**IN THE TAX COURT : DURBAN**

**CASE NO. VAT 616**

In the matter between

**XYZ CC** Appellant

**and**

**COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICES** Respondent

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**J U D G M E N T**
Delvered on 15 November 2007

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**LEVINSOHN DJP.**

[1] For ease of reference I shall refer to the appellant as “the taxpayer” and the respondent as “the Commissioner”.

[2] The salient background facts relevant to the appeal are in brief outline the following.

[3] The taxpayer was incorporated on 3rd June 2005. According to its founding statement its principal business was manufacturing, distribution and installation of diesel tracker anti-fuel-theft device units. Its

original members were A and B, each holding a 50% member's interest.

[4] Mr R the father of A and B was the inventor of the device called the "diesel tracker" and he also had registered patent rights over it. R had given exclusive rights to the taxpayer to exploit this invention of his. According to A she and B spent approximately R300 000 in research and development.

[5] With effect from the 15th July 2005 the taxpayer obtained a VAT registration number.

[6] From July 2005 to January 2006 it is common cause that the taxpayer had no turnover in the sense that it had not made any sales of its product. Therefore it had issued no tax invoices which attracted VAT.

[7] On 27th January 2006 R issued an invoice to the taxpayer. It must be said at the outset that R was not a registered vendor for purposes of VAT. The invoice sets forth the name of the taxpayer with both its

registration and VAT numbers. The body of the invoice recorded the following :

"Description Price

Exchange Rate $1 = R6

Helicopter Components:

| | | |
|---|---|---|
| 100 | Swashplate Bearings P/N SB15211 @ $5,000 each | 3,000,000.00 |
| 2 | Turbo III Engines P/N @ $750,000 each | 9,000,000.00 |
| 2 | Main Rotor Heads P/N $250,000 each | 3,000,000.00 |

Total Due
R15,000,000.00"

It is of some interest to note that the price was stated in United States dollars in the first instance then translated into South African Rand.

[8] On the same day the taxpayer in turn sold the very same components to ABC Co (Pty) Ltd in Cape Town. The price set forth in the invoice was also 15 million rand but in this instance VAT at 14% of the purchase price was added, namely 2.1 million rand.

[9] Again on 27th January 2006, certain transactions took place in Cape Town. Firstly a tax invoice was issued by an entity

called DEF Services to ABC Co (Pty) Ltd (the above-named purchaser of helicopter components from the taxpayer). In terms of this invoice DEF Services sold to ABC Co (Pty) Ltd a ship called the mv “Madiba” as well as a Taurus submarine. The total purchase price for both vessels was stated to be 15 million rand.

[10] Yet a further transaction took place on 27th January 2006. This time ABC Co (Pty) Ltd sells to the taxpayer the said two vessels also for a purchase price of 15 million rand plus VAT of 2,1 million rand, totalling 17,1 million rand.

[11] To complete the picture of what happened on 27th January 2006 we find an invoice issued by R to ABC Co (Pty) Ltd in terms of which he purportedly sold certain helicopter components for a purchase price of $16 250 000, which converts into 97.5 million rand (exchange rate $1 = R6.00). The consideration for this sale is according to a

note on the invoice shares in a company called TG (Pty) Ltd.

[12] Following the above-mentioned transactions an agreement dated 27th February 2006 was concluded between A and B on the one hand and R on the other hand. The agreement also records that the taxpayer is a party to it. In terms of the agreement A and B sell 15% of their respective member's interest to R. The purchase price is recorded as 15 million rand.

[13] According to clause 5 the terms of payment of the purchase price were recorded as follows :

> "5.1 Aangesien die koper reeds tweedehandse handelsvoorraad ten bedrae van R15 miljoen Rand aan die beslote korporasie gelewer het, en die bedrag nog nie deur die oorsponklike lede van die beslote korporasie, synde die verkopers, aan die koper betaal is nie; en
>
> 5.2 Kom die partye ooreen dat die koopprys ten bedrae van R15 miljoen ten aansien van die 30% aandele, deur die koper aan die verkopers vereffen sal word by wyse van skuldvergelyking met verwysing na paragraaf 5.1 supra"

It will be observed that in terms of this agreement the parties recognize that the taxpayer owes R 15 million rand. What they

seek to achieve is a set-off of this indebtedness as between R, the taxpayer and the two sellers, A and B respectively.

[14] The background to the acquisition of the spare parts in question and relevant facts pertaining thereto appear to be the following. On the 1st November 1993 in terms of an invoice issued by F to D (Pty) Ltd the latter purchased Super Frelon spares and airframes from F for a total purchase price of R63 840.00.

[15] D (Pty) Ltd in turn sold some of these parts to China. The remaining spare parts were regarded as useless scrap and these were sold to JR , a firm owned by one M (the written agreement concluded by the parties is at page 228 of the bundle of documents). The purchase price is recorded in clause 3 of the written agreement.

[16] In March 2006 M confirmed in a letter to the Commissioner that the spares were purchased from D (Pty) Ltd with the intent to strip and

scrap the parts. His firm was unable to do so, hence the sale to R. The transaction between him and R was one of barter. R took the spares and in exchange gave M scrap metal at an equivalent value. The value put on the transaction was R60 000.00.

[17] S who was employed by D (Pty) Ltd at the time confirmed that JR had bought the spares as scrap after the transaction was put out to tender. S's evidence established that these items could not be used as spares in helicopter aircraft. He explained that in order for this to happen a very complex and expensive process of certification and authentication had to take place. When S was shown the invoice issued by R on the 27th January 2006 he expressed the view that that purchase price of 15 million rand was inflated.

[18] For the period ended 2006 the taxpayer submitted a return in respect of VAT claiming notional input tax of R1 847 891.53 in

respect of the said sale by R to it. After investigation the Commissioner disallowed same and levied a penalty of 100% additional tax. The taxpayer objected to this assessment and hence the appeal before us.

[19] The Commissioner considered that the sale transaction between the taxpayer and R was a "scheme" within the meaning of section 73(1) of the VAT Act. This section reads as follows :-

> "(1) Notwithstanding anything in this Act, whenever the Commissioner is satisfied that any scheme (whether entered into or carried out before or after the commencement of this Act, and including a scheme involving the alienation of property)-
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> (a) has been entered into or carried out which has the effect of granting a tax benefit to any person; and
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> (b) having regard to the substance of the scheme-
>
> (i) was entered into or carried out by means or in a manner which would not

normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length; and

(c) was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit,

the Commissioner shall determine the liability for any tax imposed by this Act, and the amount thereof, as if the scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such tax benefit."

[20] Section 73(2) provides as follows : -

"(2) For the purposes of this section-

'scheme' includes any transaction, operation, scheme or understanding (whether enforceable or not), including all steps and transactions by which it is carried into effect;

'tax benefit' includes-

(a) any reduction in the liability of any person to pay tax; or

(b) any increase in the entitlement of any vendor to a refund of tax; or

(c) any reduction in the consideration payable by any person in respect of any supply of goods or services; or

(d) any other avoidance or postponement of liability for the payment of any tax, duty or levy imposed by this Act or by any other law administered by the Commissioner."

[21] A further relevant section of the VAT Act is section 1 which defines "input tax" : -

"'**Input tax**' in relation to a vendor, means -

……

(b) an amount equal to the tax fraction (being the tax fraction applicable at the time of supply is deemed to have taken place) of the lesser of any consideration in money given by the vendor for the open market value of the supply (not being a taxable supply) to him by way of a sale on or after the commencement date by a

resident of the Republic of any second-hand goods situate in the Republic.

…..

‘**Second-hand goods**’ means -

(a) goods which were previously owned and used.”

[22] There are indeed some disquieting features about various transactions that occurred. Against the background that the taxpayer’s core business was the development of the diesel tracker device, it is strange that it purchases these components for the considerable sum of 15 million rand. The probabilities are overwhelming in our view that the taxpayer’s members and indeed R himself would have realised that these components were nothing more or less than scrap metal and it was absolutely unlikely that they could be used as spares in an aircraft. The invoice price could never realistically reflect the open market value of the components.

[23] These doubts overflow when we observe that on the same day the taxpayer sells on to ABC Co for the same price. This time plus VAT.

[24] Notably all transactions up to this point are barter transactions, with the only cash flows envisaged by the parties being the refund of notional input tax that the Commissioner would have to make. We also note that the VAT return for the February period in which the notional input is claimed was submitted within a few days after the month end. This, in our opinion, points in the direction that the taxpayer was probably aware that the Commissioner has 21 business days in which to refund the input tax claimed to prevent interest accruing to the taxpayer on the refund. Normally returns are only required to be submitted by the 25th day of the month following the end of the tax period.

[25] The question then arises what purpose was served by the taxpayer's selling for no

profit? That does not appear to be a transaction in the ordinary course of business.

[26] The taxpayer's response to the Commissioner's letter dated 20th March 2006 is of some interest : -

> "As the helicopter parts were purchased for R15,000,000 VAT inclusive and sold for R15,000,000 plus VAT, this resulted in a substantial profit for [the taxpayer] and not zero profit as alleged in your letter under reply."

[27] That in our view reveals the taxpayer's state of mind. It considered that the notional input VAT which is claimable would in its words result in a substantial profit. This feature in our view is a pointer in the direction of the taxpayer having devised a scheme to obtain the alleged substantial profit.

[28] The circumstances surrounding the alleged consideration given by the taxpayer to R are suspicious. In terms of the definition of

"input tax" quoted above a consideration in money is required for the supply. It is clear that the assets of the taxpayer were such that it could not pay 15 million rand at that juncture. The members of the taxpayer and R sought to solve the problem by entering into the agreement for the sale of a 30% members' interest which we have alluded to above.

[29] That transaction is riddled with difficulty. The true debtor in respect of the 15 million rand transaction is the taxpayer given that the taxpayer is a corporate entity and its assets and liabilities are separate and distinct from that of its members. By the same token the members' interests do not concern the taxpayer. We have difficulty in seeing how R's indebtedness to his daughters for the 30% members' interests could be set off the taxpayer's indebtedness to him (R).

[30] For set-off to operate the law is clear. Four conditions have to be present. These are (1) both debts must be of the same nature;(2) they must be liquidated; (3) fully due; and (4) payable by and to the same persons in the same capacities.

(See ***Wille*** : Principles of South African Law, 8th Edition, page 483).

[31] In the instant case the creditor for the goods sold is R and the debtor is the taxpayer. Insofar as the members' interest is concerned the creditors are A and B and the debtor is R. The conditions required for a set-off of R's claim against the taxpayer are not present.

[32] On further analysis it appears that the purported transactions concluded between the taxpayer, A and R are not consistent with the taxpayer's annual financial statements for the tax year ending February 2006. On any basis the taxpayer is indebted to R for 15 million rand. When the members' interests

are sold to R by A and B they would in turn each be entitled to 7.5 million rand from R.

[33] It therefore follows in our view that the taxpayer did not pay the 15 million rand or intend to give any consideration therefor. It must have been aware of this when the purported transaction was generated. It therefore follows that no claim in respect of notional input VAT could be entertained by the Commissioner. The submission of a claim therefor was improper.

[34] In thinking our way through the facts of this case we have concluded that the inference is inescapable that this was indeed a scheme devised by the taxpayer in collaboration with R to gain a tax benefit. We record the following findings of fact : -

[a] By no stretch of the imagination can it be said that these spare parts on the date in question could have had an open market value of 15 million rand. We reject the contention that this was

an arm's length sale. S's evidence makes it clear that we are concerned with scrap, valued at no more than R60 000.00.

[b] The sale to ABC Co on the same day of the same parts for the same price is extremely suspicious and fortifies the inference that this transaction was not a normal one in the ordinary course of business. That is further reinforced by the fact that R divided the sale of the spare parts into two, the first being the sale to the taxpayer, and the second being a direct sale to ABC Co for 97 million rand. The immediate question that presents itself is why was it necessary to do this? Why was it necessary to have the intervention of the taxpayer in these transactions? The introduction of the taxpayer as a purchaser points in the direction of

an intention to derive the notional VAT input benefit. Surely he could have sold the whole parcel to ABC Co in one transaction. In our view there is an overwhelming probability that R prior to the 27th January 2006 was engaged in negotiations with ABC Co and the precise mechanics of the transactions were discussed. In that regard the VAT implications of the various transactions would likewise have been considered. When R was pressed on this issue under cross-examination we understood him to concede that he gave consideration to the VAT issues. We may say that we are far from convinced that the dealings with ABC Co were of an arm's length nature. Inasmuch as the taxpayer bore the onus in this case we would have expected some evidence from a representative of ABC Co to explain

the background to these transactions and particularly in regard to the market value of the components which they purported to purchase for what we regard as a mind-boggling amount of 112 million rand. ABC Co could conceivably have informed the Court whether the spare parts were authenticated and whether they could be used in their normal business operations. Against the background of S's evidence we believe this to be very unlikely. Hence it is perhaps understandable that such evidence was not forthcoming from the taxpayer.

[c] There is a significant discrepancy in the valuation of the assets that were bartered for the spare parts. In consideration for the 15 million rand sale to it ABC Co barters the ship and the submarine. However, one month after the purported acquisition the

assets in question are valued at 47 million rand – over three times the initial value. Here again evidence from ABC Co would have been of some assistance.

[35] In the result by reason of the foregoing we are satisfied the taxpayer has not discharged the onus of showing that the Commissioner wrongly concluded that this was a scheme to obtain a tax benefit within the meaning of section 73 *supra*.

[36] Insofar as the penalty imposed is concerned there is nothing to show that the Commissioner wrongly exercised his discretion and no basis exists for us to interfere.

[37] In the result the appeal is dismissed and the assessment is confirmed.