COMMENTS ON THE CURRENT STANDARD METHOD OF APPORTIONMENT

Dear Sir

The following comments have been provided by members of SAICA’s VAT sub-committee which is a sub-committee of the National Tax Committee.

1 The purpose of this submission is to serve as an introduction to the debate on the most appropriate and practical VAT apportionment methodology to apply in the South African context. This submission only deals with the difficulties experienced with the current approved standard method (the turnover basis of apportionment).

2 Introduction

2.1 The definition of input tax contained in section one of the VAT Act requires that an amount can only constitute input tax to the extent that it has been incurred by a vendor for the purpose of consumption, use or supply in the course of making taxable supplies. The definition directs that the extent of taxable use must be determined in accordance with the provisions of section 17 of the VAT Act.

2.2 Section 17(1) of the VAT Act determines that the extent of taxable use must be determined “in accordance with a general written ruling by the Commissioner or a written ruling given by the Commissioner to such vendor”.

2.3 Paragraph 7.1 of the Guide for Vendors (VAT 404) determines that the only approved method of apportionment is the turnover based method. It goes on to provide the following formula in terms of which the apportionment ratio must be computed:

\[ Y = \frac{a}{(a+b+c)} \times 100\% \]

where

\[ Y = \text{the apportionment percentage}. \]
a = the value of taxable supplies (including deemed supplies) made during the period.

b = the value of all exempt supplies made during the period. This will include interest received under all circumstances irrespective of the circumstances under which the interest is earned (e.g. irrespective of whether it is earned through an active or passive investment policy).

c = the sum of any other amounts 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).

2.4 In note two to the formula, “c” is explained as including “items such as dividends and statutory fines”. The term “including” indicates that “c” could include other categories of receipts/accruals as well and is merely indicative of the broad categories of receipts/accruals envisaged. The reference to “whether in respect of a supply or not” appears to indicate that every receipt or accrual not falling under “a” or “b” would be caught by “c”. This could potentially include receipts from debtors, loans received, etc.

2.5 In our opinion the strict application of the turnover based method in its current form contains so many potential uncertainties and anomalies that for all practical purposes a ruling is required from the Commissioner for each and every apportionment method for businesses with some level of complexity (which would include virtually all businesses). If the intention was that all methods of apportionment were to be pre-approved, this approach should be incorporated in the relevant legislation. The Commissioner should however then set up structures that can deal with the vast number of applications that will be the result of such an approach.

2.6 The purpose of this document is to provide the Commissioner with inputs on the key difficulties experienced with the practical application of the current approved apportionment method.

3 General principles of apportionment – impact on financial income for non-financial enterprises

3.1 The Guide for Vendors (“VAT 404”) does not provide specific details of the general guiding principles to be applied in determining the appropriate apportionment method to be applied by a vendor. It does however state on page 38 of the guide that “where the turnover based method does not yield a fair approximation of the extent of taxable supplies, the vendor should approach the local SARS office to obtain consensus on an alternative method which yields a more accurate result.”

3.2 In GSTR 2006/4 (Australian GST Ruling) the principle of “fair and reasonable” has been discussed in some detail based on the comments made in the High Court Case of Ronpibon v FC of T. The following principles have been established by the court:

- The apportionment method chosen must be fair and reasonable;
3.3 The Australian Tax Authorities have dealt with the difficulties associated with the financial exempt income distorting the recovery of VAT in an otherwise exempt organisation, by the introduction of “financial acquisition threshold”. The rules are basically the same as the de minimis rule (refer section 17(1)(i) of the VAT Act) applicable in South Africa, except that specific thresholds have been set to avoid the need for unnecessary requests for special rulings.

3.4 In GSTR 2006/3 issued by the Australian Revenue Authorities to assist taxpayers to determine the quantum of their “financial acquisition threshold”, dividends received from wholly owned subsidiaries are classified as income that “would not normally be included” in the turnover base of computing the apportionment formula. Two exclusions that apply are non-wholly owned subsidiaries and shares held in “special purpose vehicles” to facilitate a transaction for a customer of a bank. It would appear that the distinction that is being made is based on the basis of passive v active investment activities.

3.5 In Ireland the general principle applied is that “a proportion of tax deductible which correctly reflects the extent to which the dual-use inputs are used for the purposes of that person’s deductible supplies or activities and has due regard to the range of that person’s total supplies and activities.”

3.6 In applying the above general guiding principle, two tests are applied i.e. the proportion must correctly reflect the use to which the inputs are put and also reflect the range of the taxable person’s activities. The second test is of particular importance and avoids a single category of transactions or isolated transactions distorting a more appropriate recovery percentage. An example of this would be where interest on a loan to an associated company (or any other party) in an otherwise fully taxable organisation dilutes the recovery percentage, while the real activities associated with the management of the loan are negligible.

3.7 Of interest is a comment made in paragraph 8.3 of Ireland’s “A Guide to Apportionment of Input Tax”. It states that the turnover method has traditionally been seen as the standard method of apportionment as the level of turnover generally provides an objective measure of the relative use of duel-use inputs. It further states that the standard turnover method may not be appropriate where the taxable person is in receipt of dividends, grants, subsidies and other non-income receipts.

3.8 To eliminate the potential distortions that may be caused by the above transactions, Ireland has legislated the exclusion of “incidental financial transaction” and “incidental property transaction”.

3.9 The policy to address the issue of the potential distortion caused by dividends received/accrued as a category of “incidental financial transactions” is dealt with by the Ireland Revenue Authorities by the use of a category of supplies defined as “outside the scope of VAT”. Dividends received on “out of scope activities” are
excluded from the computation of the recovery percentage. Such activities include the holding of shares (and the resulting receipt/accrual of dividends). It specifically excludes shares held as trading stock (where dividends received are included in the computation of the recovery percentage).

3.10 In the United Kingdom the Court has ruled in the case of Polysar Holdings that the holding of shares is not an economic activity for VAT purposes and that the receipt of a dividend is accordingly not consideration for any supply for VAT purposes. Of importance is to note that the Court has ruled that the standard turnover method was not appropriate, not that apportionment itself was not required. Advocate General Fennelly in his opinion on Case C-142/99 Floridienne SA and Berginvest SA v Belgian State summarise the principles as follows:

“The result of all this, in so far as Article 19(1) of the Sixth Directive is concerned, is not necessarily that the applicants may deduct all of their VAT inputs. To the extent that the national court is satisfied, notwithstanding the applicants’ contention to the contrary, that a not entirely insignificant portion of those inputs relates to the performance of non-taxable transaction connected with the shareholding and lending activities of the applicants, no right to deduct may arise pursuant to Article 17(2) of the Sixth Directive. A taxable person may only deduct that portion of its inputs which may properly be assigned to its economic activities. Every taxable person is obliged by Article 22(2) of the Sixth Directive to ‘keep accounts in sufficient detail to permit application of the value added tax and inspection by the tax authority’, while Article 22(4) requires ‘every taxable person ‘ to ‘submit a return within an interval to be determined by each Member State’, which ‘may not exceed two months following the end of each tax period’, whose duration is, subject to a minimum of a year, to be determined by each Member State, although it may not ‘exceed a year’. The taxable person who seeks to exercise the right to deduct in circumstances where some of its inputs may relate to non-taxable activities is obliged to establish, to the satisfaction of the relevant authorities, the proportion of those inputs which it claims are attributable to taxable transactions and thus capable of being deducted.”

3.11 Due a lack of specific rules in South Africa (other than the general de minimis rule) the following are examples of practical difficulties associated with day-to-day operations of organisations with regards to investment income:

3.11.1 Interest automatically raised by accounting software on overdue accounts where credit is not provided by the organisation as part of its arrangement with its clients. Such systems-generated entries are normally not recovered and generally needs to be reversed by journal entry.

3.11.2 Interest charged on inter-company loans where the activities associated with the underlying loans are insignificant.

3.11.3 Incidental interest earned on temporary excess cash in organisations, where the organization’s activities do not include.
3.11.4 The treatment of preference and other dividends earned on passive investments.

4 General principles of apportionment – impact of grants/donations

4.1 Grants do not generally constitute a challenge as a close link generally exits between the grant and the underlying supply of goods or services for which the grant is granted.

4.2 True donations received are however generally not linked to any specific deliverable/supply, be it in the form of goods or services. It merely represents the manner in which the entity’s activities are financed. The amount of tax (VAT) incurred qualifying as input tax, whether financed from the proceeds of the donation or otherwise, must be determined by the application of the normal VAT principles, i.e. have such costs been incurred for the purpose of consumption, use or supply in the course of making taxable supplies.

4.3 Example one on page 14 of the VAT 414 Guide for Associations not for Gain and Welfare Organisations, supports the above contention confirming that where the funds derived from donations received are applied in wholly taxable activities, all underlying VAT incurred will qualify as input tax. It however does not go further to indicate or clarify how such donations must be treated from an apportionment percentage computation point of view, other than indicating that the rules in the VAT 404 must be applied. If the rules are applied strictly, the donations will form part of “c” in the formula. This will give a ridiculous result given that the activities conducted by the organisation would be wholly taxable in nature.

4.4 The above situation should not give rise to any VAT leakage for organisations making wholly taxable supplies as all VAT incurred should be directly attributable. The moment an organisation however also makes some level of exempt supplies (for example it receives exempt interest income), the current formula contained in the VAT 404 will require the value of donations to be included in “c” in the formula thereby resulting in an undue dilution/distortion of the organisation’s recovery percentage.

5 Recommendations

5.1 While we accept that the issue of apportionment is highly complex and often requires a situation-to-situation approach, we recommend that the following salient features of the current turnover based apportionment formula contained in the VAT 404 be reconsidered:

5.1.1 That dividends received from wholly owned subsidiaries be formally excluded from “c” in the current formula.

5.1.2 That guidelines are provided on the treatment of dividends received/accrued as a result of active investment activities.
5.1.3 That donations received be excluded from “c” in the current formula under all circumstances. This would be in line with numerous rulings issued to vendors in the past.

5.1.4 That clear guidelines be developed and published to deal with the ambit and nature of non-supplies.

5.1.5 That formal guidelines be provided for the treatment of interest received/accrued for organisations not operating in the financial services industry.

5.2 As far as the formal process to administer the legislation is concerned, we make the following additional recommendation:

5.2.1 While it is acceptable to prescribe a default method in the absence of an agreed equitable method, we propose that SARS’ discretion to approve an alternative method must not be exercised in such a fashion that it becomes detrimental to the vendor, or as a penal provision.

5.2.2 The basis for the exercise of the discretion by SARS to provide for an alternative apportionment method should be based on the principle of “equity” enshrined in the legislation. The “equity” principle should take account of the effect of distortions of the apportionment ratio (both in favour and to the detriment of the vendor).

5.2.3 The VAT Act currently allows SARS to agree to an alternative method from an equitable date. Guidelines for the exercise of this discretion must be published in order that vendors and SARS officials can have an acceptable degree of certainty. Vendors should have the right to object and appeal against decisions both on the grounds of the actual method, formula and effective date of application.

5.2.4 We recommend that policies and procedures be implemented to accelerate the granting of apportionment rulings as many vendors are uncertain as to the correct way of determining input tax while applications are in limbo. This has the result that accounting provisions have to be raised which may have an impact on investors’ valuation of such business.

5.2.5 We further recommend that all SARS rulings be published as soon as possible after it has been issued. This will assist to alleviate the level of uncertainty currently prevailing.

5.3 We recommend that the above issues be enshrined in legislation as far as possible. Where the legislative approach is not appropriate, that detailed interpretation notes are issued to deal with the various areas of practical difficulty. We shall gladly provide inputs in joint working cessions with SARS to facilitate a meaningful conclusion of this key issue in the application of VAT legislation and interpretation notes.
Please do not hesitate to contact me should you require further information.

Yours faithfully

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