 10.

5.2 Recommendation

The study focused only on the South African tax implications of MCAs. Further areas for research could be to investigate the taxation consequences of cross-border MCA agreements with reference to the source rules contained in section 9 of the Act, where either of the parties (MCASP or merchants) are non-residents for taxation purposes.

Furthermore, it was noted during the course of this study that the accounting entries of the MCA from the perspective of the merchant are similar to that of a loan. The transaction may consequently also have possible deferred tax consequences in terms of IAS 12 *Income Taxes*, which may warrant further study.

The conclusion reached in this investigation was that the MCA is a specialised form of debt factoring and not a loan. The NCA was promulgated in 2007 to establish national norms and standards relating to consumer credit. The application of the NCA on MCAs can be investigated.

Recent developments in the MCA industry also include the so-called revenue advance. The product features are essentially the same as for traditional MCAs, but whereas the MCA refers to the purchase of the future receivables generated by the credit and/or debit card sales volume of the merchant, the revenue advance is based on the insurance payments, wire transfers, cheques, cash deposits, credit and/or debit card payments and all other electronic payments received by the merchant. The taxation consequences of revenue advances may also be the subject of investigation in further research.

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Table 10: Summary of taxation consequences of MCA transactions

Component	**MCASP**	**Merchant**
Purchase price of future receivables (excluding processing fee)	Income tax consequence: Expenditure incurred not deductible in terms of section 11(a) as no expenditure or loss incurred VAT consequence: Advance is exempt "financial service"	Income tax consequence: Advance represents selling price of future receivable, not "gross income" as capital in nature. The gross amount of sales is included in "gross income" when sales take place VAT consequence: Advance is exempt "financial service", no VAT invoice received from MCASP
Subsequent bad or doubtful debt in respect of purchase price (excluding processing fee)	Income tax consequence: Bad debt in respect of: • Purchase price (no deduction) • Processing fees (possible 11(i) deduction) • Discount (possible 11(i) deduction) VAT consequence: Input tax claim not possible under section 22(1A). The deductions for income tax purposes would then include the VAT portion in terms of section 23C of the Income Tax Act	Income tax consequence: No consequences for the merchant VAT consequence: No consequences for the merchant

Processing fee	Income tax consequence: "Gross income" as earned from a scheme of profit-making in carrying on of their trade VAT consequence: Taxable supply for VAT purposes (subject to VAT) as specifically excluded from definition of "financial services"	Income tax consequence: Processing fee incidental to the income-producing activities, sufficient closeness of connection between the expenditure and the income-earning operations, section 11(a) deduction possible. VAT consequence: Taxable supply by MCASP, input tax claim possible if requirements of VAT Act are met
Discount	Income tax consequence: Could be classified as interest, therefore need to consider application of section 23J(3). • If MCASP is not a company and the term of the term does not exceed one year: Included in "gross income" on accrual. • If the MCASP is a company, 24J(3) applicable is applicable – yield to maturity amount included in "gross income" VAT consequence: Discount is an exempt "financial service" as defined	Income tax consequence: Discount is incurred with the purpose of obtaining working capital for the business. Could classify as interest, therefore need to consider application of section 23J(2). Yield to maturity determines amount allowed as a deduction from income VAT consequence: Discount is an exempt "financial service" supplied by the MCASP, therefore no input tax claim is possible

Source: Compiled by author based on literature reviewed.

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