

Value-added tax:
A critical analysis of input tax in respect of share issue costs

by

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Research assignment in partial fulfilment of the requirements for the degree
Master of Accounting (Taxation) in the Faculty of Economic and Management Sciences
at Stellenbosch University

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March 2020

DECLARATION

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ABSTRACT

The issue of shares is one of the main sources of finance used to start up or expand a business. Costs are incurred to facilitate the issue of shares in both the listed and private market. Value-added tax (VAT) is levied on the supply of these services when provided by VAT vendors, in terms of the Value-Added Tax Act (No. 89 of 1991) (hereafter referred to as the VAT Act). The South African Revenue Service's (SARS) current policy is that input tax on share issue costs incurred is not deductible based on the judgment in *Income Tax Case No. 1744* (2002) 65 SATC 154 (hereafter referred to as ITC 1744). Through reliance on earlier judgments in the Court of Justice of the European Union (CJEU), it was held in ITC 1744 that the absence of a *direct and immediate link* between share issue costs incurred and the making of taxable supplies precluded the taxpayer from claiming an input tax deduction.

South African authors disagree on whether the *direct and immediate link* test relied on in ITC 1744 should be used to apply the provisions of the VAT Act. Furthermore, South African authors have suggested that there are grounds to argue that the issue of shares does not constitute a "supply" as defined in section 1(1) of the VAT Act. In terms of the New Zealand Goods and Services Tax Act, on which the VAT Act was modelled, the New Zealand Inland Revenue Department argued that input tax on share issue costs should be deductible to satisfy the broad taxation principles of neutrality, effectiveness and fairness. Despite international developments, SARS has not clarified its policy on the treatment of input tax on share issue costs incurred since ITC 1744 was heard in 2002. This research assignment therefore set out to determine whether input tax on share issue costs incurred should be deductible.

A qualitative research approach was followed. Primary and secondary data were collected and analysed in the form of a desktop literature review to determine whether input tax on share issue costs incurred should be deductible. This research assignment found that the use of the *direct and immediate link* test relied on in ITC 1744 may not be appropriate in South Africa, and that only a direct functional link may be required by the phrase "in the course of making taxable supplies" in the input tax definition in section 1(1) of the VAT Act. It was further found that there are grounds to argue that the issue of shares does not constitute a "supply" in terms of section 1(1) of the VAT Act and that share issue costs incurred may accordingly form part of a business' general overhead costs. Lastly, it was found that the current denial of input tax on share issue costs incurred detracts from the

broad taxation principles of neutrality, effectiveness and fairness, which are fundamental to a good VAT system.

The findings of this research assignment therefore suggest that input tax on share issue costs should be deductible.

Key words: Broad taxation principles, direct and immediate link, effectiveness, exempt supply, fairness, input tax, neutrality, shares, share issues costs, supply, taxable supply

OPSOMMING

Die uitreik van aandele is een van die hoofbronne van kapitaal vir die stigting of uitbreiding van 'n besigheid. Koste word aangegaan om die uitreik van aandele te fasiliteer in beide 'n genoteerde en private mark. Belasting op toegevoegde waarde (BTW) word gehef op die lewering van dienste deur geregistreeerde BTW-ondernemers in terme van die Wet op Belasting op Toegevoegde Waarde (hierna verwys na as die Wet op BTW). Die Suid-Afrikaanse Inkomstediens (SAID) se huidige beleid is dat insetbelasting op aandeeluitreikkoste nie aftrekbaar is nie, gebaseer op die beslissing in *Income Tax Case No. 1744* (2002) 65 SATC 154 (hierna verwys na as ITC 1744). Deur te steun op vorige beslissings in die Geregshof van die Europese Unie (GEU), is daar in ITC 1744 bepaal dat die gebrek aan 'n *direkte en onmiddellike skakel* tussen aandeeluitreikkoste aangegaan en die maak van belasbare lewerings 'n ondernemerverhinder om die insetbelasting aangegaan as 'n aftrekking te eis.

Suid-Afrikaanse skrywers verskil oor of die *direkte en onmiddellike skakel*-toets, waarop in ITC 1744 gesteun is, gebruik moet word om die bepalings van die Wet op BTW toe te pas. Verder voer ander Suid-Afrikaanse skrywers aan dat daar gronde is om te argumenteer dat die uitreik van aandele nie 'n "lewering" is soos gedefinieer in artikel 1(1) van die Wet op BTW nie. In terme van die Nieu-Seelandse Belasting op Goedere en Dienste-wet, waarop die Wet op BTW gemodelleer is, voer die Nieu-Seelandse Belastingdienstedepartement aan dat insetbelasting op aandeeluitreikkoste aftrekbaar moet wees ten einde die beginsels van neutraliteit, effektiwiteit, en gelykheid te bevredig. Ten spyte van internasionale ontwikkelinge op die gebied, het die SAID nog geen leiding of duidelikheid verskaf oor die huidige beleid sedert ITC 1744 in 2002 aangehoor was nie. Hierdie navorsingstuk het dus ten doel gestel om te bepaal of insetbelasting op aandeeluitreikkoste aftrekbaar moet wees.

'n Kwalitatiewe navorsingsbenadering is gevolg. Primêre en sekondêre data is ingesamel en ontleed in die vorm van 'n lessenaar-literatuurstudie om te bepaal of insetbelasting op aandeeluitreikkoste aftrekbaar moet wees. Die studie het bevind dat die gebruik van die *direkte en onmiddellike skakel*-toets soos vasgestel in ITC 1744 dalk nie toepaslik mag wees in die Suid-Afrikaanse konteks nie, en dat slegs 'n direkte funksionele skakel vereis word deur die frase "in die loop van die maak van belasbare lewerings" in die definisie van insetbelasting in artikel 1(1) van die Wet op BTW. Dit is verder bevind dat daar gronde is om aan te voer dat die uitreik van aandele nie 'n "lewering" is in terme van artikel 1(1) van

die Wet op BTW nie en dat aandeeluitreikkostes gevolglik deel mag vorm van algemene oorhoofse kostes van 'n besigheid. Laastens is bevind dat die huidige praktyk om nie insetbelasting op aandeeluitreikkostes as 'n aftrekking toe te staan nie, afbreuk doen aan die belastingbeginsels van neutraliteit, effektiwiteit, en gelykheid, wat fundamenteel is tot 'n goeie BTW-stelsel.

Die bevindinge van hierdie navorsingstuk dui daarop dat insetbelasting op aandeeluitreikkostes aftrekbaar moet wees.

Sleutelwoorde: Aandeeluitreikkostes, aandele, belastingbeginsels, belasbare lewering, direkte en onmiddellike skakel, effektiwiteit, gelykheid, insetbelasting, lewering, neutraliteit, vrygestelde lewering

ACKNOWLEDGEMENTS

I would like to thank my study leader, Andrea Herron, for her calm guidance, dedicated involvement, and invaluable insight throughout this research assignment. I also wish to thank my family, friends, and colleagues for their interest in my studies and their words of encouragement.

A special thank you to my husband, Hannes Beukes; I would not have been able to complete this degree without his support, sacrifices, and patience.

I am also grateful for the learned judges, academics, and other tax enthusiasts from whose work and words I have gained inspiration for this research assignment. I was motivated throughout by the words of Corbett JA in *CIR v Nemojin (Pty) Ltd* 45 SATC 241, at 267:

It has been said that ‘there is no equity about a tax’. While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and the point of view of the fiscus.

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LIST OF ABBREVIATIONS AND TERMINOLOGY

ABBREVIATION	DESCRIPTION
CJEU	Court of Justice of the European Union
DBCM	De Beers Consolidated Mines
EU	European Union
GST	Goods and Services Tax [New Zealand]
IR	Inland Revenue [New Zealand]
ITC	Income Tax Case
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SATC	South African Tax Cases
SCA	Supreme Court of Appeal
UK	United Kingdom
VAT	Value-added tax
VATCOM	Value-Added Tax Committee

TERM	DESCRIPTION
Enterprise	In the case of any vendor, any enterprise, or activity that is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit
Exempt supply	A supply that is exempt from tax under section 12 of the Value-Added Tax Act (No. 89 of 1991)
First Directive	First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of member states concerning turnover taxes
HM Revenue & Customs	Her Majesty's Revenue and Customs in the United Kingdom
Input tax	The tax charged in terms of section 7 of the Value-Added Tax Act and payable by a vendor on goods or services acquired wholly for the purpose of consumption, use, or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent that the goods or services concerned are acquired by the vendor for such purpose
Legal and Policy Division	The South African Revenue Service's Legal and Policy Division

Memorandum of Co-operation	Memorandum of Co-operation signed by the Organisation for Economic Co-operation and Development, National Treasury, and SARS on 11 January 2019
New Zealand GST Act	The New Zealand Goods and Services Tax Act of 1985
Sixth Directive	European Community's Sixth Council Directive 77/338/EEC of 1977-05-12 on the harmonisation of the laws of the member states relating to turnover tax
Supply	Includes performance in terms of a sale, rental agreement, instalment credit agreement, and all other forms of supply, whether voluntary, compulsory, or by operation of law, irrespective of where the supply is effected, and any derivative of "supply" shall be construed accordingly
Taxable supply	Any supply of goods or services that is chargeable with tax under the provisions of section 7(1)(a) of the VAT Act, including tax chargeable at the rate of 0% under section 11
VATCOM	Value-Added Tax Committee appointed by the Minister of Finance to consider the comments and representations made on the South African government's Draft Value-Added Tax Bill published on 18 June 1990
VAT Act	Value-Added Tax Act (No. 89 of 1991)
VAT Directive	VAT Directive of the European Union (Council Directive 2006/112/EC), which replaced the Sixth Directive
Vendor	Any person who is or is required to be registered under the VAT Act

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CHAPTER 1:

INTRODUCTION

1.1 BACKGROUND

The issue of shares is one of the main sources of finance used to start up or expand a business (Correia, 2015:13.19). Costs are incurred to facilitate the issue of shares in both the listed and private markets and include legal and accounting fees, listing fees, and costs associated with preparing a product disclosure statement (Correia, 2015:13.19). Value-added tax (VAT) is levied on the supply of these services when provided by VAT vendors (section 7(1)(a) of the Value-Added Tax Act, No. 89 of 1991 [hereafter referred to as the VAT Act]). The South African Revenue Service's (SARS) current policy is that input tax on share issue costs incurred is not deductible in South Africa (Badenhorst, Vogelmann & Fakir, 2010).

Input tax may be deducted when VAT is incurred on goods or services acquired by a vendor, to the extent that the goods or services are used for the purpose of consumption, use, or supply in the course of making taxable supplies (definition of input tax in section 1(1) of the VAT Act). Financial services are included in section 12(a) of the VAT Act as exempt supplies and include, *inter alia*, the issue, allotment, and transfer of shares (definition of financial services in section 2(1) of the VAT Act). Input tax on costs incurred in the course of making exempt supplies is not deductible in terms of the definition of input tax in section 1(1) of the VAT Act. Where taxpayers who principally make taxable supplies issue shares to raise capital, Silver (2009) argued that input tax on the share issue costs incurred should be deductible, since the capital raised will be employed to further the taxpayer's enterprise.

SARS's current policy is, however, to deny taxpayers an input tax deduction on share issue costs incurred (Badenhorst *et al.*, 2010). This is largely based on the interpretation of the definition of input tax from the judgment in *Income Tax Case No. 1744* (2002) 65 SATC 154 (hereafter referred to as ITC 1744). It was held that a vendor is not allowed to deduct input tax on share issue costs, even where such costs are incurred to raise capital to expand its business of making taxable supplies (ITC 1744, at 155). The court relied on the principles established in the Court of Justice of the European Union (CJEU) in *BLP Group PLC v Customs and Excise Commissioners* CJEC C-4-94 1995 (hereafter referred to as the BLP Group case) where it was held, at 19, that a *direct and immediate link* should exist between costs incurred and the making of taxable supplies for input tax to be deductible. Consequently, the court concluded in ITC 1744 (*supra*), at 155, that the absence of a *direct*

and immediate link between the share issue costs incurred and the making of taxable supplies precluded the taxpayer from claiming an input tax deduction in respect of the share issue costs.

ITC 1744 (*supra*) was only heard in the Tax Court. A decision of the Tax Court is only binding on the parties to the specific case (Stiglingh, Koekemoer, Van Heerden, Wilcocks, De Swart & Van der Zwan, 2019:19). Van der Zwan and Stiglingh (2011:320) submitted that although ITC 1744 (*supra*) is not binding on SARS, the outcome is favourable to SARS and is currently the only case law that provides guidance on the treatment of input tax on share issue costs.

South African authors, however, disagree on whether the *direct and immediate link* test relied on in ITC 1744 (*supra*) should be applied to determine whether an expense is incurred in the course of making taxable supplies as per the definition of input tax in section 1(1) of the VAT Act. Van der Zwan and Stiglingh (2011:337) submitted that the use of the *direct and immediate link* test when applying the provisions of the VAT Act is appropriate, due to the similarities between the words used in the input tax definition in South Africa and Europe, where the *direct and immediate link* test is used. Other authors disagree by stating that the phrase “in the course of making taxable supplies”, as included in the definition of input tax in section 1(1) of the VAT Act, only indicates that “some relationship” should exist (Badenhorst *et al.*, 2010; Holdstock, 2013; Botes, 2018).

Although the principles of the *direct and immediate link* test relied on in ITC 1744 (*supra*) was taken from the judgment in the BLP Group case (*supra*), the BLP Group case (*supra*) centred around the disposal rather than the issue of shares. Subsequent to ITC 1744 (*supra*), other cases in the CJEU that dealt specifically with the VAT treatment of costs incurred to issue shares resulted in the CJEU allowing input tax deductions on share issue costs (HM Revenue & Customs, 2016b).

Kretztechnik AG v Finanzamt Linz 2005 ECJ C-465/03 (hereafter referred to as the Kretztechnik case) was the first CJEU case since ITC 1744 (*supra*) that dealt with the issue of shares. It was held that the issue of shares does not constitute a supply since no existing rights or portions of the business’ property are transferred to the new shareholders, and no service is therefore supplied (Kretztechnik case, at 28). It was further held that the costs incurred to issue shares are therefore considered to be part of the general overhead costs of the business, and that input tax thereon is deductible to the extent that the business as a whole makes taxable supplies (Kretztechnik case, at 36). The judgment in the Kretztechnik case (*supra*) was a departure from the earlier treatment of a share issue as an exempt

supply in *Trinity Mirror plc (formerly Mirror Group Newspapers Ltd) v Customs and Excise Commissioner* [2001] STC 192 (Ct. App. 2001) (UK) (hereafter referred to as the Trinity Mirror case), which was considered the preferred treatment of the issue of shares by European Union (EU) member states at the time (Trinity Mirror case, at 54).

Whether the issue of shares constitutes a supply was not disputed in ITC 1744 (*supra*). The court considered it common cause that the issue of shares constitutes a financial service under section 2(1) of the VAT Act, and that financial services are exempt from VAT under section 12(a) of the VAT Act (ITC 1744, at 156). Van der Zwan and Stiglingh (2011:335) submitted, however, that the words in sections 2(1) and 12(a) of the VAT Act do not explicitly deem the issue of shares to be a supply and that “grounds exist to contend that a share issue is not a supply in the South African context”, similar to the CJEU’s conclusion in the Kretztechnik case (*supra*). In the absence of a specific supply to which costs incurred can be linked, the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:58) issued by SARS stated that input tax is deductible to the extent that the business as a whole makes taxable supplies. This treatment would be a departure from the judgment in ITC 1744 (*supra*).

The New Zealand Goods and Services Tax Act of 1985 (hereafter referred to as the New Zealand GST Act) included a policy amendment in 2017 that endorsed the judgment in the Kretztechnik case (*supra*) (Trombitas, 2015). Effective 1 April 2017, section 20H of the New Zealand GST Act specifically allows an input tax deduction on share issue costs incurred to raise capital by businesses that principally make taxable supplies (New Zealand Inland Revenue [IR], 2016:6). The key objective of the amendment was to align the New Zealand IR’s policy on the deductibility of input tax on share issue costs with the Organisation for Economic Co-operation and Development’s (OECD) broad taxation principles of neutrality, effectiveness and fairness (New Zealand IR, 2016:4). In its review of the policy amendment, the New Zealand IR argued that the denial of input tax on share issue costs for businesses that principally make taxable supplies results in tax cascades, where a business “absorbs the GST cost or passes the cost on to its consumers” (New Zealand IR, 2016:4). According to the New Zealand IR (2016:4), this negates the principles of neutrality, effectiveness and fairness.

The VAT Act was modelled on the New Zealand GST Act and adjusted for differences in South African socio-economic conditions (Value-Added Tax Committee [VATCOM], 1991). VATCOM (1991) considered it necessary to evaluate the new South African VAT system against the broad taxation principles when VAT was introduced in 1991. For this reason, the

subsequent inclusion of a specific deduction for input tax on share issue costs incurred in the New Zealand GST Act, to satisfy the broad taxation principles, is considered relevant to this research assignment. To assess whether similar arguments to those followed by the New Zealand IR (2016:4) with the inclusion of section 20H may be plausible in the South African context, it is important to consider whether the arguments put forth in New Zealand were decided under comparable VAT legislation (*Income Tax Case No. 1853* (2011) 73 SATC 293 [hereafter referred to as ITC 1853], at 307). A comparative analysis of the requirements of the VAT Act and the New Zealand GST Act is therefore required to assess whether the arguments followed by the New Zealand IR could be plausible in the South African context.

As described above, the treatment of input tax on share issue costs has changed in both the CJEU and the New Zealand GST Act subsequent to the judgment in ITC 1744 (*supra*) in 2002. In both the CJEU and the New Zealand GST Act, the change resulted in the allowance of an input tax deduction on share issue costs for businesses that make taxable supplies. In the EU, the CJEU held in 2005 that the issue of shares does not constitute a supply and that share issue costs may be regarded as part of the general overhead costs of a business (Kretztechnik case, at 36). In New Zealand, tax policy was amended in 2017 to align the treatment of input tax on share issue costs incurred with the broad taxation principles of neutrality, effectiveness and fairness (New Zealand IR, 2016:4). The leading guidance in South Africa is still ITC 1744 (*supra*), where the taxpayer was denied an input tax deduction on share issue costs incurred based on the contention that the share issue costs incurred were “directly and immediately” linked to the issue of shares, which constitute an exempt supply. Since ITC 1744 (*supra*) was only heard in the Tax Court, it is not binding on SARS, the High Court, or the Supreme Court of Appeal (SCA) (Stiglingh *et al.*, 2019:19).

Despite international developments on the matter, SARS has not issued guidance or clarified its policy on the treatment of input tax on share issue costs incurred since ITC 1744 (*supra*) was heard in 2002.

1.2 PROBLEM STATEMENT

The main research question identified was whether input tax on share issue costs incurred should be deductible in South Africa. In addressing the main research question, the following secondary research questions were posed:

- 1) Does the phrase “in the course of making taxable supplies” in the definition of input tax in section 1(1) of the VAT Act include the requirement of a *direct and immediate*

link between share issue costs incurred and the making of taxable supplies, as established in ITC 1744 (*supra*)?

- 2) Does the issue of shares constitute a supply?
- 3) Does the current treatment of input tax on share issue costs in South Africa satisfy the OECD's broad taxation principles of neutrality, effectiveness and fairness?

1.3 RESEARCH OBJECTIVES

The overall research objective was to determine whether input tax on share issue costs incurred should be deductible in South Africa. This overall objective was divided into the following specific sub-objectives:

- 1) To critically analyse the meaning of the phrase "in the course of making taxable supplies" as included in the input tax definition to determine whether it means that a *direct and immediate link* should exist between share issue costs incurred and the making of taxable supplies. This was done in order to determine whether the *direct and immediate link* test relied on in ITC 1744 (*supra*), a Tax Court case, should be used to apply the provisions of the VAT Act to determine the deductibility of input tax on share issue costs.
- 2) To determine whether the issue of shares constitutes a supply. This was done to establish whether share issue costs incurred in the process of issuing shares may be linked to a specific supply or whether it may otherwise be regarded as general overhead costs of a business.
- 3) To determine whether the current treatment of input tax on share issue costs incurred in South Africa satisfies the OECD's broad taxation principles of neutrality, effectiveness and fairness.

In meeting the objectives above, this research assignment demonstrates that input tax on share issue costs should be deductible, in line with international case law, legislative developments, and the OECD's broad taxation principles of neutrality, effectiveness and fairness.

1.4 RESEARCH RATIONALE

Share issue costs incurred by businesses to raise capital may be significant in value (Van der Zwan & Stiglingh, 2011:320). In November 2016, Dis-Chem Pharmacies Limited spent an estimated R149 million in share issue costs to list on the Johannesburg Stock Exchange,

which comprised more than 3% of the capital raised (Tarrant, 2016). The taxpayer in ITC 1744 (*supra*) incurred share issue costs of 20% of the capital raised in a private share placing (ITC 1744, at 156). VAT is levied at 15% on the supply of these services when provided by VAT vendors (section 7(1)(a) of the VAT Act).

The denial of input tax deductions on share issue costs incurred therefore adds an additional 15% to taxpayers' cost to raise capital, which may already comprise 20% of the value of the capital raised, as in ITC 1744 (*supra*). Since the quantum of share issue costs incurred is affected by the deductibility of input tax paid in the process, it may influence how much capital a business decides to raise (Van der Zwan & Stiglingh, 2011:320).

In meeting the research objectives listed above, this research assignment demonstrates that input tax on share issue costs incurred should be deductible, which may benefit businesses that incur significant costs to raise capital through the issue of shares.

1.5 LITERATURE REVIEW

The literature review addresses each of the three secondary research questions through a brief analysis of the relevant academic literature and case law available.

1.5.1 A critical analysis of the phrase “in the course of making taxable supplies” in the context of the *direct and immediate link* test relied on in ITC 1744 (*supra*)

Input tax is deductible where the goods or services concerned are acquired by the vendor wholly for the purposes of consumption, use, or supply in the course of making taxable supplies (input tax definition in section 1(1) of the VAT Act). Where the goods and services are required by the vendor partly for such purpose, input tax is deductible to the extent that the goods or services are acquired by the vendor for such purpose (section 17 of the VAT Act). A taxable supply is defined in section 1(1) of the VAT Act to mean the supply of goods or services that is chargeable with tax imposed in terms of section 7(1)(a) of the VAT Act. Section 7(1)(a) of the VAT Act refers to the supply by a vendor of goods or services in the course or furtherance of any enterprise carried on. The VAT Act includes definitions for “goods”, “services”, “supply”, and “enterprise”, but does not define what the phrase “in the course of making taxable supplies” means.

Marais (2014:36) contended that the phrase “in the course of making taxable supplies” means that to be able to claim an input tax deduction, a link should exist between the expense incurred and the making of taxable supplies. In ITC 1744 (*supra*), at 157, the court

considered the closeness of the link required by the phrase “in the course of making taxable supplies” to decide whether a taxpayer could deduct input tax on share issue costs incurred in a share placing to expand its business of manufacturing steel shipping containers. It was held that “where goods or services are used for an exempt supply, it is not legitimate for the taxpayer to look through that supply to an ultimate purpose of carrying out taxable supplies” (ITC 1744, at 155). The court relied on the BLP Group case (*supra*) heard in the CJEU, where it was held that a *direct and immediate link* should exist between the costs incurred and the making of taxable supplies. The court concluded that the input tax on the share issue costs incurred is not deductible, since the share issue costs incurred had a direct link to the exempt supply of shares issued, and not to the manufacturing of shipping containers, which constituted the making of taxable supplies (ITC 1744, at 158).

South African authors disagree on whether the *direct and immediate link* test was applied in *Commissioner for South African Revenue Service v De Beers* ([2012] 3 All SA 367 (SCA)) 74 SATC 330 (hereafter referred to as the De Beers case), heard in the SCA (Marais, 2014:39; Ger & McCready, 2012). The case dealt with whether services acquired by De Beers Consolidated Mines (DBCM) were acquired for the purpose of making taxable supplies in the course or furtherance of the DBCM's enterprise (De Beers, at 341). While Marais (2014:39) contended that the *direct and immediate link* test was used in the De Beers case (*supra*), Ger and McCready (2012) expressed caution that the judgment in the De Beers case “should not be applied too widely” due to the unique set of facts it was based on.

Should the De Beers judgment not be interpreted to provide guidance on how close a link is required by the phrase “in the course of making taxable supplies”, the leading guidance on the matter in South Africa would be ITC 1744 (*supra*). Since ITC 1744 (*supra*) was only heard in the Tax Court, South African authors disagree on whether the *direct and immediate link* test should be used to apply the provisions of section 1(1) of the VAT Act (Badenhorst *et al.*, 2010; Van der Zwan & Stiglingh, 2011:337; Holdstock, 2013; Marais, 2014:37; Botes, 2018). Should the application of section 1(1) of the VAT Act only require that “some link” exists, grounds may exist for taxpayers to challenge SARS's current policy established in ITC 1744 (*supra*).

1.5.2 The issue of shares as considered against the definition of “supply” in section 1(1) of the Value-Added Tax (VAT) Act

The existence of a supply of goods or services is paramount to an activity or act being exempt from VAT. Section 12 of the VAT Act exempts transactions that would have been subject to the tax imposed in terms of section 7(1)(a) of the VAT Act, had it not been for the application of section 12 of the VAT Act (Van der Zwan & Stiglingh, 2011:331).

Section 7(1)(a) of the VAT Act states that VAT should be levied, *inter alia*, on the *supply* by a vendor of goods or services in the course or furtherance of any enterprise. To establish whether a supply exists is therefore the starting point for assessing whether input tax on costs incurred in the course of such an activity or act is deductible. The term “supply” is defined in section 1(1) of the VAT Act to include a performance in terms of a sale, rental agreement, instalment credit agreement, and *all other forms of supply*, whether voluntary, compulsory, or by operation of law, irrespective of where the supply is effected.

To assess whether the issue of shares constitutes a supply, it is necessary to firstly consider whether the wording in the VAT Act explicitly deems it a supply (Van der Zwan & Stiglingh, 2011:334). The supply of financial services as defined in section 2(1) of the VAT Act is included in section 12(a) of the VAT Act as an exempt supply. The wording in section 12 of the VAT Act refers to “the supply of *any of the following goods or services* shall be exempt from the tax imposed” (own emphasis). Van der Zwan and Stiglingh (2011:334) submitted that this exemption provision “only applies when a supply has been made and does not deem the issue of shares to be a supply”.

The wording of section 2(1) of the VAT Act states that “the following *activities* shall be deemed to be financial services” (own emphasis) and proceeds to list, *inter alia*, the issue, allotment, or transfer of ownership of an equity security. Van der Zwan and Stiglingh (2011:334) stated that there are opposing arguments on whether the wording of section 2(1) specifically deems all activities listed as supplies. On the one hand, it could be argued that section 2(1) merely determines the activities that constitute financial services and does not deem all financial services to be supplies (Van der Zwan & Stiglingh, 2011:334). On the other hand, it could be argued that the issue of shares would not be included in the definition of a financial service if the legislature intended for the issue of shares to not constitute a supply (Van der Zwan & Stiglingh, 2011:334).

South African courts have also considered the definition of a supply in circumstances other than the issue of shares. It was held in *Shell’s Annandale Farm (Pty) Ltd v CSARS* 62 SATC

97 (hereafter referred to as the Shell's Annandale case), at 106, that a supply only takes place in the form of an act or action by a supplier. This statement was further explored in *National Educare Forum v CSARS* 64 SATC 289 (hereafter referred to as the National Educare case), at 308, where the court found that the act referred to in the Shell's Annandale case (*supra*) meant that something was provided or delivered by the taxpayer. The argument in the Shell's Annandale case (*supra*) was challenged in *Income Tax Case No. 1874* (2014) 77 SATC 106 (hereafter referred to as ITC 1874), where the court held at 108 that "supply" can also include passive supplies where no act or action is performed. Since ITC 1874 (*supra*) was heard in the Zimbabwean Fiscal Appeal Court, the decision merely has persuasive value and is not binding on South African courts.

The interpretation of the definition of "supply" in the Shell's Annandale case (*supra*) and the National Educare case (*supra*), which emphasised that a supply requires an act or action to take place, therefore seems similar to the judgment in the Kretztechnik case (*supra*) heard in the CJEU. It was held in the Kretztechnik case, at 25, that the issue of new shares does not result in any goods or services given up and nothing is provided to the new shareholder. Consequently, Van der Zwan and Stiglingh (2011:331) submitted that the definition of supply in the South African and EU VAT systems in the context of share issues bear a similar meaning. This is based on the contention that the South African and EU VAT systems both require "an action where something is given up, provided, made available or delivered" for a transaction to constitute a supply (Van der Zwan & Stiglingh, 2011:334).

In consideration of the similarities between the South African and EU VAT systems' meaning of the word "supply", Van der Zwan and Stiglingh (2011:338) submitted that grounds may exist to follow the CJEU's argument that the issue of shares does not constitute a supply in the South African context. In the absence of a supply, input tax on share issue costs incurred may then be deductible to the extent that a business as a whole makes taxable supplies (Van der Zwan & Stiglingh, 2011:338).

1.5.3 The principles of neutrality, effectiveness and fairness in the treatment of input tax on share issue costs incurred

The broad taxation principles are the basic criteria to determine whether a tax system is "good" (Woellner, Vella & Chippendale, 1990:27) and include, *inter alia*, the principles of neutrality, effectiveness and fairness. The principle of effectiveness and fairness refer to a taxation system that results in the right amount of tax at the right time (OECD, 2017:18). Neutrality in a VAT system is achieved through the invoice-based credit method, where VAT

merely “flows through” the business and is ultimately borne by the final consumer, except where explicitly provided for in legislation (OECD, 2017:20). The OECD (2017:20) concedes that the exemption of financial services is an exception of when jurisdictions may legitimately place the VAT burden on businesses, since financial services are perceived to be difficult to tax.

While the Davis Tax Committee (2018:6) considered the principle of neutrality in the context of the exemption of financial services supplied by financial service providers, the principles of neutrality, effectiveness and fairness in the context of input tax on share issue costs incurred have not yet been considered in the existing body of research in South Africa. The EU (Kretztechnik case, at 34) and the New Zealand IR (2016:4) have considered whether the treatment of input tax on share issue costs incurred enhances or detracts from the principles of neutrality, effectiveness and fairness. Since the VAT Act was originally modelled on the New Zealand GST Act (VATCOM, 1991), this research assignment considers the arguments put forth by the New Zealand IR in this context to be relevant.

According to the New Zealand IR (2016:4), the denial of input tax deductions on share issue costs incurred by businesses that principally make taxable supplies detracts from the broad taxation principles of neutrality, effectiveness and fairness. To address this, the New Zealand GST Act was amended, effective 1 April 2017, to specifically allow the deduction of input tax on share issue costs incurred by businesses that principally make taxable supplies (section 20H of the New Zealand GST Act). This was a departure from the previous treatment of input tax on share issue costs incurred by businesses that principally make taxable supplies under the New Zealand GST Act (Trombitas, 2015). To assess whether similar arguments to those followed by the New Zealand IR with the inclusion of section 20H may be plausible in the South African context, it is important to consider whether the arguments put forth in New Zealand were decided under comparable VAT legislation (ITC 1853, at 307).

1.6 RESEARCH METHODOLOGY

A qualitative research approach was followed in the form of a literature review to achieve the research objectives. Primary and secondary data were collected, predominantly from legal databases, academic articles, books, publications by regulatory bodies, and theses. Law and policy developments up to 30 September 2019 are reflected in the research.

1.7 LIMITATIONS OF SCOPE

This research assignment focused on the deductibility of input tax on share issue costs incurred by businesses that principally make taxable supplies. The deductibility of input tax on share issue costs incurred by financial service providers that principally supply exempt financial services was therefore not considered.

The judgment in the De Beers case (*supra*) is considered for guidance on the closeness of the link required by the phrase “in the course of making taxable supplies” in the definition of input tax in section 1(1) of the VAT Act. Although the judgment in the De Beers case (*supra*) also dealt with the VAT consequences of foreign advisory fees incurred as part of a group restructuring, the VAT consequences of “imported services” as defined in section 1(1) of the VAT Act were not addressed in this research assignment. Furthermore, to maintain the focus of the research, this research assignment did not consider the deductibility of input tax on the acquisition, disposal, or transfer of shares or any other transaction that does not constitute the issue of shares.

One of the objectives of this research assignment was to determine whether the issue of shares constitutes a supply. The issue of shares is not explicitly deemed to be a supply in terms of the VAT Act (Van der Zwan & Stiglingh, 2011:335), although the wording in the VAT Act may indicate that it was the intention of the legislature that the issue of shares constitutes a supply in terms of section 1(1) of the VAT Act (Van der Zwan & Stiglingh, 2011:334). While the intention of the legislature is briefly discussed in the determination of whether the issue of shares constitutes a supply, this research assignment did not purport to conclude on whether it is the intention of the legislature that the issue of shares constitutes a supply or not.

This research assignment considered as part of Research Objective 2 the effect on the deductibility of input tax if the issue of shares is not considered a supply in terms of section 1(1) of the VAT Act. The impact on other sections of the VAT Act should the issue of shares not constitute a supply was not considered in order to maintain the focus of the research. In the absence of a specific supply, this research assignment considered the treatment of input tax on share issue costs incurred if it can be regarded as part of general overhead costs. While this research assignment explored the treatment of input tax on overhead costs incurred in this context, it did not address any apportionment methods in terms of section 17 of the VAT Act.

While guidance was obtained from the treatment of input tax on share issue costs in the EU and New Zealand, this research assignment did not consider the treatment of input tax on share issue costs incurred in other jurisdictions. Lastly, this research assignment did not consider the impact on the fiscus should input tax on share issue costs incurred be deductible in South Africa.

1.8 CHAPTER OUTLINE

The remaining chapters of this research assignment are structured as follows:

Chapter 2: A critical analysis of the phrase “in the course of making taxable supplies” in the context of the *direct and immediate link* test relied on in ITC 1744 (*supra*)

The meaning of the phrase “in the course of making taxable supplies” is analysed in this chapter through a review of South African case law, EU case law, and existing literature available. This is done to conclude whether the phrase “in the course of making taxable supplies” in the South African context includes the requirement of a *direct and immediate link* between share issue costs incurred and the making of taxable supplies, as this is fundamental to the current treatment of input tax on share issue costs.

Chapter 3: The issue of shares as considered against the definition of “supply” in section 1(1) of the VAT Act

For the purpose of Research Objective 2, the definition of “supply” is analysed through a review of the relevant legislative provisions, case law, and literature available to determine whether the issue of shares is considered a supply. Due to the reliance on EU court cases in ITC 1744 (*supra*), legislative provisions and case law from both the EU and South Africa are considered to conclude whether the issue of shares is considered a supply in South Africa. Furthermore, Chapter 3 considers how the treatment of input tax on share issue costs incurred would deviate from the judgment in ITC 1744 (*supra*) should the issue of shares not be considered a supply.

Chapter 4: The principles of neutrality, effectiveness and fairness in the treatment of input tax on share issue costs incurred

This chapter evaluates the current treatment of input tax on share issue costs incurred against the broad taxation principles of neutrality, effectiveness and fairness to assess whether the overall objective of a “good” VAT system is achieved by SARS’s current policy. Due to the lack of South African literature on the matter, the arguments put forth by the New Zealand IR to align the treatment of input tax on share issue costs in the New Zealand GST

Act to satisfy the broad taxation principles are considered for guidance. A comparative analysis of the requirements of the VAT Act and the New Zealand GST Act is performed to assess whether the arguments put forth by the New Zealand IR may be plausible in the South African context.

Chapter 5: Conclusion

The findings from the previous chapters are summarised and considered in order to draw a conclusion on whether input tax on share issue costs should be deductible in South Africa. A recommendation on how SARS may amend or clarify the current treatment of input tax on share issue costs incurred, in line with international case law and legislative developments, follows this conclusion.

CHAPTER 2:

A CRITICAL ANALYSIS OF THE PHRASE “IN THE COURSE OF MAKING TAXABLE SUPPLIES” IN THE CONTEXT OF THE *DIRECT AND IMMEDIATE LINK* TEST RELIED ON IN ITC 1744 (*SUPRA*)

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CHAPTER 2:

A CRITICAL ANALYSIS OF THE PHRASE “IN THE COURSE OF MAKING TAXABLE SUPPLIES” IN THE CONTEXT OF THE *DIRECT AND IMMEDIATE LINK* TEST RELIED ON IN ITC 1744 (*SUPRA*)

2.1 INTRODUCTION

The main research question of this research assignment was whether input tax on share issue costs incurred should be deductible in South Africa. SARS’s current policy is largely based on the judgment held in ITC 1744 (*supra*) (Badenhorst *et al.*, 2010), where the court considered the closeness of the link required by the phrase “in the course of making taxable supplies” in the context of input tax on share issue costs incurred. The court relied on the principles established by the CJEU in the BLP Group case (*supra*), where it was held that a *direct and immediate link* should exist between the costs incurred and the making of taxable supplies, and that the ultimate purpose of the taxpayer is irrelevant.

ITC 1744 (*supra*) was only heard in the Tax Court. Although Tax Court decisions are not binding on the High Court or the SCA (Stiglingh *et al.*, 2019:19), the judgment in ITC 1744 (*supra*) brought the principles of the *direct and immediate link* test into South African case law (Marais, 2014:39). Various South African authors disagree with the interpretation of the phrase “in the course of making taxable supplies” provided in ITC 1744 (*supra*) and state that the phrase “in the course of making taxable supplies” means that only some link should exist (Badenhorst *et al.*, 2010; Holdstock, 2013; Botes, 2018; De Koker & Badenhorst, 2019). Subsequent to ITC 1744 (*supra*), the judgment in the De Beers case (*supra*) was heard in the SCA. Although the De Beers case (*supra*) did not deal with the deductibility of input tax on share issue costs incurred, the SCA considered as part of its decision the closeness of the link required between group restructuring costs and the making of taxable supplies.

This chapter considers the closeness of the link required by the phrase “in the course of making taxable supplies”. The judgment in ITC 1744 (*supra*) is discussed to understand the Tax Court’s analysis of the phrase “in the course of making taxable supplies” through its reliance on the *direct and immediate link* test established in earlier CJEU cases (BLP Group case, at 20; UBAF Bank, at 158). This chapter also considers the judgment in the De Beers case (*supra*) and determines how the SCA’s decision may be interpreted to provide guidance on the meaning of the phrase “in the course of making taxable supplies”. The

ordinary meaning of the phrase “in the course of making taxable supplies”, as well as other relevant case law and literature, is considered to provide further insight.

Through this critical analysis of the phrase “in the course of making taxable supplies”, it is determined whether the *direct and immediate link* test as relied on in ITC 1744 (*supra*) should be used to apply the provisions of the VAT Act to determine the deductibility of input tax on share issue costs.

2.2 THE *DIRECT AND IMMEDIATE LINK* TEST RELIED ON IN ITC 1744 (*SUPRA*)

2.2.1 The facts of ITC 1744 (*supra*)

In ITC 1744 (*supra*), the Tax Court heard the appeal of a taxpayer incorporated to exploit a patent to manufacture steel shipping containers. The taxpayer employed the services of a company that specialises in the venture capital market to assist with raising capital through share placing. The taxpayer paid the specialist a fee that comprised 20% of the capital raised. The specialist was a registered VAT vendor and levied VAT on the services supplied in terms of section 7(1)(a) of the VAT Act.

The taxpayer claimed the VAT paid to the specialist as an input tax deduction. The Commissioner for SARS denied the input tax deduction, after which the taxpayer appealed to the Tax Court. The Commissioner relied on the definition of input tax in section 1(1) of the VAT Act, where input tax is defined to mean, *inter alia*,

a tax charged under section 7 and payable in terms of that section by a supplier on the supply of goods or services made by that supplier to the vendor where the goods or services concerned are acquired by the vendor wholly *for the purposes of consumption, use or supply in the course of making taxable supplies*, or where the goods and services are required by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services are acquired by the vendor for such purpose [own emphasis].

The question before the court was whether input tax paid on the specialist services acquired to issue shares fell within the definition of input tax in section 1(1) of the VAT Act as services “acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies”.

In delivering his judgment, Conradie J emphasised that the definition of input tax as included in section 1(1) of the VAT Act, read with section 17 of the VAT Act, means that input tax may only be claimed in respect of taxable supplies (ITC 1744, at 156). The court considered it common cause that the allotment, issue, and transfer of ownership of equity securities are

considered financial services in terms of section 2(1) of the VAT Act. It was also considered common cause that the supply of financial services is an exempt supply in terms of section 12 of the VAT Act (ITC 1744, at 156), which is discussed further in Chapter 3.

The taxpayer contended that even though the supply of financial services is exempt from VAT, the share issue costs were incurred to ultimately raise capital to expand its business of manufacturing and selling steel shipping containers, which constituted the making of taxable supplies (ITC 1744, at 156). The taxpayer argued that this was a close enough connection between the share issue costs incurred and the making of taxable supplies, and the claim for input tax should therefore be allowed (ITC 1744, at 156). Conradie J disagreed with the taxpayer's argument (ITC 1744, at 157) and stated that "although the raising of the capital might have been indispensable to the making of taxable supplies", the raising of capital "seems rather preparatory to the making of taxable supplies". Conradie J further stated that it was therefore not reasonable to state that the specialist's services were acquired in the course of manufacturing and selling the steel shipping containers and that "it is the closeness of the connection that counts" (ITC 1744, at 157).

Since ITC 1744 (*supra*) was the first case in South Africa that dealt with the deductibility of input tax on share issue costs incurred, Conradie J relied on principles established in the CJEU to determine the closeness of the connection required by the phrase "in the course of making taxable supplies" (ITC 1744, at 157). To arrive at his conclusion, Conradie J referred to the BLP Group case (*supra*), as well as the *Customs and Excise Commissioners v UBAF Bank Ltd* 1196 STC 37 case (hereafter referred to as the UBAF Bank case). The principles established in the BLP Group case (*supra*) and the UBAF Bank case (*supra*) are therefore considered next.

2.2.2 The principles established in the BLP Group case (*supra*) that were relied on in ITC 1744 (*supra*)

In the BLP Group case (*supra*), which was relied on in ITC 1744 (*supra*), the CJEU considered the deductibility of input tax on professional fees paid to merchant bankers, solicitors, and accountants in connection with the sale of shares in a subsidiary by BLP Group plc. The case centred around the interpretation of, *inter alia*, article 17(2) of the European Community's Sixth Council Directive 77/338/EEC of 1977-05-12 on the Harmonisation of the Laws of the Member States Relating to Turnover Tax (hereafter referred to as the Sixth Directive), which governed VAT in the EU member states at the time. With effect from 1 January 2007, the Sixth Directive was repealed and replaced by the VAT

Directive of the EU (Council Directive 2006/112/EC) (hereafter referred to as the VAT Directive). For clarity, reference is made to the legislation applicable at the time that the case was heard, as included in the Sixth Directive.

Article 17(2) of the Sixth Directive related to the deduction of input tax and stated:

[I]n so far as goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay...

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

BLP Group plc argued, at 12, that article 17(2)(a) of the Sixth Directive should be given a wide meaning to also allow a deduction for input tax on goods or services acquired for the purpose of making taxable supplies where there is an intervening exempt supply. The taxpayer's argument was based on the contention that since the purpose of the sale of shares was to settle debts that arose from their business of making taxable supplies, the professional fees were incurred for the purposes of the taxable transactions, in line with the requirements to deduct input tax set out in article 17(2) of the Sixth Directive (BLP Group case, at 12).

BLP Group plc further argued that, based on the principle of fiscal neutrality, it would be inappropriate to deny input tax deductions on professional fees acquired to sell shares for liquidity when input tax on professional fees to take out a bank loan is deductible. The principle of fiscal neutrality in the context of the deductibility of input tax on share issue costs incurred is discussed further in Chapter 4.

The CJEU disagreed and concluded, at 19, that a taxpayer is not allowed to deduct input tax on services acquired for an exempt supply, such as the sale of shares, even if the ultimate purpose of the sale of shares was to increase taxable supplies. Furthermore, it was held that to be able to deduct input tax on goods or services acquired, the goods or services in question should have a *direct and immediate link* with the taxpayer's taxable supplies (BLP Group case, at 19).

To explain this interpretation of article 17(2) of the Sixth Directive, the CJEU stated that the *direct and immediate link* requirement is confirmed in the wording of article 2 of the First Council Directive 67/227/EEC of 11 April 1967 on the Harmonisation of Member States Concerning Turnover Taxes (hereafter referred to as the First Directive) and article 17(3)(c) of the Sixth Directive. Article 2 of the First Directive used the word "directly" to describe the

closeness of the link required between costs incurred and the making of taxable supplies. Article 17(3)(c) of the Sixth Directive used the phrase “directly linked” to describe instances where an input tax deduction is also appropriate.

Article 17(3)(c) of the Sixth Directive stated that:

Member States shall also grant to every taxable person the right to a deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:

(c) any of the transactions exempted under Article 13B(a) and (d) paragraphs 1 to 5, when the customer is established outside the Community or when these transactions are *directly linked* with goods intended to be exported to a country outside the Community [own emphasis].

The CJEU therefore highlighted that in other articles of the First and the Sixth Directives, the word “directly” was used to describe how close a link is required between costs incurred and the making of taxable supplies in the context of input tax deductibility. Consequently, the CJEU concluded that the phrase “for the purposes of his taxable transactions” as included in article 17(2) of the Sixth Directive should be interpreted to mean that a *direct and immediate link* should exist between the costs incurred and the making of taxable supplies (BLP Group case, at 20).

The CJEU further clarified the *direct and immediate link* as an objective link, and not a subjective link that takes into account the intention of the taxpayer (BLP Group case, at 24). The difference between “objectively” and “subjectively” in the context of the determination of commercial substance in terms of section 80C of the Income Tax Act, No. 58 of 1962 (hereafter referred to as the Income Tax Act) (Stiglingh *et al.*, 2019:1100) is considered relevant to give context to the meaning of an objective link. According to Stiglingh *et al.* (2019:1100), “objectively” means from the viewpoint of the man on the street, whereas “subjectively” means from the viewpoint of the taxpayer.

The CJEU considered that in the absence of an objective link, authorities would have to make inquiries to determine the subjective intention with which a taxpayer incurs professional fees to determine the deductibility of input tax thereon (BLP Group case, at 24). Since such inquiries would be contrary to the VAT system’s objective of legal certainty and effectiveness, the CJEU determined that it cannot be concluded that the input tax deduction requirements should be interpreted to mean a subjective link (BLP Group case, at 24). The BLP Group case (*supra*) further highlighted the fact that the existence of an intervening exempt supply between the professional fees incurred and the ultimate making of taxable

supplies severs the link required by the input tax definition in article 17 of the Sixth Directive (HM Revenue & Customs, 2016a).

The *direct and immediate link* test established in the BLP Group case (*supra*) may be summarised as follows:

- A *direct and immediate link* should exist between professional fees incurred and the making of taxable supplies (BLP Group case, at 19).
- Such a *direct and immediate link* is an objective link established without consideration of the taxpayer's ultimate purpose of acquiring professional services (BLP Group case, at 24).
- The *direct and immediate link* required between professional fees incurred and the making of taxable supplies to deduct input tax is broken by an intervening exempt supply, such as the sale of shares (BLP Group case, at 23).

In the HM Revenue and Customs internal manual for VAT input tax (HM Revenue & Customs, 2016c), the *direct and immediate link* test as established in the BLP Group case (*supra*) is described as follows:

It prevents any 'look through' being applied to intervening transactions in favour of the ultimate purpose of the business involved. VAT is a transaction-based tax. Therefore, costs incurred must be linked to the immediate supplies made using them. It does not matter what the business then does with revenues generated by those supplies.

It therefore seems that the *direct and immediate link* test established in the BLP Group case (*supra*) refers to a link that looks not at the direct and immediate purpose of the taxpayer, but rather at the direct and immediate closest supply to which the professional fees are a cost component of, and whether this constitutes a taxable supply.

In ITC 1744 (*supra*), at 158, Conradie J concurred with the judgment in the BLP Group case (*supra*) that a taxpayer is not allowed to "look through" an exempt supply to the ultimate purpose of making taxable supplies. Conradie J further referred to the judgment in the UBAF Bank case (*supra*), at 158, to confirm the appropriateness of using the *direct and immediate link* test to determine the deductibility of input tax on share issue costs incurred. For the sake of completeness, the judgment in the UBAF Bank case (*supra*) is briefly discussed next.

2.2.3 The judgment in the UBAF Bank case (*supra*) that confirmed the *direct and immediate link* test established in the BLP Group case (*supra*)

In the UBAF Bank case (*supra*), which was referred to in ITC 1744 (*supra*), the CJEU considered whether input tax on professional fees paid by UBAF Bank Ltd to solicitors and consultants to facilitate the acquisition of shares in three leasing companies was deductible. UBAF Bank Ltd acquired the shares of the three leasing companies and thereafter acquired the business of each, which enabled UBAF Bank Ltd to make taxable supplies under the existing leases held by the three leasing companies.

The CJEU considered that the acquisition of subsidiary companies for which the professional fees were incurred enabled UBAF Bank Ltd to enhance its leasing business of making taxable supplies. The acquisition of shares for the purpose of acquiring the entire business of a company was not considered to be an exempt supply, and therefore the court noted, at 379, that there was no “intervening supply”, as in the BLP Group case (*supra*). Consequently, the CJEU held, at 380, that there was a sufficiently direct link between the professional fees paid and the making of taxable supplies, and that UBAF Bank Ltd may deduct input tax on the professional fees incurred.

In ITC 1744 (*supra*), Conradie J applied the principles from the BLP Group case (*supra*) and the UBAF Bank case (*supra*) to arrive at his conclusion in ITC 1744, at 158. A summary of Conradie J’s conclusion and application of the *direct and immediate link* test is provided next.

2.2.4 The conclusion in ITC 1744 (*supra*)

In ITC 1744 (*supra*), at 157, Conradie J interpreted the closeness of the link required by the phrase “in the course of making taxable supplies” by relying on the principles established in the BLP Group case (*supra*) and confirmed in the UBAF Bank case (*supra*). At 158, Conradie J concurred with the *direct and immediate link* test as established in the BLP Group case (*supra*): “The principle to be applied is that where goods or services are used for an exempt supply it is not legitimate for the taxpayer to look through that supply to an ultimate purpose of carrying out taxable supplies.”

Conradie J further held that although raising capital through the issue of shares might be necessary for the making of taxable supplies, the raising of capital is a preparatory act to the making of taxable supplies. It therefore seems that the court acknowledged that the direct purpose of the share issue costs incurred was to eventually increase taxable supplies,

and that it was a necessary part thereof; however, it concluded in line with the judgment in the BLP Group case (*supra*) that since the most direct and immediate closest supply to which the share issue costs are a cost component of was an exempt supply, the input tax deduction was denied (ITC 1744, at 155).

Through the judgment in ITC 1744 (*supra*), which relied on earlier judgments of the CJEU, the *direct and immediate link* test therefore became part of South African VAT law (Marais, 2014). Since ITC 1744 (*supra*) was only heard in the Tax Court, its decision is not binding on the High Court or the SCA (Stiglingh *et al.*, 2019:19). Various South African authors (Badenhorst *et al.*, 2010; Holdstock, 2013; Botes, 2018; De Koker & Badenhorst, 2019) have submitted that the use of the *direct and immediate link* test to apply the provisions of the VAT Act may not be appropriate. The appropriateness of using the *direct and immediate link* test, established in the CJEU in the BLP Group case (*supra*) and confirmed in the UBAF Bank case (*supra*), is therefore discussed next.

2.3 THE APPROPRIATENESS OF USING ARGUMENTS PUT FORTH IN THE BLP GROUP CASE (*SUPRA*) AND THE UBAF BANK CASE (*SUPRA*) IN ITC 1744 (*SUPRA*)

Authors (Badenhorst *et al.*, 2010; Van der Zwan & Stiglingh, 2011:321; Botes, 2018; De Koker & Badenhorst, 2019; Silver, 2019) have highlighted the fact that the two CJEU cases relied on in ITC 1744 (*supra*) did not deal with the issue of shares, and that subsequent CJEU cases that dealt specifically with the issue of shares have resulted in the allowance of an input tax deduction on share issue costs incurred. These subsequent CJEU cases are discussed in Chapter 3. Furthermore, authors (Holdstock, 2013; Botes, 2018) have also expressed reservations about the use of the *direct and immediate link* test based on the differences in the wording of the Sixth Directive and the VAT Act, which detract from the comparability of the requirements in the Sixth Directive and the VAT Act respectively to deduct input tax.

To assess the appropriateness of using the *direct and immediate link* test to apply the provisions of the VAT Act, the reservations expressed by these South African authors against the use of the *direct and immediate link* test to apply the provisions of the VAT Act are therefore considered next. Reservations about the fact that neither the BLP Group case (*supra*) nor the UBAF Bank case (*supra*) dealt with the issue of shares, as in ITC 1744 (*supra*), are discussed first. This is followed by a discussion of the comparability of the requirements of the Sixth Directive and the VAT Act for the deductibility of input tax.

2.3.1 The comparability of the type of share transaction in the BLP Group case (*supra*), UBAF Bank case (*supra*), and ITC 1744 (*supra*)

To assess the appropriateness of the reliance placed on the principles established in the BLP Group case (*supra*) and the UBAF Bank case (*supra*), it is important to consider whether the two CJEU cases dealt with a similar set of facts as ITC 1744 (*supra*) (Van der Zwan & Stiglingh, 2011:323).

Neither the BLP Group case (*supra*) nor the UBAF Bank case (*supra*) dealt with the issue of shares, as in ITC 1744 (*supra*). The BLP Group case (*supra*) dealt with the sale of shares in a subsidiary to settle debts that arose from the making of taxable supplies. The UBAF Bank case (*supra*) dealt with the acquisition of shares of three subsidiary companies, after which each company's business was bought, leaving the companies dormant. Although Chapter 3 focuses on the nature of a share issue transaction, a brief distinction between the issue, acquisition, and disposal of shares is considered relevant to determine the appropriateness of the reliance placed on the judgement in the BLP Group case (*supra*) and the UBAF Bank case (*supra*).

An equity security or share means, *inter alia*, an interest in or a right to a share in the capital of a juristic person (section 2(2) of the VAT Act), which includes a company. A share in a company is issued only once and allocates shareholders the right to a share of the capital (Investopedia, 2019). Thereafter it may be sold to another shareholder, similar to the transfer of any other investment (Investopedia, 2019). It therefore seems that the disposal and acquisition of issued shares may not be transactions that are similar in nature to the issue of shares. In terms of the principle of legal precedence, a court decision becomes a principle of law that may have to be applied in cases that deal with a similar set of facts (Stiglingh *et al.*, 2019:19). Consequently, it seems that since the BLP Group case (*supra*) and UBAF Bank case (*supra*) did not deal with a similar set of facts as ITC 1744 (*supra*), it may not have been appropriate to rely on the principles established in these CJEU cases to arrive at the decision in ITC 1744 (*supra*).

Subsequent to the BLP Group case (*supra*), other cases in the CJEU that dealt specifically with the VAT treatment of costs incurred to issue shares resulted in the CJEU allowing input tax deductions on share issue costs (HM Revenue & Customs, 2016b). The subsequent CJEU cases that dealt with whether the issue of shares constitute a supply are discussed in Chapter 3.

In addition to the fact that the BLP Group case (*supra*) and the UBAF Bank case (*supra*) dealt with transactions different in nature from ITC 1744 (*supra*), they were also decided in another jurisdiction. To assess the appropriateness of the reliance placed on principles established in the CJEU, it is therefore important to consider whether the arguments put forth in the CJEU were decided under comparable VAT legislation in South Africa (ITC 1853, at 307).

2.3.2 A comparison of the requirements of the Sixth Directive and the VAT Act

Merriam-Webster (2019) defines “comparable” as “capable of or suitable for comparison” and “similar, like”. “Similar” is distinguished from “same” in the Cambridge Dictionary (2019b) in that “same” is used when “two or more things are exactly like one another” and “similar” is used when “two or more things are not entirely the same”. It follows that it is important to consider whether the arguments put forth in the BLP Group case (*supra*) were decided under VAT legislation that is *similar* to that in South Africa, and not necessarily the *same*.

In both the Sixth Directive and the VAT Act, input tax is only deductible on costs incurred that relate to the making of taxable supplies (the VAT Act) or taxable transactions (the Sixth Directive) (Van der Zwan & Stiglingh, 2011:337). However, it is important to consider whether there is a difference between “taxable supplies” and “taxable transactions” (Van der Zwan & Stiglingh, 2011:337). A taxable supply is defined in section 1(1) of the VAT Act as a supply “which is chargeable with tax under the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent under section 11”. Taxable transactions are defined in article 2(1) of the Sixth Directive as economic activities (the supply of goods or services) that are subject to VAT.

Van der Zwan and Stiglingh (2011:337) submit that since both “taxable supplies” and “taxable transactions” refer to transactions where goods or services supplied are subject to VAT and exclude exempt supplies; “there is no significant difference between the meaning of taxable supplies and taxable transactions”. Furthermore, article 17(2) of the Sixth Directive and section 17(1) of the VAT Act similarly only allow an input tax deduction to the extent that or insofar as the goods or services are used for the making of taxable supplies or taxable transactions (Van der Zwan & Stiglingh, 2011:337). Based on this analysis, Van der Zwan and Stiglingh (2011:337) submit that there is “no significant difference” between the requirements of the VAT Act and the EU VAT directives to deduct input tax.

There are, however, differences in the wording of the wider input tax deduction requirements in the EU VAT directives and the VAT Act. The word “directly” is included twice in the EU VAT directives in the context of input tax in article 2 of the First Directive and article 17(3)(c) of the Sixth Directive. In the BLP Group case (*supra*), the court highlighted the use of the word “directly” in article 2 of the First Directive and article 17(3)(c) of the Sixth Directive as confirmation of its conclusion that the words “for his taxable transactions” mean a *direct and immediate link*. It therefore seems that the inclusion of the word “directly” in other articles of the First and Sixth Directives was paramount to the CJEU’s conclusion of how close a link is required between cost incurred and the making of taxable supplies.

In contrast, the word “directly” is neither included in the input tax definition in section 1(1) of the VAT Act, nor in section 17(1) of the VAT Act, which determines the primary requirements to deduct input tax. It therefore seems that the absence of the word “directly” in the VAT Act may detract from the similarity between the VAT legislation of the EU and South African jurisdictions. It follows that the use of the *direct and immediate link* test relied on in ITC 1744 (*supra*) may therefore not be appropriate in South Africa, since the principles of the *direct and immediate link* test were argued in terms of EU VAT legislation that differed from that of South African VAT legislation at the time.

In consideration of the fact that ITC 1744 (*supra*) is only binding on the parties to the case, some South African authors have submitted that the *direct and immediate link* test was also applied in the De Beers case (*supra*), heard in the SCA (Holdstock, 2013; Marais, 2014:38; Moodaley, 2017). The SCA’s decisions are binding on all subordinate courts and will generally be followed in subsequent SCA cases (Stiglingh *et al.*, 2019:19). This research assignment therefore considers the judgment in the De Beers case (*supra*) to be relevant to determine whether the phrase “in the course of making taxable supplies” requires a *direct and immediate link* between the costs incurred and the making of taxable supplies and will be discussed in the following section.

2.4 THE PRINCIPLES ESTABLISHED IN THE DE BEERS CASE (*SUPRA*) WITH REGARD TO THE INTERPRETATION OF THE PHRASE “IN THE COURSE OF MAKING TAXABLE SUPPLIES”

The De Beers case (*supra*) centred around whether services acquired by the DBCM to assess the reasonableness of a restructuring offer were utilised or consumed in the course of making taxable supplies. Although the judgment in the De Beers case (*supra*) focused on

the interpretation of the definition of “enterprise” in section 1(1) of the VAT Act, it also provided guidance on how the phrase “in the course of making taxable supplies” should be applied in terms of section 1(1) of the VAT Act.

For completeness, the facts of the case are briefly outlined next to provide context to the principles established in the judgement that are relevant to the interpretation of the phrase “in the course of making taxable supplies”.

2.4.1 The facts of the De Beers case (*supra*)

The DBCM conducted the business of mining and selling diamonds and was listed on the Johannesburg Stock Exchange, the London Stock Exchange, and the Swiss Exchange. In 2000, the DBCM received a proposal from a consortium of shareholders to restructure the group through establishing a new holding company incorporated in Luxembourg. An independent committee of directors was established to assess the reasonableness and fairness of the consortium’s offer. Various foreign and local advisors, including attorneys, accountants, and a bank, were appointed to assist with the assessment of the offer.

The DBCM received invoices for the advisory services provided by the foreign advisors, who were not registered VAT vendors in South Africa. The Commissioner for SARS contended that the foreign advisory fees were imported services as defined in section 1(1) of the VAT Act and levied VAT on the foreign advisory fees in terms of section 7(1)(c) of the VAT Act. The DBCM also received invoices for the services rendered by the local advisors, on which VAT was levied in terms of section 7(1)(a) of the VAT Act. The DBCM claimed an input tax deduction on the local advisory fees, which was disallowed by the Commissioner for SARS. The Commissioner for SARS contended that input tax incurred on the local advisory fees was not deductible in terms of the definition of input tax in section 1(1) of the VAT Act. The DBCM lodged an objection against this assessment. The objection was subsequently disallowed, after which both parties appealed to the Tax Court.

In terms of section 7(1)(c) of the VAT Act, VAT should be levied on the supply of imported services. Imported services are defined in section 1(1) of the VAT Act to mean:

a supply of services that is made by a supplier who is resident or carries on business outside the Republic to a recipient who is a resident of the Republic *to the extent that such services are utilised or consumed in the Republic otherwise than for the purpose of making taxable supplies* [own emphasis].

The DBCM emphasised that it could not continue its business without these foreign advisory fees, which would enable it to comply with its legal obligations as a listed company (ITC 1853, at 295). The DBCM therefore argued that the foreign advisory fees were utilised or consumed for the purpose of making taxable supplies since they were part of the overhead costs “necessarily attached to and accordingly concomitant of its mining or commercial enterprise as a public company” (ITC 1853, at 295). On this basis, the DBCM contended that the foreign advisory services did not constitute imported services as defined in section 7(1)(c) of the VAT Act, since they were utilised or consumed for the purpose of making taxable supplies (ITC 1853, at 295) and therefore no VAT should be levied on these services.

The DBCM further argued that, based on the same contention, the local advisory fees were also directly linked to its enterprise of mining and selling diamonds on the same basis as the foreign advisory fees, and the input tax incurred on the advisory fees was therefore deductible in terms of section 1(1) of the VAT Act (ITC 1853, at 307).

2.4.2 The Tax Court’s decision

The Tax Court largely found favour in the DBCM’s arguments, and held that the foreign advisory services did not constitute imported services as defined in section 1(1) of the VAT Act since they were utilised or consumed by the DBCM for the purpose of making taxable supplies, in the course or furtherance of its enterprise of mining and selling diamonds (ITC 1853, at 313). The Tax Court based its decision on the contention that the foreign advisory services were necessary for the DBCM to comply as a listed company and therefore “constituted an activity performed in the course or furtherance” of the DBCM’s enterprise (ITC 1853, at 313).

For the sake of completeness, the relevant parts of the enterprise definition in section 1(1) of the VAT Act are highlighted. In terms of section 1(1) of the VAT Act, “enterprise” means:

a) in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person ... in the course or furtherance of which goods or services are supplied to any other person for a consideration ...

Provided that -

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

The Tax Court found that while the foreign advisory services “were not directly linked” to the DBCM’s operations of mining and selling diamonds, these services related to the activities

that the DBCM's board had to carry out as part of its mining concern, and therefore fell within the definition of "enterprise" (ITC 1853, at 308). The Tax Court also held that insofar as the local advisory fees were concerned, the DBCM should determine the extent to which the local advisory fees were incurred in the course of making taxable supplies, in accordance with section 17(1) of the VAT Act.

Although it seems that the Tax Court considered the closeness of the link required between costs incurred and the making of taxable supplies, the judgment in ITC 1744 (*supra*) was not expressly mentioned as authority. To arrive at his decision, Davis J focused on a wider interpretation of "enterprise", and stated, at 308, that although the advisory fees were a once-off occurrence, they fell within the definition of an enterprise since they were incurred by the DBCM in the form of its commercial or mining concern. Davis J furthermore stated, at 308, that the definition of "enterprise" should not be limited to apply only to assets used directly in the making of taxable supplies, and a legal obligation imposed on a company was therefore "sufficiently closely connected" to the overall activities of the company.

Consequently, the Tax Court concluded, at 313, that the foreign advisory services did not constitute imported services, and that input tax on part of the local advisory fees incurred should be apportioned. Both the DBCM and the Commissioner for SARS appealed the Tax Court's decision, whereafter it was subsequently overturned by the SCA.

2.4.3 The Supreme Court of Appeal's (SCA) decision

In the appeal, Southwood AJA stated, at 349, that the question to be answered is "[w]hether the services acquired by DBCM were required for the purpose of consumption, use or supply in the course of making 'taxable supplies', *which means supplying goods or services in the course or furtherance of the 'enterprise'*" [own emphasis].

The SCA emphasised the fundamental principle that the determination of whether goods or services were utilised or consumed in the course of making taxable supplies can only be made in relation to a specific enterprise (De Beers case, at 349):

The primary question requires that there be clarity as to the nature of the 'enterprise' *because the purpose of acquiring the services and whether they were consumed or utilized [sic] in making 'taxable supplies' can only be determined in relation to a particular 'enterprise'* [own emphasis].

In arriving at his decision, Southwood AJA adopted a narrower interpretation of the definition of "enterprise" in section 1(1) of the VAT Act than that of the Tax Court before it (Ger &

McCready, 2012). The SCA stated that the DBCM is not a dealer in shares and therefore the holding of shares and receipt of dividends do not fall within the enterprise definition (De Beers case, at 349). Furthermore, the SCA emphasised, at 349, that the DBCM's enterprise consisted of mining and selling diamonds, and that the question to be answered was whether the foreign advisory fees "were acquired for the purpose of making taxable supplies in that enterprise".

Although the closest activity to the advisory fees incurred was the changes in shareholding prescribed by the restructuring offer, it seems that the SCA looked past the non-enterprise activity of holding shares, to the DBCM's enterprise of mining and selling diamonds. The only question that remained was whether the advisory fees were incurred in the course or furtherance of that enterprise (De Beers case, at 349).

The SCA agreed with the submission on behalf of the Commissioner for SARS that all expenses that a company is legally obliged to incur do not necessarily constitute overhead expenses incurred in the course or furtherance of its enterprise. Navsa JA and Van Heerden JA further stated that duties imposed on public companies to comply with specific legal requirements are "too far removed" from the furtherance of an enterprise to justify that advisory fees acquired in the process thereof were acquired for the purpose of making taxable supplies (De Beers case, at 343).

The SCA held that the DBCM's enterprise of mining and selling diamonds "was not in the least affected" by the advisory services acquired for the restructuring and that the advisory fees acquired "could not contribute in any way to the making of DBCM's taxable supplies" (De Beers case, at 349). It follows that in its consideration of how closely linked the advisory fees incurred and the DBCM's enterprise of mining and selling diamonds were, the SCA concluded that there was no link or causal relationship at all. It is therefore suggested that the SCA did not go further to consider how strong a link exists between the advisory fees incurred and the making of taxable supplies, since it found that there was, in the first place, no link with the enterprise in the course of which taxable supplies are made.

Marais (2014:38) contended that the SCA applied the principles of the *direct and immediate link* test in arriving at its conclusion; however, the SCA, like the Tax Court before it, did not refer to the *direct and immediate link* test relied on in ITC 1744 (*supra*) in its judgment, nor did it use the words "direct" or "immediate" to describe the relationship required between the advisory fees incurred and the DBCM's enterprise. The next section compares the arguments put forth in ITC 1744 (*supra*) and the De Beers case (*supra*) in respect of the

direct and immediate link test to determine whether the *direct and immediate link* test was also applied in the De Beers case (*supra*).

2.4.4 Comparison between ITC 1744 (*supra*) and the De Beers case (*supra*) in respect of the *direct and immediate link* test

In the De Beers case (*supra*), the SCA firstly determined the nature of the DBCM's enterprise, since it was established that taxable supplies can only be made in relation to a specific enterprise that falls within the definition set out in section 1(1) of the VAT Act (De Beers case, at 349). Furthermore, the SCA determined that once the nature of the enterprise was identified, the only question to be answered is whether the advisory fees were incurred for the purpose of making taxable supplies in that enterprise. It is here that the DBCM's contention failed, and the SCA held that the DBCM's enterprise of mining and selling diamonds was not "in the least affected" or "enhanced" by the foreign or local advisory fees incurred (De Beers case, at 349).

It follows that the SCA in the De Beers case did not have to consider how direct a link existed between the advisory fees incurred and the making of taxable supplies, since the SCA determined that the activities for which the advisory fees were required did not in the first place affect or enhance the DBCM's enterprise. It is submitted that this approach is different from the decision in ITC 1744 (*supra*).

It seems that the taxpayer's enterprise in ITC 1744 (*supra*) that fell within the definition of section 1(1) of the VAT Act was the manufacturing and selling of steel shipping containers. The court, however, focused on the fact that the issue of shares was a non-enterprise activity as per proviso (v) to the definition of enterprise in section 1(1) of the VAT Act (ITC 1744, at 155). Notwithstanding the fact that the issue of shares was held to be "indispensable to the making of taxable supplies", the judgment in ITC 1744 (*supra*) went further and considered the closeness of the link between the share issue costs incurred and the making of taxable supplies (ITC 1744, at 155). The court used the *direct and immediate link* test established in the BLP Group case (*supra*) and held that although the issue of shares did affect and enhance the taxpayer's enterprise of manufacturing and selling steel shipping containers, there was an intervening exempt supply between the share issue costs incurred and the making of taxable supplies. On this basis, Conradie J denied the taxpayer's input tax deduction on share issue costs incurred (ITC 1744, at 158).

It appears that the SCA in the De Beers case (*supra*) dismissed the DBCM's arguments because the advisory fees incurred did not enhance the DBCM's enterprise. In contrast, it seems that the court in ITC 1744 (*supra*) dismissed the taxpayer's reasoning despite the fact that the share issue costs enhanced its enterprise. In addition, the court in ITC 1744 (*supra*) considered whether the share issue costs incurred were objectively linked to the making of taxable supplies through examining the closest supply to the share issue costs incurred, without regarding the purpose for which the taxpayer acquired the services. This appears to be in contrast with the judgment in the De Beers case (*supra*), where the SCA considered the DBCM's purpose for which it acquired the advisory fees (De Beers case, at 343), and also considered what it affected (De Beers case, at 349).

It therefore follows that the SCA's approach in the De Beers case (*supra*) was a subjective test that looked at a direct functional rather than a direct proximate link. Consequently, it is submitted that the *direct and immediate link* test relied on in ITC 1744 (*supra*) was not used in the De Beers case (*supra*). Although the De Beers case (*supra*) considered the closeness of the connection, it was the connection between the advisory fees incurred and the DBCM's enterprise, and not the advisory fees incurred and the DBCM's closest proximate supply, to which the advisory fees are a cost component.

In the absence of a decision by the SCA that applies or endorses the *direct and immediate link* test, it is therefore concluded that ITC 1744 (*supra*) is still the leading case in South Africa to date that deals with the closeness of the link required by the phrase "in the course of making taxable supplies" in the context of share issue costs incurred. Since ITC 1744 (*supra*) was only heard in the Tax Court and is therefore only binding on the parties to the specific case (Stiglingh *et al.*, 2019:19), a further analysis of the phrase "in the course of making taxable supplies" is required with reference to the ordinary meaning of the words, as well as case law and relevant literature available. Such an analysis is provided to determine the closeness of the link required between share issue costs incurred and the making of taxable supplies for the purpose of the input tax definition included in section 1(1) of the VAT Act. This is discussed in the following section.

2.5 ANALYSIS OF THE PHRASE “IN THE COURSE OF MAKING TAXABLE SUPPLIES” WITH REFERENCE TO OTHER CASE LAW AND AVAILABLE LITERATURE

The ordinary meaning of the phrase “in the course of making taxable supplies” is analysed to understand the closeness of the link required between share issue costs incurred and the making of taxable supplies.

A dictionary definition can provide a court with insight into the statute’s ordinary meaning where necessary (*Blue Circle Cement Ltd v CIR* 1984 2 SA 764 (A)). The Oxford English Dictionary (2019b) defines the phrase “in the course of” as “in the process of; during the progress of”. It therefore seems that the ordinary meaning of the phrase “in the course of” conveys a less direct link, and merely refers to something that happens in the process of or during the process of.

The phrase “in the course of” has also been dealt with in other South African judgments, where it was held that only some causal link should exist, and not necessarily a *direct and immediate link* (Badenhorst *et al.*, 2010; Holdstock, 2013). The interpretation by South African courts of the phrase “in the course of” in section 11(c) of the Income Tax Act provides guidance on the meaning of the phrase “in the course of” included in the input tax definition in section 1(1) of the VAT Act (De Koker & Badenhorst, 2019).

In section 11(c) of the Income Tax Act, the phrase “in the course of or by reason of” is used to describe the relationship that should exist between the claims on which legal fees are based and the ordinary operations undertaken by a taxpayer in carrying on a trade. South African courts have interpreted this phrase to mean “a sufficient and clear causal connection between the related legal expenses and the taxpayer’s operations” (De Koker & Badenhorst, 2019). The phrase “in the course of or by reason of” in the context of section 11(c) of the Income Tax Act was considered in *Commissioner for Inland Revenue v Genn and Co (Pty) Ltd* 1955 (3) SA 293 (AD) (hereafter referred to as the Genn and Co case). Schreiner JA stated, at 386, that “the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the *purpose* of the expenditure and to *what it actually effects*” (own emphasis).

According to De Koker and Badenhorst (2019), “purpose signifies the object or aim that a person has in mind”. In the context of a share issue, it follows that the purpose of incurring the share issue costs may be to expand the taxpayer’s business of making taxable supplies. The Cambridge Dictionary (2019a) defines the verb “effect” as used in the Genn and Co

case (*supra*) to mean “to achieve something and cause it to happen”, which indicates that a causal relationship should exist.

Consequently, it may be argued that the phrase “in the course of making taxable supplies” in the input tax definition in section 1(1) of the VAT Act should similarly be interpreted to mean that a causal relationship should exist regarding the purpose and effect of the expenses incurred. It may then be argued that where share issue costs incurred cause taxable supplies to increase or be made in the first place, a causal relationship exists between the share issue costs incurred and the making of taxable supplies. It seems that such an interpretation may be in contrast with the judgment in ITC 1744 (*supra*), where “in the course of making taxable supplies” was interpreted, at 158, to mean that an objective *direct and immediate link* should exist.

According to the principles established in the BLP Group case (*supra*), such an objective *direct and immediate link* should be determined without regarding the taxpayer’s ultimate purpose for acquiring the goods or services, where there is an intervening exempt supply (BLP Group case, at 19). Holdstock (2013) highlighted the difference between the “most immediate and proximate activity” in relation to expenditure incurred and the closest activity to the expenditure incurred having regards to its purpose:

If one can consider that a direct link can be satisfied by a functional link then a close linear link is not required. In other words, the question is not whether there is a direct and immediate link between the services used and the taxable supply, but whether there is a sufficiently close relationship with the enterprise in the course of which the taxable supplies are made.

In the context of share issue costs incurred, it seems that there is a direct functional link between the share issue costs incurred and the making of taxable supplies. The share issue costs are incurred to issue shares, to raise capital, with which the business of making taxable supplies is expanded. The function or purpose of the share issue costs is therefore to expand the making of taxable supplies; however, should a direct linear link be required, the closest proximate activity to the share issue costs incurred would be the issue of shares, which was considered an exempt supply in ITC 1744 (*supra*).

According to De Koker and Badenhorst (2019), the South African courts tend to require a more direct connection between the expenditure incurred and the making of taxable supplies. It appears, however, as if De Koker and Badenhorst (2019) concede that the *direct and immediate link* test is secondary to the determination of whether goods or services are utilised or consumed in the course or furtherance of a specific enterprise:

The question is not whether there is a direct and immediate link between the services used and the taxable supply, but whether there is a *sufficiently close relationship with the enterprise in the course of which the taxable supplies are made* [own emphasis].

It seems that De Koker and Badenhorst's view (2019) is in line with the judgment in the De Beers case (*supra*), which highlighted that the phrase "in the course of making taxable supplies" can only be applied in relation to a specific enterprise as defined in section 1(1) of the VAT Act (De Beers case, at 349), with regard to the purpose of acquiring the goods or services (De Beers case, at 343). It therefore follows that the approach adopted in the De Beers case (*supra*) included the application of a direct functional link test, which examined whether the expenses incurred affected or enhanced the enterprise, and not necessarily at the closest supply to which the goods or services acquired were a part of. Although the De Beers case (*supra*) did not deal specifically with the deductibility of input tax on share issue costs incurred, the principles established by the SCA in arriving at its conclusion are considered relevant to determine the closeness of the link required by the input tax definition in section 1(1) of the VAT Act.

Further guidance may be obtained from the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:58), where direct attribution is explained as follows: "Direct attribution means that *you will be required to attribute* the VAT expense according to the *intended purpose* for which the goods or services acquired will be used" (own emphasis).

From the above explanation, it follows that the taxpayer's intended purpose for which the goods or services are acquired should be considered. It is therefore concluded that the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017) makes provision for a subjective determination of the intended purpose for which goods or services are acquired, in line with the judgment in the De Beers case (*supra*). In ITC 1744 (*supra*), the taxpayer's intended purpose for which it incurred the share issue costs was to expand its business of making taxable supplies through the manufacturing and sale of steel shipping containers. It is therefore submitted that should the taxpayer's purpose for acquiring the share issue costs have been taken into account in ITC 1744 (*supra*), it could have been found that a direct functional link existed between the share issue costs incurred and the making of taxable supplies.

Based on the analysis above, it seems that the phrase "in the course of making taxable supplies" in the context of input tax on share issue costs incurred should be interpreted to

mean a direct functional link between the share issue costs incurred and a taxpayer's enterprise in the course of which taxable supplies are made.

2.6 SUMMARY AND CONCLUSIONS

Through the judgment in ITC 1744 (*supra*), which relied on earlier judgments of the CJEU, the *direct and immediate link* test became part of South African VAT law (Marais, 2014). The principles of the *direct and immediate link* test were established in the CJEU in the BLP Group case (*supra*), where it was held that a *direct and immediate link* should exist between professional fees incurred and the making of taxable supplies (BLP Group case, at 19). Such a *direct and immediate link* is an objective link, without regard of the ultimate purpose of the taxpayer (BLP Group case, at 24) and is broken by an intervening exempt supply, such as the sale of shares (BLP Group case, at 23).

Chapter 2, however, determined that since the principles of the *direct and immediate link* test were argued under EU VAT legislation that differed from that of South African VAT legislation at the time, the use of the *direct and immediate link* test relied on in ITC 1744 (*supra*) may not be appropriate in South Africa.

It was also submitted in Chapter 2 that the *direct and immediate link* test relied on in ITC 1744 (*supra*) was not used in the De Beers case (*supra*) that was heard in the SCA. Based on an analysis of the judgment in the De Beers case (*supra*) and other relevant case law and literature available, Chapter 2 determined that the phrase "in the course of making taxable supplies" in the input tax definition in section 1(1) of the VAT Act in the context of share issue costs does include a requirement of a direct link between the share issue costs incurred and the making of taxable supplies. It was further determined that such a direct link should be interpreted as a direct functional link that considers what the goods or services acquired affect, the purpose for which they were acquired, as well as whether they enhance the taxpayer's enterprise. Such an interpretation is more in line with the judgment in the De Beers case (*supra*) that was heard in the SCA than that of the *direct and immediate link* test relied on in ITC 1744 (*supra*), which was only heard in the Tax Court.

Chapter 2 also established that in the context of share issue costs incurred, the existence of an intervening exempt supply, such as the issue of shares, casts doubt on whether SARS will allow a deduction of input tax, even if the ultimate purpose of issuing the shares should be considered. Whether the issue of shares constitutes a supply is therefore considered further in Chapter 3.

Furthermore, Chapter 2 highlighted the argument put forth in the BLP Group case (*supra*) that the *direct and immediate link* principle, which was relied on in ITC 1744 (*supra*), detracts from the principle of neutrality in a VAT system. The CJEU's reservations about the principles of effectiveness and legal certainty in a VAT system that require consideration of a taxpayer's intention were also noted. The broad taxation principles of neutrality, effectiveness and fairness in the context of input tax on share issue costs incurred are discussed further in Chapter 4.

CHAPTER 3:

THE ISSUE OF SHARES AS CONSIDERED AGAINST THE DEFINITION OF “SUPPLY” IN SECTION 1(1) OF THE VAT ACT

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CHAPTER 3:

THE ISSUE OF SHARES AS CONSIDERED AGAINST THE DEFINITION OF “SUPPLY” IN SECTION 1(1) OF THE VAT ACT

3.1 INTRODUCTION

It was submitted in Chapter 2 that the phrase “in the course of making taxable supplies” in the context of input tax on share issue costs incurred should be interpreted to mean that a direct functional link should exist between the share issue costs incurred and a taxpayer’s enterprise in the course of which taxable supplies are made. Such a direct functional link should consider the taxpayer’s intended purpose for which the goods or services are acquired, and not merely look at the closest proximate supply to which the costs incurred are a cost component of. Chapter 2 highlighted that despite consideration of the purpose of issuing shares, the existence of an intervening exempt supply may still result in SARS denying input tax deductions on share issue costs incurred.

This is based on the judgment in ITC 1744 (*supra*), where the court considered it common cause that the issue of shares constitutes an exempt supply as defined in section 1(1) of the VAT Act (ITC 1744, at 156). The judgment in ITC 1744 (*supra*) relied on principles established in two earlier CJEU cases, namely the BLP Group case (*supra*) and the UBAF Bank case (*supra*), which dealt with the disposal and acquisition of shares respectively. At the time, the CJEU had not dealt with the deductibility of input tax on costs incurred to issue shares. The judgment in the Trinity Mirror case (*supra*), heard in the United Kingdom (UK) Court of Appeal, suggested, however, that the position in the EU in 2001 was consistent with that in ITC 1744 (*supra*), namely that the issue of shares constituted an exempt supply. The position taken in the Trinity Mirror case (*supra*) was reversed in 2005 when the CJEU finally dealt with the deductibility of input tax on share issue costs incurred in the Kretztechnik case (*supra*), at 17.

The judgment in the Kretztechnik case (*supra*) determined that the issue of a company’s own shares does not constitute a supply of services, since no existing rights or portions of the business’ property are transferred to the new shareholders (Kretztechnik case, at 28). In the absence of a specific supply, the CJEU held that the costs incurred to issue shares should be considered as part of the general overhead costs of the business (Kretztechnik case, at 36). Consequently, it was held that input tax on share issue costs incurred is deductible to the extent that the business as a whole makes taxable supplies (*Securenta*

Göttinger Immobilienanlagen und Vermögensmanagement AG v Finanzamt Göttingen 2008 ECJ C-437/06 [hereafter referred to as the *Securenta* case]).

Since the CJEU judgments were relied on in ITC 1744 (*supra*), the arguments put forth in the CJEU cases subsequent to ITC 1744 (*supra*) may provide grounds to argue that the position in South Africa should be reconsidered (Van der Zwan & Stiglingh, 2011:321). Based on the wording of the definition of “exempt supply” in section 1(1) of the VAT Act, the existence of a supply of goods or services is paramount to an activity or act being exempt from VAT. Chapter 3 therefore considers the arguments put forth by the CJEU to arrive at the conclusion that the issue of shares to raise capital does not constitute a supply. Furthermore, Chapter 3 considers the CJEU’s view on the deductibility of input tax on share issue costs in the absence of a supply. This is followed by consideration of whether the arguments put forth by the CJEU may find their place in the South African context, to allow an input tax deduction on share issue costs incurred in line with the developments in the CJEU.

Van der Zwan and Stiglingh’s (2011:329) research on the CJEU cases subsequent to ITC 1744 (*supra*) and whether a similar argument can be followed in the South African context is used as foundation for the discussion in this chapter. This chapter builds on Van der Zwan and Stiglingh’s (2011:329) research through the addition of case law principles subsequent to 2011 and consideration of the intention of the legislature in terms of the definition of “supply”. The position on whether the issue of shares constitutes a supply in South Africa has not been clarified since Van der Zwan and Stiglingh’s (2011:329) research was published in 2011. Chapter 3 therefore objectively considers whether the issue of shares constitutes a supply and how that determination affects the deductibility of input tax incurred in the process.

3.2 THE COURT OF JUSTICE OF THE EUROPEAN UNION’S (CJEU) TREATMENT OF INPUT TAX ON SHARE ISSUE COSTS INCURRED SUBSEQUENT TO ITC 1744 (*SUPRA*)

At the time ITC 1744 (*supra*) was heard, the UK Court of Appeal held in the *Trinity Mirror* case (*supra*) in 2001 that the issue of shares to raise capital constituted a supply in the ordinary meaning of the word, and therefore constituted an exempt supply in terms of article 13B(d)(5) of the Sixth Directive. It was determined in the *Trinity Mirror* case (*supra*), at 54, that there was a lack of case law from other EU member states that supported any other conclusion. Consequently, the UK Court of Appeal held, at 56, that the issue of shares

constituted an exempt supply, and considered it unnecessary to refer the case to the CJEU for a preliminary hearing since there was no doubt as to the conclusion reached.

In 2005, the CJEU dealt for the first time with whether the issue of shares constituted an exempt supply and reversed the treatment of the issue of shares as an exempt supply in the UK as established in the Trinity Mirror case (*supra*) (HM Revenue and Customs, 2016b). The Kretztechnik case (*supra*) was therefore also the first case that dealt with the deductibility of input tax on share issue costs incurred subsequent to ITC 1744 (*supra*) (Van der Zwan & Stiglingh, 2011:326). The judgment in the Kretztechnik case relied on the principle established in *Cibo Participants SA v Directeur Régional des Impôts de Nord-Pas-de-Calais* 2001 ECJ C-16/00 (hereafter referred to as the Cibo case), that where costs incurred cannot be linked to a specific supply, they should be viewed as a general cost to the business. The judgment in the Kretztechnik case (*supra*) also relied on the principle established in *KapHag Renditefonds v Finanzamt Charlottenburg* 2003 ECJ C-442/01 (hereafter referred to as the KapHag case), that the admission of a new partner to a partnership does not constitute a supply of services, since it is not an economic activity. The judgment in the Securenta case (*supra*), as well as in *Skatteverket v AB SKF* 2009 ECJ C-29/08 (hereafter referred to as the SKF case), heard subsequent to the Kretztechnik case (*supra*), provided further guidance on the treatment of input tax on share issue costs incurred.

To consider the CJEU's interpretation of the definition of "supply" in the context of share issue costs incurred, and the impact on the deductibility of input tax on share issue costs incurred in the absence of a specific supply, the five CJEU cases mentioned above are briefly discussed next.

3.2.1 The Cibo case

The Cibo case (*supra*), heard in 2001, dealt with the deductibility of input tax on costs incurred to acquire shares in subsidiary companies (Cibo case, at 9). The costs incurred related to audit fees, services acquired for price negotiations, and administrative, legal, and tax compliance services (Cibo case, at 9). It appears that the circumstances in the Cibo case (*supra*) were similar to the UBAF Bank case (*supra*), which was relied on in ITC 1744.

The court first considered whether Cibo's acquisition of shares in the subsidiary companies resulted in a "taxable transaction" in terms of article 17 of the Sixth Directive. In terms of article 4(2) of the Sixth Directive, an economic activity should be present for a transaction to

be considered a “taxable transaction”. The court, at 22, agreed with the taxpayer that Cibo’s purpose with the acquisition of shares was to become involved in the management of the subsidiaries in exchange for a management fee, which is regarded as an economic activity (Cibo case, at 22).

Secondly, the court considered the deductibility of input tax on the costs incurred to acquire the shares, in consideration of the fact that the acquisition of shares was held to be an economic activity (Cibo case, at 23). The court, at 32, concurred with the *direct and immediate link* test established in the BLP Group case (*supra*), and confirmed that there was no *direct and immediate link* between the share acquisition costs incurred and the making of specific taxable supplies, since the share acquisition costs did not form part of the cost component of a specific taxable supply in terms of which input tax can be deducted.

The court concluded, however, that the share acquisition costs formed part of the general costs of the business and therefore had a *direct and immediate link* with the taxable business as a whole (Cibo case, at 33). Consequently, the court held that the input tax thereon is deductible to the extent that the business makes taxable supplies (Cibo case, at 34). Although the court noted the importance of considering the neutrality principle in a VAT system to arrive at its conclusion (Cibo case, 27), it seems that this was not the focus of the CJEU’s decision to rule in favour of the taxpayer. The principle of neutrality in a VAT system, in the context of the deductibility of input tax on share issue costs incurred, is considered further in Chapter 4.

In summary, the CJEU established the principle in the Cibo case (*supra*) that where costs incurred cannot be linked to a specific supply, they should be viewed as a general cost to the business. Whereas the Cibo case (*supra*) dealt with the principle to follow where costs cannot be linked to a specific supply, the KapHag case (*supra*), discussed next, dealt with a situation where it was determined that a supply does not exist in the first place.

3.2.2 The KapHag case

The KapHag case (*supra*), heard in 2003, considered whether the admission of a new partner to a partnership in exchange for consideration, constituted a supply of services by the partnership to the new partner. Although the KapHag case (*supra*) did not deal with the issue of shares to raise capital by a company, the principle established in the KapHag case (*supra*) was relied on in the Kretztechnik case (*supra*) and is therefore considered relevant to this research assignment.

The court considered that only economic activities are subject to VAT in terms of article 2 of the Sixth Directive, and that the mere acquisition and holding of shares in a company are not economic activities as established in previous CJEU cases (KapHag case, at 35-37). Economic activities are defined in article 4(2) of the Sixth Directive as including “all activities of producers, traders and persons supplying services”, as well as “the exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis” (KapHag case, at 36). The court emphasised, at 37, that “exploitation” within the meaning of article 4(2) of the Sixth Directive refers to any transaction from which a taxpayer seeks to obtain income on a continuing basis. On this basis, the court highlighted, at 38, that

the mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property.

Consequently, the court concluded that, on the same basis, when a new partner enters a partnership, their contribution in cash for a share in the partnership also does not constitute an economic activity (KapHag case, at 39).

The court concluded, at 42, that the partnership did not supply any goods or services to the new partner, and that the new partner’s contribution to the partnership merely secured him the prospect of sharing in future profits. Consequently, the court concluded, at 43, that the admission of a new partner to a partnership does not constitute a supply of services, since it is not an economic activity. This principle was relied on in the Kretztechnik case (*supra*), which is discussed next.

3.2.3 The Kretztechnik case

The Kretztechnik case (*supra*), heard in 2005, was the first case in the CJEU since ITC 1744 (*supra*) that dealt with the deductibility of input tax on share issue costs incurred (Van der Zwan & Stiglingh, 2011:326). Prior to the judgment in the Kretztechnik case (*supra*), the CJEU had not dealt with a referral from one of the EU member states on the matter (Kretztechnik case, at 39). The judgment in the Trinity Mirror case (*supra*) suggested that, prior to the Kretztechnik case (*supra*), most EU member states treated the issue of shares as an exempt supply (Trinity Mirror case, at 48). The Kretztechnik case resulted in input tax on share issue costs being deductible in the EU across all member states (HM Revenue and Customs, 2016b), and is therefore considered pivotal to determine the CJEU’s treatment of input tax on share issue costs incurred subsequent to ITC 1744 (*supra*).

Kretztechnik AG was an Austrian company that was involved in the development and distribution of medical equipment (Kretztechnik, at 12). The company listed on the Frankfurt Stock Exchange through the issue of shares, and incurred costs in the process of the listing. Kretztechnik AG sought to deduct the input tax on share issue costs incurred. The deduction was denied on the basis that the issue of shares was considered to be an exempt supply by the Austrian tax authorities at the time, in line with the judgment in the Trinity Mirror case (*supra*); input tax on costs incurred in the process was therefore not deductible (Kretztechnik case, at 14).

In its judgment, the CJEU considered three questions:

- i. Does the issue of shares to raise capital constitute a supply for consideration within the meaning of article 2 of the Sixth Directive?
- ii. If the answer to (i) is yes, should article 2(1) and article 17 of the Sixth Directive be interpreted to mean that all share issue costs incurred are attributable to the making of exempt supplies, and therefore input tax thereon is not deductible?
- iii. If the answer to (i) is no, can input tax on the share issue costs incurred be regarded as part of the overhead costs of the business, and therefore input tax thereon is deductible to the extent that the business as a whole makes taxable supplies?

In order to answer the first question, the court determined whether the issue of shares to raise capital would constitute a supply of goods or a supply of services (Kretztechnik case, at 22). In terms of article 5(1) of the Sixth Directive, the phrase “supply of goods” is defined as “the transfer of the right to dispose of tangible property as owner”. A “supply of services” in terms of article 6(1) of the Sixth Directive is any transaction that is not a supply of goods as set out in article 5(1) of the Sixth Directive.

The court found that the issue of shares to raise capital did not constitute a supply of goods in terms of article 5(1) of the Sixth Directive, since no right to dispose of tangible property is transferred with the issue of shares. To consider whether the issue of shares to raise capital constitutes a supply of services, the court relied on the principle established in the KapHag case (*supra*) that the admission of a new partner to a partnership does not constitute a supply of services. The court concluded that, on the same basis, the issue of shares to raise capital did not constitute a supply of services. To arrive at this conclusion, the court noted that a company that issues new shares increases its assets through the acquisition of new capital for the purpose of raising financing and not to provide services to the new shareholder (Kretztechnik case, at 26). The new shareholder acquires the right of ownership of part of

the business' capital, and consideration paid by the new shareholder constitutes an investment on their part, rather than consideration for services received (Kretztechnik case, at 26). The court found, at 27, that the issue of shares to raise capital did not therefore constitute a supply of services and was therefore not within the scope of article 2(1) of the Sixth Directive.

It seems that the Kretztechnik case (*supra*) dealt with a similar set of facts as ITC 1744 (*supra*) – apart from the fact that Kretztechnik issued shares in a listed environment, whereas the taxpayer in ITC 1744 (*supra*) issued shares in a private share placing. However, the judgment in the Kretztechnik case (*supra*) confirmed, at 21, that the nature of the transaction was not different whether the shares are issued in a listed environment or in a private share placing. The fact that the Kretztechnik case (*supra*) dealt with the issue of shares as part of listing on a stock exchange and ITC 1744 (*supra*) dealt with the issue of shares in a private placing therefore does not detract from the relevance of the principles established in the Kretztechnik case (*supra*) in consideration of the judgment in ITC 1744 (*supra*).

After the court in the Kretztechnik case (*supra*) confirmed that the issue of shares was not considered a supply, it considered the deductibility of input tax on share issue costs incurred, in consideration of the fact that the issue of shares to raise capital does not constitute a supply. On this matter, the court considered the findings in the BLP Group case (*supra*) and the Cibo case (*supra*). The court emphasised that, with reference to the *direct and immediate link* test established in the BLP Group case (*supra*), for input tax to be deductible, costs incurred should have a *direct and immediate link* to the taxpayer's taxable transactions (taxable supplies) (Kretztechnik case, at 36). Furthermore, the court relied on the principle established in the Cibo case (*supra*), that in the absence of a specific supply to which costs incurred can be linked, the costs incurred can be viewed as a general cost to the business. The court held, at 36, that since the issue of shares was carried out in order to raise capital to benefit its economic activity as a whole, "it must be considered that the costs ... form[ed] part of its overheads". The court therefore considered Kretztechnik's purpose for incurring the share issue costs to determine whether there was a *direct and immediate link* between the share issue costs incurred and the making of taxable supplies (Kretztechnik case, at 36).

It is also noted that the court emphasised in its consideration the importance of considering the neutrality principle of VAT, and stated that the "deduction system is meant to relieve the trader entirely of the burden of VAT ... in the course of all his economic activities" (Kretztechnik case, at 34). As in the Cibo case (*supra*), it seems that this was not the focus

of the court's decision to rule in favour of the taxpayer, although it provided persuasive value. The consideration given by the court to the neutrality principle of VAT is analysed further in Chapter 4.

In summary, the Kretztechnik case established two principles in the context of input tax on share issue costs incurred. Firstly, it was held that the issue of shares to raise capital did not constitute a supply of services, since the company that issued the shares did not provide or give up anything, and the new shareholder merely obtained the prospect of sharing in future profits (Kretztechnik case, at 26). Secondly, it was confirmed that, in line with the judgment in the Cibo case (*supra*), where costs incurred could not be linked to a specific supply, it can be regarded as part of the general overhead costs of the business (Kretztechnik case, at 36). The application of the two principles established in the Kretztechnik case (*supra*) was confirmed in the Securenta case (*supra*), which is discussed next.

3.2.4 The Securenta case

The Securenta case (*supra*), heard in 2008, confirmed the principles established in the Kretztechnik case (*supra*), Cibo case (*supra*), and the KapHag case (*supra*) and provided further guidance on the apportionment of input tax on overhead costs incurred.

Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG (hereafter referred to as Securenta AG) was involved in the trading of real estate, the acquisition and disposal of securities, and the holding of financial investments. In terms of established EU case law, the court considered only the trading of real estate as a taxable supply, and Securenta AG was therefore considered to be involved in a combination of taxable supplies, exempt supplies, and non-economic activities in terms of the Sixth Directive (Securenta case, at 23). Securenta AG issued shares and admitted new silent partners to the business to raise capital and incurred various fees in the process. The taxpayer claimed an input tax deduction for the full amount of these fees, which was disallowed on the basis that not all of its transactions were taxable transactions, and the input tax incurred should therefore be apportioned (Securenta case, at 14).

The court confirmed that the issue of shares to raise capital did not constitute a supply in line with the judgment in the Kretztechnik case (*supra*), and that costs incurred in the process should be regarded as a general cost to the business, in line with the judgment in the Cibo case (*supra*) (Securenta case, at 29). The court then considered whether the taxpayer was

entitled to deduct the full amount of input tax on the share issue costs incurred, or only to a certain extent. In its consideration, the court noted the importance of fiscal neutrality in a VAT system and confirmed that the rules of the Sixth Directive are meant to relieve companies of their “tax burden” (Securenta case, at 25); however, the court emphasised, at 30, that to the extent that input tax on expenditure incurred by a taxpayer related to exempt supplies and non-economic activities, it cannot give rise to a deduction. Consequently, it was held, at 31, that input tax on share issue costs incurred is only deductible to the extent that the business as a whole makes taxable supplies. The concept of fiscal neutrality highlighted by the CJEU is discussed further in Chapter 4.

The SKF case (*supra*), which is considered the last CJEU case relevant to this research assignment, dealt with circumstances similar to the BLP Group case (*supra*), which was relied on in ITC 1744 (*supra*) (De Koker & Badenhorst, 2019). Although the SKF case (*supra*) dealt with the deductibility of costs incurred where a specific supply existed, the SKF case (*supra*) highlighted that it was important to distinguish between the issue of shares and the sale of shares. This distinction is considered relevant since the court in ITC 1744 (*supra*) relied on the BLP Group case (*supra*), which dealt with the sale of shares, to determine the treatment of input tax on costs incurred to issue shares. The SKF case (*supra*) is therefore considered next.

3.2.5 The SKF case

The SKF case (*supra*), heard in 2009, dealt with the deductibility of input tax on costs incurred to sell shares in subsidiary companies, similar to the BLP Group case (*supra*) (De Koker & Badenhorst, 2019). AB SKF held investments in subsidiaries and was involved in the management of these subsidiaries for a fee. AB SKF disposed of its investment in two of the subsidiaries to raise funding for its other business operations where taxable supplies were made. Costs were incurred in the process, and AB SKF deducted the full amount of input tax on the costs incurred. The tax authorities disallowed the deduction on the basis that the sale of shares constituted an exempt supply. AB SKF contended that the purpose for which it sold the shares was ultimately to raise funding for its other business that made taxable supplies.

The court confirmed, at 41, that the disposal of shares in a subsidiary company held as an investment, where management services were provided to the subsidiary, constituted an economic activity within the scope of the Sixth Directive. The court concluded that the disposal of shares is an exempt transaction in terms of article 13B(d)(5) of the Sixth Directive

(SKF case, at 64). The court emphasised that, in line with the judgment in the Cibo case (*supra*), Kretztechnik case (*supra*), and Securenta case (*supra*), there was a right to deduct input tax on costs incurred to dispose of shares should there be a *direct and immediate link* between the disposal costs incurred and the entity's "overall economic activities".

Although the SKF case (*supra*) did not deal with the issue of shares, the case highlighted the fact that a distinction should be made between the issue of shares to raise capital and the disposal of shares for the purpose of determining the deductibility of input tax incurred in the process (Van der Zwan & Stiglingh, 2011:329). The SKF case, together with the judgments in the Cibo case (*supra*), KapHag case (*supra*), Kretztechnik case (*supra*), and Securenta case (*supra*), shows that the CJEU's view on the deductibility of input tax on share issue costs incurred changed since ITC 1744 (*supra*) was heard in 2002. For completeness, a summary of the CJEU's view on the deductibility of input tax on share issue costs incurred subsequent to ITC 1744 (*supra*) is provided in the following section.

3.2.6 Summary of the CJEU's treatment of input tax on share issue costs incurred subsequent to ITC 1744 (*supra*)

ITC 1744 (*supra*) was heard in 2002 and relied on principles established in earlier CJEU cases, namely the BLP Group case (*supra*) and the UBAF Bank case (*supra*) (ITC 1744, at 157). The BLP Group case (*supra*), heard in 1995, established the principles that a *direct and immediate link* should exist between share sale costs incurred and the making of taxable supplies, and that an intervening exempt supply severs the *direct and immediate link* (BLP Group case, at 28). The UBAF Bank case (*supra*), heard in 1996, confirmed the *direct and immediate link* test established in the BLP Group case in the context of the deductibility of share acquisition costs incurred. The Trinity Mirror case (*supra*), heard in the UK Court of Appeal in 2001, established that the issue of shares constituted a supply in the ordinary meaning of the word and suggested that this was also the view held by the other EU member states at the time. Subsequent to 2001, the CJEU heard five cases (discussed in this section) that collectively changed the CJEU's view on the deductibility of input tax on share issue costs incurred.

In the Cibo case (*supra*), it was held that where expenditure cannot be linked to a specific supply, it forms part of the overhead costs of the business and input tax thereon is deductible to the extent that the business makes taxable supplies. In the KapHag case (*supra*), it was held that the admission of a new partner to a partnership did not fall within the ambit of VAT,

and input tax on costs incurred in the process was therefore deductible to the extent that the business as a whole makes taxable supplies.

This was further expanded upon in the Kretztechnik case (*supra*), where it was held, at 26, that the issue of shares to raise capital did not constitute a supply of services. This was based on the argument by the court that since the new shareholder acquired the right of ownership of part of the business' capital, consideration paid constitutes an investment on their part and not consideration of services received (Kretztechnik case, at 26). Furthermore, it was held that in the absence of a specific supply, costs incurred could be viewed as part of the general overhead costs of the business. The Securenta case (*supra*) confirmed that even in such a case, input tax on these general overhead costs is only deductible to the extent that the business as a whole makes taxable supplies. Finally, the SKF case (*supra*) emphasised the principles established in the previous CJEU cases mentioned and confirmed that there was a difference in the treatment of input tax on costs incurred to issue shares, and to dispose of shares (Van der Zwan & Stiglingh, 2011:329).

It can therefore be concluded that the treatment of input tax on share issue costs incurred in the CJEU subsequent to the BLP Group case (*supra*) is different from the principles relied on in ITC 1744 (*supra*), which considered the issue of shares to raise capital as an intervening exempt supply (ITC 1744, at 155). Van der Zwan and Stiglingh (2011:321) also submitted that since reliance was previously placed on CJEU judgments in ITC 1744 (*supra*), the "reasoning by the CJEU may provide compelling arguments to reconsider the position in South Africa".

The ensuing sections consider whether the arguments put forth by the CJEU to allow a deduction of input tax on share issue costs incurred can similarly be followed in South Africa. To that end, it is considered in Section 0 whether the issue of shares to raise capital constitutes a supply in South Africa based on the relevant VAT legislation, case law, and available literature. Lastly, the treatment of input tax on share issue costs incurred in the absence of a specific supply is considered in Section 0 in the context of the relevant VAT legislation, case law, and guidance from SARS.

3.3 IS THE ISSUE OF SHARES TO RAISE CAPITAL A TRANSACTION THAT CONSTITUTES A SUPPLY IN TERMS OF SECTION 1(1) OF THE VAT ACT?

Shares are issued by companies to raise capital (Correia, 2015:13.19). A share or equity security means, *inter alia*, an interest in or a right to a share in the capital of a juristic person (section 2(2) of the VAT Act), which includes a company.

Van der Zwan and Stiglingh (2011:331) submitted that to be able to follow the CJEU's argument that the issue of shares to raise capital does not constitute a supply, it is important to consider whether the term "supply" in the VAT Act has a similar meaning as in the Sixth Directive. To that end, it is important to firstly establish whether the issue of shares is explicitly deemed a supply in terms of VAT Act, since that would eliminate the possibility of following the CJEU's argument that the issue of shares to raise capital is not a supply in the South African context (Van der Zwan & Stiglingh, 2011:334).

The existing research published by Van der Zwan and Stiglingh in 2011 is supplemented by reference to case law subsequent to 2011, as well as consideration of the legislature's intention regarding whether the issue of shares constitutes a supply in terms of section 1(1) of the VAT Act. Although the research by Van der Zwan and Stiglingh (2011:331) provided invaluable insight into the consideration of whether the issue of shares constitutes a supply, the position in South Africa has not changed. This research assignment therefore deems it necessary to reconsider the position objectively.

3.3.1 Is the issue of shares explicitly deemed to be a "supply" in terms of the VAT Act?

The term "supply" is defined in section 1(1) of the VAT Act, and includes

performance in terms of a sale, rental agreement, instalment credit agreement and *all other forms of supply*, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of 'supply' shall be construed accordingly [own emphasis].

The definition of "supply" therefore does not specifically include the issue of shares as an activity deemed as a "supply". Van der Zwan and Stiglingh (2011:334) submitted that the wording of sections 2 and 12 of the VAT Act should also be considered to determine whether the issue of shares to raise capital is explicitly deemed a supply.

Section 2(1)(d) of the VAT Act includes, *inter alia*, the "issue ... of an equity security" as an activity deemed as a financial service. Van der Zwan and Stiglingh (2011:334) pointed out

that, on the one hand, it can be argued that the wording used in section 2(1) of the VAT Act only determines the types of activities that are deemed as financial services, and that section 2(1) does not deem activities that would not otherwise be regarded as supplies to become supplies. On the other hand, it can be argued that the inclusion of the issue of an equity security in the definition of a financial service indicates that it was the intention of the legislature that the issue of shares is considered a supply (Van der Zwan & Stiglingh, 2011:334). Caution should, however, be exercised with the second argument since it would be speculation as to what the intention of the legislature is (Van der Zwan & Stiglingh, 2011:335). The intention of the legislature is considered in more detail in Section 3.3.6. Other jurisdictions, including Australia, have specifically defined a financial service as a supply to eliminate any confusion created in this manner (Van der Zwan & Stiglingh, 2011:335). This is, however, not the case in the VAT Act, where the issue of shares is not specifically listed as a supply (definition of “supply” in section 1(1) of the VAT Act).

Van der Zwan and Stiglingh (2011:334) further suggested that the wording of section 12 of the VAT Act should be considered to determine whether section 12 explicitly deems the issue of shares a supply. Section 12 states that the “supply of *any of the following goods or services* shall be exempt from the tax imposed under section 7(1)(a)” and lists the supply of financial services in subsection (a).

The wording in section 12 of the VAT Act rests on the fact that a supply already exists and does not deem the issue of shares to be a supply (Van der Zwan & Stiglingh, 2011:334). It seems, however, that the wording of section 12 explicitly deems a financial service to be a good or service, since it refers to “the supply of *any of the following goods or services*” before listing financial services in subsection (a). Therefore, although the VAT Act does not explicitly deem the issue of shares a supply, it does deem the issue of shares to be goods or services as defined in section 1(1) of the VAT Act. It seems, however, that the phrase “supply of any of the following goods or services” includes two requirements, namely that the transaction in question should be one of “the following goods or services” and that a “supply” thereof should take place. It follows that even though the issue of shares is deemed goods or services by the wording used in section 12 of the VAT Act, it does not deem the issue of shares to also be a supply. This research assignment therefore agrees with Van der Zwan and Stiglingh (2011:335) that “no provision in the VAT Act explicitly deems the issue of an entity’s own shares to be a supply”.

The ensuing section further considers the definition of “supply” in section 1(1) of the VAT Act to determine whether the arguments put forth by the CJEU can also be followed in the

South African context. Since the definition of “supply” includes reference to “all other forms of supply”, the ordinary meaning of the word “supply”, as well as the meaning provided by case law, is considered. The ordinary meaning of the word “supply” is considered first.

3.3.2 The ordinary meaning of “supply”

A dictionary definition can provide a court with insight into a legislative provision’s ordinary meaning where necessary (*Blue Circle Cement Ltd v CIR* 1984 2 SA 764 (A)). The Oxford English Dictionary (2019a) defines the term “supply” as “to furnish or provide (a person) with something” and “to furnish with regular supplies of a commodity”. The Cambridge Dictionary (2019c) defines it as “to provide something that is wanted or needed”.

The ordinary meaning of the term “supply” therefore refers to the supplier giving something to another person. Van der Zwan and Stiglingh (2011:332) submitted that the ordinary meaning of the term “supply” is in line with the argument in the Kretztechnik case (*supra*), where it was held that a company does not give up anything when shares are issued, and it is therefore not considered a supply of services. Guidance from case law that extends the meaning of the word “supply” beyond its ordinary meaning should also be considered (Van der Zwan & Stiglingh, 2011:332). Guidance from South African case law is considered first.

3.3.3 The meaning of “supply” in South African case law

The meaning of the word “supply” was considered in the Shell’s Annandale case (*supra*) in 1999, as well as in the National Educare case (*supra*) in 2002.

It was held in the Shell’s Annandale case (*supra*) that a supply only takes place in the form of an act or action by a supplier, in line with the ordinary meaning of the word. The case dealt with whether land expropriated from the taxpayer constituted a supply as defined in section 1(1) of the VAT Act, to determine whether the taxpayer should levy VAT in terms of section 7(1)(a) of the VAT Act on the consideration received. The taxpayer argued that since no act was performed by them, the expropriation of land could not be considered a “supply” as defined in section 1(1) of the VAT Act. The court agreed, and concluded, at 106, that other sections in the Act emphasise that the definition of “supply” should be considered to include an active, rather than a passive, connotation. The court stated, at 106, that

whilst it is possible to construe ‘supply’ to include a passive connotation, the Act needs to be read as a whole in order to extract the meaning from the text and its purpose. Thus the word ‘services’ as employed in s 7(1) of the Act is defined to *include anything done or to be done ...* There are indications in the Act which

would appear to employ the *active as opposed to the passive meaning* of the word ‘supply’ as set out in the dictionary [own emphasis].

To emphasise the view that “supply” conveys an active as opposed to a passive meaning, Davis J emphasised that section 7(1)(a) of the VAT Act refers to two requirements that must be met before VAT is levied, namely that a supply exists, and that such a supply is made in the course of furtherance of an enterprise carried on by a vendor (Shell’s Annandale case, at 106). For this reason, Davis J noted that the wording used in the definition of “enterprise” in section 1(1) of the VAT Act provides key insight into how the term “supply” should be interpreted. The definition of “enterprise” in section 1(1) of the VAT Act refers to “any enterprise or *activity which is carried out* continuously or regularly in the course of which goods or services are supplied for a consideration” (own emphasis). Davis J further highlighted that proviso (i) to the definition of “enterprise” in section 1(1) of the VAT Act refers to the words “anything *done*” (own emphasis), which highlights that “some act on the part of the vendor” should take place prior to VAT being charged (Shell’s Annandale case, at 100). Consequently, it was held in the Shell’s Annandale case (*supra*), at 100, that a supply can only take place in the form of an act or action by the supplier.

Furthermore, it was determined that the definition of “supply” and the reference to “all other forms of supply” therein were ambiguous (Shell’s Annandale case, at 108). The court suggested, at 108, that National Treasury should consider a legislative amendment to provide clarity as to the scope and extent of the definition of supply, and to ensure that the wording of the definition displayed and resulted in the legislature’s intention with which the definition was drafted. This was subsequently enacted through the amendment of the definition of “supply” through section 81(1)(f) of the Revenue Laws Amendment Act, No. 53 of 1999, through the inclusion of the words “performance in terms of a sale, rental agreement, instalment credit agreement ... whether voluntary, compulsory or by operation of law”. It is submitted that this amendment to clarify the definition of “supply” following the judgment in the Shell’s Annandale case (*supra*) speaks to the intention of the legislature, which is discussed further in Section 3.3.6.

Although the Shell’s Annandale case (*supra*) established that a “supply” only takes place in the form of an act or an action, the nature of the act required was not expanded on and was subsequently addressed in the National Educare case (*supra*) (Van der Zwan & Stiglingh, 2011:332). In the National Educare case (*supra*), the court found, at 308, that the act referred to in the Shell’s Annandale case (*supra*) means that something is provided or delivered by the taxpayer. Van der Zwan and Stiglingh submitted that the definition of “supply” in the

National Educare case (*supra*) did not extend the term beyond its ordinary meaning, which also has a more active, rather than passive, connotation, and is therefore in line with the argument put forth in the Kretztechnik case (*supra*). This view finds further support in Interpretation Note No. 70 (Legal and Policy Division: SARS, 2013:13), where it is stated that “a commercial transaction where something is supplied from one person to another ... will generally constitute the supply of goods or services”.

The interpretation of “supply” to exclude passive transactions was challenged in ITC 1874, which was heard in the Zimbabwean Fiscal Appeal Court in 2014 and included in the South African Tax Cases (SATC) Reports. Although decisions from other jurisdictions are considered valuable and influential in South African courts where they deal with similar aspects of the law, they are not binding in South Africa (Stiglingh *et al.*, 2019:19). However, since the interpretation of “supply” in ITC 1874 (*supra*) indicated a shift away from the Kretztechnik case (*supra*) argument that “supply” only includes transactions where something is given up (active transactions), the argument put forth in ITC 1874 (*supra*) is considered relevant to provide guidance on whether the term “supply” can also include passive supplies, and is therefore considered in the following section.

3.3.4 The meaning of “supply” in case law from other jurisdictions included in the South African Tax Cases (SATC) Reports

ITC 1874 (*supra*) dealt with whether the settlement of a debt owed by a manufacturer of steel products to a fuel and grocery company, through the provision of steel, constituted a “supply”, or whether the provision of steel was merely payment for fuel and grocery goods supplied on a loan account.

The term “supply” is defined in section 2 of the Zimbabwean Value-Added Tax Act, No. 12 of 2002 (hereafter referred to as the Zimbabwean VAT Act) to include “all forms of supply, irrespective of where the supply is effected, and any derivative of supply shall be construed accordingly”. It is submitted that wording of the definition of “supply” in the Zimbabwean VAT Act is similar to the wording of the definition of “supply” in the VAT Act, since both refer to “all ... forms of supply” and “any derivative of supply shall be construed accordingly”. The Zimbabwean VAT Act was also modelled on the New Zealand GST Act (Madzivanyika, 2017), similar to the South African VAT Act (VATCOM, 1991). The Zimbabwean Fiscal Appeal Court’s interpretation of the meaning of the word “supply” in ITC 1874 (*supra*) is therefore considered relevant to this research assignment.

Based on the inclusion of the all-encompassing phrase “all other forms of supply”, the taxpayer in ITC 1874 (*supra*) argued that the definition of “supply” in the Zimbabwean VAT Act was ambiguous, and the term should therefore be interpreted by the court in favour of the taxpayer (ITC 1874, at 113). This contention was based on the *contra fiscum* principle that in the case of ambiguity, a fiscal provision should be construed in favour of the taxpayer (*Estate Reynolds and Others v Commissioner for Inland Revenue* 1937 AD 57, at 70). Kudya J considered, at 113, that the intention of the legislature was decisive in the matter to determine whether an ambiguity existed in the first place, before looking to the *contra fiscum* principle for guidance on the interpretation of legislative provisions. This was in line with the remarks of Botha JA in *Glen Anil Development Corporation Ltd v Secretary for Inland Revenue* 37 SATC 319 (hereafter referred to as the Glen Anil case), at 334, where the court concluded that

[a]part from the rule that in the case of an ambiguity a fiscal provision should be construed *contra fiscum* (*Estate Reynolds & others v CIR* 1937 AD 5742 at 70) ... the true intention of the legislature is of paramount importance, and, I should say, decisive.

Consequently, the court proceeded, at 144, to consider the intention of the legislature with reference to the definition of “supply” in section 2 of the Zimbabwean VAT Act, before considering the *contra fiscum* rule. Kudya J held, at 108, that the legislature was aware of the wide variety of meanings of the word “supply”. Kudya J further held, at 108, that the inclusion of the phrase “all forms of” shows that it was the intention of the legislature to “catch all shades of the meaning of the word ‘supply’”. Based on this, Kudya J concluded, at 114, that the definition of “supply” in section 2 of the Zimbabwean VAT Act is not ambiguous, and therefore the *contra fiscum* rule cannot be relied on by the taxpayer. Consequently, the court dismissed the reasoning in the Shell’s Annandale case (*supra*) that “supply” should be interpreted to include only transactions where there is an act or action on the part of the taxpayer, and held that “supply” can also include passive supplies, where no act or action is performed (ITC 1874, at 108). Kudya J stated, at 112: “In my view a passive supply is as much a supply as an active one. The ground for distinction eludes me. The word ‘supply’ bears both the passive and active meaning”.

It therefore seems that the definition of “supply” in ITC 1874 (*supra*) conveys a wider meaning than the interpretation of “supply” in the Shell’s Annandale case (*supra*) and the National Educare case (*supra*) and includes passive supplies where nothing is provided or delivered. It therefore follows that the meaning of the term “supply” in ITC 1874 (*supra*) can be considered wider than that given to the term “supply” in the Kretztechnik case (*supra*)

and would mean that a transaction where nothing is provided or given up, such as the issue of shares, could still be considered a supply in the South African context.

Since ITC 1874 (*supra*) was heard in the Zimbabwean Fiscal Appeal Court, it is important to consider that decisions from other jurisdictions, although invaluable and influential in South African courts where they deal with similar aspects of the law, are not binding in South Africa (Stiglingh *et al.*, 2019:19). Therefore, although the judgment in ITC 1874 (*supra*) is considered to provide valuable insight into the interpretation of the definition of “supply”, the leading South African cases to date dealing with the interpretation of the term “supply” are still the Shell’s Annandale case (*supra*) and the National Educare case (*supra*). Both these cases interpreted the term “supply” to have an active connotation, requiring some form of act or action in terms of which something is given up by the supplier. This interpretation is in line with the CJEU’s interpretation of “supply”, as evidenced in the Kretztechnik case (*supra*) (Van der Zwan & Stiglingh, 2011:331).

Van der Zwan and Stiglingh (2011:330) submitted that since the VAT Act was modelled on the New Zealand GST Act (VATCOM, 1991), the view in New Zealand on whether the issue of shares to raise capital is considered a supply is considered relevant. Therefore, for completeness, New Zealand case law on the matter is briefly discussed next.

3.3.5 The meaning of “supply” in New Zealand case law

To consider whether the issue of shares constitutes a supply in terms of the New Zealand GST Act, the meaning of “supply” in terms of the New Zealand GST Act is considered first, followed by a brief analysis of the principles established in New Zealand tax cases on the matter. Section 5(1) of the New Zealand GST Act states that the term “supply” includes “all forms of supply”, similar to the definition of “supply” in section 1(1) of the VAT Act. Case law in New Zealand has also confirmed, in line with the South African cases discussed in this research assignment, that the term “supply” refers to transactions where there is an act or action on the part of the taxpayer.

In *Databank Systems Ltd v Commissioner of Inland Revenue* (1990) 12 NZTC 7 (hereafter referred to as the Databank case), it was held, at 227, that “supply” means “to furnish with or provide”. This was further emphasised in *Commissioner of Inland Revenue v New Zealand Refining Co Ltd* (1997) 18 NZTC 13, at 187, where it was held that even though the definition refers to “all forms of supply”, such a wide interpretation should not result in a transaction deemed to be a supply where nothing has been provided or furnished to the

counterparty by the recipient. Trombitas (2006) agreed with this view, and consequently suggested that the issue of shares in the context of the New Zealand GST Act “may not even relevantly qualify as a supply for GST purposes”. In concurrence with the judgment in the Kretztechnik case (*supra*), the issue of shares “does nothing more than formally recognise who invested the capital and who the shareholders are” (Trombitas, 2006).

The New Zealand IR still considers the issue of shares to be a supply, although the New Zealand GST Act specifically allows an input tax deduction on share issue costs incurred, effective 1 April 2017 (section 20H of the New Zealand GST Act) (Trombitas, 2019). Despite bringing the New Zealand GST policy on the treatment of input tax on share issue costs incurred in line with the EU VAT policy after the Kretztechnik case (*supra*) by allowing a deduction, the reason for the amendment was not based on the argument that the issue of shares does not constitute a supply (Trombitas, 2019). The reason for the amendment was to ensure that the treatment of input tax on share issue costs incurred by businesses that principally make taxable supplies enhances the broad taxation principles of neutrality, effectiveness and fairness (New Zealand IR, 2016:4). This is discussed further in Chapter 4.

The analysis conducted thus far indicated that there is room to argue that the issue of shares does not fall within the definition of “supply” in section 1(1) of the VAT Act, and consequently does not constitute an exempt supply as determined in ITC 1744 (*supra*). In consideration of the fact that there is still uncertainty as to the interpretation of “supply” and whether the issue of shares falls within the definition in section 1(1) of the VAT Act, the following subsection considers the intention of the legislature to provide clarity on whether the issue of shares was intended to be considered a supply.

3.3.6 The intention of the legislature

South African courts have considered the intention of the legislature in cases where the wording of legislation is uncertain, ambiguous, or results in absurdity (Goldswain, 2008). Even where legislation is clear and unambiguous, consideration of the intention of the legislature may also provide guidance on the ambit and extent of the legislation. The intention of the legislature for a specific section may be obtained by examining a section as a whole, the circumstances and history in which it was enacted, and the policy it attempted to establish (Glen Anil case, at 335). Consideration of the intention of the legislature has led to circumstances in which a phrase or word was given a wide meaning by South African courts, as well as circumstances in which it was given a narrow or restricted meaning, so as to align the interpretation with the intended policy of the legislature (Goldswain, 2008).

It is submitted that the phrase “all other forms of supply” in the definition of “supply” in section 1(1) of the VAT Act seems to indicate that the intention of the legislature was to capture all forms of supply, whether active or passive. This view is supported by the arguments in ITC 1874 (*supra*), in which the definition of “supply” in the Zimbabwean VAT Act was interpreted to also include passive supplies, where there is no act or action on the part of the supplier. It is further supported by the fact that, following the judgment in the Shell’s Annandale case (*supra*), National Treasury amended the definition of “supply” so as to include the expropriation of assets in the case where no act or action was performed by the supplier.

Caution should be exercised when ascertaining the intention of the legislature. De Villiers JA stated in *Shenker v The Master and Another* 1936 AD 136, at 143, that “it is dangerous to speculate as to the intention of the legislature and what seems an absurdity to one man does not seem absurd to another”. Although it seems that the intention of the legislature with the inclusion of “all forms of supply” was to also include passive supplies, this is mere speculation and does not conclusively suggest that the issue of shares is a supply in the ordinary meaning of the word. An overall conclusion is reached in the following section on whether the issue of shares constitutes a “supply” in terms of the definition in section 1(1) of the VAT Act and relevant case law.

3.3.7 Conclusion on whether the issue of shares constitutes a “supply” in terms of the definition in section 1(1) of the VAT Act and relevant case law

This section considers whether the issue of shares constitutes a “supply” in terms of the definition in section 1(1) of the VAT Act, through an analysis of the relevant South African legislation and case law, as well as case law from other jurisdictions included in the SATC Reports and New Zealand. The findings of this section are set out in Table 3.1.

Table 3.1: Findings on whether the issue of shares constitutes a “supply” in terms of the definition in section 1(1) of the VAT Act and relevant case law

Subsection	Findings
3.3.1) Whether the issue of shares is explicitly deemed to be a supply	The issue of shares is not explicitly deemed to be a supply in terms of the VAT Act. Since the definition of “supply” in section 1(1) of the VAT Act includes a reference to “all other forms of supply”, it was found that the ordinary meaning of the word “supply” should also be considered.
3.3.2) The ordinary meaning of the word “supply”	It was found that the ordinary meaning of the term “supply” means “to furnish or provide (a person) with something” (Oxford English Dictionary, 2019a). This is in line with the interpretation of “supply” in the Kretztechnik case (<i>supra</i>), where it was determined that the issue of shares to raise capital does not constitute a supply, since the company issuing the shares does not provide or give up anything (Kretztechnik case, at 26).
3.3.3) Meaning of “supply” in South African case law	The term “supply” is interpreted to mean that “some act on the part of the vendor” should take place for a “supply” to exist (Shell’s Annandale case, at 100) and that “something is provided or delivered by the taxpayer” (National Educare case, at 308). It was found that this interpretation of “supply” is in line with the decision in the Kretztechnik case (<i>supra</i>), at 26, that “supply” means that something should be provided or given up.
3.3.4) Meaning of “supply” in other cases from the SATC Reports	It was noted in Section 3.3.4 that ITC 1874 (<i>supra</i>) dismissed the argument put forth in the Shell’s Annandale case (<i>supra</i>) that “supply” only conveys an active meaning. Since ITC 1874 (<i>supra</i>) was heard in the Zimbabwean Fiscal Appeal Court, it merely provides persuasive value and is not binding on the South African Tax Court.
3.3.5) Meaning of “supply” in New Zealand case law	The interpretation of the definition of “supply” in the New Zealand GST Act, on which the VAT Act was modelled (VATCOM, 1991), also indicates that “supply” means “to furnish with or provide”. The issue of shares is still considered to be an exempt supply in terms of the New Zealand GST Act, although Trombitas (2019) suggested that the argument in the Kretztechnik case (<i>supra</i>) should also be followed in a New Zealand context.
3.3.6) Intention of the legislature	It seems that the intention of the legislature, with the inclusion of “all forms of supply”, is to convey a wide and all-encompassing meaning of the word “supply”. Such a wide definition may include the issue of shares as a supply even though there is no act or action on the part of the supplier when shares are issued.

Based on the analysis conducted in this section, this research assignment agrees with Van der Zwan and Stiglingh (2011:334) that the meaning of “supply” in South African VAT legislation, case law, and other relevant literature indicates that “supply” means that something should be provided, given up, or made available – similar to the argument put forth in the Kretztechnik case (*supra*). The determination of whether the issue of shares

constitutes an act or action where something is provided or given up requires consideration of the nature of a share issue transaction.

When shares are issued, a shareholder receives a share certificate in return for capital given to the company to set up or expand its operations (Investopedia, 2019). A share certificate is merely a receipt for the capital provided by the shareholder (Trombitas, 2019). It therefore seems that the issue of a share certificate by a company does not constitute something being “given up”, since a share certificate is merely proof of the capital provided by the shareholder.

Further support for this argument is gained from consideration of what a share offers a shareholder. A share gives a shareholder a right to vote, to share in future profits, as well as a claim on assets held by the company (Efinancemanagement, 2019). In circumstances where the shares of a company are 100% owned by one shareholder, it is suggested that the issue of more shares to the same shareholder does not result in the shareholder receiving an additional share in future profits, since it already has a 100% share in future profits; however, in such a situation, the company still obtains more capital from the shareholder, although it provides nothing additional, not even a larger share of the profits, in return. This research assignment therefore supports the view of Van der Zwan and Stiglingh (2011:334) that grounds exist to conclude that the issue of shares does not constitute a supply in South African, similar to the argument put forth in the Kretztechnik case (*supra*).

Given the different views of the interpretation of “supply” given in ITC 1874 (*supra*), as well as the fact that the inclusion of the words “all other forms of supply” indicate a wider meaning, it is submitted that SARS should provide guidance on the definition and interpretation of the term “supply” and whether the issue of shares to raise capital constitutes a supply.

The following section considers the treatment of input tax on share issue costs incurred in the absence of an intervening exempt supply, in line with the judgment in the Kretztechnik case (*supra*). This is done by examining the requirements of the VAT Act and relevant case law on how input tax on costs incurred that cannot be attributed to a specific supply should be treated.

3.4 THE TREATMENT OF INPUT TAX ON SHARE ISSUE COSTS IN THE ABSENCE OF AN INTERVENING EXEMPT SUPPLY

In the Kretztechnik case (*supra*), the court determined that share issue costs incurred had a *direct and immediate link* to Kretztechnik AG's overall business of making taxable supplies, since the purpose for which it was acquired was to benefit and increase its business of making taxable supplies (Kretztechnik case, at 36). The court therefore held, at 36, that since the share issue costs incurred had a *direct and immediate link* to the making of taxable supplies, the share issue costs incurred formed part of the overhead costs of the business. It was held in the Securenta case (*supra*), at 31, that input tax on overhead costs incurred is deductible to the extent that a taxpayer's business as a whole makes taxable supplies.

To determine whether a similar argument can be followed in the South African context, this section firstly considers the treatment of input tax on general overhead costs incurred in terms of the VAT Act and relevant guidance available. Secondly, the conclusions reached in Chapter 2 on the application of the *direct and immediate link* test in applying the provisions of the VAT Act are briefly summarised to determine whether, in the absence of a supply, share issue costs incurred may be regarded as part of the general overhead costs of a taxpayer's business in the South African context.

3.4.1 The treatment of input tax on general overhead costs in South Africa

The treatment of input tax on general overhead costs in South Africa is considered with reference to the relevant sections of the VAT Act, as well as guidance from SARS. In terms of the input tax definition in section 1(1) of the VAT Act, input tax is deductible

where the goods or services concerned are acquired wholly for the purpose of consumption, use or supply in the course of making taxable supplies, or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services concerned are acquired by the vendor for such purpose.

In accordance with the provisions of section 17 of the VAT Act, the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:59) states that where expenses are incurred partly for the purpose of taxable supplies and partly for exempt and other non-taxable purposes, the input tax thereon should be apportioned. The VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:59) further states that "the most common expenses that need to be apportioned are the general overheads of the business". It therefore seems that where a business makes partly taxable and partly exempt or non-

taxable supplies, input tax on the general overhead costs of the business, which can include share issue costs as determined in Section 3.4.1, should be apportioned. Although the concept of apportionment is considered relevant to the deductibility of input tax on share issue costs incurred, should it be considered as part of general overhead costs, apportionment methodology is not considered further in this research assignment.

The wording of section 1(1) of the VAT Act and the guidance provided by the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:59) are considered to be similar to the judgment in the *Securenta* case (*supra*), where it was held that input tax on share issue costs incurred is only deductible to the extent that the business as a whole makes taxable supplies. It is therefore submitted that, similar to the approach followed by the CJEU in the *Securenta* case (*supra*), input tax on general overhead costs is deductible to the extent that a business as a whole makes taxable supplies. To determine whether share issue costs incurred can be regarded as general overhead costs in the South African context, the conclusions reached in Chapter 2 on the application of the *direct and immediate link* test in applying the provisions of the VAT Act are briefly summarised next.

3.4.2 Can share issue costs incurred be regarded as general overhead costs in the absence of a specific supply?

To determine whether share issue costs incurred can be regarded as general overhead costs, this subsection considers whether input tax on share issue costs incurred in the absence of a specific supply can have a direct functional link to the taxpayer's business as a whole. The conclusions reached in Chapter 2 on the closeness of the link required by the phrase "in the course of making taxable supplies" are considered. The judgment in the *De Beers* case (*supra*) and the guidance it provided on the nature of expenses that can be included as part of general overhead costs are also considered further.

Chapter 2 highlighted that the phrase "in the course of making taxable supplies" indicates that only a direct functional link should exist between share issue costs incurred and the making of taxable supplies, and not necessarily a *direct and immediate link*. Such a direct functional link should take into account the purpose with which the taxpayer incurred the share issue costs. This was explored in the *De Beers* case (*supra*), where the court considered the purpose for which the DBCM incurred advisory fees in its determination of whether the advisory fees could form part of DBCM's general overhead costs.

In the De Beers case (*supra*), of which the facts were outlined in Chapter 2, no specific supply existed to which the advisory fees incurred could be attributed or linked. The SCA then proceeded to consider whether the advisory fees were incurred by the DBCM in the course of making taxable supplies, by determining whether the advisory fees incurred formed part of the DBCM's general overhead costs (De Beers case, at 343). It seems that the SCA's considerations in the De Beers case (*supra*) were similar to the judgment in the Kretztechnik case (*supra*), where the court also considered whether, in the absence of a specific supply, costs incurred can be regarded as part of the general overhead costs of the taxpayer's business.

The SCA in the De Beers case (*supra*) emphasised that not all costs incurred to legally comply with the relevant requirements to operate a company can be regarded as overhead costs (De Beers case, at 343). Southwood AJA confirmed, at 349, that to determine whether the advisory fees incurred formed part of the DBCM's overhead costs, it was important to consider whether the advisory services were acquired for the purpose of making taxable supplies in the course or furtherance of the DBCM's enterprise of mining and selling diamonds. This included the determination of whether the advisory fees enhanced, affected, or in any way contributed to the DBCM's enterprise of mining and selling diamonds (De Beers case, at 349). The court concluded, at 349, that since the advisory fees did not enhance, affect, or contribute to the DBCM's enterprise of mining and selling diamonds, the advisory fees were not incurred for the purpose of making taxable supplies and were also not part of the DBCM's general overhead costs. In the Kretztechnik case (*supra*), the court considered that since the issue of shares was carried out in order to raise capital to benefit its economic activity as a whole, "it must be considered that the costs ... form[ed] part of its overheads".

It therefore seems that the judgments in both the De Beers case (*supra*) and the Kretztechnik case (*supra*) considered whether the costs incurred benefitted, enhanced, affected, or contributed to the making of taxable supplies, to determine whether costs incurred that cannot be linked to a specific supply can be regarded as overhead costs to the business as a whole. Although the taxpayer in the De Beers case (*supra*) was denied an input tax deduction and the taxpayer in the Kretztechnik case (*supra*) was allowed an input tax deduction, both cases considered the taxpayer's purpose for acquiring goods or services to determine whether it could form part of general overhead costs. Based on this similarity, it is submitted that the argument put forth by the CJEU to consider share issue costs as part of the overhead costs of the taxpayer can also be followed in the South African context.

For emphasis, the arguments put forth in the Kretztechnik case (*supra*) and the De Beers case (*supra*) are applied to the facts of ITC 1744 (*supra*).

In ITC 1744 (*supra*), the purpose of the taxpayer was to raise funding to expand its business (ITC 1744, at 155). The taxpayer's enterprise was the manufacturing and selling of steel shipping containers (ITC 1744, at 155) and the court considered whether the share issue costs were incurred in the course or furtherance of the taxpayer's enterprise. A supply made in the course of an enterprise is made in performing the normal activities of that enterprise (De Koker & Badenhorst, 2019). A supply made in the furtherance of an enterprise is, conversely, not made in performing the normal activities of the enterprise, but rather to the benefit of the enterprise (De Koker & Badenhorst, 2019; Marais, 2014). Through the issue of shares, the taxpayer in ITC 1744 (*supra*) increased its ability to manufacture and sell shipping containers through application of the funding obtained from the issue of shares to purchase machinery and expand its business. It therefore seems that the share issue costs incurred by the taxpayer in ITC 1744 (*supra*) enhanced, affected, benefited, and contributed to the taxpayer's enterprise of manufacturing and selling steel shipping containers.

It follows that, based on the same reasoning as in the De Beers case (*supra*), share issue costs incurred in the absence of a specific supply may be considered as part of the general overhead costs of a taxpayer's business. A conclusion is reached in the ensuing section on the treatment of input tax on share issue costs incurred in the absence of a specific supply.

3.4.3 Conclusion

This section determined that input tax on general overhead costs in South Africa is deductible to the extent that a taxpayer makes taxable supplies. Furthermore, this section determined that, based on the principles established in the De Beers case (*supra*) and guidance from SARS, costs incurred can be regarded as part of general overhead costs where they affect, enhance, and contribute to a taxpayer's enterprise in the course of which taxable supplies are made. Consequently, this research assignment is of the opinion that in the absence of a specific supply to which share issue costs can be linked, share issue costs incurred would constitute general overhead costs of the taxpayer's business, in line with the judgment in the Kretztechnik case (*supra*) and the De Beers case (*supra*). Input tax on share issue costs incurred would then be deductible to the extent that the business as a whole makes taxable supplies.

3.5 SUMMARY AND CONCLUSIONS

Chapter 3 highlighted that the treatment of input tax on share issue costs incurred in the CJEU subsequent to the BLP Group case (*supra*) is different from the principles relied on in ITC 1744 (*supra*), which considered the issue of shares to raise capital to be an intervening exempt supply (ITC 1744, at 155). Through a summary of the relevant CJEU cases, Chapter 3 indicated that, subsequent to ITC 1744 (*supra*), the CJEU allowed for an input tax deduction on share issue costs incurred based on the argument that the issue of shares does not constitute a supply, and that in the absence of a supply, share issue costs should be regarded as part of the overhead costs of the business. It was further highlighted that the CJEU did not distinguish between shares issued in a listed or a private environment to determine the deductibility of input tax on share issue costs incurred.

Chapter 3 determined that the definition of “supply” in the South African context, based on the relevant legislative provisions and case law available, may be given a meaning similar to the CJEU’s interpretation of “supply”, which requires that an act or action must be present where something is given up by the taxpayer. Based on this similarity, Chapter 3 submitted that grounds exist to argue that the issue of shares to raise capital does not constitute a supply as defined in section 1(1) of the VAT Act. Furthermore, Chapter 3 determined that in the absence of a specific supply, share issue costs can be considered as part of the general overhead costs of a taxpayer’s business, in line with the judgment in the Kretztechnik case (*supra*) and the principles from the De Beers case (*supra*). Input tax on share issue costs incurred is then deductible to the extent that the business as a whole makes taxable supplies, in line with the provisions of section 17 of the VAT Act and the guidance provided by SARS in the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:59). This is a departure from the judgment in ITC 1744 (*supra*), where the taxpayer was denied an input tax deduction on share issue costs incurred. Refer to Figure 1 in the Appendix for a graphic representation of the steps to determine the deductibility of input tax on share issue costs incurred.

It was submitted in Chapter 3 that to eliminate confusion, SARS should provide guidance on the definition and interpretation of the term “supply” and must clarify whether the issue of shares constitutes a supply. Such guidance would ensure effectiveness and fairness in the application of the provisions of the VAT Act with regard to the treatment of input tax on share issue costs incurred. Chapter 3 also highlighted the various instances where the concept of fiscal neutrality was considered in the CJEU, as well as in policy changes to the New Zealand GST Act with regard to the deductibility of input tax on share issue costs incurred.

A further investigation of whether the current treatment of input tax on share issue costs incurred detracts from the broad taxation principles of neutrality, effectiveness and fairness follows in Chapter 4. This investigation provided further support to the conclusions reached in Chapters 2 and 3 that input tax on share issue costs incurred should be deductible in South Africa.

CHAPTER 4:

THE PRINCIPLES OF NEUTRALITY, EFFECTIVENESS AND FAIRNESS IN THE TREATMENT OF INPUT TAX ON SHARE ISSUE COSTS INCURRED

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CHAPTER 4:

THE PRINCIPLES OF NEUTRALITY, EFFECTIVENESS AND FAIRNESS IN THE TREATMENT OF INPUT TAX ON SHARE ISSUE COSTS INCURRED

4.1 INTRODUCTION

The main research question of this research assignment is whether input tax on share issue costs incurred should be deductible in South Africa. Chapters 2 and 3 focused on the wording of the VAT Act to determine whether input tax on share issue costs should be deductible. Chapter 2 determined that the phrase “in the course of making taxable supplies” in the context of share issue costs incurred means that a direct functional link should exist between share issue costs incurred and a taxpayer’s enterprise in the course of which taxable supplies are made. Chapter 3 determined that grounds exist to argue that the issue of shares to raise capital does not constitute a supply as defined in section 1(1) of the VAT Act. It was highlighted in both Chapters 2 and 3 that the broad taxation principles of neutrality, effectiveness and fairness were considered by the CJEU (BLP Group case, at 26; Cibo case, at 27; KapHag case, at 25; Kretztechnik case, at 34; Securenta case, at 25; SKF case, at 56) and the New Zealand IR (2016:4) in their respective decisions to allow an input tax deduction on professional fees incurred in respect of the transfer of shares.

Since the VAT Act was modelled on the New Zealand GST Act (VATCOM, 1991), the subsequent inclusion of a specific deduction for input tax on share issue costs incurred in the New Zealand GST Act to satisfy the broad taxation principles is considered relevant to this research assignment to determine whether input tax on share issue costs incurred should be deductible. Although the New Zealand IR (2016:6) also considered the principles of efficiency, certainty, simplicity, and flexibility in its determination of whether input tax on share issue costs should be deductible, only the principles of neutrality, effectiveness and fairness were considered as key objectives.

To determine whether input tax on share issue costs should be deductible, Chapter 4 therefore evaluates whether the denial of input tax deductions on share issue costs incurred enhances or detracts from the broad taxation principles of neutrality, effectiveness and fairness. Since the broad taxation principles are interconnected (OECD, 2017:80), reference is briefly made to the remaining principles of efficiency, certainty, simplicity, and flexibility, while focus is placed on neutrality, effectiveness and fairness.

To provide context, the New Zealand IR's inclusion of a specific deduction for input tax on share issue costs incurred to enhance the principles of neutrality, effectiveness and fairness is briefly considered first. This is followed by an analysis of whether input tax on share issue costs enhances or detracts from the principles of neutrality, effectiveness and fairness in the South African context, based on the arguments put forth by the New Zealand IR. Since reliance was previously placed on judgments in the CJEU, the CJEU's consideration of the principles of neutrality, effectiveness and fairness is also considered relevant.

To assess whether the arguments put forth by the New Zealand IR to allow a specific input tax deduction on share issue costs incurred may be followed in the South African context, a comparative analysis of the requirements of the VAT Act and the New Zealand GST Act is also performed. Finally, a conclusion is reached on whether the current denial of input tax deductions on share issue costs incurred satisfies the broad taxation principles of neutrality, effectiveness and fairness. This is done to support the main research objective of determining whether share issue costs should be deductible in South Africa.

4.2 AMENDMENT OF THE NEW ZEALAND GOODS AND SERVICES TAX (GST) ACT TO ENHANCE THE PRINCIPLES OF NEUTRALITY, EFFECTIVENESS AND FAIRNESS

Before the introduction of section 20H of the New Zealand GST Act, effective 1 April 2017, input tax on share issue costs incurred by businesses that principally make taxable supplies to raise capital was not deductible in New Zealand (New Zealand IR, 2016:4). Prior to 1 April 2017, the New Zealand IR has traditionally taken the view that the issue of shares is an exempt supply of financial services, and that a business that principally makes taxable supplies is unable to deduct GST on the costs incurred in the process (Trombitas, 2015).

Subsequent to the Kretztechnik case (*supra*) heard in the CJEU in 2005, Trombitas (2006) urged the New Zealand IR to also revisit its policy on the deductibility of input tax on share issue costs incurred for businesses that principally make taxable supplies to align with the developments in the CJEU. Before the introduction of section 20H of the New Zealand GST Act, taxpayers in New Zealand who argued that the issue of shares does not constitute a supply and that input tax on share issue costs incurred is deductible to the extent that the business as a whole makes taxable supplies, in line with the Kretztechnik case (*supra*), were unsuccessful (Trombitas, 2015).

In 2015, The New Zealand IR announced a legislative amendment to the New Zealand GST Act to allow a specific deduction of input tax on share issue costs incurred to raise capital by businesses that principally make taxable supplies (New Zealand IR, 2015:4). Although the Kretztechnik case (*supra*) was endorsed in the Tax Policy document issued by the New Zealand IR (2015:4), the final amendment, which consisted of the inclusion of section 20H in the New Zealand GST Act, did not determine that the issue of shares is not a supply for GST purposes (New Zealand IR, 2016:3-4). Alternatively, the New Zealand IR (2016:4) considered that the key objective of the inclusion of section 20H in the New Zealand GST Act was to align the treatment of input tax on share issue costs incurred by businesses that principally make taxable supplies with the broad taxation principles of neutrality, effectiveness and fairness (New Zealand IR, 2016:4).

The next section considers the arguments put forth by the New Zealand IR (2016:4) to determine whether the denial of input tax deductions on costs incurred to issue shares to raise capital detracts from the principles of neutrality, effectiveness and fairness. Since reliance was previously placed on judgments in the CJEU, the CJEU's consideration of the principles of neutrality, effectiveness and fairness in the cases subsequent to ITC 1744 (*supra*) is also deemed relevant. Focus is placed on the two key principles identified by the New Zealand IR (2016:4), namely the principle of neutrality, and the principle of effectiveness and fairness.

4.3 THE PRINCIPLES OF NEUTRALITY, EFFECTIVENESS AND FAIRNESS IN THE CONTEXT OF INPUT TAX ON SHARE ISSUE COSTS INCURRED

The broad taxation principles are based on the so-called canons of taxation as advocated by Adam Smith in 1776 (Stack, Stiglingh & Koekemoer, 2015:151), which are considered the basic criteria to determine whether a tax system is “good” (Smith, 1776). The canons of taxation were restated by the OECD in 1998 for application in the new electronic era (Stack *et al.*, 2015:152) and subsequently included in the OECD International VAT/GST Guidelines (OECD, 2017:18). In terms of the OECD International VAT/GST Guidelines (OECD, 2017:18), the broad taxation principles are: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. The OECD International VAT/GST Guidelines (2017:11) acknowledge that jurisdictions are sovereign with respect to the drafting and implementation of VAT legislation but aim to provide a reference point from which jurisdictions can evaluate and develop VAT policy.

To determine whether the denial of input tax deductions on share issue costs incurred enhances or detracts from the broad taxation principles of neutrality, effectiveness and fairness in the South African context, this section considers the meaning of each principle, the considerations given to them by the CJEU, and the arguments put forth by the New Zealand IR to allow a deduction. A conclusion is also drawn on whether the denial of input tax deductions on share issue costs incurred in the South African context enhances or detracts from the principles. The principle of neutrality in the context of input tax on share issue costs incurred is discussed first.

4.3.1 Neutrality

The OECD (2017:20) laid down three guidelines for the neutrality principle, namely:

- VAT rules should be framed in such a way that they are not the primary influence on business decisions.
- Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- The burden of VAT should not lie on taxable businesses except where explicitly provided for in legislation.

To determine whether the denial of input tax on share issue costs satisfies the broad taxation principle of neutrality, each of these three guidelines above are considered separately in the following section.

4.3.1.1 VAT rules should be framed in such a way that they are not the primary influence on business decisions

In terms of the neutrality principle, VAT should be neutral and equitable between different forms of commercial transactions so that business decisions are motivated by economic factors and not by the VAT implications thereof (OECD, 2017:18). Although it is likely that VAT may be considered in a business' decision-making process, VAT legislation should not drive businesses to change the way they structure transactions or the legal framework within which they operate (OECD, 2017:21).

A practical example is seen in the BLP Group case (*supra*), where the taxpayer argued, at 15, that the neutrality principle is violated if the CJEU denies an input tax deduction on costs incurred to dispose of shares for liquidity, but allows an input tax deduction for costs incurred to obtain a bank loan. The CJEU dismissed the taxpayer's argument and highlighted the

principle established in *D.A. Rompelman and E.A. Rompelman-Van Deelen and Minister van Financiën* 1985 ECR C-268/83 that the neutrality principle can only be applied where comparable transactions are subject to VAT in the first place (BLP Group case, at 26). Although the taxpayer's argument was unsuccessful, it raised an important concept in terms of neutrality in the treatment of input tax on share issue costs incurred, which was considered further in New Zealand.

Trombitas (2006) held the view that the New Zealand GST Act's allowance of input tax deductions on costs incurred to obtain one method of financing, such as a bank loan, but to deny input tax deductions on costs incurred to obtain another method of financing, such as the issue of shares, negated the neutrality principle. Both the issue of shares and the provision of credit are considered exempt supplies in terms of the New Zealand GST Act (section 3). The differential tax treatment of two methods of financing that are both considered exempt supplies in terms of the New Zealand GST Act detracts from the principle of neutrality, since it may be the primary influence on a business' decision regarding the type of financing raised (Trombitas, 2006).

Similar concerns to those raised by Trombitas (2006) were considered by the New Zealand IR (2016:4) with the inclusion of section 20H of the New Zealand GST Act. While Trombitas (2006) focused on the differential treatment of input tax on costs incurred to obtain a bank loan as opposed to issuing shares, the New Zealand IR (2016:4) highlighted the differential treatment of input tax on costs incurred to issue shares to shareholders who are residents and those who are not. Before the inclusion of section 20H in the New Zealand GST Act, input tax on costs incurred to issue shares in New Zealand was not deductible since the share issue costs were incurred for an exempt supply (New Zealand IR, 2016:4). Conversely, input tax on costs incurred to issue shares to foreign shareholders is deductible since the issue of shares to foreign shareholders is considered a zero-rated supply (a zero-rated supply is still a taxable supply, but the VAT levied is at a rate of 0%). The New Zealand IR (2016:4) therefore emphasised the bias created by allowing an input tax deduction on costs incurred to issue shares to non-residents while disallowing input tax deductions on costs incurred to issue shares to residents. This bias created a disincentive for local funding, which negated the neutrality principle (New Zealand IR, 2016:5).

In the South African context, similar differential treatment of input tax on costs incurred to obtain a bank loan, to issue shares to resident shareholders, and to issue shares to non-resident shareholders is also found.

Currently, input tax on share issue costs incurred to raise capital in South Africa is not deductible (Badenhorst *et al.*, 2010), compared to input tax on costs incurred to obtain a bank loan, which is deductible. The provision of credit, which includes a bank loan, is included in section 2(1)(f) of the VAT Act as a financial service. The interest incurred on a bank loan is also a financial service, as defined in terms of section 2(1)(f) of the VAT Act. Financial services are exempt from VAT in terms of section 12(a) of the VAT Act. The proviso to section 2(1) states, however, that to the extent that the consideration payable in respect of the provision of credit, among others, consists of “any fee, commission, merchant’s discount or similar charge”, it shall not be deemed to be financial services. The supply of financial services for a fee in relation to the provision of credit is therefore not considered a financial service and is therefore not an exempt supply. Input tax on costs incurred to obtain a bank loan is therefore deductible in South Africa where the services rendered incur a fee or similar charge. Since input tax on share issue costs incurred is currently not deductible, taxpayers may prefer to obtain a bank loan to finance their business rather than issuing shares, to take advantage of the input tax deduction on costs incurred in the process.

In addition, the issue of shares to non-resident shareholders may also be considered a zero-rated supply in terms of the VAT Act. This results in a similar bias in terms of the treatment of input tax on share issue costs incurred to obtain local and foreign funding, which derogates the neutrality principle of a good VAT system. In terms of section 11(2)(l) of the VAT Act, services supplied to non-residents that are not supplied directly in connection with land, land improvements, or moveable property, with the exclusion of, *inter alia*, equity securities, shall be charged with tax at a rate of 0%. Section 11(2)(l)(iii) further provides that, if the non-resident is in the Republic at the time that the services are rendered, the zero-rating will not apply. The issue of shares to non-resident shareholders, who are not in the Republic at the time the services are rendered, may therefore fall within the ambit of section 11(2)(l) if the issue of shares is considered a supply in the first place.

For financial services that fall within the ambit of section 11(2)(l), or any other subsection in terms of which VAT is charged at a rate of 0%, the zero-rating provision takes precedence over the exemption provided in section 12(a) (Silver, 2019). Since zero-rated supplies in terms of section 11 of the VAT Act are also considered taxable supplies (definition of taxable supply in section 1(1) of the VAT Act), input tax on costs incurred in the course of making zero-rated supplies is deductible in terms of the definition of input tax in section 1(1) of the VAT Act. It follows that input tax on share issue costs incurred to issue shares to non-resident shareholders may be deductible – should the non-resident shareholder not be

present in the Republic at the time the shares are issued and should the issue of shares constitute a supply. If a business issues shares to a non-resident shareholder outside the Republic and similarly issues shares to a resident shareholder inside the Republic, differential treatment of input tax on the share issue costs incurred therefore arises.

Where the quantum of costs incurred to obtain financing is material to an organisation's cash flow and budgetary constraints, the deductibility of input tax on costs incurred in the process may therefore be the primary reason a taxpayer chooses one method of financing above another – to rather obtain a bank loan instead of issuing shares, or to issue shares to a non-resident instead of a resident shareholder. It follows that this would detract from the neutrality principle and negate the OECD's (2017:21) guideline that VAT rules should not be the primary influence on commercial decisions.

The second guideline of the neutrality principle states that in addition to the concept that VAT rules should not influence business decisions, businesses in similar situations that carry out similar transactions should be taxed similarly (OECD, 2017:18). This is considered next.

4.3.1.2 Businesses in similar situations that carry out similar transactions should be subject to similar levels of taxation

Similar levels of taxation should apply to taxpayers in similar situations who carry out similar transactions (OECD, 2017:18). In a VAT system, this is to ensure that the correct amount of VAT is collected along the supply chain, which is proportional to the VAT paid by the end consumer irrespective of the nature of the supply (OECD, 2017:21). According to the OECD (2017:20), neutrality is further achieved in a VAT system that is “unbiased and impartial”, with no undue tax burden or disproportionate compliance cost for taxpayers. The principle of efficiency is complementary to the neutrality principle and maintains that the administrative cost for tax authorities and the cost of compliance for taxpayers should be kept at a minimum (OECD, 2017:80).

Administrative costs refer to the cost incurred by tax authorities to administer and collect taxes; from initial policy formulation through to the cost of a judicial and tax dispute system (Evans, 2008:450). Compliance costs include the cost to calculate, remit, and account for VAT, as well as the cost of acquiring the knowledge to do so and to understand the legal obligations thereof (Sandford, Godwin & Hardwick, 1989). The New Zealand IR (2015:2) argued that higher compliance costs are expected in situations where input tax on share issue costs incurred is not deductible. Businesses that principally make taxable supplies and

then issue shares as a once-off exempt supply are required to determine which portion of goods or services acquired relate to the issue of shares and which relate to making taxable supplies (New Zealand IR, 2015:1). This increases compliance costs (New Zealand IR, 2015:1), which detracts from the neutrality principle (OECD, 2017:20).

In the South African context, it is submitted that the denial of input tax on share issue costs incurred also detracts from the neutrality principle since it similarly results in undue compliance costs for taxpayers. Input tax on share issue costs incurred is currently not deductible based on the judgment in ITC 1744 (*supra*) (Badenhorst *et al.*, 2010), which considered the issue of shares to be an exempt supply. In accordance with the provisions of section 17 of the VAT Act, where expenses are incurred partly for the purpose of taxable supplies and partly for exempt and other non-taxable purposes, the input tax thereon should be apportioned (Legal and Policy Division: SARS, 2017:59). Businesses who principally make taxable supplies are therefore required to determine which portion of goods or services acquired relate to the issue of shares and which relate to the making of taxable supplies. It follows that this may result in undue compliance costs for taxpayers who principally make taxable supplies, which derogates the neutrality principle (OECD, 2017:20).

In addition to compliance costs incurred to apportion goods or services acquired, compliance costs also include the cost to obtain legal guidance or refer a matter to the Tax Court (Sandford *et al.*, 1989). It is suggested that the need to resort to the Tax Court to determine the correct VAT treatment of a transaction may result in disproportionate compliance costs for taxpayers and administrative costs for tax authorities to fund the legal proceedings, which negates the neutrality principle. It is submitted that this may currently be the case in South Africa, where the judgment in ITC 1744 (*supra*) currently directs SARS's policy on the deductibility of input tax on share issue costs incurred. Since no guidance on the matter has been provided since ITC 1744 (*supra*) was heard in 2002, taxpayers may resort to the Tax Court to determine whether input tax on share issue costs is deductible.

The principle of flexibility seems to enhance neutrality. Flexibility refers to a taxation system that is flexible and dynamic enough to accommodate new commercial transactions and technologies (OECD, 2017:18). It is concluded that a flexible taxation system may also enhance neutrality, since flexibility may enable taxation systems to adapt to changes to ensure that businesses that carry out similar transactions are subject to similar levels of taxation.

The third and last guideline of the neutrality principle requires that VAT merely “flows through” the business, which is dealt with next.

4.3.1.3 *The burden of VAT should not lie on taxable businesses except where explicitly provided for in legislation*

Neutrality in a VAT system is achieved through the invoice-based credit method where VAT merely “flows through” the business and is ultimately borne by the end consumer (OECD, 2017:20). The fundamental principle that the VAT burden should not be placed on businesses was considered by the CJEU in the cases that led to the conclusion that input tax on share issue costs is deductible (Cibo case, at 27; KapHag case, at 37; Kretztechnik case, at 34; Securenta case, at 25; SKF case, at 56). In the Cibo case (*supra*), at 27, the CJEU observed that input tax deductions are meant to relieve taxpayers of the VAT burden since it should enable taxpayers to pass the VAT burden on to end consumers. This was emphasised again in the Kretztechnik case (*supra*), at 33 and 34, where the CJEU noted that a taxpayer’s right of deduction provided in the Sixth Directive may not be limited, since this right of deduction is integral to the scheme and purpose of a VAT system.

In its International VAT/GST Guidelines, the OECD (2017:21) emphasised that there are situations where it is legitimate for jurisdictions to place the VAT burden on businesses rather than on end consumers, where explicitly and clearly provided for in legislation. Since financial services are perceived to be complex in nature and therefore difficult to tax, the OECD (2017:20) highlighted the exemption of financial services as an exception of when jurisdictions may legitimately place the VAT burden on businesses instead of on end consumers. Financial services are perceived to be difficult to tax since fees charged by financial service providers can easily be substituted for margins made on the financial services supplied (New Zealand IR, 2015:1). For this reason, the supply of financial services in most jurisdictions are exempt from VAT (Mirrlees *et al.*, 2011:196). VAT on exempt financial services is then collected by governments through the denial of input tax deductions on costs incurred in the process of making the exempt supplies of financial services (Mirrlees *et al.*, 2011:196). The VAT burden is therefore intentionally placed on businesses instead of on end consumers to allow easier collection of VAT through the denial of input tax deductions.

Businesses can then either pass the cost of the non-deductible input tax on to their customers or absorb it into their businesses, which creates a cascading effect (New Zealand IR, 2015:2). VAT cascades that arise from the exemption of financial services and the

subsequent denial of input tax deductions on costs incurred in the process have been identified as a breach of the neutrality principle (Davis Tax Committee, 2018:6). VAT cascades occur in circumstances where financial services are supplied as an intermediate supply in relation to a subsequent taxable supply and the input tax paid on the goods or services acquired to make the supply of financial services is not deductible (Davis Tax Committee, 2018:30). VAT cascades detract from the neutrality principle since they do not result in the VAT burden being carried by the end consumer, but rather by a business that makes taxable supplies (Moodley, 2016:28).

The New Zealand IR (2016:4) specifically addressed the issue of tax cascades, which is similar to VAT cascades in terms of the VAT Act, through the inclusion of section 20H in the New Zealand GST Act. The New Zealand IR (2016:4) emphasised that the denial of input tax deductions for businesses that principally make taxable supplies causes tax cascades, since taxpayers are not always able to pass the tax cost on to their end consumers. This unduly places the GST burden on businesses rather than on end consumers (New Zealand IR, 2016:4). The New Zealand IR (2016:4) suggested that GST is intended to be a tax applied only once on final consumption, and since the denial of input tax deductions on share issue costs incurred results in tax cascades, this intended purpose is not met.

In the South African context, the Davis Tax Committee (2018:29) has considered whether the exemption of financial services and the subsequent denial of input tax deductions incurred in the process negate the principle of neutrality due to the existence of VAT cascades. The existence of VAT cascades as a result of the exemption of financial services was deemed the most important area for consideration in the context of VAT exemptions (Davis Tax Committee, 2018:6). The committee did not, however, specifically consider the VAT treatment of financial services in the context of businesses that principally make taxable supplies, where shares are issued to raise capital. Alternatively, the focus was placed on financial services supplied by financial service providers, such as banks and other financial institutions.

SARS's current policy is based on the judgment in ITC 1744 (*supra*), which denies taxpayers an input tax deduction on share issue costs incurred. Since taxpayers may not be able to pass the VAT cost on to end consumers, the denial of input tax deductions on share issue costs incurred may result in the VAT burden being carried by businesses that principally make taxable supplies. This results in VAT cascades, in terms of which the VAT paid is not allowed to flow through the business even though the capital raised from the issue of shares may be utilised to increase the making of taxable supplies. It follows that since the denial of

input tax on share issue costs incurred results in VAT cascades, it detracts from the neutrality principle of a good VAT system.

Although the neutrality principle was considered an important objective for the New Zealand IR (2016:4) in its allowance of an input tax deduction on share issue costs incurred, the key objective was effectiveness and fairness, as discussed next.

4.3.2 Effectiveness and fairness

The principle of effectiveness and fairness refers to a taxation system that produces the right amount of tax at the right time and where the potential for tax avoidance and tax evasion is minimal (OECD, 2017:18). Certainty and simplicity are required for a VAT system to achieve effectiveness and fairness (OECD, 2017:80). The principle of effectiveness and fairness is therefore discussed first in the context of certainty and simplicity.

4.3.2.1 The principle of certainty and simplicity is required to achieve effectiveness and fairness

The principle of certainty and simplicity refers to a VAT system with rules that are clear and simple and where it is easy to anticipate the VAT consequences of a transaction (OECD, 2017:18). It follows that where VAT legislation enhances the principles of certainty and simplicity, it is likely to also produce results that are effective and fair with the right amount of tax levied at the right time.

Practical examples of the principle of certainty and simplicity, which enhances effectiveness and fairness, were considered by the CJEU in the BLP Group case (*supra*) and the SKF case (*supra*). In the BLP Group case (*supra*), at 24, the CJEU argued that the principle of certainty would not be met if tax authorities needed to carry out inquiries to determine a taxpayer's intention for acquiring goods or services in the absence of an objective link to the making of taxable supplies. The CJEU further confirmed in the SKF case (*supra*), at 76, that legislation should enable taxpayers to know with certainty the exact obligation a provision imposes on them. It follows that where provisions of VAT legislation are unclear, ambiguous, and open to different interpretations by different taxpayers, the principle of certainty and simplicity is not met. Since certainty and simplicity are required for a VAT system to achieve effectiveness and fairness, the absence of certainty and simplicity detracts from the principle of effectiveness and fairness (OECD, 2017:80).

It seems that a similar line of reasoning was followed by the New Zealand IR (2016:4) in its consideration of whether certainty and simplicity are achieved by the denial of input tax on share issue costs incurred. The New Zealand IR (2016:5) concluded that the denial of an input tax deduction on share issue costs incurred leads to legislation that is less transparent and certain, which detracts from the principle of certainty and simplicity. The absence of certainty and simplicity derogates the principle of effectiveness and fairness (OECD, 2017:80), which requires a good VAT system to produce the right amount of tax at the right time.

In the South African context, Interpretation Note No. 70 (Legal and Policy Division: SARS, 2013:5) mirrors the principle of certainty and simplicity where it stated that VAT legislation should ideally make it clear which circumstances give rise to taxable or non-taxable supplies. Chapter 3 determined that there are grounds to argue that the issue of shares is not a supply in terms of section 1(1) of the VAT Act; in contrast with the Tax Court's considerations in ITC 1744 (*supra*), at 156. SARS's current policy is based on the judgment in ITC 1744 (*supra*), which may not be appropriate based on the findings of Chapter 3. It is therefore submitted that the current treatment of input tax on share issue costs incurred in terms of the VAT Act is not clear, simple enough to understand, or easy to anticipate. It follows that the denial of input tax deductions on share issue costs incurred in South Africa detracts from the broad taxation principle of effectiveness and fairness.

The New Zealand IR (2016:5) further considered that in terms of the principle of effectiveness and fairness, the New Zealand GST Act should produce the right amount of tax at the right time. This is considered further in the next section.

4.3.2.2 A taxation system should produce the right amount of tax at the right time

Effectiveness and fairness refer to a VAT system that results in the right amount of tax at the right time (OECD, 2017:18). According to Moodley (2016:26), fairness or equity refers to the ability of a VAT system to treat all parties equally. It seems that fairness is achieved when every taxpayer contributes their "fair share" of VAT in line with the purpose of the VAT system. According to the OECD (2017:14), "the overarching purpose of a VAT is to impose a broad-based tax on consumption, which is understood to mean final consumption by households".

Similarly, the New Zealand IR (2016:4) emphasised that the ultimate purpose of GST is to be a tax on final consumption, applied only once. The New Zealand IR (2016:4) argued that

tax cascades caused by the denial of input tax on share issue costs incurred detract from the principle of effectiveness and fairness, since they do not produce the right amount of tax at the right time. To arrive at this conclusion, the New Zealand IR (2016:4) focused on the reason for denying input tax deductions on share issue costs incurred in the first place.

The New Zealand IR (2016:4) highlighted that it is important to distinguish between financial services supplied by financial service providers, such as banks and other financial institutions, and financial services incidentally supplied by businesses that principally make taxable supplies through the issue of shares. This distinction highlighted that the exemption of financial services was intended to address the difficulty experienced in taxing the supply of financial services supplied by financial service providers. However, since no distinction is made in the New Zealand GST Act between the issue of shares by financial service providers and businesses that principally make taxable supplies, it inappropriately also resulted in the denial of input tax deductions for businesses that issue shares in the pursuit of raising capital (New Zealand IR, 2015:1). In its 2015 Tax Policy publication, the New Zealand IR (2015:1) stated that it “may not be appropriate to deny deductions when a regular taxable business supplies financial services to raise funds for furthering its taxable activity, particularly when the business is not seeking to add value to the supply of financial services”.

The New Zealand IR (2016:4) emphasised that there is a fundamental difference between financial services supplied by financial service providers, and those incidentally supplied by businesses that principally make taxable supplies through issuing shares to raise capital. Financial services supplied by financial service providers such as banks and other financial institutions are mostly consumed by the recipient of the financial service; for example, the consumer who receives a loan from a bank (New Zealand IR, 2016:4). Where financial services are supplied to raise capital through the issue of shares, the New Zealand IR (2016:4) argued that the financial services supplied are not consumed by the providers of the capital, namely the shareholders.

Since the supply of financial services to raise capital through the issue of shares is merely an intermediate supply in relation to a taxable supply made to an end consumer, it therefore should not be treated the same as financial services supplied by financial service providers (New Zealand IR, 2015:2). Consequently, the New Zealand IR (2015:2) concluded that the denial of input tax deductions on share issue costs incurred to raise capital detracts from the ultimate purpose of the New Zealand GST Act to be a tax on final consumption. Since the right amount of tax was not produced at the right time, the denial of input tax deductions

on share issue costs incurred is contrary to the principle of effectiveness and fairness (New Zealand IR, 2016:5).

In the South African context, it was established in the previous section that the denial of input tax on share issue costs incurred results in VAT cascades. Similar to the argument put forth by the New Zealand IR (2015:1; 2016:4), the existence of VAT cascades in the South African context may also negate the principle of effectiveness and fairness, since they do not result in the right amount of tax at the right time. In addition, it is submitted that the VAT Act also does not distinguish between the supply of financial services by financial service providers and businesses that principally make taxable supplies. This is considered fundamental to this research assignment's overall objective to determine whether input tax on share issue costs incurred should be deductible, since it seems to provide insight into why input tax on share issue costs incurred is denied in the first place.

The wording of section 2(1) of the VAT Act states that "the following activities shall be deemed to be financial services". Furthermore, section 12 states that "the supply of any of the following goods or services shall be exempt from the tax imposed under section 7(1)(a)", which includes in subsection (a) the "supply of any financial services". This is mirrored in the report of VATCOM (1991), which stated that it is not the financial institutions that are exempt from VAT, but rather financial services. It therefore seems that the VAT Act does not distinguish between the supply of financial services by financial service providers and businesses that principally make taxable supplies. It follows that the issue of shares by a financial service provider and the issue of shares by a business that principally makes taxable supplies are currently treated uniformly. Whether it was the intention of the legislature to treat input tax on share issue costs incurred by financial service providers and businesses that principally make taxable supplies similarly is outside the scope of this research assignment. Nevertheless, this research assignment is of the opinion that the lack of a distinction between input tax on share issue costs incurred by financial service providers such as banks and other financial institutions and businesses that principally make taxable supplies aggravates the derogation of the effectiveness and fairness principle.

Since a business that principally makes taxable supplies may use the capital raised through the issue of shares to expand its business of making taxable supplies, it seems that the denial of input tax deductions on share issue costs incurred does not enhance the principle of effectiveness and fairness, since it does not produce the right amount of tax at the right time.

4.3.3 Conclusion

The analysis of the broad taxation principles of neutrality, effectiveness and fairness in the context of input tax on share issue costs incurred found that SARS's current policy to deny an input tax deduction on share issue costs incurred (Badenhorst *et al.*, 2010) detracts from the broad taxation principles of neutrality, effectiveness and fairness of a good VAT system. The findings of this section may accordingly be summarised as set out in Table 4.1.

Table 4.1: Input tax on share issue costs in the context of the principles of neutrality, effectiveness and fairness

Broad taxation principle	Findings on the denial of input tax on share issue costs
4.3.1.1) Neutrality: VAT rules should be framed in such a way that they are not the primary influence on business decisions.	The principle is not enhanced, since the differential treatment of input tax on costs incurred to raise similar types of financing may result in businesses preferring one method of financing over another.
4.3.1.2) Neutrality: Businesses in similar situations that carry out similar transactions should be subject to similar levels of taxation.	The principle is not enhanced, since the need to resort to the Tax Court to determine the deductibility of input tax on share issue costs incurred may result in disproportionate compliance costs for taxpayers and administrative costs for tax authorities.
4.3.1.3) Neutrality: The burden of VAT should not lie on taxable businesses, except where explicitly provided for in legislation.	The principle is not enhanced, since input tax on share issue costs incurred results in a tax cost to businesses that principally make taxable supplies.
4.3.2.1) Effectiveness and fairness: The principle of certainty and simplicity is required to achieve effectiveness and fairness.	The principle is not enhanced. Based on the issues identified with SARS's current policy on the deductibility of input tax on share issue costs incurred, it is submitted that the current treatment of input tax on share issue costs incurred in terms of the VAT Act is not clear, simple enough to understand, or easy to anticipate.
4.3.2.2) Effectiveness and fairness: A taxation system should produce the right amount of tax at the right time.	The principle is not enhanced, since the denial of input tax on share issue costs incurred does not result in the right amount of tax at the right time due to the existence of VAT cascades. In addition, it was found that the uniform treatment of input tax on share issue costs incurred by financial service providers and businesses that principally make taxable supplies may not be appropriate.

The New Zealand IR (2016:4) argued that since the denial of input tax on share issue costs incurred does not achieve the key objectives of neutrality, effectiveness and fairness, a specific deduction for input tax on share issue costs incurred should be included in the New Zealand GST Act. To determine whether it is appropriate to follow a similar argument to that of the New Zealand IR in the South African context to determine whether input tax on share issue costs should be deductible to enhance the broad taxation principles, it must be

considered whether the arguments put forth by the New Zealand IR were made under comparable VAT legislation (ITC 1853, at 307).

To that end, the following section considers the comparability of the requirements to deduct input tax on share issue costs incurred in terms of the New Zealand GST Act and the VAT Act respectively.

4.4 THE APPROPRIATENESS OF FOLLOWING THE ARGUMENTS PUT FORTH BY THE NEW ZEALAND INLAND REVENUE (IR) IN THE SOUTH AFRICAN CONTEXT

For completeness, consideration is first made of whether the OECD's broad taxation principles may be considered as guidance to evaluate the provisions of the VAT Act, since South Africa is not a member of the OECD (OECD, 2018). This is followed by a comparison of the requirements to deduct input tax in terms of the New Zealand GST Act and the VAT Act respectively, before section 20H was introduced in the New Zealand GST Act.

4.4.1 The appropriateness of evaluating the provisions of the VAT Act against the broad taxation principles

Although South Africa is not a member of the OECD, its relationship with the OECD is classified as "mutually beneficial" (OECD, 2018). Furthermore, the OECD, National Treasury, and SARS signed a Memorandum of Co-operation on 11 January 2019 in which the three parties agreed to continue to work together in the area of taxation (SARS, 2019). The common objectives of the cooperation between the three parties is to promote fair and efficient tax systems and to strengthen and modernise international tax areas through sharing experiences (SARS, 2019).

Additionally, the broad taxation principles were specifically considered by VATCOM in 1991 to evaluate the policy design of the VAT Act (VATCOM, 1991). Subsequent reports by the Davis Tax Committee (2018:6) also highlighted that proposed legislative amendments in terms of the VAT treatment of financial services should be done with the purpose of enhancing the broad taxation principle of neutrality. It follows that the OECD's broad taxation principles may be relevant to interpret and evaluate the provisions of the VAT Act. To determine whether the arguments put forth by the New Zealand IR (2016:4) with the inclusion of section 20H may be appropriate in the South African context, it is now necessary to consider whether the issue of shares is treated similarly in terms of the New Zealand GST

Act and the VAT Act respectively. This is followed by consideration of the comparative requirements to deduct input tax in terms of the New Zealand GST Act and the VAT Act.

4.4.2 Comparative treatment of the issue of shares

The issue of shares is included as a financial service in terms of section 3 of the New Zealand GST Act. Section 14 of the New Zealand GST Act states that the supply of any financial services shall be exempt from tax. The New Zealand GST Act, however, allows two exceptions to the exemption of financial services supplied:

- Financial services supplied by financial service providers to businesses that principally make taxable supplies are zero-rated and input tax on the costs incurred in the process is deductible (New Zealand IR, 2016:3).
- Financial services supplied to non-residents outside New Zealand are also considered zero-rated supplies, and input tax on costs incurred in the process is deductible (New Zealand IR, 2016:3).

Despite the two exceptions to the exemption of financial services provided above, the New Zealand GST Act considers the issue of shares to raise capital as an exempt supply of financial services (New Zealand IR, 2016:3). Although Trombitas (2015) submitted that there are grounds to argue that the issue of shares does not constitute a supply in terms of the New Zealand GST Act, the New Zealand IR is currently treating the issue of shares as a supply (New Zealand IR, 2016:3; Trombitas, 2019).

The VAT Act similarly states that the issue of shares is a financial service (definition of financial services in section 2(1)(d) of the VAT Act) and that the supply of financial services shall be exempt from tax (section 12(a) of the VAT Act). Although Chapter 3 submitted, in agreement with Van der Zwan and Stiglingh (2011:335), that there are grounds to argue that the issue of shares is not a supply in the South African context, the judgment in ITC 1744 (*supra*) indicated that the issue of shares is currently treated as a supply in terms of the VAT Act. The issue of shares is therefore currently treated as a supply in terms of the New Zealand GST Act and the VAT Act, as highlighted in Chapter 3. Since this is currently the case, the definition of “supply” in terms of the New Zealand GST Act and the VAT Act is not discussed further in this chapter. The requirements in terms of the New Zealand GST Act and the VAT Act to deduct input tax on share issue costs incurred are discussed next, in consideration of the fact that the issue of shares is currently considered to be an exempt supply in both jurisdictions.

4.4.3 Comparative treatment of the requirements to deduct input tax in the context of share issue costs incurred

Input tax is defined in section 3A(1)(a) of the New Zealand GST Act to mean a “tax charged under section 8(1) on the supply of goods and services acquired by the person”. Section 20(3C) of the New Zealand GST Act states that “input tax as defined in section 3A(1)(a) and (c) may be deducted to the extent to which the goods or services are used for, or are available for use in, making taxable supplies”.

Input tax is defined in section 1(1) of the VAT Act to mean, *inter alia*, a tax charged under section 7 and payable in terms of that section by a supplier on the supply of goods or services made by that supplier to the vendor where the goods or services concerned are acquired by the vendor wholly for the purposes of consumption, use, or supply in the course of making taxable supplies. Where the goods and services are acquired by the vendor partly for such a purpose, input tax is deductible to the extent (as determined in accordance with the provisions of section 17) that the goods or services are acquired by the vendor for such purpose (definition of input tax in section 1(1) of the VAT Act). Both the New Zealand GST Act and the VAT Act therefore allow input tax deductions to the extent that the goods or services concerned are used to make taxable supplies (section 20(3C) of the New Zealand GST Act; definition of input tax in section 1(1) of the VAT Act).

The New Zealand IR considered the closeness of the connection required between share issue costs incurred and the making of taxable supplies in terms of section 20(3C) of the New Zealand GST Act in its 2015 Tax Policy publication (New Zealand IR, 2015:1). It stated that the deductibility of input tax on costs incurred depends on the underlying supply to which the costs incurred relate, and not the taxpayer’s overall business (New Zealand IR, 2015:1). The New Zealand IR (2015:1) emphasised that, on this basis, input tax on share issue costs incurred that relate to an intervening exempt supply, such as the issue of shares, is not deductible. Before the New Zealand IR made a specific exception to this rule through the inclusion of section 20H, it seems that the New Zealand IR (2015:1) considered the existence of an intervening exempt supply to mean that the link between the share issue costs incurred and the making of taxable supplies is not direct enough, which resulted in the denial of an input tax deduction on share issue costs incurred.

In the South African context, it was submitted in Chapter 2 that the phrase “in the course of making taxable supplies” should be interpreted to mean that a direct functional link should exist between the share issue costs incurred and the making of taxable supplies, which

considers the taxpayer's purpose for incurring the share issue costs. However, SARS's policy is currently based on ITC 1744 (*supra*) (Badenhorst *et al.*, 2010), in which it was held that for input tax on share issue costs incurred to be deductible, a *direct and immediate link* should exist between share issue costs incurred and the making of taxable supplies. It therefore seems that input tax on share issue costs incurred in both the New Zealand GST Act before the inclusion of section 20H, and the VAT Act in terms of SARS's current policy based on ITC 1744 (*supra*), is not deductible where an intervening exempt supply exists.

4.4.4 Conclusion

Based on the analysis provided in this section, it is suggested that the deductibility of input tax on share issue costs in both New Zealand and South Africa was treated similarly before section 20H was introduced in the New Zealand GST Act. Although South Africa is not a member of the OECD (OECD, 2018), the analysis provided in this section suggested that the broad taxation principles may be relevant to evaluate the provisions of the VAT Act. It is therefore submitted that it may be appropriate to consider the arguments put forth by the New Zealand IR (2015:1; 2016:4) to determine that input tax on share issue costs incurred should be deductible in the South African context.

The previous section suggested that the denial of input tax on share issue costs incurred in the South African context negates the principles of neutrality, effectiveness and fairness. Consequently, it is concluded that since the allowance of an input tax on share issue costs incurred would satisfy the broad taxation principles of a good VAT system, this may indicate that input tax on share issue costs should be deductible. The New Zealand IR's (2016:4) solution to allow an input tax deduction on share issue costs incurred through the inclusion of a specific deduction in section 20H of the New Zealand GST Act is considered next. This is done to conclude whether a similar provision may find its place in the VAT Act.

4.5 ANALYSIS OF SECTION 20H OF THE NEW ZEALAND GST ACT

The New Zealand IR (2015:3) concluded that the most pragmatic way to solve the unintended consequences of the exempt treatment of the issue of shares was to disregard the exemption for businesses that principally make taxable supplies when issuing shares. Furthermore, the New Zealand IR (2015:3) suggested that, since money is fungible between different activities, it is impossible for taxpayers to attribute share issue costs incurred to a specific business activity. The New Zealand IR (2015:3) therefore concluded that input tax on share issue costs incurred should be deductible to the extent that the business as a whole

makes taxable supplies, apportioned in the same reasonable and fair manner as general overhead costs (New Zealand IR, 2015:3). The New Zealand IR (2015:3) maintained that such an approach would provide certainty to taxpayers on the extent to which share issue costs are deductible and would enhance the broad taxation principles of neutrality, effectiveness and fairness. Furthermore, it would align with the treatment of input tax on share issue costs in the CJEU.

This section considers the wording of section 20H of the New Zealand GST Act, followed by a conclusion on whether a similar provision could find its place in the VAT Act.

4.5.1 The wording of section 20H of the New Zealand GST Act

To facilitate the proposed solution, the New Zealand IR introduced section 20H of the New Zealand GST Act, which determines in subsection (1) that:

A registered person who principally makes taxable supplies and who makes supplies of financial services in the course of an activity of raising funds that are intended for use by the registered person for expenditure in a taxable activity has a deduction under section 20(3)(hd) of input tax for the supplies of financial services, if the financial services- ...

(c) are the issue or allotment of a debt security or equity security...

Provisos (a) and (b) to section 20H(1) maintain that where the financial services in question are zero-rated in terms of sections 11A(1)(q) and (r) of the New Zealand GST Act or do not give rise to a deduction in the absence of section 20H(1), no deduction is allowed. Where shares are issued to non-resident shareholders, which are considered a zero-rated supply, input tax on share issue costs incurred is therefore deductible in terms of the zero-rating provisions. In terms of proviso (d) to section 20H, the deduction is allowed whether the financial services fail to raise the funds or succeed in raising the funds that are used to further taxable activities. Section 20H(2) disqualifies non-resident persons who are registered for GST from the deduction in section 20H(1). Section 20H of the New Zealand GST Act therefore allows an input tax deduction on share issue costs incurred by resident taxpayers that principally make taxable supplies, to the extent that the capital raised by the issue of shares is used to further the taxpayer's business of making taxable supplies (New Zealand Goods and Services Tax Legislation, n.d.).

It follows that businesses that principally make exempt supplies, such as banks and other financial institutions, do not qualify for a deduction under section 20H of the New Zealand GST Act, along with non-resident GST-registered businesses. The amendment was

celebrated by the New Zealand tax community as a “principled solution to a long running issue and area of dispute” (KPMG TaxMail, 2015) and a “welcome GST policy law change” that brings certainty to taxpayers (Trombitas, 2015). Trombitas (2019), however, suggested that the issue of shares should not be considered a supply in terms of the New Zealand GST Act and that, although its result is beneficial to taxpayers, the inclusion of section 20H of the New Zealand GST Act does not address this fundamental concept.

The following section considers whether a specific deduction for input tax on share issue costs incurred, similar to section 20H of the New Zealand GST Act, may find its place in the VAT Act to remedy the current denial of input tax deductions on share issue costs incurred based on the judgment in ITC 1744 (*supra*).

4.5.2 Whether a similar provision to section 20H of the New Zealand GST Act may find its place in the VAT Act

Section 4.4 highlighted that the deductibility of input tax on share issue costs incurred in terms of the New Zealand GST Act and VAT Act respectively was treated similarly before section 20H was introduced in the New Zealand GST Act, effective 1 April 2017. Therefore, based on the similarities between the provisions of the New Zealand GST Act and the VAT Act in terms of the deductibility of input tax on share issue costs incurred, it is submitted that a provision similar to that of section 20H of the New Zealand GST Act may find its place in the VAT Act.

Section 20H of the New Zealand GST Act explicitly deems input tax on share issue costs to be deductible if the capital raised is used to further the business of making taxable supplies. It follows that the inclusion of a provision similar to section 20H of the New Zealand GST Act in the VAT Act may nullify the argument put forth in ITC 1744 (*supra*) that the issue of shares is an intervening exempt supply that severs the link required by the phrase “in the course of making taxable supplies”. If a similar provision to section 20H of the New Zealand GST Act was included in the VAT Act at the time ITC 1744 (*supra*) was heard, the taxpayer in ITC 1744 (*supra*) may therefore have been allowed an input tax deduction on the share issue costs incurred. Consequently, this research assignment is of the opinion that the inclusion of a similar provision in the VAT Act to that of section 20H of the New Zealand GST Act may be considered by National Treasury and SARS to allow an input tax deduction on share issue costs incurred.

Trombitas (2019) suggested, however, that the provisions of section 20H of the New Zealand GST Act do not address the fundamental concept that the issue of shares does not constitute a supply, as highlighted by the CJEU in the Kretztechnik case (*supra*) and considered in Chapter 3. Furthermore, it seems that the inclusion of a specific deduction for input tax on share issue costs incurred may not provide taxpayers with clarity on the closeness of the link required by the phrase “in the course of making taxable supplies”, as considered in Chapter 2, since it would specifically exclude the issue of shares as an intervening exempt supply. Therefore, although it is suggested that SARS should consider allowing an input tax deduction on share issue costs incurred to enhance the principles of neutrality, effectiveness and fairness, the inclusion of a specific deduction in the VAT Act similar to section 20H of the New Zealand GST Act may not be the most holistic solution, albeit possibly the most pragmatic. A conclusion is drawn in Chapter 5 on whether this is indeed the case.

An overall conclusion is drawn next on whether the allowance of an input tax deduction on share issue costs incurred enhances the principles of neutrality, effectiveness and fairness in the treatment of input tax on share issue costs incurred.

4.6 SUMMARY AND CONCLUSIONS

The objective of this chapter was to determine whether the current treatment of input tax on share issue costs incurred in South Africa satisfies the OECD’s broad taxation principles of neutrality, effectiveness and fairness. Chapter 4 submitted that SARS’s current policy to deny input tax deduction on share issue costs incurred detracts from the broad taxation principles of neutrality, effectiveness and fairness of a good VAT system. It was further suggested that the lack of a distinction between input tax on share issue costs incurred by financial service providers, such as banks and other financial institutions, and businesses that principally make taxable supplies, aggravates the derogation of the effectiveness and fairness principle.

Based on the similarity between the treatment of input tax on share issue costs incurred in terms of the VAT Act and the New Zealand GST Act before section 20H was introduced, it seems appropriate to consider the arguments put forth by the New Zealand IR to allow a deduction of input tax on share issue costs incurred in the South African context. Consequently, it is suggested that SARS should consider amending its current policy and allow an input tax deduction on share issue costs incurred, since this would enhance the principles of neutrality, effectiveness and fairness, which are fundamental to a good VAT

system. To that end, it is concluded that a similar provision to that of section 20H in the New Zealand GST Act, which specifically allows input tax deductions on share issue costs incurred to raise capital, may find its place in the VAT Act. Whether such a solution would holistically address the issues identified in Chapters 2 and 3, while providing an acceptable result to taxpayers who incur significant costs to raise capital, is considered in Chapter 5.

CHAPTER 5: CONCLUSION

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CHAPTER 5: CONCLUSION

5.1 INTRODUCTION

Input tax on share issue costs incurred is currently not deductible in South Africa based on the judgment held in ITC 1744 (*supra*) (Badenhorst *et al.*, 2010), heard in the Tax Court in 2002. The court considered it common cause that the issue of shares constituted an exempt supply in terms of section 12(a) of the VAT Act (ITC 1744, at 156). The judgment in ITC 1744 (*supra*) relied on earlier CJEU judgments where it was determined that for input tax to be deductible, a *direct and immediate link* should exist between costs incurred and the making of taxable supplies (ITC 1744, at 158). Consequently, Conradie J held in ITC 1744 (*supra*), at 158, that since the issue of shares was an exempt supply, the share issue costs were incurred by the taxpayer for the making of exempt supplies and therefore no *direct and immediate link* existed between the share issue costs incurred and the making of taxable supplies.

ITC 1744 (*supra*) was only heard in the Tax Court and therefore the decision is only binding on the parties to the specific case; however, the judgment in ITC 1744 (*supra*) still directs SARS's current policy on the deductibility of input tax on share issue costs incurred (Badenhorst *et al.*, 2010). The deductibility of input tax on share issue costs incurred has not been dealt with by the South African courts since ITC 1744 (*supra*) was heard in 2002. Developments in the CJEU on whose principles the decision in ITC 1744 (*supra*) relied, as well as the New Zealand GST Act on which the VAT Act was modelled (VATCOM, 1991), have, however, resulted in input tax on share issue costs being deductible in the EU and New Zealand.

The CJEU determined in 2005 that the issue of shares does not constitute a supply (Kretztechnik case, at 27) and that in the absence of a supply, share issue costs incurred may be regarded as part of general overhead costs (Kretztechnik case, at 36). The CJEU further determined that in the absence of a supply, input tax on share issue costs is deductible to the extent that a business as a whole makes taxable supplies (Securenta case, at 31). Alternatively, the New Zealand IR (2016:4) included a specific deduction for input tax on share issue costs incurred, effective 1 April 2017, which allows taxpayers who principally make taxable supplies to deduct input tax on share issue costs incurred to raise capital (section 20H of the New Zealand GST Act). The inclusion of section 20H of the New Zealand

GST Act aimed to ensure that the treatment of input tax on share issue costs incurred enhances the broad taxation principles of neutrality, effectiveness and fairness, which are fundamental to a good VAT system (New Zealand IR, 2016:4). For both the CJEU and the New Zealand IR, this was a change from their previous position that the issue of shares constituted an exempt supply, and that input tax on the making of exempt supplies is not deductible, similar to the judgment in ITC 1744 (*supra*) (HM Revenue and Customs, 2016b; New Zealand IR, 2016:4).

The current treatment of input tax on share issue costs in South Africa therefore differs from the treatment by the CJEU and in New Zealand subsequent to ITC 1744 (*supra*). The aim of this research assignment was to determine whether, in consideration of the developments in the CJEU and New Zealand, input tax on share issue costs should be deductible in South Africa. A summary of the findings of Chapters 2, 3, and 4 is provided next, which is used to draw a conclusion on whether input tax on share issue costs should be deductible.

5.2 SUMMARY OF FINDINGS

5.2.1 A critical analysis of the phrase “in the course of making taxable supplies” in the context of the *direct and immediate link* test relied on in ITC 1744 (*supra*)

Chapter 2 focused on whether the phrase “in the course of making taxable supplies” should be interpreted to mean that a *direct and immediate link* should exist between share issue costs incurred and the making of taxable supplies, as established in ITC 1744 (*supra*). Chapter 2 determined that the use of the *direct and immediate link* test might not be appropriate in South Africa, since the principles of the *direct and immediate link* test that were argued in terms of EU VAT legislation differed from that of South African VAT legislation at the time.

Furthermore, Chapter 2 suggested that the *direct and immediate link* test was not used in the De Beers case (*supra*), which, since it was heard in the SCA, may have created a precedent on the use of the *direct and immediate link* test to apply the provisions of the VAT Act. Based on the analysis of the relevant case law and guidance available, it was determined that the phrase “in the course of making taxable supplies” in the input tax definition in section 1(1) of the VAT Act should be interpreted to mean that only a direct functional link should exist, and not a *direct and immediate link*. Such a direct functional link should be established with consideration of the purpose for which the goods or services

were acquired and whether it enhances or at least affects the taxpayer's enterprise in the course of which taxable supplies are made.

In the case of share issue costs incurred, the capital raised may be used to expand or grow a taxpayer's business, which may ultimately enhance or at least affect the taxpayer's enterprise in the course of which taxable supplies are made. It was therefore concluded in Chapter 2 that a direct functional link may exist between share issue costs incurred and the making of taxable supplies. Chapter 2 suggested that if the court in ITC 1744 (*supra*) had considered that merely a direct functional link should exist between the share issue costs incurred and the making of taxable supplies, the taxpayer in ITC 1744 (*supra*) may have been allowed an input tax deduction on share issue costs incurred.

5.2.2 The issue of shares as considered against the definition of “supply” in section 1(1) of the VAT Act

Based on the wording of the definition of “exempt supply” in section 1(1) of the VAT Act, the existence of a supply of goods or services is paramount to an activity or act being exempt from VAT. The judgment in the Kretztechnik case (*supra*) highlighted that if the issue of shares does not constitute a supply in the first place, it is outside the scope of VAT and therefore also does not constitute an exempt supply (Kretztechnik case, at 27). In the absence of an exempt supply, it was suggested that the court's argument in ITC 1744 (*supra*) that the issue of shares constituted an intervening exempt supply, loses its relevance.

Since reliance was previously placed on judgments by the CJEU, such as the BLP Group case (*supra*) and the UBAF Bank case (*supra*) in ITC 1744 (*supra*), the arguments put forth in the Kretztechnik case (*supra*) were considered relevant to determine whether input tax on share issue costs should be deductible (Van der Zwan & Stiglingh, 2011:321). The objective of Chapter 3 was to determine whether the issue of shares constitutes a supply in the first place. This was done to determine whether an intervening exempt supply exists, which is considered fundamental to determine the deductibility of input tax on share issue costs incurred in consideration of the ITC 1744 (*supra*) judgment.

Chapter 3 summarised the relevant CJEU cases subsequent to ITC 1744 (*supra*), which led to the allowance of an input tax deduction on share issue costs incurred in the EU. Consequently, Chapter 3 indicated that subsequent to ITC 1744 (*supra*), the CJEU allowed input tax deduction on share issue costs incurred based on the argument that the issue of

shares does not constitute a supply (Kretztechnik case, at 27). It was held in the Kretztechnik case, at 26, that consideration paid by the new shareholder who received the issued shares constituted an investment on their part, rather than consideration for services received. Since nothing is provided or given up by the supplier, a “supply” does not take place. The nature of the transaction does not differ whether the shares are issued in a listed environment or in a private share placing (Kretztechnik case, at 21). In the absence of a supply, share issue costs incurred should be regarded as part of the overhead costs of the business, and are deductible to the extent that the business as a whole makes taxable supplies (Securenta case, at 31).

Chapter 3 determined that “supply” in the South African context may be given a similar meaning to that of “supply” in the Kretztechnik case (*supra*), which was based on the contention that for a “supply” to take place, there must be an act or action on the part of the supplier in terms of which something is given up. This finding was based on an analysis of the ordinary meaning of the term “supply”, South African case law (Shell’s Annandale case, at 100; National Educare case, at 308), as well as guidance from the interpretation of “supply” in terms of the New Zealand GST Act, on which the VAT Act was modelled (VATCOM, 1991). Additionally, it was found that neither the wording of section 2 nor section 12 of the VAT Act explicitly deems the issue of shares to be a supply.

Furthermore, Chapter 3 suggested that through the inclusion of the wording “all other forms of supply” in the definition of “supply” in section 1(1) of the VAT Act, it may have been the intention of the legislature to include the issue of shares as a “supply”. Chapter 3 concluded, however, that the determination of the intention of the legislature is mere speculation and therefore does not provide conclusive guidance on whether the issue of shares constitutes a supply. Based on the similarity between “supply” in terms of the VAT Act and “supply” in the EU following the Kretztechnik case (*supra*) judgment, Chapter 3 therefore submitted that grounds exist to argue that the issue of shares to raise capital does not constitute a supply as defined in section 1(1) of the VAT Act.

Chapter 3 determined that, based on an analysis of the relevant provisions of the VAT Act together with the judgment in the De Beers case (*supra*), share issue costs may be considered as part of the general overhead costs of a taxpayer’s business in the absence of a specific supply. Input tax on share issue costs incurred may then be deductible to the extent that a business as a whole makes taxable supplies, based on the interpretation of section 17 of the VAT Act and the guidance provided by SARS in the VAT 404: Guide for Vendors (Legal and Policy Division: SARS, 2017:59). This is a departure from the judgment

in ITC 1744 (*supra*), in which the taxpayer was denied an input tax deduction on share issue costs incurred.

5.2.3 The principles of neutrality, effectiveness and fairness in the treatment of input tax on share issue costs incurred

The main research question was whether input tax on share issue costs incurred should be deductible. While Chapters 2 and 3 focused on the wording of the VAT Act to answer this main research question, Chapter 4 considered whether the current denial of input tax deductions on share issue costs incurred enhances or detracts from the broad taxation principles as set out by the OECD (2017:18). Chapter 4 found that, although South Africa is not a member of the OECD, the Davis Tax Committee (2018:6) and VATCOM (1991) indicated that the broad taxation principles may be considered as guidance in the evaluation of South African VAT policy. Chapter 4 therefore concluded that the OECD's broad taxation principles may be relevant to interpret, evaluate, and develop VAT policy in South Africa.

It was found that the CJEU considered the broad taxation principles of neutrality, effectiveness and fairness in the interpretation of the provisions of the Sixth Directive to conclude that input tax on share issue costs is deductible. Furthermore, Chapter 4 highlighted that enhancement of the broad taxation principles of neutrality, effectiveness and fairness resulted in the inclusion of section 20H of the New Zealand GST Act, which allows a specific deduction of input tax on share issue costs incurred. Since the VAT Act was modelled on the New Zealand GST Act (VATCOM, 1991), Chapter 4 considered this fundamental to the objective to determine whether input tax on share issue costs incurred should be deductible.

Based on the similarity between the treatment of input tax on share issue costs incurred in terms of the VAT Act and the New Zealand GST Act before the inclusion of section 20H, Chapter 4 found that it may be appropriate to consider the arguments put forth by the New Zealand IR (2015:1; 2016:4) in the South African context. Chapter 4 therefore analysed the current denial of input tax deductions on share issue costs incurred in terms of the principles of neutrality, effectiveness and fairness. It was found that the denial of input tax deductions on share issue costs incurred in South Africa negates the principles of neutrality, effectiveness and fairness, which are fundamental to a good VAT system. It followed that the allowance of an input tax deduction on share issue costs incurred may result in the alternative – satisfying the broad taxation principles of neutrality, effectiveness and fairness. Since the broad taxation principles are based on the so-called canons of taxation (Stack *et*

al., 2015:151), which are considered the basic criteria to determine whether a tax system is “good” (Smith, 1776), it was suggested that SARS should consider the fact that the current denial of input tax deductions on share issue costs incurred negates the broad taxation principles.

Chapter 4 further suggested that the lack of distinction in the VAT Act between input tax on share issue costs incurred by financial service providers, such as banks and other financial institutions, and businesses that principally make taxable supplies, aggravates the derogation of the effectiveness and fairness principle. Chapter 4 found that the exemption of financial services, which include the issue of shares, was intended to relieve the difficulty in valuing the supply of financial services supplied by banks and other financial institutions, which are considered complex in nature. It was highlighted in Chapter 4 that it may not be appropriate to apply similar VAT policy to input tax on share issue costs incurred by businesses that principally make taxable supplies to raise capital, since the transactions are fundamentally different. Lastly, Chapter 4 concluded that a similar provision to section 20H of the New Zealand GST Act may find its place in the VAT Act to allow a deduction of input tax on share issue costs incurred.

The findings summarised above are used to draw a conclusion on whether input tax on share issue costs should be deductible in South Africa. The conclusions that may be drawn from the findings of this research assignment are, however, subject to certain limitations.

5.3 DISCUSSION OF RESEARCH LIMITATIONS

This research assignment dealt only with the issue of shares to raise capital by businesses that principally make taxable supplies. The issue of shares by financial service providers such as banks and other financial institutions for purposes other than for the raising of capital was considered outside the scope of this research assignment. This distinction is supported by the discussion in Chapter 4.

A further limitation on the conclusions reached is that the scope of the study did not include what the effect would be on other provisions of the VAT Act if it was found that the issue of shares does not constitute a supply as defined in section 1(1) of the VAT Act. The conclusions below therefore relate only to what the impact on the deductibility of input tax on share issue costs would be if the issue of shares does not constitute a supply. It was further noted in Chapter 3 that caution should be exercised in the attempt to determine whether it is the intention of the legislature that the issue of shares is considered a “supply”

in terms of section 1(1) of the VAT Act. The conclusions in this research assignment are therefore drawn without purporting to determine whether the intention of the legislature was to include the issue of shares as a “supply” in terms of section 1(1) of the VAT Act.

In addition, this research assignment focused on guidance from the legislative amendments in the New Zealand GST Act and cases heard in the CJEU to reach a conclusion on whether input tax on share issue costs should be deductible. The comparative treatment of input tax on share issue costs incurred in terms of the VAT/GST legislation in other jurisdictions was not considered. Lastly, this research assignment did not consider the apportionment method in detail, and the reader is urged to consider existing literature and research available to determine the appropriate apportionment method in instances where input tax on share issue costs is deductible to the extent that a business makes taxable supplies.

5.4 CONCLUSIONS

This research assignment aimed to determine whether input tax on share issue costs should be deductible. The objectives of this research assignment were accordingly as follows:

- 1) To critically analyse the meaning of the phrase “in the course of making taxable supplies” as included in the input tax definition to determine whether it means that a *direct and immediate link* should exist between share issue costs incurred and the making of taxable supplies.
- 2) To determine whether the issue of shares constitutes a supply.
- 3) To determine whether the current treatment of input tax on share issue costs incurred in South Africa satisfies the OECD’s broad taxation principles of neutrality, effectiveness and fairness.

The findings in Chapter 2 suggested that the use of the *direct and immediate link* test relied on in ITC 1744 (*supra*) may not be appropriate in South Africa. It was also found that the phrase “in the course of making taxable supplies” should be interpreted to mean that a direct functional link should exist between share issue costs incurred and the making of taxable supplies. Consequently, Chapter 2 determined that a direct functional link may exist between share issue costs incurred and the making of taxable supplies, since the issue of shares to raise capital enhances, affects, and furthers a taxpayer’s enterprise in the course of which taxable supplies are made. This suggests that input tax on share issue costs incurred may be deductible since it could be argued that share issue costs are incurred in the course of making taxable supplies, even in the presence of an intervening exempt supply.

The findings in Chapter 3 suggested that the issue of shares does not constitute a supply in South Africa, in line with the argument in the Kretztechnik case (*supra*). It was found in Chapter 3 that in the absence of a specific supply, share issue costs incurred may be regarded as part of the general overhead costs of a taxpayer's business. Input tax on share issue costs incurred may then be deductible to the extent that the business as a whole makes taxable supplies.

The findings in Chapter 4 suggested that the denial of input tax on share issue costs incurred detracts from the broad taxation principles of neutrality, effectiveness and fairness. It is therefore concluded that the allowance of an input tax deduction on share issue costs incurred to raise capital may ensure that the provisions of the VAT Act are applied in harmony with the broad taxation principles that are fundamental to a good VAT system. Consequently, the findings of this research assignment suggest that input tax on share issue costs should be deductible in South Africa.

SARS and National Treasury may maintain the current status quo and deny taxpayers an input tax deduction on share issue costs incurred; however, the allowance of a deduction would accord with the overall scheme and purpose of the VAT Act to be a tax on final consumption. It would also satisfy the broad taxation principles that underpin a good VAT system. Furthermore, it would align the treatment of input tax on share issue costs incurred with the current policy in the CJEU and the New Zealand GST Act, on whose judgments and policy developments the South African courts and legislature have relied in the past.

The allowance of an input tax deduction on share issue costs incurred may be well received by South African businesses that incur significant share issue costs to raise capital to further their enterprises, and, in effect, the South African economy. In the words of Corbett JA (*CIR v Nemojin (Pty) Ltd* 45 SATC 241, at 276):

It has been said that 'there is no equity about a tax'. While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and the point of view of the fiscus.

It is therefore suggested that SARS and National Treasury should consider the recommendations proposed by this research assignment to allow an input tax deduction on share issue costs incurred.

5.5 RECOMMENDATIONS

This research assignment recommends that SARS and National Treasury reconsider their current policy to deny input tax deductions on share issue costs incurred based on the judgment in ITC 1744 (*supra*). To that end, it is suggested that SARS and National Treasury consider one or more of the three recommendations proposed below to allow a deduction of input tax on share issue costs incurred to raise capital.

In the first place, SARS and National Treasury may provide clarity on the closeness of the link required by the phrase “in the course of making taxable supplies” as suggested in Chapter 2. It is recommended that SARS and National Treasury confirm whether the *direct and immediate link* test should be used to apply the provisions of the VAT Act. Chapter 2 suggested that if the phrase “in course of making taxable supplies” means that only a direct functional link should exist between share issue costs incurred and the making of taxable supplies, input tax on share issue costs incurred may be deductible even if the issue of shares is treated as a supply.

Secondly, SARS and National Treasury may provide clarity on whether the issue of shares is considered a supply, as suggested in Chapter 3. This may be done either through legislative amendments, which explicitly include the issue of shares in the definition of “supply” in section 1(1) of the VAT Act, or through the provision of guidance to the same effect. Such guidance may include clarity on whether the legislature’s intention with the inclusion of the words “all forms of supply” in the definition of “supply” in section 1(1) of the VAT Act was to include transactions such as the issue of shares as a supply. If SARS and National Treasury determine that the issue of shares is not a supply, input tax on share issue costs incurred may be deductible to the extent that a business makes taxable supplies.

Lastly, SARS and National Treasury may consider the inclusion of a provision in the VAT Act that specifically allows the deduction of input tax on share issue costs incurred to raise capital. This approach would mirror the approach followed in New Zealand, where the issue of shares is considered a supply (New Zealand IR, 2016:3) and input tax deductions on share issue costs are specifically allowed in terms of section 20H of the New Zealand GST Act. It is recommended, however, that the inclusion of a specific deduction in the VAT Act similar to section 20H of the New Zealand GST Act should be approached with caution. Chapter 4 highlighted that the provisions of section 20H of the New Zealand GST Act do not address the fundamental concept highlighted by the CJEU in the Kretztechnik case (*supra*) that the issue of shares does not constitute a supply (Trombitas, 2019). Additionally, the

inclusion of a specific deduction for input tax on share issue costs incurred may not provide taxpayers with clarity on the closeness of the link required by the phrase “in the course of making taxable supplies”, as discussed in Chapter 2.

It is therefore recommended that SARS and National Treasury consider the most pragmatic and holistic solution to allow an input tax deduction on share issue costs incurred. Figure 1 in the Appendix provides a graphic representation of the three recommendations discussed above.

5.6 SUMMARY OF CONTRIBUTIONS

The last South African Tax Court case that dealt with the deductibility of input tax on share issue costs incurred, ITC 1744 (*supra*), was heard in 2002. Van der Zwan and Stiglingh (2011:338) contributed valuable research in 2011 on the deductibility of input tax on share issue costs incurred and suggested that the time may have come for taxpayers to challenge SARS’s current policy. Nevertheless, SARS and National Treasury still maintain the argument put forth in ITC 1744 (*supra*) that denies an input tax deduction on share issue costs incurred. This research assignment therefore contributes an objective analysis of whether input tax on share issue costs should be deductible in support of Van der Zwan and Stiglingh’s (2011:338) submissions. This research assignment is the first to consider the judgment in the De Beers case (*supra*) and the developments in the New Zealand GST Act subsequent to 2011 in the context of input tax on share issue costs incurred in South Africa.

The findings of this research assignment suggested that the phrase “in the course of making taxable supplies” should be interpreted to mean that a direct functional link should exist between share issue costs incurred and the making of taxable supplies, and not a *direct and immediate link* as held in ITC 1744 (*supra*). This research assignment also revealed that the wording “all other forms of supply” in the definition of “supply” suggests that it may be the intention of the legislature to include all forms of supply, including passive supplies where nothing is given up.

While the Davis Tax Committee (2018:6) considered the principle of neutrality in the context of the exemption of financial services supplied by financial service providers, the principles of neutrality, effectiveness and fairness in the context of the deductibility of input tax on share issue costs incurred have not yet been considered in the existing body of research in South Africa. This research assignment is therefore the first study to consider whether the

denial of input tax deductions on share issue costs incurred in South Africa enhances or detracts from the broad taxation principles of neutrality, effectiveness and fairness.

This research assignment demonstrated that the denial of input tax deductions on share issue costs incurred detracts from the broad taxation principles of neutrality, effectiveness and fairness of a good VAT system as set out by the OECD (2017:18). The findings of this research assignment revealed that the lack of distinction in the VAT Act between input tax on share issue costs incurred by financial service providers, such as banks and other financial institutions, and businesses that principally make taxable supplies aggravates the derogation of the effectiveness and fairness principle.

It was further demonstrated that allowing an input tax deduction on share issue costs incurred would accord with the overall scheme and purpose of the VAT Act to be a tax on final consumption.

5.7 SUGGESTIONS FOR FURTHER RESEARCH

Further research to determine the most suitable solution to allow an input tax deduction on share issue costs incurred in terms of the VAT Act may be undertaken. Such further research may include an investigation into the effect on other provisions of the VAT Act if the issue of shares is not considered a supply. Further research is also suggested on how deductions for input tax on share issue costs incurred may impact the fiscus.

This research assignment did not include an investigation into the deductibility of input tax on share issue costs incurred in comparative jurisdictions other than New Zealand and the EU. Further research on the treatment of input tax on share issue costs incurred in other jurisdictions might provide additional support for the allowance of an input tax deduction on share issue costs incurred in South Africa.

The focus of this research assignment was the deductibility of input tax on share issue costs incurred. This research assignment did not include an investigation into the deductibility of input tax on costs incurred in transactions with shares other than the issue thereof. Further research is therefore suggested on the deductibility of input tax on costs incurred in other share transactions, which may include the disposal, acquisition, and transfer of shares, as well as corporate restructuring and broad-based black economic empowerment transactions.

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APPENDIX

Figure 1: Current treatment of input tax on share issue costs incurred and the recommendations to be considered by SARS and National Treasury to allow a deduction

