ANNEXURE C PROPOSALS FOR 2010: VALUE ADDED TAX

The SAICA National Tax Committee has identified certain issues that require the attention of National Treasury and possibly an amendment to the Value-Added Tax Act No 89 of 1991 (the Act). Please find our proposals below.

1. Section 11(1)(q) of the Act

   **Problem statement**
   Section 11(1)(q) currently only deals with the situation where moveable goods are delivered to a SA recipient that will be entitled to a full input tax credit. This avoids unintended VAT leakages that would result if such goods had to be supplied at the standard rate (not having been exported as defined in the Act).

   An anomaly may arise where a local supplier of goods (which would otherwise have been exempt from VAT upon importation if acquired from a non-resident) is contracted to supply such goods to a non-resident, but where physical delivery is made to a SA non-vendor recipient. For example, if a non-resident entity enters into an agreement with a SA University for the supply of medical equipment to be used for academic research purposes and the University imports such equipment, such importation will be exempt from VAT in terms of section 13(3) of the Act.

   However, should the non-resident have contracted with a SA vendor to supply the medical equipment to the non-resident but to deliver it to the University, the zero rate provision in section 11(1)(q) will not apply, where the University is not a vendor. This will result in the University, under current legislation, incurring a 14% VAT cost which will be non-recoverable. To further illustrate the point, if the local vendor in the said scenario first exports the goods to the non-resident and the University imports same, the export will be zero rated and the importation will be exempt from VAT, leaving the University with no VAT cost.

   We submit that this situation gives rise to an unintended VAT leakage.
Proposed solution
We propose that the ambit of section 11(1)(q) either be extended or a new section be introduced to zero-rate supplies made under the above circumstances.

2. Section 16(3) of the Act

Problem statement
Section 16(3) of the Act currently determines that the net amount payable to SARS must be calculated “by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period, as determined under subsection (4), and the amounts (if any) received by the vendor during that period by way of refunds of tax charged under section 7(1)(b) and (c) and 7(3)(a), the following amounts, namely—”

The requirement to include amounts of refunds received in respect of payments in terms of section 7(1)(c) of the Act in the computation of the net amount payable to SARS results in nullifying any refund of VAT on imported services (thereby unduly increasing the VAT burden on the vendor). The intention with the inclusion of refunds received in terms of VAT paid on the importation of goods (section 7(1)(b)) and VAT paid on excisable goods and goods subject to the environmental levy (section 7(3)(a)) in the amount to determine the net amount of VAT payable to SARS, is based on the assumption that the vendor will be entitled to an input tax deduction in respect of the original payment of VAT made. This ensures that the vendor does not get a “double refund” of the VAT paid, i.e. such amounts qualifying as normal deductible input tax and being refunded by customs and excise through the refund mechanisms applicable there (on the overpayment of VAT and customs and excise duties).

VAT payable in terms of section 7(1)(c) of the Act is however only payable to the extent that services are acquired for the purpose other than making taxable supplies (normally non-enterprise (exempt) activities). Such amounts paid can never constitute input tax as it has not been incurred for the purpose of consumption, use or supply in the course of making taxable supplies. Where VAT on imported services are accordingly refunded on the basis of there being an overpayment (which generally would be the result of having overstated the extent of the exempt use), the amount of VAT initially paid would not have been recoverable through the normal VAT system. These amounts should accordingly also not be added to output tax attributable to a tax period as is currently required.

The above can be explained by the following example. Assume that a vendor imports services with a value of R100. At the time of importation the vendor estimates that he will use the services 30% of taxable purposes (i.e. 70% for exempt/non-enterprise purposes). After the importation the vendor discovers a computation error. The actual use of the service will be wholly for taxable purposes. The vendor initially pays VAT @ 14% of R70, but thereafter applies for a refund of the amount so paid on the basis
that no VAT was payable on the import of the service (being used wholly for taxable purposes).

The VAT payable on the importation of the service should be nil, the supply being used wholly for taxable purposes. The practical effect of the current wording of the Act is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT Paid on importation (R70*14%)</td>
<td>R9.80</td>
</tr>
<tr>
<td>Input tax deduction (not input tax as defined)</td>
<td>Nil</td>
</tr>
<tr>
<td>Refund received on application</td>
<td>R(9.80)</td>
</tr>
<tr>
<td>Refund added to output tax (section 16(3))</td>
<td>R9.80</td>
</tr>
<tr>
<td>Net cost to the vendor (not recoverable)</td>
<td>R9.80</td>
</tr>
</tbody>
</table>

Proposed solution
We recommend that the section be amended with the following suggested wording:

“by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period, as determined under subsection (4), and the amounts (if any) received by the vendor during that period by way of refunds of tax charged under section 7(1)(b) and (c) and 7(3)(a), the following amounts, namely-.”

3. Sections 8(2) and 22(3)(b)(ii)(dd) of the Act

Problem statement
The combination of the above sections has the effect that a vendor who decides to deregister and who holds capital assets at the time of deregistration will be required to account for output tax on both the value of the assets held on the date of deregistration as well as the outstanding debt relating to such assets. Where significant assets have been acquired under instalment sale agreements, this will represent a significant cost to the vendor.

The above can be demonstrated by the following example. Assume that a vendor acquires new machinery for R1,140,000 (including VAT at 14%) the day before he decides to deregister as a VAT vendor. The vendor settles the supplier’s account the day after he has deregistered as a vendor. Section 8(2) will require an adjustment of R140,000 and a further adjustment of R140,000 will be required in terms of section 22(3)(b)(ii)(dd), the debt not having been settled at the time of deregistration.

Proposed solution
The above double taxation could not have been intended by the legislator. We therefore recommend that section 22(3)(b)(ii)(dd) be amended to exclude any goods or services to which section 8(2) applies.
We further propose that section 22(3) be amended to exclude inter-group transactions where both parties are registered vendors. The current situation does not add any monetary gain to the fiscus but results in significant practical difficulties within a group context. Alternatively it should only apply to inter-group transactions where one group company has made an adjustment for doubtful debts.

4. **Section 1 - definition of foreign donor funded project**

**Problem statement**
The current ambit of the definition only includes donations by foreign donors to South African institutions.

**Proposed solution**
Consideration should be given to expanding the ambit of the definition to include local donors. Local donors are currently reluctant to make donations where the VAT cost is a cost to the projects. The definition may still be restrictive as far as the application of the funds and the nature of funded projects are concerned, but should not exclude local donors.

5. **VAT Practice Note # 2 – Format of tax invoices**

**Problem statement**
The current VAT legislation dealing with the issuing of tax invoices have not kept up with modern developments in electronic commerce. Especially developments in the use of PDF formats are causing operational difficulties in practice.

**Proposed solution**
In light of VAT being a self-assessment system and SARS’ increased capacity to conduct computer based audits, we would appreciate SARS’ consideration to issue of an updated Practice Note #2 on the requirements of a tax invoice (combining recommendations made in this document with VAT News 20 and Practice Note 2). We recommend that SARS consider the following:

- Relaxation of the current Electronic Invoicing requirements to allow PDF’s and not only EDI circumstances. SARS’ access to computer-based auditing techniques can ensure to a much greater extent than in the past that input tax deductions are not duplicated;

- Finalization of the Draft Interpretation Note on STATUTORY CHARGES LEVIED ON AIRCRAFT PASSENGERS (6 September 2005);

- Relaxation of the requirement to issue tax invoices by industries where the recipients are barred from claiming input tax deductions, including the
entertainment industry and travel and tourism. This measure could also combat non-compliance by recipients;

- Guidance on documentary compliance with section 54 of the Act.

6. Section 22(3) of the Act

Background
Often, groups of companies are set up in such a manner that they make taxable supplies to one another via their inter-company loan accounts. In other words, the principal company will purchase goods or services, claim an input tax deduction and on supply the goods or services through the loan account to its subsidiary. This scenario represents a taxable supply by the principal company to its subsidiary on which the principal company will charge output tax and issue a tax invoice. The subsidiary will be entitled to an input tax deduction and the group will therefore remain VAT neutral.

However, the VAT neutrality of the group is often at risk where the subsidiaries loan account balances are in credit with respect to the principal company. The risk is brought about due to the application of section 22(3).

This section requires that a recipient, who initially claimed an input tax deduction on the costs incurred, should make payment within a period of twelve months after the expiry of the tax period within which such deduction was made. If such a recipient does not make payment within the stipulated period then such recipient should account for VAT on the portion of the liability that has not been paid as yet.

It is therefore apparent that groups of companies would be jeopardised by this particular section for reasons that did not take into account circumstances pertinent to group companies.

It is important to understand why transactions are concluded on loan account between connected parties. Commercially, the main trading company in the group would generally acquire all the goods or services for the benefit of the group because in so doing it would be in a position to negotiate better prices for the entire group. Suppliers are generally prepared to allow bigger discounts where it deals with companies trading in higher volumes and have the financial means to pay for the goods or services. In many cases start-up subsidiaries are not in a position to repay the loan to its main trading or holding company as it has not yet generated sufficient profits to yield a positive cash flow. It may take a few years before the loan account is fully settled.

Problem statement
Section 22(3) of the Act was introduced to discourage vendors from claiming an input tax deduction on the supply made where the supplier would also claim an input tax deduction on the write-off of such debts. This would result in a VAT leakage for the fiscus. However, this is often not the case with connected parties as the supplier would not write-off the debt of the recipient unless the recipient will not be in a position to pay such liability as contemplated in proviso (ii) of section 22(3) of the Act. This would be the case where the recipient is sequestrated, declared insolvent, entered into a compromise or an arrangement in terms of section 311 of the Companies Act, 1973, or a similar arrangement with creditors or the vendor ceases to be a vendor as contemplated in section 8(2) of the Act. Furthermore, the nature of transactions between connected parties where a supply is made to the recipient is normally a recovery of costs incurred by the holding company and passed on to the subsidiaries. The holding company would then charge a management fee to the affected subsidiary. Any liabilities between the group entities or connected parties are generally settled by movements in the inter-company loan accounts.

The connected parties or group entities do not always monitor every transaction or invoice in respect of taxable supplies between each other. It is often difficult or an administrative burden to track each supply or invoice between such connected parties to the date when such payment was made by the recipient. This is because the recipient does not settle each liability amount individually but rather the recipient would offset any liabilities incurred by either cash or by making supplies to the group entities itself. As mentioned above, the group entities remain in an owing position until it has reserves to settle its loan account.

It is then possible that in respect of a specific tax invoice issued to the recipient, that the corresponding liability has not as yet been extinguished by the recipient. In such instances the recipient would be required to account for output tax on the amount that has not as yet been paid in terms of section 22(3). The supplier, however, would not have written-off the debt where the recipient is not insolvent or liquidated. Where the recipient becomes insolvent or liquidated the recipient would be required to account for VAT in terms of section 22(3)(ii) of the Act. It would appear that the second proviso to section 22(3) caters for instances where the recipient becomes insolvent, liquidated, enters into a compromise or an arrangement in terms of section 311 of the Companies Act, 1973 or a similar arrangement with creditors or the vendor ceases to be a vendor as envisaged in terms of section 8(2) of the Act. In such instances the recipient should account for output tax as the supplier would have most likely have written-off the debt owing by the recipient.

Accordingly we submit that in instances where the recipient does not fall within any of the categories stipulated in the second proviso of section 22(3) the vendor should not be required to account for output tax in respect of the unpaid liability. This is supported by the first proviso to section 22(3) which allows for such vendors not to
account for output tax where the contract between the supplier and the recipient stipulates that payment is only due after the expiry of such twelve months.

**Proposed solution**

- We propose that with regard to persons who are connected persons, section 22(3) be amended to provide that recipients of goods or services supplied are not required to make an output tax adjustment where the actual consideration has not been paid (i.e. the loan account has not been settled) within the 12-month period.
- Conversely, the supplier should not be able to claim an adjustment in terms of section 22(1).
- These provisions should not apply to the cases envisaged in proviso (ii) of section 22(3).

7. **VAT and scrip lending arrangements**

**Introduction**

In our experience, the financial services industry, SARS, and the consulting industry generally agree on the intentions of the parties entering into typical scrip lending arrangements.

Typical characteristics of scrip lending arrangements include:

- Lenders typically consist of pension funds or long term fiduciary investment vehicles.
- Lenders enter into scrip lending to secure additional income streams from the equities on their balance sheets in the form of the scrip lending fees, without divesting themselves of the risks and rewards. As a result, the borrowers agree to return equities of a same or similar kind and quality to the lenders at the expiry of the arrangement.
- Lenders typically do not have the desire and the authority to divest themselves of the potential dividend income streams. As a result, the borrowers contractually agree to pay a so-called “manufactured” dividend or interest to the lender in lieu of actual dividends declared to the then shareholder.
- Borrowers often enter into these arrangements to enable them to deliver on the sale of equities (short positions) – i.e. selling equities which they do not have at that time.
- Borrowers may also enter into these arrangements to lend to other borrowers on request.
- Due to the nature of listed equities, ownership in the equities has to transfer from the lender to the borrower on entering into the arrangement and from the borrower back to the lender on expiry of the arrangement.

**Problem Statement**
SARS issued Practice Note 5 in 1999 (PN5) which deals with the Income Tax and VAT treatment resulting from scrip lending arrangements.

PN5 views a scrip lending fee as subject to VAT.

PN5 views “manufactured” dividends or interest as consideration for the supply of a financial service (as envisaged in section 2(1)(c), (d) and (f)) which is exempt from VAT in terms of section 12(a) of the VAT Act.

PN5 does not deal with the VAT consequences of the supply of the equities by the lender to the borrower and the subsequent return of similar equities.

Based on our experience, the financial services industry has by enlarge, until recently, followed PN5 by treating scrip lending fees as being subject to VAT. We have noted that it has recently been mooted in certain discussions that scrip lending fees may potentially not be subject to VAT and should be exempt for VAT purposes.

Legislative and market uncertainty currently exists with regards to the VAT treatment of:

- The value and the supply of the equity by the lender to the borrower;
- The value and the subsequent return of the equity by the borrower to the lender;
- The manufactured dividend or interest paid; and
- The so-called scrip lending fee.

In essence, the reason for the uncertainty regarding the VAT treatment of scrip lending arrangements is attributable to the fact that the VAT Act, unlike the Income Tax Act and the International Accounting Standards (specifically IAS 39), does not contain specific provisions which deal with scrip lending arrangements.

**Proposed solution**

We recommend that amendments to the VAT Act with regards to scrip lending arrangements should be made to achieve the following objectives:

- Enhance legislative certainty;
- Give effect to the true intentions of the parties entering into scrip lending arrangements;
- Acknowledge the economic substance of these arrangements; and
- Sufficiently align the VAT Act with the Income Tax and Accounting treatment.

We are of the view that the following amendments to the VAT Act would achieve these objectives:
Inserting in section 2(2) of the VAT Act the following definitions contained in the Securities Transfer Tax Act:

“lending arrangement” means any arrangement in terms of which—

(a) a person (hereinafter referred to as the lender) lends a listed security to another person (hereinafter referred to as the borrower) in order to enable that borrower to effect delivery (other than to any lender in relation to that borrower, unless the borrower can demonstrate that the arrangement was not entered into for the purposes of the avoidance of tax and was not entered into for the purposes of keeping any position open for more than 12 months) of that security within 10 business days after the date of transfer of that security from the lender to the borrower in terms of that arrangement;

(b) that borrower in return contractually agrees in writing to deliver a listed security of the same kind and quality to that lender within a period of 12 months from the date of transfer of that security from the lender to the borrower in terms of that arrangement;

(c) that borrower is contractually required to compensate that lender for any distributions in respect of the listed security which that lender would have been entitled to receive during that period had that arrangement not been entered into; and

(d) that arrangement does not affect the lender’s benefits or risks arising from fluctuations in the market value of the listed security, but does not include an arrangement where the borrower has not—

(i) on-delivered the listed security within the period referred to in paragraph (a); or
(ii) returned the listed security contemplated in paragraph (b) to the lender within the period referred to in that paragraph;

“listed security” means any security that is listed on an exchange;

Section 2(1) or section 8 of the VAT Act be amended to deem:

A manufactured dividend paid in terms of a lending arrangement not to be in respect of a supply,

A manufactured dividend received in terms of a lending arrangement to be a dividend,

The transfer of equities by the lender to the borrower or by the borrower to the lender in terms of a “lending arrangement” not to be a supply,

With respect of equities to which exclusions (i) and (ii) in paragraph (d) of the definition of “lending arrangement” apply that a supply of those equities was
made in terms of section 2(1)(d) in the first period following the end of the periods contemplated in paragraph (a) of the definition of “lending arrangement”, as applicable, at the open market value of equities at date of transfer (value can be dealt with in section 10),

- Collateral supplied in terms of a “lending arrangement” not to be a supply,
- Section 2 should be amended to put it beyond doubt that a scrip lending fee payable in terms of a “lending arrangement” is a supply as envisaged by section 7(1)(a).

8. **Sections 12(e) & 11(1)(c)**

**Introduction**
Section 12(e) of the VAT Act currently exempts the supply of land (and any improvements) situated outside the Republic where the supply is made by way of a sale or letting.

Sections 11(1)(c) of the VAT Act zero rates movable goods supplied under a rental agreement, charter party or agreement for chartering, if the goods are used exclusively in an export country or by a customs controlled area enterprise or an IDZ operator in a customs controlled area. Section 11(1)(c) zero rate previously (pre January 2005) applied to goods (which would have included land).

**Problem statement**
The effect of the exemption contained in section 12(e) is that a South African vendor which incurs local VAT in respect of the management or administration of its foreign portfolio of land (and any improvements) should technically apply direct attribution and disallow itself any potential input tax deductions. A further consequence is that such vendor would arguably also need to apportion VAT on overhead expenses.

This seems to be inequitable in instances where the foreign land is used to make supplies which would have been taxable if the land was situated in South Africa (other than exempt use such as residential accommodation).

**Proposed solution**
Section 12(e) should be amended to limit its exemption to land (and any improvements) which would have been used to make exempt supplies if the land was situated in South Africa, such as those addressed by section 12(c).

Consideration could be given to zero rate supplies (by way of sales or letting) of land which would have been taxable if the land was situated in South Africa to enable vendors to claim South African VAT incurred in respect of the administration and management thereof as an input tax deduction.

9. **Section 12(h)**
**Introduction**
Section 12(h)(ii) of the VAT Act exempts the supply by certain educational institutions of certain goods or services where such goods or services are supplied for a consideration in the form of school fees, tuition fees or payment for board and lodging.

The reference to board and lodging previously read board or lodging (changed by Act 20 of 2006).

**Problem Statement**
The phrase “board and lodging” is unduly restrictive and impractical.

**Proposed Solution**
The phrase “board and lodging” should be changed to read “board or lodging”.

Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully

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