Dear Madam

SUBMISSION: VALUE-ADDED TAX APPORTIONMENT

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INTRODUCTION

This submission is made as a result of the large number of disputes with the South African Revenue Service ("SARS") and long outstanding rulings with regard to the apportionment of value-added tax ("VAT") by vendors that derive income from taxable activities which is subject to VAT and income from other sources which are not subject to VAT.

The problem that many of these vendors are confronted with is that the SARS insists that dividends and similar passive income be included in the denominator of the prescribed formula to determine the ratio in which the VAT incurred on taxable expenses may be claimed. However, due to the fact that such income is not attributable to any activities of the vendor and no taxable expenses are incurred to generate the income, the inclusion thereof substantially distorts the ratio in which input tax can be claimed.

The vendor is then forced to apply for approval to use another apportionment method which in many instances proves to be a challenge in view of the fact that no expenses are attributable to such passive income and alternative apportionment methods also generally do not find favour with the SARS. In the event that an alternative method (or direct attribution method) is finally agreed upon at great cost and effort by the vendor, it provides a very similar result than that if the passive income had simply been excluded from the denominator of the prescribed apportionment formula.

The inclusion of passive income in the denominator of the prescribed apportionment formula is contrary to the policies of many Revenue Authorities of South Africa’s major trading partners that operate VAT systems, and also European Court judgments in this regard. The uncertainty with regard to the amount of input tax that can be claimed may also impact on South Africa being used as a destination by corporate headquarter companies, or for South Africa as being used as a distribution hub into Africa.

The purpose of this submission is to request National Treasury to consider legal intervention in order to bring South Africa in line with the rest of the world with regard to the exclusion of dividends and other passive income from the denominator of its standard apportionment formula, and to eliminate the costly and long drawn out disputes with the SARS to search for scientifically accurate alternative apportionment methods that generally yields the same result.
THE CURRENT LEGAL POSITION

1. Section 17(1) of the Value-Added Tax Act, No 89 of 1991 ("the VAT Act") provides that where goods or services are acquired by a vendor partly for consumption, use or supply in the course of making taxable supplies and partly for another intended use, an input tax deduction may be claimed equal to an amount which bears to the full amount of such tax, the same ratio (as determined by the Commissioner in accordance with a ruling as contemplated in section 41A or 41B) as the intended use of such goods or services in the course of making taxable supplies bears to the total intended use of such goods or services: Provided that:

   (i) where the intended use of goods or services in the course of making taxable supplies is equal to not less than 95% of the total intended use of such goods or services, the goods or services concerned may be regarded as having been acquired wholly for the purpose of making taxable supplies.

2. The South African Revenue Service ("SARS") stated in its Guide for Vendors (VAT 404) that for the purpose of section 17(1) of the VAT Act, the only approved method which may be used to apportion input tax without specific prior written approval from the Commissioner is the turnover-based method. The SARS states that this method applies by default in the absence of a specific ruling obtained by the vendor to use another method as there is usually a fairly good correlation between the turnover of a business and the resources (or inputs) which are employed to produce that turnover.

3. It further has for this purpose published a binding general ruling in terms of section 41A in the Guide for Vendors regarding the formula that must be applied for the turnover-based method. The formula is described as follows:

   Formula: \[ y = \frac{a}{(a + b + c)} \times \frac{100}{1} \]

   Where:

   \( y \) = the apportionment ratio/percentage;

   \( a \) = the value of all taxable supplies (including deemed taxable supplies) made during the period;
b = the value of all exempt supplies made during the period; and

c = the sum of any other amounts of income not included in “a” or “b” in the formula, which were received or which accrued during the period (whether in respect of a supply or not).

Notes:

1. The term “value” excludes any VAT component.

2. “c” in the formula will typically include items such as dividends and statutory fines (if any).

3. Exclude from the calculation the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease or instalment sale agreement). 20

4. Exclude from the calculation the value of any goods or services supplied where input tax on those goods or services was specifically denied.

5. The apportionment ratio/percentage should be rounded off to two decimal places.

6. Where the formula yields an apportionment ratio/percentage of 95% or more, the full amount of VAT incurred on mixed expenses may be deducted (referred to as the de minimis rule).

THE ISSUE

4. The problem that many vendors experience with the prescribed turnover-based apportionment formula is the inclusion of “c” in the formula.

5. The amounts which would be received by or accrued to a vendor not being in respect of any supply, include the following:
   - Dividends;
   - Unrealised foreign exchange gains;
• Delinquency interest;
• Loan proceeds; and
• Collection of payments from outstanding debtors.

6. Although loan proceeds and payments received from debtors are amounts “received by or accrued to” a vendor, SARS has accepted in practice that the inclusion of such amounts would distort the apportionment formula and that they should not be included in “c” of the formula (although this is not stated anywhere by the SARS). However, the SARS insists that any other amounts “received by or accrued to” a vendor must be included in the formula. This includes, for example, the proceeds in terms of a debt factoring transaction, which is in essence no different from loan proceeds. The inclusion that causes the biggest problem for vendors in applying the prescribed turnover-based method is dividends.

7. The vendors that are mainly affected by the inclusion of dividend income in the denominator of the prescribed turnover-based formula are head quarter companies and operating holding companies.

8. The purpose of an apportionment formula is to determine the extent to which taxable expenses are attributable to the making of taxable supplies. A turnover-based method of apportionment is a fair and equitable method of determining the extent to which taxable expenses are attributable to taxable supplies in the following circumstances:

8.1. There is a correlation between the values of the different supplies (and non-supplies) made by a vendor with the taxable expenses incurred and taxable assets applied in making such supplies;

8.2. There is a simple and constant relationship between the value of the vendor’s supplies and the taxable expenses incurred, i.e. that each R1 of taxable output uses roughly the same amount of taxable costs and R1 of exempt output.

8.3. There are no significant differences in the timing between costs incurred and corresponding supplies; and
8.4. There are no large one-off income receipts in respect of which few costs or expenses are incurred in making them.

9. The inclusion of dividend receipts does not meet any of the above and severely distorts the apportionment ratio, principally because dividends are not consideration received for any supply made by the vendor\(^1\). There is further no correlation between expenses incurred and the value of dividends received, no expenses are incurred in order to generate dividend income, and dividends are generally only received once or twice a year.

10. Practical example:

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<tr>
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<th>2012</th>
<th>2011</th>
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<tbody>
<tr>
<td>Taxable revenue</td>
<td>600</td>
<td>500</td>
</tr>
<tr>
<td>Direct taxable expenses</td>
<td>-300</td>
<td>-250</td>
</tr>
<tr>
<td>Staff expenses (non-taxable)</td>
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<td>-85</td>
</tr>
<tr>
<td>Taxable administration expenses</td>
<td>-60</td>
<td>-50</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
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<td>-35</td>
</tr>
<tr>
<td>Operation profit</td>
<td>100</td>
<td>80</td>
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<tr>
<td>Finance income</td>
<td>35</td>
<td>30</td>
</tr>
<tr>
<td>Dividend income</td>
<td>200</td>
<td>50</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>335</td>
<td>160</td>
</tr>
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VAT apportionment ratio excluding dividends 94.49\% 94.34\%  
VAT apportionment ratio including dividends 71.86\% 86.21\%  

11. It is for this reason that a number of European Court judgments confirmed that dividends are not consideration for any supply\(^2\) and as a result should be excluded.

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\(^1\) Cibo Participations SA v Directeur regional des impost du Nord-Pas-de Calais. Par 44

from an apportionment formula based on turnover. These court judgments have been widely accepted and are applied accordingly by tax authorities world-wide\(^3\).

12. The insistence of SARS to include dividends (and similar passive income) in the denominator of the prescribed apportionment formula forces vendors to apply for an alternative apportionment method due to the distortion it creates. The problem that these vendors face is that it is very difficult in many instances to find an alternative apportionment method that can be scientifically accurately calculated (which is the only alternative apportionment method that SARS will accept), due to the following:

12.1. There are seldom taxable expenses incurred which are wholly attributable to exempt supplies. An input tax based apportionment method can therefore not be applied.

12.2. A transaction volume based apportionment method often proves to be problematic due to the difficulty in identifying and counting VAT exempt transactions such as interest bearing transactions.

12.3. Staff and areas are mostly not dedicated only to taxable or exempt transactions and therefore apportionment methods based on number of staff or floor areas cannot be applied. Similarly, staff members generally do not keep record of time spent on taxable and exempt transactions and therefore an apportionment method on this basis is not appropriate.

13. The vendor is then left with the analysing of each expense transaction in detail at great time and cost to attempt to prove on some scientific basis that such expense is not attributable to the non-taxable income.

14. The SARS Guide for Vendors (VAT404) stipulates as follows with regard to the application of the prescribed turnover-based method\(^4\):


\(^4\) At par 7.4.3
“Note, however, that in circumstances where the turnover-based method is inappropriate because it produces an absurd result, proves impossible to use, or does not yield a fair approximation of the extent of taxable application of the enterprise’s VAT-inclusive expenses, the vendor must approach SARS to obtain consensus on an alternative method which yields a more accurate result.

In deciding whether the turnover-based method is appropriate, the vendor must apply a common-sense approach which would be applied by a reasonable person. The method must therefore achieve a “fair and reasonable” result which is a proper reflection of the manner in which the vendor’s resources (business inputs) are applied for making taxable and non-taxable supplies respectively. Although the term “fair and reasonable” will usually be perceived as a subjective concept, vendors applying the turnover-based method of apportionment should try to be objective and consider that the result must be perceived as “fair and reasonable” from both the vendor’s perspective as well as SARS’s perspective.”

15. Ironically, in many instances the SARS seems to agree that the inclusion of dividend income in the apportionment formula “produces an absurd result” or is not “fair and reasonable”, but they insist on its inclusion, and the determination of an appropriate alternative apportionment method becomes a costly challenge for the vendor.

16. The search for an acceptable alternative apportionment method becomes a lengthy drawn-out process (some of which are now in excess of 3 years) whilst the vendor has no certainty as to the apportionment method and ratio to which the SARS will eventually agree. In addition, the Tax Administration Act has now restricted the retrospective application of any alternative VAT apportionment method to two years.

THE INTERNATIONAL POSITION

United Kingdom
The United Kingdom prescribes a standard method of apportionment which must be used unless HMRC has given approval to operate a special method\(^5\).

The standard method determines a recoverable percentage of residual input tax using the following formula:

\[
\frac{\text{Value of taxable supplies in the period (excluding VAT)}}{\text{Value of supplies in the period (excluding VAT)}} \times \frac{100}{1}
\]

The judgments of the Courts that dividends are not consideration for any supplies is accepted and therefore dividends are not included in the “value of supplies” in the denominator of the formula.

In addition, incidental supplies are also specifically excluded from the formula. Incidental supplies are viewed in two ways\(^6\):

A one off situation such as the sale by a factory by a fully taxable manufacturing company, where there is activity but not sufficient to be regarded as a business; or

Regular income such as interest from deposits at the bank that are received passively, incurring little or no related input tax, where in reality, there is no activity at all.

**Australia**

The Australian Tax Authority issued Goods and Services Tax Ruling GSTR 2006/4 in which it sets out its policies and requirements with regard to VAT apportionment.

Vendors are allowed to choose their own apportionment method, but the method chosen must:

- be fair and reasonable in the circumstances of the vendor’s enterprise; appropriately reflect the intended or actual use of the vendor’s acquisitions or importations\(^7\); and

- be appropriately documented.

**New Zealand**

\(^1\) HM Revenue & Customs. 2011. VAT Partial Exemption (HMRC Reference Notice 706)
\(^2\) HM Revenue & Customs. 2009. *V1-15 Partial Exemption* at par 4.5
\(^3\) GSTR 2006/4 at par 32 to 34
The New Zealand Inland Revenue Department does not prescribe any apportionment method that must be applied for determining the input tax that may be claimed on mixed use supplies.

With effect from 1 April 2011, in determining the extent to which goods or services are used for making taxable supplies, a person must estimate on acquisition how they intend to use the goods or services, and choose a determination method that provides a fair and reasonable result (a new section 20(3G) to the New Zealand VAT legislation refers)\(^8\).

The estimate could be made on the basis of any records that are available, previous experience, business plans or other suitable methods. The method of working out the extent of intended taxable use will largely depend on the nature of the goods and services in question.

The estimated intended taxable use of the goods or services will determine the proportion of the input tax that can be deducted (the new section 20(3H) refers).

A new section 20(3D) is introduced which is a *de minimis* provision to relieve recipients from the obligation to apportion input tax on the acquisition of goods or services in certain circumstances. Vendors are not required to apportion input tax if they make both taxable and exempt supplies and have reasonable grounds to believe that the total value of their exempt supplies in the first adjustment period will be no more than the lesser of NZ$90,000 or 5% of the total consideration for all taxable and exempt supplies.

An “adjustment period” (described in a new section 21G(2)) is a period at the end of which a person is required to estimate whether an adjustment for a subsequent change in use is required. The first adjustment period is a period that starts on the date of acquisition and ends on the date as the person chooses that either corresponds to the person’s first balance date that falls after the date of acquisition or to the person’s first balance date that falls at least 12 months after the date of acquisition. All subsequent adjustment periods will be annual periods that start on the day after the end of the earlier adjustment period and end on the last day of the equivalent taxable period in which the first adjustment period ended. The adjustment periods are limited based on a sliding scale depending on the value of the assets concerned. No subsequent change-in-use adjustment is required for goods and services acquired for the GST-exclusive value of $5,000 or less.

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\(^8\) Tax Information Bulletin Vol 23 No 1, February 2011


Canada

Canada does not prescribe any apportionment method that must be used for claiming input tax deductions.

Where a vendor makes both taxable and exempt supplies and the vendor cannot allocate at least 90% (the de minimis percentage applicable in Canada) of an expense to a commercial or exempt activity, the vendor can only claim input tax credits for the part of the expense used in the vendor’s commercial activities.

The method to be applied to determine the percentage of operating expenses used in commercial activities has to be fair and reasonable and it has to be used consistently throughout the year.

PROPOSED LEGISLATIVE INTERVENTION

In order to overcome the practical difficulties described above which vendors experience with regard to the treatment of dividends (and similar passive income) in the standard prescribed turnover-based method of apportionment, we propose that consideration be given to prescribe by Regulation the formula with the exclusion of dividends (and similar passive income) from the denominator, in accordance with the world-wide treatment of such income.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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9 Canada Revenue Agency, General Information for GST/HST Registrants RC4022(E) Rev. 12/2010