Dear Madam

VALUE ADDED TAX (“VAT”): CONTRACTS CONCLUDED IN A FOREIGN CURRENCY AT A FIXED EXCHANGE RATE

We set out below the SAICA VAT Sub-Committee’s (a Sub-Committee of SAICA’s National Tax Committee) submission comments in relation to the VAT implication on contracts concluded in a foreign currency at a fixed exchange rate.

BACKGROUND

Various VAT vendors conclude contracts for the supply of goods and services to recipients inside South Africa (SA) for a consideration agreed in a foreign currency. These contracts do not relate to the exportation of goods and or services and the supplies are accordingly subject to VAT at the standard rate of 14%.

The main reason for concluding the agreements in a foreign currency is that the vendor normally needs to source goods or services offshore and import such goods or services in order to enable them to deliver under the contracts concluded with the SA recipients. As a substantial portion of the SA vendor’s costs will be incurred in a foreign currency the consideration, or a portion of the consideration, in terms of the contract is concluded in that foreign currency.

In practice these contracts, especially where it involves major infrastructure developments in SA, is concluded in various currencies. A portion of the contract may be in Rand and the balance may for example be concluded in Dollar, Euro, Pound or a combination of these currencies. The vendor will generally receive payment for the taxable value of the supply in the agreed currency whilst the VAT portion may be received in either the foreign currency or Rand.

The contracts would generally also express the portion of the consideration payable in a foreign currency in Rand based on the exchange rate applicable when the contract is concluded. The VAT Act requires that tax invoices for all standard rated supplies must be issued in the currency of the Republic and the vendor accordingly issues tax invoices to the recipient in Rand. The practice when issuing these invoices, in numerous industries, is to use the exchange rate as agreed in the contract and not the exchange rate (i.e.
the spot rate) applicable at the date of issuing the invoice.

Due to the nature of the underlying supplies, which may relate to major infrastructure developments, the contracts involve progressive supplies which may span over a number of years. As mentioned, the practice followed by industry is to issue tax invoices, as far as it relates to the foreign currency portion, at the exchange rate agreed in the contract. The result is that all the tax invoices issued for the duration of the contract will be based on the agreed exchange rate as per the contract despite the fact that the actual exchange rate to the foreign currency will change over the period.

Due to the volatility of the Rand the difference between the contract rate and the exchange rate at the date of issuing the tax invoices may be material.

The result of the above practice is that the output tax paid to SARS by the supplier, based on the contract rate, may be materially different (higher or lower) to the output tax that would have been paid should the exchange rate applicable at the time of the actual supply when the tax invoice is issued be applied.

It should be noted that to the extent that the recipient of the service would be entitled to an input tax credit on the goods or services there will be no financial gain or loss to SARS. The output tax paid by the vendor would be the exact same value claimed as an input tax by the recipient. This is on the assumption that the recipient claimed input tax based on the actual Rand amount reflected on the tax invoice and not the actual amount received in Rand after being converted from a foreign currency (provided the VAT is paid in a foreign currency).

As far as we are aware the above practice only occurs where the recipient is entitled to a full input tax credit.

**Issue to consider**

Uncertainty exist as to whether the above practice of using the exchange rate as agreed in the contract is acceptable or whether the vendors must use the exchange rate applicable at the actual time of supply when the tax invoice is issued.

Although the current practice does not result in a loss to SARS based on the fact that the output tax paid to SARS paid by the supplier is equal to the input tax claimed by the recipient, the vendors may be exposed to penalties and interest relating to the potential underpayment of output tax or an overstatement of input tax should the exchange rate applicable at the time of supply need to be used instead of the rate contractually agreed.

**EXAMPLE**

The following example illustrates the potential impact for VAT purposes.

- Company A, a registered VAT vendor, is a service provider in respect of an infrastructure investment programme and entered into an agreement in 2006 with Company B which is also a registered vendor and only making taxable supplies. The agreement provides for progressive supplies over a period of 4 years.
• In the contract it is agreed between the parties that the consideration (excluding the VAT portion) is payable in Dollars (USD). The contract was based on the exchange rate applicable in 2006 of 8:1.

• In February 2010 Company A need to issue an invoice for supplies in terms of the above contract for USD1 million. The actual exchange rate in 2010 moved to 10:1.

• Based on the current practice Company A will issue a tax invoice for R8 million (USD1 million X 8) plus VAT at the standard rate of R1 120 000.

• The output VAT of R1 120 000 is paid to SARS by Company A and input tax to the same value is claimed from SARS by Company B.

• Company A will receive the following payment, USD1 million as well as VAT in Rand to the value of R1 120 000.

Alternative:

• Should the exchange rate applicable at the time of supply be used the invoice would have been issued for R10 million (USD1 million X 10) plus VAT at the standard rate of R1 400 000.

• The output VAT of R1 400 000 is paid to SARS by Company A and input tax to the same value is claimed from SARS by Company B.

• Company A will receive the following payment, USD1 million as well as VAT in Rand to the value of R1 400 000.

• The difference between the scenarios is that based on the current practice R280 000 (R1 400 000 – R1 120 000) less output tax is paid by Company A to SARS.

• It should be noted that should the exchange rate have moved in the opposite direction (2006 – 10:1, February 2010 – 8:1) the result based on the above example and the current practice is that excess output tax of R280 000 is being paid to SARS.

• The current practice may either positively or negatively influence the vendor’s cash-flow but should not affect the VAT ultimately payable to SARS assuming that:

  o The recipient is VAT registered and uses the goods or services wholly for taxable purposes; and

  o The recipient claims the VAT amount actually reflected on the tax invoice issued by the supplier.
LEGISLATION

“Consideration” includes any payment made or to be made in relation to the supply of goods and services.

A registered vendor is required to issue a valid tax invoice within 21 days after a supply has been made. The tax invoice shall be in the currency of the Republic (Rand), unless a full tax invoice is issued for a zero-rated supply, in which case the tax invoice may be issued in foreign currency. In general, the time of supply is determined as the earlier of date of invoice or date of payment.

OTHER RELEVANT RESEARCH

Even though VAT rulings were officially withdrawn, it still gives an indication of SARS’ interpretation of various practical scenario’s encountered by vendors.

VAT ruling 60

Foreign exchange gains and losses do not influence the value of a supply. The nature of such transactions is viewed as a supply of money and therefore has no VAT implications.

VAT ruling 435

Where goods and services are delivered to a purchaser at an address in South Africa, the supply is subject to VAT at the standard rate. The supply may be invoiced in a foreign currency, but the value, tax and consideration must also be stated in rand.

Explanatory Memorandum on the Taxation Laws Amendment Bill 1998 - Clause 94

Sections 20(4) and (5) sets out the particulars which a tax invoice must contain, but does not require the value of the supply, the amount of tax charged or the consideration for the supply to be stated in South African currency. This situation is undesirable as it complicates the auditing of vendors’ VAT returns and also leads to a mismatch between input tax deducted and output tax accounted for.

Where vendors prefer to issue tax invoices in foreign currency they are now required to also state the consideration and the tax in South African currency. The VAT liability is fixed at the time of supply (not the time of issue of the tax invoice). Should the amount eventually paid differ from the amount of consideration reflected on the tax invoice due to currency fluctuations, this difference will not affect the VAT charged on the supply. Input tax may be deducted and output tax has to be accounted for in accordance with the tax invoice issued.

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1 Section 1 of the Value Added Tax Act No 89 of 1991
2 Section 20(1) of the VAT Act
3 Proviso to Section 20(4) of the VAT Act
4 Section 9(1) of the VAT Act
The amendment requires vendors to issue tax invoices in South African currency, unless tax is charged at the zero rate in terms of section 11.

**New Zealand BR PUB 04/01**

This ruling deals with the situation where a registered person accepts foreign currency as payment for a supply of goods and services and uses an “in-house” exchange rate. It was ruled that a person selling goods and services to a customer who pays in foreign currency is making only one supply, i.e. the supply of goods and services. When a registered person accepts foreign currency in payment for supplies, there is no exempt supply of the exchange of currency. To be an exchange of currency, one currency must be exchanged for another; it does not cover the situation when currency is exchanged for goods or services.

When a customer tenders foreign currency as consideration for a supply, the value of the supply is the amount of foreign currency. New Zealand legislation requires that all amounts of money tendered in consideration of a supply be “expressed in terms of New Zealand currency at the time of that supply”. In *Payne v Deputy FCT* [1936] 2 All ER 793, it was held that foreign currency must be converted to the currency of the taxing country at the current market exchange rate. The Ruling stated that the exchange rate applying at the time of payment is to be used and not the rate used by the registered person converting the foreign currency. The Commissioner will accept the exchange rates offered by approved banks and approved bureau de change.

**PONTENTIAL APPLICATION**

The Taxation Laws Amendment Act of 1998 amended the VAT Act to require that a valid tax invoice has to reflect the consideration or value of supplies in the currency of the Republic. Consideration is the amount of money that is payable in respect of the supply. The Explanatory Memorandum on the Taxation Laws Amendment Bill of 1998 clearly states that the purpose of the 1998 amendment was to address the potential mismatch between input tax deducted and output tax accounted for where supplies were made in return for foreign currency. It therefore appears that the intention of the legislation was therefore not to require vendors to use the market related exchange rate on the date the supply is made to translate foreign currency values to rand, but rather to fix the rand amount on invoice date in order to prevent a mismatch between output tax declared by the supplier and input tax potentially claimable by the recipient.

Where a vendor and its client contractually agreed to a fixed exchange rate in relation to payments to be made in Dollar in order to facilitate cost effective payments to subcontractors in other countries the parties are entitled to agree upon a fixed conversion rate and will be bound to it on the basis that consensus was reached. The invoice amounts are determined at a later stage when the value of actual supplies made is translated into foreign currency using the fixed conversion rate. Any subsequent currency fluctuations do not affect the VAT charged on the supply, but is regarded as a supply of money.

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5 Section 20(4) of the VAT Act was amended in 1998

6 The definition of ‘money’ per section 1 of the VAT Act specifically includes currency of another country which is used as currency.
RECOMMENDATION

SAICA request a meeting with SARS to discuss the affect on vendors and agreed practice going forward.

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

Yours faithfully

Muneer Hassan CA(SA)
PROJECT DIRECTOR: TAX
The South African Institute of Chartered Accountants

cc: nalberts@sars.gov.za