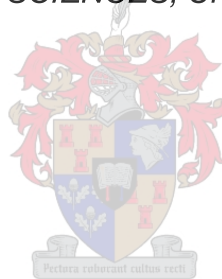
A critical evaluation of the enterprise concept and the effect thereof on input tax and its apportionment for VAT purposes

by

PIERRE MARAIS

The Research Assignment submitted in fulfilment of the requirements for the degree M.ACCOUNTING (TAXATION) to the FACULTY ECONOMIC AND MANAGEMENT SCIENCES, University of Stellenbosch



Study leader: Mr L Willemse

Faculty Economic and Management Sciences

Department Accounting

April 2014

Stellenbosch University http://scholar.sun.ac.za

DECLARATION

1. I acknowledge that plagiarism means, that when I present the work of another person as my own, it is an offence. I also understand that direct translation will be regarded as plagiarism.

2. Accordingly, all quotes and contributions from any source (including the internet) must be referenced. I acknowledge that the literal quotation of text without quotation marks (even with full acknowledgement of the source) will be regarded as plagiarism.

3. I declare that the content in this research assignment is my own original work and was not presented in part or in whole in this module or any other module for a mark or a final mark.

Name and surname: Pierre Marais
Signature:

Stellenbosch University http://scholar.sun.ac.za

ACKNOWLEDGEMENTS

- To my wife, Janine, for all the support and love during this time;
- To my sons, Luke and Carl, for their continued understanding of the importance of this research assignment;
- To my parents, Pierre and Henny, for their support;
- To my mother-in-law, Daleen, for her support;
- To my study leader, Mr L Willemse, for all the relevant proposals, support and motivation;
- To Jonathan David Amid from the writing laboratory for his support, motivation and proposals.

Stellenbosch University http://scholar.sun.ac.za

SUMMARY

In South Africa, value-added tax ('VAT') is classified as an indirect tax which is levied on goods or services supplied in the Republic of South Africa. In South Africa, VAT is a destination-based invoice type tax system which means that the consumption of goods and services are taxed.

To register as a vendor for VAT purposes, the business conducted must fall within the ambit of an 'enterprise' as defined in section 1(1) of the Value-Added Tax Act, 1991 (Act No. 89 of 1991) (the VAT Act).

Where a registered vendor makes taxable supplies of goods or services, it is subject to VAT at the standard rate in terms of section 7(1) of the VAT Act, unless and exemption or exception applies thereto.

VAT incurred will constitute "input tax" as defined in section 1(1) of the VAT Act, where amongst others, the goods or services are acquired wholly for the purpose of consumption, use or supply in the course of making taxable supplies, or where the goods or services are acquired partly for such purpose, to such extent as determined in accordance with section 17(1) of the VAT Act.

The vendor will therefore be confronted with various questions with regard to whether the activities are performed by the enterprise, or whether such activities fall outside the scope of VAT and therefore constitute non-enterprise activities. When the activities are regarded as enterprise activities, the vendor will have to determine whether the VAT incurred for the enterprise activities are used, consumed or supplied in making taxable supplies.

Where the VAT incurred cannot be attributed to the making of taxable supplies, an apportionment of the VAT incurred is required. The apportionment method used in apportioning the VAT incurred for mixed purposes, must be fair and reasonable.

This research assignment will therefore investigate and focus on the treatment of the VAT incurred by the business in deducting the correct amount of input tax.

Stellenbosch University http://scholar.sun.ac.za

OPSOMMING

In Suid-Afrika word belasting op toegevoegde waarde (‘BTW’) geklassifiseer as ‘n indirekte belasting wat gehef word op die lewering van goed of dienste. BTW is ‘n destinasie-gebaseerde faktuurbasis wat beteken dat die verbruik van goed of dienste in Suid-Afrika aan belasting onderhewig is.

Om vir BTW doeleindes te registreer, moet die besigheid of die bedryf aan die vereistes van ‘n ‘onderneming’ soos gedefineer in artikel 1(1) van die Belasting op Toegevoegde Waarde Wet (die BTW Wet) voldoen. ‘n Geregistreerde ondernemer wat goed of dienste lewer, moet BTW teen die standaardkoers ingevolge artikel 7(1) van die BTW Wet hef, tensy ‘n vrystelling of uitsondering op hierdie reël van toepassing is.

Die belasting gehef ingevolge artikel 7(1) van die BTW Wet verteenwoordig insetbelasting indien die betrokke goed of dienste deur die ondernemer verkry word geheel en al met die doel van verbruik, gebruik of lewering in die loop van die doen vir belasbare lewerings. Indien die goed of dienste gedeeltelik vir daardie doel aangewend word, is die ondernemer verplig om die belasting toe te deel ingevolge artikel 17 van die BTW Wet.

Die ondernemer word dus met verskeie vrae gekonfronteer om te bepaal of die goed of dienste aangewend word in die loop ter bevordering van die onderneming. Indien die goed of dienste nie vir daardie doel aangewend word nie, die sogenaamde ondernemingsaktiwiteite, sal die BTW aangegaan deur die ondernemer buite die bestek van die BTW Wet val en gevolglik as nie-ondernemingsaktiwitiete geklassifiseer word.

Indien die BTW nie geheel en al gebruik word vir die maak van belasbare lewerings nie, moet die ondernemer die sogenaamde BTW toedeel volgens ‘n erkende toedelingsmetode ingevolge artikel 17 van die BTW Wet. Hierdie metode moet aan die vereistes van regverdigheid en redelikheid voldoen.

Hierdie werkstuk fokus en ontleed die hantering van die BTW aangegaan deur die ondernemer met die doel om die korrekte insetbelasting aftrekking te bepaal.

Stellenbosch University http://scholar.sun.ac.za

INDEX

Chapter 1: Introduction Page 1

1.1 Background Page 1

1.2 Problem statement Page 5

1.3 Importance and value of the research Page 9

1.4 Objective Page 9

1.5 Research design, methods and scope Page 9

1.6 Framework of study Page 10

1.6.1 Chapter 2: Definition of enterprise with a specific focus on the enterprise versus non-enterprise activity and the effect thereof on input tax Page 10

1.6.2 Chapter 3: Definition of input tax: in particular the direct and immediate link test with the view of direct attribution Page 10

1.6.3 Chapter 4: Apportionment methodology, suggested method of apportionment, with specific focus on the varied turnover-based method of apportionment Page 11

1.6.4 Chapter 5: A reasonability test when an apportionment method is applied by the registered VAT vendor Page 11

1.6.5 Chapter 6: Conclusion Page 11

1.6.6 Reference list Page 11

Chapter 2: Definition of enterprise with a specific focus on the enterprise versus the non-enterprise activity and the effect thereof on input tax Page 12

2.1 Introduction Page 12

2.2 Enterprise as defined Page 12

2.2.1 Any enterprise or activity carried on by any person Page 13

2.2.2 Continuously and regularly Page 15

2.2.3 In the Republic or partly in the Republic Page 18

2.2.4 In the course or furtherance of which goods or services are supplied to any person for a consideration Page 21

2.3 Non-enterprise activity versus enterprise activity Page 24

2.3.1 Non-enterprise activity Page 24

Stellenbosch University http://scholar.sun.ac.za

2.4 The effect of non-enterprise activities on input tax and related examples Page 29
2.5 Conclusion Page 30

Chapter 3: Definition of input tax: in particular the direct and immediate link test with the view of direct attribution Page 32
3.1 Introduction Page 32
3.2 Input tax as defined in section 1(1) Page 32
3.2.1 General Page 32
3.2.2 Acquired by the vendor Page 33
3.2.3 The purpose for which the acquisition was made Page 34
3.2.4 In the course of making taxable supplies Page 35
3.3 Five step approach to determine input tax Page 39
3.4 Classification of supplies Page 41
3.4.1 Multiple supply Page 41
3.4.2 Composite supply Page 42
3.4.3 Single supply Page 43
3.5 Differentiating between single, composite and multiple supplies Page 43
3.6 Using single, composite and multiple supplies when attempting direct attribution Page 45
3.7 Conclusion Page 47

Chapter 4: Apportionment methodology, suggested methods of apportionment, with specific focus on the varied turnover-based method Page 49
4.1 Introduction Page 49
4.2 Apportionment in general Page 49
4.2.1 Input tax as defined in section 1(1) Page 49
4.2.2 Apportionment of VAT in terms of section 17(1) Page 50
4.3 Turnover-based method of apportionment Page 51
4.4 Varied input-based method of apportionment Page 53
4.5 Floor space method of apportionment Page 55
4.6 Multiple method of apportionment Page 56
4.7 Varied turnover-based method of apportionment Page 58
4.7.1 Dividend income Page 58
4.7.1.1 General essentials of dividends in South Africa Page 58

Stellenbosch University http://scholar.sun.ac.za

4.7.1.2 The nature of dividends Page 60
4.7.1.3 The role of directors with regard to dividends Page 61
4.7.1.4 The inclusion of dividend income in apportionment method Page 62
4.7.2 Incidental supplies Page 70
4.7.3 Inclusion of interest in the turnover-based method of apportionment Page 71
4.8 The effect of non-enterprise activities on apportionment Page 75
4.9 Conclusion Page 77

Chapter 5: A reasonability test when an apportionment method is applied by the registered vendor Page 79
5.1 Introduction Page 79
5.2 Requirements for the apportionment method must be fair and reasonable Page 79
5.3 The application of the fair and reasonable test in other jurisdictions Page 84
5.4 Conclusion Page 88

Chapter 6: Conclusion Page 90
6.1 Introduction Page 90
6.2 The distinction between enterprise and non-enterprise activities and the effect thereof in claiming an input tax deduction Page 90
6.3 To what extent the vendor can perform direct attribution with regard to the different supplies being made to the enterprise Page 91
6.4 Which method of apportionment is the most appropriate method to use by the vendor to determine the input tax claimable in respect of goods and services acquired partly for making taxable supplies Page 92
6.5 The method of apportionment must be fair and reasonable Page 94
6.6 Summary Page 95

Reference list Page 96

Stellenbosch University http://scholar.sun.ac.za

ABBREVIATIONS AND TERMINOLOGY

"BASA" –	Banking Association of South Africa
"BGR" –	Binding General Ruling issued by the Commissioner for the South African Revenue Service
"Commissioner" –	Commissioner for the South African Revenue Service
"ECJ" –	European Court of Justice
"Enterprise" –	An enterprise as defined in section 1(1) of the Value-Added Tax Act No. 89 of 1991
"EU" –	European Union
"HM Revenue & Customs" –	Her Majesty Revenue and Customs in the United Kingdom
"Input tax" –	The tax charged where the goods or services are acquired by the vendor wholly for the purpose of use, consumption or supply in the course of making taxable supplies or where used, consumed or supplied partly such purpose, in accordance with an apportionment method in terms of section 17 of the Value-Added Tax Act No. 89 of 1991
"Interpretation Note" –	A document issued by the Commissioner for the South African Revenue Service to indicate his interpretation of the provisions that it applies to
"ITC" –	Income Tax Court

Stellenbosch University http://scholar.sun.ac.za

"Legal and Policy Division" –	The South African Revenue Service, Legal and Policy Division
"SARS" –	South African Revenue Service
"TA Act" –	Tax Administration Act No. 28 of 2011
"Taxable supply" –	Any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(*a*) or under section 11 of the Value-Added Tax Act No. 89 of 1991
"VAT" –	Value-Added Tax
"VAT Act" –	The Value-Added Tax Act No. 89 of 1991
"VAT 404" –	Guide for Vendors issued by the Commissioner for the South African Revenue Service
"Vendor" –	A person required to be registered under the Value-Added Tax Act No. 89 of 1991

Stellenbosch University http://scholar.sun.ac.za

Chapter 1: Introduction

1.1 Background

In South Africa, value-added tax ('VAT') is classified as an indirect tax which is levied on goods or services supplied in the Republic of South Africa. In South Africa, VAT is a destination-based invoice type tax system which means that the consumption of goods and services are taxed. The Guide for Vendors (VAT 404) (Legal and Policy Division, 2013: 9) states: *"this is known as the invoice-based credit method of consumption-type VAT".*

To register as a vendor for VAT purposes, the business conducted must fall within the ambit of an 'enterprise' as defined in section 1 of the Value-Added Tax Act, 1991 (Act No. 89 of 1991) ('the VAT Act'). This concept is one of the most important fundamentals of the VAT Act. All references to sections hereinafter are to sections of the VAT Act unless stated otherwise. An 'enterprise' is defined in section 1(1) as:

> *[…] In the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club;*

Section 1(1) defines an "enterprise" for VAT purposes as a business that carries on an enterprise or activity on a continuous or regular basis in the Republic or partly in the Republic where goods or services are supplied for a consideration. This business will be able to register for VAT purposes if certain requirements are met.

Where a registered vendor makes taxable supplies of goods or services, it is subject to VAT at the standard rate in terms of section 7(1), unless and exemption or exception applies thereto. Section 11 deals with zero-rated supplies and are exceptions to the general rule. The definition of "enterprise" in section 1(1) specifically excludes exempt

Stellenbosch University http://scholar.sun.ac.za

supplies and will therefore not be supplied in the course or furtherance of an enterprise carried on by that business.

In order to constitute "input tax" in terms of paragraph (*a*) of that definition in section 1(1), tax must have been charged under section 7(1). Furthermore, the VAT incurred will constitute "input tax" as defined in section 1(1), where amongst others, the goods or services are acquired wholly for the purpose of consumption, use or supply in the course of making taxable supplies, or where the goods or services are acquired partly for such purpose, to such extent as determined in accordance with section 17(1).

A registered vendor is therefore required to directly attribute the VAT incurred on goods or services according to the intended purpose to the extent that the goods or services are consumed, used or supplied in making taxable supplies, prior to applying an apportionment method. The VAT incurred wholly for the purpose of consumption, use or supply in the course of making taxable supplies, may be deducted as "input tax". The VAT incurred wholly for the purpose of consumption, use or supply in the course of making other than taxable supplies does not qualify as "input tax". Where the VAT incurred is acquired partly for the purpose of making taxable supplies and partly for another purpose, the VAT must be apportioned in accordance with section 17(1).

This research assignment focuses on the amount of input tax claimable by a registered vendor when making taxable, exempt, non-supplies or non-enterprise activities.

1. A decision making process needs to be followed to determine the deductible input tax. Before a person can register as a vendor, he must firstly conduct an enterprise for VAT purposes. It is only the enterprise activities carried on in the making of taxable supplies which give rise to an input tax deduction. It is therefore important to distinguish between the activities which generate taxable supplies, which fall within the ambit of the enterprise, and those activities which fall outside the scope of VAT and considered to be the non-enterprise activities. In the first mentioned instance, input tax can be deducted by the vendor but in the latter no input tax is deductible. Furthermore, where expenditure is incurred for enterprise and non-enterprise activities, an apportionment of input tax is required in terms of section 17(1).

Stellenbosch University http://scholar.sun.ac.za

2. Direct attribution is one of the cornerstones in determining the input tax deductible by the registered vendor. The Guide for Vendors (VAT 404) (Legal and Policy Division, 2013: 47) states that *"[d]irect attribution means that you will be required to attribute the VAT expense according to the intended purpose for which it will be used."*

   Where the VAT incurred is wholly for the purpose of making taxable supplies, it may be deducted as input tax. Conversely, whereas the VAT incurred wholly for the making of exempt, non-supplies or non-enterprise activities may not be deducted as input tax. Moreover, where the expenditure is incurred in making a taxable, exempt or a non-supply, or it is incurred during a non-enterprise activity, such expenditure will be subject to apportionment.

   It is therefore of further importance to distinguish between *single*, *composite* and *multiple supplies*. By defining these supplies would assist the vendor to ascertain whether the supply can be attributable to a taxable, exempt, non-supply or non-enterprise activities. Where the expense cannot be attributed into its various supplies, an apportionment of the expenses is required in terms of section 17(1).

3. An apportionment method needs to be considered where an expense cannot be attributed into its various components for VAT purposes. The *turnover-based method* of apportionment is the prescribed method of apportionment that needs to be applied by the vendor. The Guide for Vendors (VAT 404) (Legal and Policy Division, 2012: 46) mentions the following:

   > *As from the November 2000 tax period, 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.*

   Although the 2013 edition of the VAT 404 Guide for Vendors omits the abovementioned statement it is the SARS' practice to apply previous versions of the VAT 404 Guide for Vendors such as the 2012 edition (Legal and Policy Division: Indirect Tax, 2013). In the event where the turnover-based method of apportionment is not fair and reasonable, an alternative method may be requested

Stellenbosch University http://scholar.sun.ac.za

by the vendor. In this regard, the VAT 404 Guide for Vendors (South African Revenue Service, 2012: 46) states:

> *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.*

Various methods can be used as an alternative. One of the methods is a varied turnover-based apportionment method where various income streams are eliminated, reduced or altered. The reason why the turnover of the business is adjusted is to reflect the extent to which expenditure is incurred for the making of taxable supplies. The inclusion of dividends is a contentious issue as it is a non-supply for VAT purposes. Binding General Ruling No.10 (Legal and Policy Division: 2012) states that:

> *An out of scope supply refers to a supply that is made by a municipality that is neither in the course or furtherance of that municipality's enterprise nor is it an exempt supply. This term is also synonymous with the term "non-supply", for example dividends and statutory fines.*

There are various arguments which can be raised in whether a dividend should be excluded or included in the turnover-based method of apportionment. It is important to differentiate between the type of company you are dealing with, whether the dividend are worked for, for instance an investment holding company, or a group company managing its subsidiary in the best way and therefore maximising profits in the form of a dividend.

In the two examples above, the inclusion of the dividend can be argued to form part of the apportionment calculation as certain costs can be attributed to the producing of the dividend income. The research assignment therefore focusses on the different apportionment methods and in particular the varied turnover-based method

with the exclusion of dividends and the multiple apportionment method where different cost drivers are used in determining the input tax deductible.

Furthermore, the apportionment method must be *fair* and *reasonable*. This area will also be addressed as what is meant by fair and reasonable and when will the method result in the most appropriate method of apportionment.

1.2 Problem statement

In terms of the definition of "input tax" in section 1(1), input tax is the tax payable on the acquisition of goods or services, where the goods or services concerned are acquired by the vendor for the purpose of making taxable supplies. Where goods or services are acquired partly for such purpose, the tax payable need to be apportioned in terms of section 17(1). Taxable supplies consist of supplies that are subject to VAT at the standard rate of fourteen per cent in terms of section 7(1)(*a*), or that are zero-rated under section 11. Section 7(1)(*a*) subjects to VAT a supply made by a vendor of goods or services in the course or furtherance of carrying on any enterprise. Paragraph (*a*) of "enterprise" as defined in section 1(1) means any enterprise or activity which is carried on continuously or regularly by any person in the Republic, or partly in the Republic, and in the course or furtherance of which goods or services are supplied to any other person for a consideration.

In determining whether the tax payable on an acquisition of goods and services constitute input tax, it is essential to establish whether that acquisition forms part of the vendor's enterprise or non-enterprise activities, which is considered to be the first step. It is proposed that in determining whether an acquisition forms part of a vendor's enterprise activities, proviso (v) to the definition of "enterprise", which excludes exempt activities from the definition will be discussed below.

Fundamental to the concept of enterprise is the notion of an on-going activity. A non-enterprise activity is an activity that falls within a sphere of the vendor's business, where the activities within that sphere are not on-going, but passive. An example of such a sphere would be the holding of shares as a mere investment, as opposed to a holding within the framework of commercial share dealings. If the acquisition is made for a non-enterprise activity, then the tax payable on that acquisition does not constitute input tax.

Stellenbosch University http://scholar.sun.ac.za

Income Tax Case 1841 (72 SATC 92) confirmed the approach that any expenditure relating to goods or services acquired for the purposes of non-enterprise activities would not constitute input tax. In an article by Badenhorst (2010) *Tax Ensight* it states the following:

> *SARS argued that the distribution of the magazines is not a supply of goods for a consideration as they are distributed free of charge and, therefore, the distribution of the magazines does not comprise an "enterprise" as defined." It further stated that: "In effect, the Court is saying that any activity involving the supply of goods or services for no consideration does not comprise an enterprise activity and, therefore, the input tax deduction on any related costs should be denied.*

The first question that arises is what is meant by an enterprise activity and a non-enterprise activity. The vendor is therefore required to distinguish between enterprise activities and non-enterprise activities. If the acquisition is made for a non-enterprise activity, then the tax payable on that acquisition does not constitute input tax. If the acquisition is made for an enterprise activity, the second step is to determine whether the acquisition is made for the purpose of making taxable or exempt supplies.

Exempt supplies are specifically excluded from the definition of enterprise in section 1(1). If exempt supplies were not specifically excluded from the definition, it would have fallen within the definition for the following reasons:

- Section 12 provides that "*the following goods or services shall be exempt from the tax imposed under section 7(1)(a)*."

  This implies that a supply has to meet the requirements of section 7(1)(*a*), including that the supply has to be part of an enterprise activity, before it can qualify for the section 12 exemption; and

- Section 7(1) provides further that "*subject to the exemptions […]*" the relevant tax will be levied.

  This implies that the tax should first be leviable in terms of section 7(1)(*a*), before considering whether the supply is exempt.

Stellenbosch University http://scholar.sun.ac.za

If the acquisition is made for the purpose of making taxable supplies, the tax payable on the acquisition constitutes input tax. If the acquisition is made for the purpose of making an exempt supply, then the tax payable is not input tax. Direct attribution is the term used in allocating the tax payable on the acquisitions made for a taxable or exempt purpose.

It is therefore important to define and discuss *single*, *composite* and *multiple supplies* with the view to perform direct attribution.

- A single supply exists where one or more elements of the supply are to be treated as one supply for VAT purposes.

- A composite supply occurs where two or more elements are part of a single supply and are integral ancillary or incidental components.

- A multiple supply occurs when one or more of the elements can sensibly or realistically be broken down. In other words, the element is viewed as a supply distinct and independent from other elements.

The second question that arises is to what extent the vendor can perform direct attribution with regard to the different supplies being made to the enterprise. An example of such a supply would be multiple supply of goods where the goods acquired can be attributed to the supply being made by the enterprise. If the acquired goods or services are attributed to the making of taxable supplies, the tax payable on such goods or services would constitute input tax. Similarly, if the goods or services are attributed to the making of exempt supplies, the tax payable would not constitute input tax.

The tax payable on goods or services that are acquired partly for the purpose of making of taxable supplies and partly for some other purpose, such tax payable is subject to apportionment. In this regard the various apportionment methods will be discussed.

The vendor is required to determine to what extent the input tax relates to the making of taxable supplies which can be deducted as ‘input tax’ by applying an apportionment method in terms of section 17(1). It is important to note that the South African Revenue Service (SARS) prescribes the turnover-based method as the only method to use without

Stellenbosch University http://scholar.sun.ac.za

prior approval from the Commissioner. If the vendor believes that this method of apportionment is inappropriate, a special method may be requested by the vendor.

This raises a third question as to which method is the most appropriate method to use by the vendor. The varied turnover-based method with the exclusion of dividends is very controversial. The method will be discussed in detail and will include the following variations:

- Where the company is an investment holding company and requests that dividends must be excluded;
- A normal holding company where dividends are declared by its subsidiaries by virtue of its structure; and
- Where the company is an operating company and an arms-length management fee is charged and requests the exclusion of dividends.

Furthermore, the multiple method of apportionment will also be discussed with the view to incorporate various apportionment drivers in a single apportionment method. The drivers are based on various activities performed by the vendor and the related expenditure attached to such activities. This method is most suitable where a single entity can be divided into various business units which perform different activities.

Non-enterprise activities performed by the vendor will also impact the apportionment ratio. As mentioned above, the non-enterprise activities are those activities which do not fall within the ambit of an "enterprise" as defined in section 1(1). Any goods or services acquired by the enterprise partly for the purpose of making taxable supplies and partly for another purpose, which includes the non-enterprise activities, is subject to apportionment in terms of section 17(1). It is proposed that the formula used for the turnover-based method be clarified to incorporate the non-enterprise activities as a separate valuation.

These alternative apportionment methods are subject to approval by SARS on the basis that it is fair and reasonable. This raises a fourth and final question, what is meant by fair and reasonable.

Stellenbosch University http://scholar.sun.ac.za

1.3 Importance and value of the research

The outcome of this research assignment could assist registered VAT vendors and the academic fraternity regarding the claiming of an input tax deduction where taxable, exempt, non-supplies are made or non-enterprise activities are carried out. A decision making process needs to be followed to determine the deductible input tax. It is only the enterprise activities carried on in the making of taxable supplies which give rise to an input tax deduction.

Direct attribution and the apportionment of expenses are crucial to what the vendor is able to deduct as an input tax deduction. Where the VAT incurred is wholly for the purpose of making taxable supplies, it will constitute input tax whereas the VAT incurred wholly for the making of exempt, non-supplies or non-enterprise activities will not constitute input tax. The research assignment will address the issues and problems encountered by registered VAT vendors in determining the correct input tax deduction when applying direct attribution or where direct attribution is not possible, an apportionment of the VAT incurred must be performed.

1.4 Objective

The research assignment aims to provide clarity and assistance with regard to the deduction of input tax by a registered VAT vendor. The research assignment focuses on enterprise versus non-enterprise activities, provide clarity on the concept of direct attribution where single, composite and multiple supplies are discussed. Furthermore, it will address apportionment methods and reasonability tests. The research assignment will also consider the approach of different jurisdictions when dealing with the above mentioned issues.

1.5 Research design, methods and scope

The research assignment will follow a non-empirical method. It will make use and incorporate current VAT legislation in South Africa, case law in South Africa and foreign jurisdictions, interpretation notes and so forth. The research assignment is a pure literature study which will focus on theoretical aspects of the VAT Act and the interpretation thereof. It will address the various issues by interpreting the relevant sections applicable to input tax and the claiming thereof. It will also incorporate the interpretation and treatment of input tax in different jurisdictions i.e. New Zealand, the European Union, Australia, Ireland, etc. It will also incorporate local and international court cases.

1.6 Framework of the study

1.6.1 Chapter 2: Definition of enterprise with a specific focus on the enterprise versus non-enterprise activity and the effect thereof on input tax

This chapter focuses on the different components of the definition of "enterprise" in section 1(1) which are relevant in determining whether the tax payable will be regarded as input tax and thus claimable by the vendor. The objective in this chapter relates to whether the activities performed by the vendor are in the course or furtherance of the enterprise or whether it falls outside the ambit of the enterprise activities, the so-called non-enterprise activities. The tax payable on activities performed for the making of taxable supplies will be regarded as input tax. Where the tax payable relates to the non-enterprise activities, the tax payable will not be regarded as input tax. This chapter will discuss the difference between the activities which fall within the ambit of an "enterprise" as defined in section 1(1) and those activities which will fall outside the ambit of the enterprise.

1.6.2 Chapter 3: Definition of input tax: in particular the direct and immediate link test with the view of direct attribution

In this chapter the input tax definition in section 1(1) is discussed in its various components. These components include the phrases "acquired by the vendor", "the purpose of the acquisition" and whether the acquisition was made "in the course of making taxable supplies". A five step approach is discussed where the tax payable are allocated to its intended purpose for which the expense was incurred. Where the tax payable relates to the making of taxable supplies, the tax may be deducted as input tax. Where the tax payable relates to the making of supplies other than the making of taxable supplies, the

Stellenbosch University http://scholar.sun.ac.za

tax payable will not constitute input tax. In the event that the expenditure incurred relates to both taxable and exempt supplies, it will have to be apportioned in terms of section 17(1). Single, composite and multiple supplies are discussed with the view to apply direct attribution and to what extent direct attribution can be performed with regard to the different type of supplies.

1.6.3 Chapter 4: Apportionment methodology, suggested methods of apportionment, with specific focus on the varied turnover-based method of apportionment

The various special apportionment methods will be discussed which include the varied input-based method, transaction-based method and the method used by the Banking Association of South Africa (BASA method). In particular, the varied turnover-based method will be discussed with different variations. The exclusion of interest or the use of net interest, the valuation and inclusion of financial instruments will form part of this discussion. Dividend income will focus in particular whether the dividends were earned by an ultimate holding company, intermediate holding company, an investment company or a company involved in operations. International precedent with regard to the treatment of dividend income pertaining to the apportionment of input tax will also be addressed. The effect of non-enterprise activities performed by the business and the effect on apportionment will also be discussed.

1.6.4 Chapter 5: A reasonability test when an apportionment method is applied by the registered VAT vendor

A short discussion on whether the apportionment method applied is reasonable and results in the fairest method both for SARS and the vendor. This will include the approach that the court will use in determining whether the apportionment method is fair and reasonable.

1.6.5 Chapter 6: Conclusion

This chapter contains and overview of the problem statement and on what basis the business can claim input tax in relation to the taxable supplies made by it. It will conclude on enterprise versus non-enterprise activities. The business must evaluate these activities at the starting point. Thereafter, the business needs to evaluate its enterprise activity whereby it would differentiate between taxable, exempt supplies. The final evaluation by

Stellenbosch University http://scholar.sun.ac.za

the business relates to expenditure incurred for taxable, exempt, non-supply and non-enterprise activities. In this case an apportionment methodology must be applied to determine the input tax deduction.

1.6.6 Reference list

Chapter 2: Definition of enterprise with a specific focus on the enterprise versus non-enterprise activity and the effect thereof on input tax

2.1 Introduction

This chapter focusses on what constitutes an *enterprise* for VAT purposes. The distinction between *enterprise activities* and the *non-enterprise activities* are fundamental concepts which will impact on the business as a whole. The effect of the *non-enterprise activities* relating to input tax is vital in determining whether the enterprise would qualify for a deduction of the tax paid.

2.2 Enterprise as defined

One of the fundamental cornerstones in VAT is whether the vendor makes supplies of goods or services in the course or furtherance of any *enterprise* carried on by that vendor. The concept of an 'enterprise' is defined as follows in section 1(1):

> *[…] In the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit, including any enterprise or activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature or in the form of an association or club;*

From the definition above, various important components of 'enterprise' can be identified as follows:

- any enterprise or activity carried on by any person;
- continuously or regularly;

- in the Republic or partly in the Republic;
- in the course or furtherance of which goods or services are supplied to any other person for a consideration.

A comprehensive discussion on the above mentioned components will follow to determine whether the business will constitute an *enterprise* for VAT purposes.

2.2.1 Any enterprise or activity carried on by any person

Where the same word is used to define itself in a definition, the word must follow its ordinary meaning. Based on the South African doctrine of precedent, regard should be given to the definitions offered in case law. In addition, consideration must be given to the ordinary meaning of the word. In *R v Peters* ((1886) 16 QBD 636 at 641) it is stated that *"it is a well-known rule of courts of law that words should be taken to be used in their ordinary sense".*

Meyerowitz (2004:3-5) confirms this approach by stating that:

> *It is often said that a grammatical and logical construction must be placed on the words of a statute. The words must be read in the light of their popular or ordinary and natural sense, carelessness in drafting notwithstanding, and the context not be ignored.*

Meyerowitz (2004:3-5) supports his view by citing two cases in substantiating the above mentioned statement, being *Custodian Parent v CoT* (17 SATC 37) and *New Union Goldfield Ltd v CIR* (404).

From the above, it is submitted that when the same word is used in the definition which needs to be defined, the ordinary meaning to the word needs to be ascribed to that specific word. *Enterprise* as mentioned in the definition of 'enterprise' in section 1(1) must therefore follow its ordinary meaning.

An *enterprise* is defined in the Oxford Dictionaries (2013) as *"a project or undertaking […]* or *a business or company".* Merriam-Webster (2013) is that, an *enterprise* as "*a project or*

undertaking […] or a unit of economic organisation or activity, especially a business organisation". Both the dictionary meanings of *enterprise* include any business or company.

A further part of the definition of 'enterprise' in section 1(1) refers to an *activity*. Activity is also not defined in the VAT Act and must be interpreted to its ordinary meaning. The Oxford Dictionaries (2013) define an *activity* to mean "*a condition in which things are happening or being done, there has been a sustained level of activity in the economy".* Merriam-Webster (2013) defines an *activity* as "*a form of organised, supervised, often extracurricular reaction or an organisational unit for performing a specific function".*

The word activity therefore has a very wide interpretation, which includes almost everything that is to be done. The first part of the definition of 'enterprise' in section 1(1) includes any business or company or any action taken by a person in obtaining its objective.

The enterprise or activity must be *carried on* by the person. It is therefore important to ascertain what is meant by the phrase *carried on*. *Carried on* is also not defined nor is there any precedent that deals with this phrase.

In an Goods and Services Tax Ruling, Australia (Commissioner for Taxation, 2006/3:53), the meaning of the words *carried on* was considered and interpreted to mean any *'management'* or *'conducting'* of an enterprise. The Australian Tax Ruling (Commissioner for Taxation, 2006/3: 53) further stated that the "*[c]arrying on an enterprise includes those activities that you undertake in actually managing or conducting that enterprise".*

Applying this interpretation in ascertaining whether an enterprise is conducted for VAT purposes, an enterprise can be construed to incorporate any business or company or even any actions taken which are being controlled or managed. The first component of the definition lends itself to a wide interpretation which incorporates almost anything being managed or controlled in relation to a business or activity, including actions taken to reach an objective.

2.2.2 Continuously and regularly

This component of the definition requires that the business or activity managed or controlled must be of a continuous or regular nature. The phrase is not defined and should therefore be interpreted to its ordinary meaning or definition offered in case law.

The Oxford Dictionaries (2013) define *continuous* to mean *"forming an unbroken whole, without interruption or forming a series with no exceptions or reversals".* Merriam-Webster (2013) also defines *continuous* as "*marked by uninterrupted extension in space, time or sequence".*

Therefore, when an enterprise is conducted, the business or activity must be on going without any interruption. The goods or services must be supplied on a continuous basis without any break in the activities of that business or company.

Regular means a *"recurring at uniform intervals or done or happening frequently"* as defined in the Oxford Dictionaries (2013). Merriam-Webster (2013) also defines *regular* as "*recurring, attending or functioning at fixed, uniform, or normal intervals* or *constituted, conducted, scheduled, or done in conformity […]*". The ordinary meaning of *continuous* and *regular* indicates some form of recurring and ongoing activity or acts conducted by the business or company.

From the above it can be seen that an isolated or once-off transaction would generally not fall within the ambit of an 'enterprise' as defined as there is no continuous or regular activity or business being conducted by the enterprise. However, in certain situations one needs to be careful to generalise that isolated or once-off transaction will not meet the requirements of the definition of an 'enterprise' as defined in section 1(1).

Stephan v Commissioner for Inland Revenue (32 SATC 54) deals with isolated transactions for income tax purposes. This case can also be made relevant to the application of the above mentioned principles with regard to whether the business or venture carried on will be considered to be an enterprise for VAT purposes.

In *Stephan supra* the appellant was in the business of a general merchant, a fish dealer, and so forth. He had a small fleet of coasting vessels which he disposed-off in a particular

Stellenbosch University http://scholar.sun.ac.za

year, only retaining two of the fleet. The appellant undertook salvage operations and used his own staff and vessels to conduct the said salvage operations. He hired the salvage equipment to perform the work. The respondent taxed the profit as a revenue receipt and included such receipt into the appellant's 'gross income'. The court agreed with the respondent and dismissed the appeal. The court's reasoning was that the business operated by Stephan demanded various business acts, in fact similar to what a business doing salvage operations would perform. The profit constituted revenue receipts and were incorporated in the 'gross income' of Stephan and taxed accordingly.

In *Stephan supra* (32 SATC 54: 59) Mason J quoted that:

> *[…] these salvage operations which were managed by the staff of the appellant's business, and which necessitated so many ordinary business acts such as engaging the services of men, hiring apparatus, purchasing equipment, the transport of cargo to Cape Town, and the like, stand on an entirely different footing. The whole thing was an adventure or concern of the nature of a business or trade […].*

Although the above case refers to a once-off salvage operation, it is a business *carried on* which necessitated many ordinary business acts which would meet the requirement of *regular* in the definition of 'enterprise'. The view that a series of steps which leads to an isolated or once-off transaction can fall within the ambit of 'enterprise' as defined in section 1(1) is also supported by De Koker and Kruger (2007: 3.6) as follows:

> *The South African Revenue Service (SARS) could well take the view that if the development in question takes place systematically over a long period of time, the background activities pertaining to the transaction will have been sufficiently continuous (involving, say, drainage, contouring, and road marking) to make the sale of that land a supply in the course or furtherance of 'an enterprise'.*

According to Botes and De Wet (2012: 1-5) the SARS generally interprets *continuously* as being ongoing where the duration of the activity has *not ceased* in a permanent sense and has not been interrupted. Furthermore, that the activity does not have to be carried on all the time but it must have a logical progression of the relevant steps needed to bring the activity to conclusion.

Stellenbosch University http://scholar.sun.ac.za

The Tax Information Bulletin (New Zealand) (Commissioner for Inland Revenue, 1995: 9) supports the aforementioned, and also states that activity is continuous if there is no interruption in the activity. Temporary interruptions in the activity do not indicate that the activity is not continuous. The following extract explains a 'continuous' activity:

> *Whether or not a taxable activity exists depends on the particular facts of each case. For example, a sub-division of land into two allotments, involving no development work, will not by itself amount to a taxable activity. However, the greater the number of allotments created and sold, the more extensive the development work, the more time and effort involved and the higher the financial commitment on the project, the more likely that the activity is carried on continuously.*

The *continuous* requirement of the definition of 'enterprise' in section 1(1) indicates that the activity of the enterprise must be ongoing. The intention of the vendor in conducting the business or activity would be an indicator whether the continuous nature of the business has been met. If the vendor intends a business venture, that venture would ordinarily fall within the ambit of *continuity*. The issue that the vendor will be confronted with is when it is not anticipated that the venture would be ongoing and a once-off transaction comprising of various steps are involved. As mentioned above in *Stephen supra*, the various steps and acts performed is similar to that of a business and will potentially fall within the *continuous* and *regular* requirement of enterprise.

The Guide for Fixed Property and Construction (VAT 409) (Legal and Policy Division, 2011: 9) clarifies to a certain extent that the enterprise activity which are carried on all the time will be *continuous* in nature. However, where it is carried on at reasonable short intervals it will be regarded as *regular*. The guide further states that *continuous* is therefore interpreted as ongoing where the duration of the enterprise activity has neither ceased in a permanent sense or interrupted in a substantial way. Conversely, *regular* refers to repeated at fixed intervals taking into account the time taken to complete the activities associated with making the supply (The VAT 409 Legal and Policy Division, 2011: 9).

The VAT 409 (Legal and Policy Division, 2011: 9) provide certain examples with regards to whether a business will constitute an enterprise for VAT purposes:

Stellenbosch University http://scholar.sun.ac.za

> *The mere subdivision of farmland might not be an activity that is carried on continuously but the subdivision and sale of the subdivided farmland is usually regarded as a continuous activity. […] there must be an element of continuity about the transactions. […] number of separate and continuous steps, which are, of necessity, involved in the subdivision and sale of the land.*

From the above, it is clear that where the enterprise activities are ongoing and are not interrupted in any way, those activities will be *continuous* in nature. Moreover, where the enterprise activities are repeated actions or various business acts being conducted, such actions or business acts will be regarded as *regular*. These are subjective tests and will depend on the factual position of each business or company. Therefore, where a business or activity is carried on *continuously* or *regularly*, the requirements of those components of the definition of enterprise in section 1(1) have been complied with.

2.2.3 In the Republic or partly in the Republic

For purposes of this component 'Republic' is defined in section 1(1) as being the territory of the Republic and includes the territorial waters, the contiguous zone and the continental shelf referred to in the Maritime Zones Act, 1994. A business or activity carried on in the Republic will therefore meet that requirement of the definition.

If a business or activity is carried on partly in the Republic, it becomes more difficult to determine whether the business or activity meets the requirements of an enterprise. Where a foreign company or business supplies goods or services in the Republic, the company will be carrying on activities partly in the Republic. The physical presence test used to determine residence for income tax purposes provides some form of guidance. If any activities are conducted by the foreign business in the Republic which leads to the supply of goods or services, that business or company will most probably fall within the ambit of enterprise.

Stellenbosch University http://scholar.sun.ac.za

Botes and De Wet (2012: 1-6) state:

> *A non-resident, without an office in the RSA, rendered technical services on the continental shelf. His technical employees and equipment were stationed on the rig. SARS ruled that the person carried on an enterprise in the Republic and had to register as a vendor under section 23(1).*

It is submitted that a foreign business using an agent could be regarded as an enterprise. The activities of the agent can be regarded as that of the foreign business. If certain supplies are made on behalf of a foreign principal, those activities may well oblige the foreign business to register as it would be regarded as carrying on a business *partly* in the Republic.

Botes and De Wet (2012: 1-5) support the aforementioned view by stating that a person will not be carrying on a business or activity in the Republic unless he is physically present in the Republic or he provides goods or services personally or through an agent.

It must, however, be noted that section 54(2A)(*b*) provides for an exception where the non-resident principal using a local agent need not to register for VAT purposes. As confirmed by Botes and De Wet (2012: 1-5), by applying the normal principles as discussed above, the foreign principal could create an enterprise through the actions of his local agent. The application of section 54(2A)(*b*) will depend on the following conditions:

- The local agent must be registered for VAT in the Republic;
- The principal is not a resident of the Republic and is not a registered vendor;
- The goods are imported by the principal for the purposes of a supply made or to be made by him to a person in the Republic;
- The agent obtains the necessary documentation proof that he has paid the tax on importation of the goods and that the non-resident principal will not reimburse the tax paid by the agent.

If the aforementioned conditions are met, the agent will be regarded as the principal for the importation of goods. Therefore, the foreign principal will not be regarded as conducting an enterprise in the Republic.

Stellenbosch University http://scholar.sun.ac.za

A further example of a foreign business – who would have to register for VAT because an agent's activities is attributed to the foreign business being the principal – is where goods are being sold in the Republic by the agent, where different acts are being performed. The different acts could involve sourcing a buyer, doing repair work, making decisions on the goods imported, invoicing on behalf of the foreign principal, and so forth. All these activities can result in the foreign business conducting an enterprise without having a physical presence in the Republic.

Controversy surrounding royalty, franchise and agency agreements forced the SARS to issue VAT News 13 (Legal and Policy Division, 1999: 1) with regard to the conduction of an enterprise partly in the Republic. The SARS was of the view that foreign enterprises granting intellectual property in the Republic on a continuous basis will be regarded an enterprise for VAT purposes.

This resulted in foreign enterprises conducting an enterprise in the Republic without having any presence in the Republic because various activities are conducted in South Africa. The SARS issued VAT News 37 (Legal and Policy, 2011: 1) clarifying the position by providing relief that the foreign business providing intellectual property in the Republic would not be regarded as an enterprise based on the fact that the activities are passive in nature. It stated that:

> *if the activities were completely passive and if the non-resident did not have a physical presence or fixed place of business in South Africa, SARS would not insist on the non-resident business having to register for VAT. This policy and others related to non-resident businesses are in the process of being reviewed.*

From the above, it is clear that the SARS want to revert back to pure guidelines as to when the activities performed by non-residents are being conducted partly in the Republic such activities will constitute an enterprise for VAT purposes. This pure approach is in line with the original publication as mentioned in VAT News 13 (Legal and Policy, 1999: 1).

Where a business is carried on in the Republic, the activities performed by that business will be regarded as being performed in the Republic. In the event where a non-resident performs activities partly in the Republic, it becomes a more complex issue. If a non-

Stellenbosch University http://scholar.sun.ac.za

resident performs activities partly in the Republic or through a local agent, the non-resident would probably conduct an enterprise in South Africa.

The SARS have in the past provided relief for a foreign business not to register as a VAT vendor, but it seems that the SARS wants to revisit this approach by applying pure principles. If all the components above have been met, the business still needs to satisfy the last requirement that goods or services are being supplied for a consideration in the course or furtherance of any enterprise.

2.2.4 In the course or furtherance of which goods or services are supplied to any other person for a consideration

A fundamental concept of the definition of ‘enterprise’ in section 1(1) is that goods or services need to supplied *in the course or furtherance of an enterprise*. This is one of the cornerstones in the VAT system. In *Income Tax Case No. 1841* (72 SATC 92: 96) Van Oosten J states the following in support:

> *The supply of goods and services by a vendor lies at the heart of the VAT system. The supply of goods and services, in the course or furtherance of any enterprise, is a precondition for the vendor’s liability under the VAT Act.*

It is therefore important to enquire what activities are performed by the business in the course or furtherance of the enterprise. It is those specific activities which result in the conducting of an enterprise.

Botes and De Wet (2011: 1-6A) support this view that a vendor must first establish which enterprise he carries on. The vendor must thereafter determine whether the supply is made in the course or furtherance of such enterprise. Therefore, all the activities which are associated with the activities of that specific business will be part of the enterprise activity it conducts.

Botes and De Wet (2011: 1-6A) observes that a supply made in the course of any enterprise is generally made in performing the normal activities of that enterprise. It is those activities which are normally associated with the enterprise as a business.

Conversely, a supply made in the furtherance of an enterprise is a supply which is not normally made by the business but made for the benefit and advantage of the enterprise. The following example can be used to illustrate the difference between in the *course of any enterprise* and *in the furtherance of any enterprise*:

A company is a manufacturer of pens which it sells to various clients. The pens sold to its clients will be supplies made in the *course* of an enterprise. On the other hand, where the machine which manufactures the pens is sold, such machine is sold in the *furtherance* of an enterprise.

Enterprise activities are an important concept that consists of its normal supplies made to clients and those part of the enterprise. For example, the assets of the enterprise which is supplied on an *ad hoc* basis. Therefore, supplies made in the *course* or *furtherance* of the enterprise is considered to be *enterprise activities*.

De Koker and Kruger (2007: 3.7) state that:

> *[…] SARS maintains that 'the requirement is wide enough to cover any supplies made in connection with an enterprise' and, furthermore, that 'provided there is a discernable relationship or connection between the supply and activities of the enterprise, the supply will be in the course or furtherance of the enterprise' […]. The words 'in the course or furtherance' of an enterprise do not, however, extend to the supply of private or exempt commodities.*

This is a fundamental concept, because the normal enterprise activities and those activities associated with the enterprise as a whole will be regarded to be part of the enterprise. The activities not associated with the enterprise – classified as *non-enterprise activities* – stand on an entirely different footing, because they will not be regarded as part of the enterprise as defined in section 1(1), and the expenses attached thereto will not qualify for an input tax deduction.

For the sake of completeness, it is worth noting that the enterprise definition in section 1(1) extends to paragraph (*b*). Emslie (2012: 63) is of the opinion that the enterprise definition falls into two distinct parts. The first part of the definition pertains to paragraph (*a*) which

was discussed in detail above and a second part in paragraph (*b*) which does not require all the cumbersome requirements of paragraph (*a*).

Emslie (2012: 63) states that:

> *[t]hat the second part expands, or is alternative to, the first part of the definition, in the sense that, in terms of the second part of the definition, any enterprise or activity carried on in the form of commercial, financial, industrial, mining, farming, fishing, municipal or professional concern or any other concern of a continuing nature constitutes an 'enterprise' as defined by this fact alone.*

This is *not* the correct interpretation of the definition of enterprise, as the second part to the definition is a mere extension of the first part in paragraph (*a*), and that the requirements as discussed above pertaining to all the components of the enterprise must be present to create an enterprise for VAT purposes. This issue was in fact considered in the case *Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited* (503/2011 [2012] ZASCA 103: 16-17), where Navsa JA concludes:

> *[…] that once a vendor falls within the ambit of the definition of 'enterprise' (regardless of whether in the first or in the second category), any activity whatsoever of that enterprise forms an integral part and parcel of the enterprise, unless such activity is excluded in terms of paragraph (v) of the proviso thereof. The submission is wholly without merit. The word 'including' indicates that what follows is illustrative of what precedes it. There is no room for an interpretation that two categories of 'enterprise' are envisaged.*

It is therefore submitted that the enterprise definition in section 1(1) *cannot* be divided into two distinct parts. From the discussion above, the enterprise definition consists of various different components which need to be complied with before an enterprise is being conducted for VAT purposes. Moreover, the second part of the definition in paragraph (*b*) is a mere extension of the first part and does not stand on its own footing.

A further important concept to an enterprise is how to deal with activities which cannot be attributed to the enterprise as a whole. These activities will have an impact on the enterprise and the VAT payable on the goods or services acquired for such purposes

cannot be regarded as input tax. The tax paid in such cases will become a VAT cost to the enterprise as a whole. These activities will be referred to as the *non-enterprise activities* of the business.

2.3 Non-enterprise activity versus enterprise activity

Non-enterprise activities are those activities which cannot be attributed to the enterprise as defined in section 1(1). From the above discussion, where goods or services are acquired for the enterprise, the tax payable on those goods or services will be regarded as input tax. Various components were discussed to ascertain whether a business conducts an enterprise for VAT purposes.

In the event where goods or services are acquired for a purpose other than for the enterprise, those goods or services does not fall within the ambit of the VAT enterprise. Non-enterprise activities are not defined in the VAT Act. The concept of non-enterprise activities is a fairly new concept, and the general implications thereof are discussed in this part of the research assignment.

2.3.1 Non-enterprise activity

In the case *Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited* (503/2011 [2012] ZASCA 103: 16-17), Navsa JA makes the following statement to differentiate between the services acquired for the enterprise for VAT purposes and those that fall outside the ambit of the enterprise:

> *The duty imposed on a public company that is the target of a take-over is too far removed from the advancement of the VAT enterprise to justify characterising services acquired in the discharge of that duty as services acquired for purposes of making taxable supplies, especially in the circumstances of this case.*

The above indicates that the non-enterprise activities are those which cannot be attributed to the enterprise as a whole. It involves activities far removed from the normal activities which the enterprise is involved in, leading to the making of taxable supplies together with those indirectly associated with the enterprise.

Stellenbosch University http://scholar.sun.ac.za

When a business is involved in different activities, a distinction between the activities carried on in the course or furtherance of the enterprise and those activities that are removed from the enterprise (which constitute the non-enterprise activities of the business) has to be made for VAT purposes. This is a factual question confronting businesses which, has a direct relationship with the deduction of input tax by the vendor.

To summarise, one could refer to *Income Tax Case No. 1841* (72 SATC 92), where an interdenominational Christian ministry was 'an association not for gain' performing activities which related to teachings and messages spread by printing a magazine and distributed it free of charge. It also operated a small bookshop where it sold books, DVD's and other religious material. It therefore operated an enterprise activity with regards to the bookshop but for the related spread of the Word of God, those activities were not considered to be enterprise activities and therefore fell outside the ambit of an 'enterprise' as defined.

In *Income Tax Case No. 1841* (72 SATC 92: 93) it was stated that an association not for gain made taxable supplies when it supplied goods or services otherwise than for a profit or consideration, provided the supply was made in the furtherance of its aims and objectives. Where the supplies was made not for a consideration and distributed free of charge, it did not qualify as taxable supplies and therefore regarded as non-taxable supplies.

The above case needed some clarification from the SARS with regard to supplies made for no consideration, as not all supplies made for no consideration can be classified as non-enterprise supplies. The SARS issued a publication regarding the concept of non-enterprise activities. In VAT News 35 (Legal and Policy, 2010: 1-2) the following passages are relevant:

> *The principle was confirmed that an association not for gain is not permitted to deduct input tax on the cost incurred to make supplies for no consideration if those supplies are made in the course of carrying on a non-taxable or non-enterprise activity. […] VAT was incurred for the purpose of carrying out religious objectives which involved the making of supplies for no consideration, rather than being for the purpose of making taxable supplies from the bookshop. It was accepted by the Court that only a portion of the VAT incurred was for the purposes of making*

> *taxable supplies and that the supplies made for no consideration constituted non-taxable supplies. Consequently, input tax could not be deducted to the extent that the expenses were incurred for the purpose of carrying out those non-taxable (religious) activities.*

The above confirms that any business with various activities will have to examine those activities closely to determine whether they fall into enterprise activities, the objectives of the business or whether it is far removed from the normal business activities that they are classified as non-enterprise activities.

Various tax commentators commented on the above finding and the interpretation thereof by the SARS. An article in Synopsis (PricewaterhouseCoopers, 2009: 8) supports the conclusion of the judgment by stating the following:

> *The first test is whether a person carries on an 'enterprise'. Assuming all the other requirements are met […]. […] the second test is whether a specific supply of goods or services will be made 'in the course or furtherance' of that enterprise. If the answer is 'yes', the supply will be a taxable supply and VAT incurred to make such a supply qualifies as input tax. But if the answer is 'no' the supply is not a taxable supply and VAT incurred to make the supply cannot be deducted as input tax.*

It confirms the fact that the factual question that a business has to answer is whether the expenditure is incurred for the enterprise in the *course* or *furtherance* of its main objectives.

In a further article by Ensight (Edward Nathan Sonnenbergs, 2009: 1), the writer agrees with the principle established that one needs to consider the objectives of the company in order to determine whether the activities performed by the business forms part of the enterprise:

> *It seems that the entire enterprise activity of the vendor in view of its aims and objectives must be considered to determine whether it comprises an 'enterprise' as defined and all activities performed to achieve such aims and objectives then forms part of such enterprise.*

Stellenbosch University http://scholar.sun.ac.za

The above approach also finds support in foreign jurisdictions in that a business needs to consider what acquisitions were made as part of your enterprise activity and which acquisitions were made for another purpose. In a Goods and Services Tax Ruling, Australia (Commissioner of Taxation, 2006: 51), the following support the application of enterprise activities as opposed to non-enterprise activities:

> *[…] acquire a thing for a creditable purpose to the extent that you acquire it in carrying on you enterprise. The acquisition must be made in the course of the activities that constitute your enterprise. An acquisition is made 'in carrying on your enterprise' if it is made for the purposes of that enterprise, but not if it is made for some other purpose.*

Non-enterprise activity was also considered in the *Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited* (503/2011 [2012] ZASCA 103: 25-28) where Navsa JA summarises that:

> *[…] so it was contended, was to acquire advice in relation to a takeover by the parties to which it was related. Accordingly, its board had a duty to report to the independent unit holder as to whether the offer was fair and reasonable […]. Put simply, the Commissioner contended that NMR's services were unrelated to DBCM's core activities, which was the mining and sale of diamonds. NMR was not providing services directed at making any of DBCM's businesses better or more valuable. It was the interest of DBCM's departing shareholders and investors, rather than the interest of DBCM itself, that formed the focus of NMR's services. […] in our view the submissions on behalf of the Commissioner, set out in the preceding paragraphs, are undoubtedly correct.*

In a further statement by Southwood AJA in *De Beers Consolidated Mines Limited supra* (2012: 53), the following is relevant:

> *The question to be answered therefore is whether NMR's services were acquired for the purpose of making 'taxable supplies' in that 'enterprise'. The answer in clearly no. DBCM acquired NMR's services because DBCM was the target of a take-over by parties whom it was related and DBCM's board had a duty to report to independent unit holders as to whether the consortium's offer was fair and*

> *reasonable and to obtain independent financial advice in that regard. In order to do this NMR was obliged to determine the value of DBCM's diamond business and then express an opinion that the consideration offered for the shares was fair and reasonable in the light of that evaluation. Such services were not acquired to enable DBCM to enhance its VAT 'enterprise' of mining, marketing and selling diamonds. The 'enterprise' was not in the least affected by whether or not DBCM acquired NMR's services. They could not contribute in any way to the making of DBCM's 'taxable supplies'. They were also not acquired in the ordinary course of DBCM's 'enterprise' as part of its overhead expenditure as argued by DBCM. They were supplied simply to enable DBCM's board to comply with its legal obligations.*

To summarise the above, De Beers Consolidated Mines Limited (DBCM) was approached by a consortium with a proposal to form a new company which will ultimately become the new owners of DBCM's diamond operations and all its associated holdings. DBCM approached independent financial advisors, based in London, to consider the proposal. DBCM also made use of South African based financial advisors. It was these fees payable to the advisors that was disputed by the Commissioner for the South African Revenue Services (the Commissioner). The Commissioner argued that the court should look at who was the acquirer of the services. The Commissioner further stated that the acquirer of the services for takeover was the outgoing shareholders. If that was the case, the advice from the advisors based in London was unrelated to the DBCM's core activities. The court agreed with this argument and found that the services rendered by the foreign based advisors were not related to the core business activities of DBCM. With regard to the local services, the court concluded that the services were acquired for the purpose of dealing with the proposal in question and therefore did not qualify for an input tax deduction.

From the above it is clear that when a business is involved in different activities, it will have to determine whether those activities are connected to the 'enterprise'. It will differ from business to business and will depend on the activities and objectives of such 'enterprise'. Of course, those activities associated closely to that of the business, which are classified as the overhead costs of the business will be regarded in the *course* or *furtherance* of the enterprise. The crucial question to be answered is whether the activities are far removed from the ordinary business activities that they fall into the category of non-enterprise activities. Businesses will be confronted with this difficult fact of law, and it would depend on the activities performed by that 'enterprise'.

2.4 The effect of non-enterprise activities on input tax and related examples

The effect of non-enterprise activities for a vendor is that the input tax incurred would not qualify for an input tax deduction and will therefore be a VAT cost to the vendor. The areas that would be severely affected by the judgment of *De Beers Consolidated Mines Limited supra* are merger and acquisitions of businesses which would include the take-overs of target companies. In an article by Kruger (2012: 19-20) the application of the *De Beers Consolidated Mines Limited case supra* to merger and acquisitions is commented on as follows, stating that:

> *[it] is of vital importance in the context of all merger and acquisition (M & A) activity. The case dealt in essence with an M & A transaction involving the restructuring of the company's shareholding, and its attendant implementation. The touchstone of deductibility of the VAT incurred in respect of services rendered in relation to the M & A activity would seem to me, based on the dicta in this case, to be limited to the VAT incurred on goods and services acquired by the vendor that can be closely linked to the enterprise activity. M & A activity involving the transfer of shares is particularly at risk in light of this judgment.*

This study supports the view of Kruger that all merger and acquisition activities would be regarded as non-enterprise activities, and would be exposed to an attack by the SARS that the expenditure cannot be deducted as 'input tax' as defined in section 1(1). There are some areas (refer to subsequent paragraphs) in the VAT Act that deal with supplies which are considered to be taxable supplies in the course or furtherance of an 'enterprise'.

Interpretation Note No. 30 (Legal and Policy, 2006: 14) deals with a situation where a vendor supplies moveable goods outside the Republic of South Africa, a sale on the high seas, which are regarded as a zero-rated supply in terms of section 11(1)(*a*)(i). Although the goods never entered the territory of the Republic, if not mentioned specifically in the Interpretation Note, it would have been regarded as an out of scope supply being a non-enterprise activity. Any expenditure which is directly attributable to such supplies would not have qualified as an input tax deduction. Furthermore, any overhead expenditure would also need some apportionment calculation. By classifying the supply as a taxable supply in the course or furtherance of an enterprise, the adjacent expenditure would qualify as an input tax deduction.

A similar provision for services rendered outside the Republic is regarded as a zero-rated supply in terms of section 11(2)(*k*). If the services rendered outside the Republic was not specifically mentioned in the statute, it would have been regarded as an out of scope supply being a non-enterprise supply. If that was the case, any expenditure linked to these services would therefore not qualify as an 'input tax' deduction.

The SARS have therefore identified areas which would lead to an absurd result if not specifically mentioned to be in the *course* or *furtherance* of an 'enterprise'. The input tax would therefore be deductible in these circumstances.

2.5 Conclusion

In paragraph 2.1, the concept of enterprise activities were discussed and whether expenditure incurred in relation to such activities would be classified as in the *course* or *furtherance* of the enterprise. The different components of the enterprise were identified which constitutes an enterprise as defined in section 1(1). The elements consisted of a business or activity carried on in the Republic on a continuous or regular basis where goods or services are supplied in the course or furtherance of the enterprise.

The VAT charged on the acquisition of goods or services which are used, supplied or consumed by the enterprise in the course or furtherance of making any taxable supplies will be regarded as input tax. The tax payable will qualify for an input tax deduction if certain additional requirements are met. These requirements will be discussed in chapter 3 of this research assignment. The question that arises is where the goods and services were acquired for a non-taxable purpose the related expenditure will not be regarded as expenditure incurred for the VAT enterprise.

Non-enterprise activities were discussed in 2.2 above. The vendor will have to determine whether the activities performed are connected to the normal objectives of the enterprise or whether they are far removed from the normal objectives. In the first instance, where the expenditure relates to the normal objectives of the enterprise, the goods or services acquired by the enterprise will be regarded in the course of furtherance of such enterprise.

Stellenbosch University http://scholar.sun.ac.za

Conversely, where the expenditure are removed from the normal business activities of the enterprise, for instance, the expenditure are not closely attached to the making of taxable supplies, the goods or services acquired for that purpose will fall out of scope for VAT. As mentioned in the *De Beers Consolidated Mines Limited case supra,* the services did not relate to the core business activities of De Beers Consolidated Mines Limited. The services were for the benefit of the outgoing shareholders, which were not acquired, used or consumed for the making of taxable supplies. These activities were classified as non-enterprise activities. The tax payable on these activities would not be deductible by the enterprise as input tax.

Chapter 4 will deal with an apportionment method in terms of section 17(1). Furthermore, the effect of non-enterprise activities with regard to overhead expenses would also be part of the discussion.

Stellenbosch University http://scholar.sun.ac.za

Chapter 3: Definition of input tax: in particular the direct and immediate link test with the view of direct attribution

3.1 Introduction

In the previous chapter the enterprise versus non-enterprise activities was discussed. The vendor is required to ascertain whether the tax paid in respect of goods or services are in fact acquired in the *course* or *furtherance* of the enterprise. The VAT paid on goods or services acquired for non-enterprise activities will not constitute deductible input tax. The crux is that these expenses will not form part of the enterprise and therefore fall out of scope. It is only enterprise activities that fall within the ambit of the VAT Act and the goods or services acquired by the enterprise should be evaluated against the definition of input tax in section 1(1). A second test that the vendor must apply when determining whether input tax may be deducted by the vendor relates to the application of the definition of input tax.

This chapter focusses on expenses that can be attributed to either taxable or exempt supplies. The definition of input tax in section 1(1) is dissected in its various components and how these components link with the concept of direct attribution principles.

The *direct and immediate link test* which is used by the European Union to attribute the VAT paid to the different supplies will be discussed and its applicability in the South African context. The different types of supplies will be discussed with the view of direct attribution.

3.2 Input tax as defined in section 1(1)

3.2.1 General

Input tax as defined in section 1(1) will only apply to a vendor. Input tax consists of various components which are as follows:

- the tax charged in terms of section 7(1)(*a*) on a supply by another vendor;
- the tax paid on an importation of goods by the vendor in terms of section 7(1)(*b*);

Stellenbosch University http://scholar.sun.ac.za

- where VAT was levied on an amount of excise duty payable on goods manufactured in terms of section 7(3);
- second-hand goods where a notional input tax may qualify as input tax;
- when repossessions of goods are acquired under an instalment credit agreement where the repossession is not a taxable supply from the debtor.

A vendor needs to acquire goods or services in order to potentially be able to claim input tax. The concept direct attribution is an important basis when deductible input tax is determined and the various supplies made to the vendor acquiring the goods or services. It is therefore firstly important to determine what is meant by *acquired* by the vendor.

3.2.2 Acquired by the vendor

A vendor must acquire goods or services in the course of making taxable supplies. The goods or services must be acquired by the vendor, and not by another person.

De Koker and Kruger (2007: 2.3) state that where expenditure is incurred on behalf of the vendor and the expenditure is reimbursed by the vendor, the vendor will be entitled to an input tax deduction – provided that the vendor is in possession of a tax invoice in its name.

De Koker and Kruger (2007: 2.3) continue to state that where the expenditure is not reimbursed, for instance where an employer pays an allowance to the employee, no input tax will be deductible by the vendor, because the VAT is not incurred by the vendor. The reason is that there is not a close connection between the expenditure incurred and the allowance granted.

Botes and De Wet (2011: 6) state that in the event that a partner buys an asset as agent for a partnership, the input tax will be allowed as input tax when the asset is shown in the financial statements of the partnership.

It is also pressing to scrutinise foreign jurisdictions with regard to the treatment of the phrase *acquired*. This is a requirement and term used in other countries' domestic law with regard to input tax.

Stellenbosch University http://scholar.sun.ac.za

Goods and Service Tax Ruling, Australia (Commissioner for Taxation, 2008/1: 16) provides some guidance in determining whether the acquisition was made in carrying on an enterprise which includes:

> *[…] the acquisition is incidental or relevant to the commencement, continuance or termination of the enterprise;*
> *[…] the thing acquired is used by the enterprise in making supplies;*
> *[…] the acquisition secures a real benefit or advantage for the commencement, continuance or termination of the enterprise;*
> *[…] the acquisition is one which an ordinary business person in the position of the recipient would be likely to make for the enterprise;*
> *[…] the acquisition does not meet the personal needs of the individuals such as partners or directors;*
> *[…] the acquisition helps to protect or preserve the enterprise entity, structure or organisation; and*
> *[…] the acquisition is made by the entity in accordance with, or to satisfy, a statutory requirement imposed on the enterprise.*

The above clearly indicates that both the vendor – in South Africa and Australia – needs to *acquire* the goods or services for his or its own purpose to qualify as "input tax" as defined in section 1(1). The vendor needs to further determine its *purpose* for such acquisition of the goods or services.

3.2.3 The purpose for which the acquisition was made

The purpose for which the acquisition was made would determine whether input tax may be claimed as a deduction. The definition of input tax in section 1(1) requires that the purpose of incurring expenses must be used, consumed or supplied in the course of making taxable supplies. The purpose of the acquisition relates to the intention of the vendor at the time that the expense had been incurred.

De Koker and Kruger (2013: 2.3) highlights that New Zealand had settled that 'purpose' means the end which the taxpayer had in mind. It will therefore be relevant to determine the *intended purpose* or intention with which the expense had been incurred. If the

Stellenbosch University http://scholar.sun.ac.za

purpose, for which the expense was incurred, was incurred in the course of making taxable supplies, the input tax related to that expense would be deductible.

Whether the expense is incurred for resale or in a process of manufacturing or as overhead expenditure in supporting the business is irrelevant. Provided that the expenses are incurred in the course of making taxable supplies, the tax paid would qualify as input tax. The definition also requires that the goods or services must be acquired in the *course of making taxable supplies.*

3.2.4 In the course of making taxable supplies

This is one of the most important links to determine whether an amount of tax paid would qualify as input tax. Various commentary and tax cases are relevant to determine whether the expense was incurred in making taxable supplies. As mentioned above, tax must have been paid, whether to another vendor or a deemed notional input tax when second-hand goods are acquired from a non-vendor. Furthermore, a deemed notional input tax on second-hand goods acquired from a *vendor* would qualify as input tax where such goods were not used for the purpose of making taxable supplies.

The goods or services had to be acquired by the vendor for his own purpose. It is important to note that such acquisition can be acquired for the purpose of supply, use or consumption. With regard to consumption the expense can be classified as general overhead expenditure, provided that the expenses are incurred for the making of taxable supplies.

All the above requirements are linked to the phrase *making taxable supplies*. There must be a causal relationship between the expense incurred and the making of taxable supplies. This phrase led to some controversy and uncertainty in determining whether the expense is incurred in the course of making taxable supplies.

As a starting point, taxable supplies are defined in section 1(1). It includes both standard and zero-rated supplies. Any expenses incurred must therefore be used in making taxable supplies.

The tax paid will only be regarded as input tax to the extent that is wholly acquired in the course of making taxable supplies. In the event where it is partly used in the course of making taxable supplies, it is subject to an apportionment in terms of section 17(1) which will be dealt with in chapter 4.

The wording of the definition of input tax requires the vendor to link the expense to the making of taxable supplies. The European Court of Justice (ECJ) applied a direct and immediate link test to decide whether the tax paid would qualify as an input tax deduction.

The Partial exemption basics and the standard method (PE1300): Attribution case law (HM Revenue & Customs, 2013: 1) explains the direct and immediate link test. There must be a direct and immediate link between an input supply and the taxable outputs for there to be an entitlement to deduct the tax paid as input tax.

Van der Zwan and Stiglingh (2011: 338) conclude with the authority obtained from the *ITC 1744* (65 SATC 154) case and state that "*there was no "direct and immediate link" between the taxable supplies that the company was going to make and the funding obtained*".

The question is whether this test is applicable to VAT in South Africa which can be applied to determine whether the expense incurred by the vendor would be regarded as in the course of making taxable supplies. *Income Tax Case 1744* (65 SATC 154) used the *direct and immediate link* test to determine whether input tax were in fact deductible where expenditure related to the issuance of shares. The vendor argued that although the expenses related to the issuance of shares which is an exempt supply, it did so to raise funding which enabled the vendor to make taxable supplies. The vendor argued that there were thus a close connection between the funding acquired and the taxable supplies made by the vendor.

On the abovementioned matter, Conradie J referred to an ECJ case in *BLP Group plc v Commissioner of Customs and Excise* with approval.

> *BLP Group plc was a management holding company which disposed of shares in a subsidiary. The sale of shares was an exempt transaction in terms of the VAT legislation. It sought to deduct as input tax VAT paid on professional services*

Stellenbosch University http://scholar.sun.ac.za

supplied by merchant bankers, solicitors and accountants in connection with the sale on the basis that the purpose of the sale was to pay off debts that had arisen directly from its taxable transactions. The European Court of Justice held that where a taxable person uses services for an exempt transaction, he is not entitled to deduct the input tax paid even if the ultimate purpose of the transaction is the making of taxable supplies.

Conradie J ruled in *Income Tax Case 1744* (65 SATC 154: 158) that the input tax paid on the services had a *direct and immediate link* to the issuance of the shares, and cannot be linked to the manufacturing of containers which constituted its taxable supplies. The following quote from the judgement is relevant:

[…] direct and immediate link between the services of A and the making of the taxable supply was not required. His argument was that there was such link since the capital raised was used for the running of the Appellant's business.

From the above, it is submitted that the *direct and immediate link* test is therefore applicable in our domestic law, and should be applied to determine whether an expense is incurred in the course of making taxable supplies.

This decision was criticised by various commentators. Botes and De Wet (2011: 6) submitted that the *direct and immediate link* test of the European Union does not apply in South Africa by stating that:

It is respectively submitted, however, that the 'direct and immediate link' test of the European Union does not apply in South Africa. Instead, VAT may qualify as input tax to the extent that the goods or services have been acquired for the purpose of consumption, use or supply in the making of taxable supplies.

In a further article by Van der Zwan and Stiglingh (2011: 337), the impact of *Income Tax Case 1744* (65 SATC 154) evaluated whether costs incurred to raise share capital would qualify as an input tax deduction in South Africa. Although the article discusses the deductibility of cost incurred in issuing shares, what is important here is the fact that the writers conclude that the *direct and immediate link* test is applicable to South African VAT:

Stellenbosch University http://scholar.sun.ac.za

> *In light of the above analysis, it is submitted that there is no significant difference between the requirements respectively imposed on input tax deductions in South Africa and in the European Union that could impede the application of the arguments in the ECJ judgements in South Africa. It would therefore be appropriate to use the "direct and immediate link" test to apply the provisions of the VAT Act.*

The article further states that where the expenditure cannot be linked to a specific supply, the expenditure should be linked to the business as a whole. This is how the ECJ treats the *direct and immediate link* test. If the expenditure cannot be linked to a supply, it will be classified as general overhead cost.

As discussed in Chapter 2, there is a further consideration which is applicable to South African VAT. The vendor needs to consider whether the expense relates to the enterprise activities, that is, the normal business activities performed by the business as confirmed in *De Beers Consolidated Mines Limited case supra*. It appears that the Supreme Court of Appeal applied the *direct and immediate link test*, although not specifically mentioned in the judgement.

If the expense incurred falls into the normal business activities of the vendor, the vendor should apply the *direct and immediate link* test to determine whether the expense would ultimately lead to a supply of goods or services. Such an expense must of course be incurred *wholly* for the purpose of making a taxable supply to qualify as input tax. If the expense is *wholly* incurred for exempt supplies, a *direct and immediate link* to exempt supplies as decided in *Income Tax Case 1744* (65 SATC 154) is applicable, and the tax payable would not qualify as input tax as defined in section 1(1).

The *direct and immediate link* test therefore requires a sufficient positive connection to the making of taxable supplies. By implication, the test to be applied to input tax is a *positive test*.

If the expense is acquired partly for taxable supplies and partly for another purpose, it will be subject to apportionment in terms of section 17(1). The apportionment methodology will be discussed in Chapter 4. In order to determine whether the tax payable will constitute an input tax deduction, a five step approach is suggested.

Stellenbosch University http://scholar.sun.ac.za

This research assignment is of the view that the *direct and immediate link* test is applicable in the South African context. Although *ITC 1744* (65 SATC 154) is only a Tax Court judgement, which is not binding on the high court or the supreme court of appeal, it brought the principles of the *direct and immediate link* test into South African tax law. This research assignment remains of the opinion that the *direct and immediate link* test was applied in the *De Beers Consolidated Mines Limited case supra*, a Supreme Court of Appeal judgement, although the test was not specifically mentioned. As mentioned above, there must be a direct and immediate link between the tax paid and the supply made by the vendor to quality as an input tax deduction.

3.3 Five step approach to determine input tax

The definition of input tax in section 1(1) requires that a vendor must determine the extent to which VAT was paid or incurred in making taxable supplies which can be deducted as input tax. As a reference guide, the following procedures can be used in determining the input tax deduction:

Step 1 – Direct attribution to taxable supplies

Determine the VAT paid on expenses incurred for purpose of consumption, use or supply in the course of making taxable supplies in accordance with the definition of "input tax" as defined in section 1(1). The VAT on expenses incurred which relates *wholly* to the making of taxable supplies can be deducted as input tax.

Step 2 – Direct attribution to exempt supplies

Determine the VAT on expenses incurred for purpose of consumption, use or supply in the course of making exempt supplies in accordance with the definition of "input tax" as defined in section 1(1). The VAT on expenses incurred which relates *wholly* to the making of exempt supplies cannot be deducted as input tax.

Step 3 – Direct attribution to another intended use

Determine the VAT on expenses incurred for purpose of consumption, use or supply other than in the course of making taxable or exempt supplies. The VAT on expenses incurred which relates *wholly* to an intended use other than for the making of taxable supplies cannot be deducted as input tax.

Step 4 – Determine the VAT subject to an apportionment method

Determine the VAT on expenses incurred partly for purposes of consumption, use or supply in the course of making taxable supplies. This amount of VAT will be subject to apportionment in terms of section 17(1).

Step 5 - Determine and apply the method of apportionment to the VAT subject to apportionment

VAT on expenses incurred which cannot be attributed wholly to the making of taxable, exempt supplies, or other than for making taxable or exempt supplies, needs to be apportioned on the turnover-based method without prior approval, or the use of a special method of apportionment, which needs approval from the Commissioner for the South African Revenue Service. Apportionment method will be discussed in chapter 4.

The above five step approach will assist the vendor to perform direct attribution of the expenses incurred by allocating the expenses to the different supplies made by the vendor. It is therefore necessary to classify the different supplies in order to determine whether the supply can be split into its various components. This research assignment will now deal with the different types of supplies, for example single, composite and multiple supplies.

3.4 Classification of supplies

From the results and discussions of the previous sections it is important to classify various types of supplies. The classification of supplies is important as it will assist in the attribution of the expenses incurred because supplies can be classified as a single, composite and multiple supply. If attribution is not possible, the expense is subject to apportionment. Various jurisdictions have defined the various supplies, and it is submitted that it could prove helpful to use these definitions within a South African context. The reason for considering foreign jurisdiction's interpretations is that the term *supply* is a generic term across the board.

3.4.1 Multiple supply

Mixed Supplies of Goods and Services, Ireland (Irish Tax Authority, 2006: 6) defines a multiple supply as:

> *being two or more supplies made in conjunction with each other to a customer for a total consideration covering all those where each of those supplies are physically and economically dissociable from each other. In this arrangement each of the supplies made in conjunction with others is treated as an individual supply and is taxable/exempt in its own right.*

From the above definition, a multiple supply is separate supplies with each supply being an indivisible economic supply. Goods and Services Tax Ruling, Australia (Commissioner for Taxation, 2001/8: 4) defined a multiple supply as:

> *A mixed supply is a supply that has to be separated or unbundled as it contains separately identifiable taxable and non-taxable parts that need to be individually recognised.*

Similar to the Irish Tax Authority, a multiple supply can be divided into various components and each component is a single supply in its own right. The supply is independent from one another. This can equally be applied to the South African context that would assist the vendor to determine the various components of the supply.

3.4.2 Composite supply

Mixed Supplies of Goods and Services, Ireland (Irish Tax Authority, 2006: 3) defines a composite supply as:

> *[…] one principal element referred to as a principal supply with the other elements of that supply being described as ancillary supplies. These always accompany the principal supply and the main feature of an ancillary supply is that it would not make sense from an economic or practical point of view to supply it other than in the context of that principle supply.*

In a composite supply there is one principal element which cannot be divided into various supplies. From an economic point of view, it would not make sense to artificially split the supply in various components. Furthermore, a composite supply is a single supply with the composite or ancillary part enhancing the principal supply.

In a policy statement of Single and Multiple Supplies, Canada (Canada Revenue Agency, 2004: 2), a composite supply is defined as follows:

> *[T]wo or more elements are part of a single supply when the elements are integral components; the elements are inextricable bound up with each other; the elements are so intertwined and interdepended that they must be supplied together; or one element of the transaction is so dominated by another element that the first element has lost any identity for fiscal purposes.*

The above further substantiates that the ancillary part of the supply is inferior to the principal supply, and that the ancillary element of the supply loses its identity. By implication the supply is also a single supply which cannot be artificially split into different components.

Goods and Services Tax Ruling, Australia (Commissioner for Taxation, 2001/8: 4) defines a composite supply as:

> *[…] a dominant part of the supply includes something that is integral, ancillary or incidental to that part, then the supply is composite. You treat a composite supply as a supply of a single thing.*

The Australian Tax Authority therefore concludes with other tax authorities when defining a composite supply. These definitions are useful in the South African context as it will assist the vendor in performing direct attribution with regards to the deduction of input tax.

In *British Airways plc v Customs and Excise Commissioners [1990]* the Commissioner argued that the in-flight food had to be treated as a separate supply. The court ruled that the food was an integral part of the supply of the transportation and should not be separated. This case clearly indicates that it would be artificial to split the in-flight food supplied to the passengers from the transportation. Therefore, the composite supply should be treated as a single supply of transportation with the food being ancillary to the principal supply.

3.4.3 Single supply

A single supply, in contrast with a multiple and composite supply, is a supply of goods or services where no individual components are part of the supply. It is the only thing that is supplied and there you are therefore not confronted with the various components to that specific supply. The supply is therefore an indivisible economic supply.

3.5 Differentiating between single, composite and multiple supplies

In Goods and Services Tax Ruling, Australia (Commissioner for Taxation, 2001/8: 5), the difference between a multiple and composite supply was discussed. The ruling mentioned that the vendor needs to consider all the relevant circumstances of the transaction and to identify all the essential characters where the transaction comprises of a bundle of features and acts. A transaction is a mixed supply if the transaction consists of separately identifiable parts. In the case of a composite supply one component will be the dominant part with the other parts being integral, ancillary or incidental to the dominant part.

Stellenbosch University http://scholar.sun.ac.za

Mixed Supplies of Goods and Services, Ireland (Irish Tax Authority, 2006: 4), further states that:

> *[a] feature of an individual supply, which by definition always forms part of a multiple supply, is that is physically and economically dissociable from the other elements of that multiple supply. This means that each element the customer is being supplied with must be a distinct element of the overall supply. It must amount to more than a mere enhancement of a principal supply.*

The supply can therefore be divided into different elements which would stand independently. The principal elements of a multiple supply would, if supplied separately, be classified as a single supply. A composite supply on the other hand is where various supplies are ancillary to the principal supply and cannot be supplied without the principal element.

The policy statement of Single and Multiple Supplies, Canada (Canada Revenue Agency, 2004: 2) comments that the different elements of a supply *[s]hould not involve artificially splitting something that commercially is a single supply.* The context of all the elements of the supply should be viewed together, and it needs to be determined whether the elements are enhancing the principal supply or whether these elements be regarded as supplies in their own right.

In *College of Estate Management v Commissioners of Customs and Excise* (November 2005-Corporate Tax, Legal Developments) the taxpayer provided educational services which included study material, assignments, teaching sessions and access to 'virtual learning'. In arriving at his judgement the learned judge states the following:

> *Lord Walker examined the leading case of Card Protection Plan Ltd v Commissioners of Customs and Excise and considered the principles arising from the case. He suggested that one should take an overall view without 'over-zealous dissection', look for the essential purpose of the transaction (objectively assessed), and also be aware of the commercial reality and not attempt to split what is, in economic terms, a single supply.*

Stellenbosch University http://scholar.sun.ac.za

One will have to objectively assess each transaction and determine whether it will make sense to artificially split the transaction into different components. In the case *Commissioners of Customs and Excise v Plantiflor Limited* it was held that the delivery of the goods by a third party to the customer was not part of the supply which Plantiflor gave to the customer. In the judgement it was stated that:

> *[the] supply was completed when the package goods were handed by Plantiflor to Parcelforce for delivery and the payment for it was made.*

In this case the delivery change was not part of the supply of the goods. In fact some goods were sold without a delivery charge. All these factors could indicate whether the supply is a single supply, or whether the supply of the components could be split. It would not be artificial to make such a split. The delivery service could economically be separated from the goods as the goods were already in its final form and was not dependent on the delivery service.

3.6 Using single, composite and multiple supplies when attempting direct attribution

From the above, it is possible to use the different supply classifications when a vendor needs to perform direct attribution according to the definition of input tax in section 1(1). A single supply cannot be split and there are no elements to the supply which could create uncertainty. The vendor can therefore determine whether the single supply is attributable to a taxable supply, exempt supply or subject to apportionment where the single supply is used partly for the making of taxable supplies (mixed supplies). The vendor should, before evaluating the above, determine whether the single supply was incurred for the enterprise or whether it is incurred for non-enterprise purposes as discussed in chapter 2.

With regard to composite supplies, these supplies are also classified as a single supply. The comparisons discussed above, showed that it would be impossible to split the various components as the ancillary components to the supply only enhance the principal supply. From an economic perspective, it would be impractical to artificially split the supply into its various components.

Stellenbosch University http://scholar.sun.ac.za

From a VAT perspective, composite supplies should be treated in the same manner as a single supply. The various components to the supply can therefore not be attributed to taxable, exempt or mixed supplies.

A multiple supply can be split into the different components which if supplied individually, be regarded as a single supply. Although the supply is stated a one supply, it can be broken down into its various components which in its own right be regarded as a principal supply. It is independent from each other and can therefore be attributed to the various supplies it supports i.e. a part of the supply to taxable, a part to exempt and a part to mixed use.

The following examples are used to illustrate how a multiple supply can be attributed.

Example 1

Twenty one litre cans of paint are acquired to paint different buildings of the enterprise. Five litres of paint are used to paint the building that is involved with the making of taxable supplies. Eight litres of paint are used to paint the building involved in making exempt supplies. The other seven litres of paint are placed in storage. All the paint was purchased form one supplier, and one tax invoice issued for the supply.

This is a multiple supply, and can therefore be attributed to its intended use. The VAT charged on the five litres of paint used to paint the building making taxable supplies is input tax as defined and can be claimed in full. The VAT charged on the eight litres of paint used to paint the building which is involved in making exempt supplies will not be regarded as input tax as these expenses are not acquired in the course of making taxable supplies. The remaining seven litres which are placed in storage would be regarded as mixed supplies and will be subject to an apportionment method in terms of section 17(1). The apportionment regime will be dealt with in chapter 4.

Stellenbosch University http://scholar.sun.ac.za

Example 2

Another example of a multiple supply which is attributable is for instance a telephone account. If a company has a system of identifying the calls made by its employees, direct attribution is possible with regard to the cost of the calls made by the employees where taxable, exempt and mixed supplies are made. The rental of the line however cannot be attributed and therefore needs to be apportioned in terms of section 17(1). This is an example where an expense account can be divided into its different components which initially looked like a single supply.

From the above, it will be possible to attribute an expense which is a multiple supply into its different components without making use of an apportionment of expenses.

3.7 Conclusion

A vendor will only be allowed to deduct input tax, if the expense were incurred in the course of making taxable supplies. The expense incurred must be used, consumed or supplied in the course of making taxable supplies.

It is important that tax had to be charged and is payable by the vendor. Furthermore, the goods or services had to be acquired by the vendor in the course of making taxable supplies. *Acquired* means that the vendor need to acquire the goods or services for his purpose. The crux is whether the acquisition was made in the course of making taxable supplies.

In *Income Tax Case 1744* (65 SATC 154), the *direct and immediate link* test were used in determining whether the tax charged can be regarded as input tax. The test is relevant in South Africa context to determine if the tax charged is input tax as defined in section 1(1). The *De Beers Consolidated Mines Limited case supra* also supported this view in that the vendor had to determine to which part of the business the expense relates to.

The acquisition of goods or services which consist of a single, composite and a multiple supply was also evaluated with a view to what extent it would be possible to attribute the supply to the various supplies made by the vendor. The view is maintained that a multiple supply can be attributed to taxable, exempt supplies but in the case of a composite supply

Stellenbosch University http://scholar.sun.ac.za

it will not be possible. This is due to the fact that the supply cannot be artificially split into its various components.

The following chapter will focus on the apportionment methodology. It will deal with expenses that cannot be attributed to taxable or exempt supplies. Therefore, where expenses relate to both taxable and exempt supplies, the expenses need to be apportioned.

Stellenbosch University http://scholar.sun.ac.za

Chapter 4: Apportionment methodology, suggested methods of apportionment, with specific focus on the varied turnover-based method of apportionment

4.1 Introduction

The previous chapter focussed on the nature and extent of input tax and it was evident that the vendor has to *acquire* the goods or services for the making of taxable supplies. Furthermore, the direct and immediate link test was discussed to establish its applicability to VAT in South Africa. The test was applied in *Income Tax Case 1744* (65 SATC 154) where the enquiry to deduct input tax is the link between the expense and the taxable supply made by the vendor. This research assignment is also of the view that the *De Beers Consolidated Mines Limited case supra* also applied this test to determine whether the expenses incurred were linked to the enterprise activity of the business.

Various types of supplies were discussed with the view to apply direct attribution principles to the expenses incurred by the enterprise. Where the expenses can be allocated between taxable and exempt supplies, direct attribution was possible.

This chapter focusses on expenses that cannot be attributed to taxable or exempt supplies. The expenses therefore relate to both taxable and exempt supplies, and a method of apportionment must be applied to determine to which extent the VAT incurred relates to the making taxable supplies. The definition of input tax is further examined to ascertain to which extend the expenses are acquired for both taxable and exempt supplies and which portion of these expenses relate to the making of taxable supplies.

4.2 Apportionment in general

4.2.1 Input tax as defined in section 1(1)

The definition of input tax in section 1(1) incorporates the process the enterprise must apply to determine the VAT deductible as input tax where the expenses are acquired both for the making of taxable and exempt supplies. Input tax is defined as follows in section 1(1):

Stellenbosch University http://scholar.sun.ac.za

[…] where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services concerned are acquired by the vendor for such purpose.

From the above definition of input tax in section 1(1), where the vendor acquires the goods partly for the purpose of making taxable supplies, the vendor must apply the apportionment regime in section 17(1).

4.2.2 Apportionment of VAT in terms of section 17(1)

The apportionment methodology is governed by section 17(1). This section deals with the apportionment of VAT where the expenses relate to the making of both taxable supplies and exempt supplies. Section 17(1) states that:

[w]here goods or services are acquired or imported by a vendor partly for consumption, use or supply (hereinafter referred to as the intended use) in the course of making taxable supplies and partly for another intended use, the extent to which any tax which has become payable in respect of such goods under section 7(3) or any amount determined in accordance with paragraph (b) or (c) of the definition of "input tax" in section 1, is input tax, shall be an amount which bears to the full amount of such tax or amount, as the case may be, the same ratio (as determined by the Commissioner in accordance with a ruling as contemplated in Chapter 7 of the Tax Administration Act or section 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 […]

The above indicates that where goods or services are acquired by the vendor partly in the course of making taxable supplies, the vendor is required to apply a ratio or an apportionment ratio to determine the input tax deductible on goods or services acquired for such purpose. The various apportionment methods are discussed below.

Stellenbosch University http://scholar.sun.ac.za

4.3 Turnover-based method of apportionment

The turnover-based method is the only method that can be used by the vendor to calculate the deductible input tax in respect of the acquisition of goods or services partly for the purpose of consumption, use or supply in the course of making taxable supplies and partly for another intended use (mixed purposes), without special approval by the SARS. Section 17(1) refers to a method as contemplated by the Commissioner for the South African Revenue Service in accordance with a ruling issued by him in terms of section 89 of the Tax Administration Act No. 28 of 2011 (the TA Act) or section 41B.

The turnover-based method of apportionment contained in Binding General Ruling (VAT) No. 16 (Legal and Policy Division, 2013: 1) constitutes a binding general ruling in terms of section 89 of the TA Act and will remain in force until withdrawn or replaced. Binding General Ruling (VAT) No. 16 (Legal and Policy Division, 2013: 1) sets out the formula that a vendor must apply to determine the input tax deductible for mixed purposes as follows:

$$y = \frac{a}{(a + b + c)} \times \frac{100}{1}$$

[w]here:

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 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).*

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 percentage should be rounded off to two decimal places.*
6. *Where the formula yield 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 turnover-based method can be used by the vendor without prior approval from the SARS on condition that the method is *fair and reasonable*. In the event that the method is not fair and reasonable or inappropriate, the vendor needs to apply for an alternative method in terms of section 41B. This research assignment will focus on the *fair and reasonability test* in chapter 5.

The turnover-based method of apportionment presupposes that the total goods or services acquired by the vendor are applied to support taxable supplies in the same ratio as taxable supplies bear to the total supplies made by the vendor.

De Koker and Kruger (2013: 7.2) also state that the turnover-based method of apportionment implies where:

> *[t]here is a necessary correlation between the amounts of costs incurred and amounts of turnover generated, directly or indirectly, vendors whose enterprises differ from this position will prefer to use some other method of apportionment.*

The above indicates that all income items of the enterprise shares in the same ratio as the costs incurred in producing or acquiring such item. This would mean that various income items such as the interest, dividends and the *normal supplies* (the enterprise trade or business) would share in the same ratio the expenses of the enterprise. This is clearly not correct, as interest and dividends have much less cost attributed to it than the normal supplies made by the enterprise. In such cases, the vendor would approach the SARS for an alternative method of apportionment.

It should be noted that the turnover-based method of apportionment is also regarded as the *standard method* in other jurisdictions that must be applied by the vendor, except in circumstances where the turnover-based method does not provide an equitable method of

Stellenbosch University http://scholar.sun.ac.za

apportionment. According to the Value-Added Tax: A guide to apportionment of input tax (Irish Tax and Customs Authority, 2001: 21) the turnover method is regarded as the standard method of apportionment in the Republic of Ireland.

Where the turnover-based method of apportionment does not yield a fair and reasonable approximation of the input tax which should be recovered by the vendor, the vendor may apply to the SARS for an alternative method of apportionment. In VAT News No. 32 (Legal and Policy Division, 2008: 2) the vendor must present sufficient information which clearly demonstrates why the turnover-based method provides an unfair and unreasonable result. The vendor must motivate and demonstrate that the proposed method yields a fairer and more reasonable result as in the case of the turnover-based method.

The alternative methods are discussed below, with an extended discussion of the varied turnover-based method of apportionment. In particular, the inclusion of dividends and interest in the method are discussed more comprehensively.

4.4 Varied input-based method of apportionment

The varied input-based method of apportionment is one of the alternative methods of apportionment. The vendor needs to specifically apply to the SARS by way of a binding private ruling in terms of section 41B to use this method to apportion the expenses incurred for mixed purposes.

The Guide for Vendors (VAT 404) (Legal and Policy Division, 2008: 30) states that:

> *[t]his method is based on the ratio of VAT wholly attributable to taxable supplies to the total VAT incurred for all supplies (excluding the VAT incurred for mixed taxable and exempt supplies). The ratio obtained is multiplied by the VAT incurred for goods and services acquired/imported for mixed use […]*

The varied input-based method, therefore, applies the direct attribution principle with regards to the VAT incurred by the enterprise. It is only the VAT incurred wholly for the purposes of making taxable supplies and the VAT incurred wholly for making other than taxable supplies that form the basis of the method. Any VAT incurred for mixed purposes are ignored when the calculation is done.

Stellenbosch University http://scholar.sun.ac.za

It is important to note that in the event that no attribution of VAT incurred to either the making of taxable supplies or other than making taxable supplies is possible, the varied input-based method will not be appropriate to use as an alternative. Furthermore, the varied input-based method will only be a suitable method in the event that more than fifty per cent of the VAT incurred is directly attributable to either the making of taxable supplies or other than taxable supplies. It will also provide a more accurate reflection of the expenses incurred in making the different supplies of the enterprise.

The formula for the varied input-based method is as follows:

$$y = \frac{a}{(a + b)} \times \frac{100}{1}$$

[w]here:

y = the apportionment ratio/percentage;

a = VAT incurred wholly for the purposes of making taxable supplies; and

b = VAT incurred wholly for the purposes of making exempt supplies or for any other purpose.

It must further be noted that all the exclusions under the notes with regards to the turnover-based method of apportionment are also applicable. For example, VAT incurred in acquiring a capital asset must be disregarded as it would create an abnormal effect in relation to the apportionment calculation.

The varied input-based method is appropriate when the majority of VAT incurred by the enterprise is attributable to the making of taxable supplies or exempt supplies with the minority of the VAT incurred are attributable for mixed purposes. The varied input-based method is also appropriate when the turnover of a specific company or industry is difficult to determine. The varied-input-based method of apportionment is mostly applied by the Long-term Insurance industry.

4.5 Floor space method of apportionment

This method operates on the same basis as in the case of the varied input-based method of apportionment. The method uses the floor space wholly attributable to the making of taxable supplies, and the floor space wholly attributable to exempt supplies or non-taxable supplies. For the purposes of determining the ratio, areas used for mixed purposes are ignored when the ratio is calculated.

The ratio is determined by using the following formula:

$$y = \frac{a}{(a + b)} \times \frac{100}{1}$$

[w]here:

y = *the apportionment ratio/percentage;*

a = *floor area used wholly for the purposes of making taxable supplies; and*

b = *floor area used wholly for the purposes of making exempt supplies or for any other purpose.*

The ratio is applied to expenses or VAT incurred by the enterprise for mixed purposes. It must be noted that where no dedicated floor areas are directly attributable to taxable supplies or exempt supplies, the method will not result in a fair and reasonable method. Fair and reasonable will be discussed in Chapter 5 of this research assignment.

The VAT 404 (Legal and Policy, 2008: 30) provides for an example of the floor space method where:

> *[v]endor E owns a building which is used as a shop (taxable) and a crèche (exempt purposes). The floor area of the shop is 200 square meters and the crèche is 300 square meters. The vendor incurs R500 VAT wholly for the purposes of the shop, R400 VAT wholly for the purposes of the crèche and R300 for both parts of the business. The input tax which may be claimed is calculated as follows:*
>
> *R500 + (R300 x 200/500) = R620*

The above example shows that the ratio is determined by taking the taxable floor area as a percentage of the total floor area, which is the sum of the exempt floor area and the taxable floor area. The floor area used for mixed purposes is ignored.

There are various other special methods that use the same terminology as in the varied input-based method and the floor space method. These methods include, amongst others the transaction-based method and the headcount method.

As stated above, all these methods apply direct attribution principles. Where direct attribution is not possible to taxable supplies and supplies other than exempt supplies, the methods cannot be used. This is a severe limitation to the various apportionment methods proposed by the SARS in apportioning expenses used for mixed purposes.

As a result of the limited apportionment methods available, the turnover-based method is adjusted or varied to calculate a fair and reasonable method of apportionment. These variations include, amongst others, the exclusion of dividend income, the recognition of incidental supplies, the exclusion of passive interest and the inclusion of net interest. Various variations of the turnover-based method are discussed below.

4.6 Multiple method of apportionment (Sectorised approach)

The multiple method of apportionment is not a method that has been applied and approved by the SARS in past. This method was never published in any document issued by the SARS or in any VAT guide.

The multiple method has been applied by the United Kingdom and has been published in the partial exemption document which was issued by the HM Revenue & Customs Authority. This document contains, amongst others, direct attribution of input tax, the various apportionment methods, examples of the apportionment methods and industry preferred methods of apportionment. Partial Exemption Special Methods: Sectorisation (HM Revenue & Customs, 2013: 1) is useful where the input tax is divided between different business units.

It is submitted that this method would also be useful in South Africa where one single entity is divided into different divisions which is not similar in nature. For instance, where

Stellenbosch University http://scholar.sun.ac.za

company sales, merchandise storage and credit transactions are managed by three separate divisions of a company. These divisions are completely different form each other in nature. It will be useful if the company applies the multiple method of apportionment by using different methods of apportionment in each division. Therefore, the company uses more than one single method in its apportionment calculation.

Partial Exemption Special Methods: Sectorisation (HM Revenue & Customs, 2013: 1) states that:

> *[a] sectorised method allows for the allocation of input tax to sectors where the costs are similarly used to make supplies. The non-attributable input tax may be allocated between the different sectors using similar ratios as for apportionment calculations, for example values, head count, etc. Different (or similar) apportionment methods can then be used to determine the deductible portion for each sector.*

As mentioned above, this method will be applicable where a company has different sectors or divisions which are not the same in nature. The different methods of apportionment can then be applied to the clusters of expenses which are incurred in the different sectors or divisions.

Partial Exemption Special Methods: Sectorisation (HM Revenue & Customs, 2013: 1) further states that this method will be appropriate because there are different business activities that incur costs in different ways. This method is also more complex than the other apportionment methods, but it will provide a more accurate result, resulting in a fair and reasonable method of apportionment in the writer’s opinion.

Partial Exemption Special Methods: Sectorisation (HM Revenue & Customs, 2013: 1) also mentions that it is appropriate to use a management accounting system which allocates the costs to the different profit/cost centres. It is important to note that the management accounting system should allocate cost on management accounting principles and not to manipulate the costs where the vendor’s apportionment ratio gives the best possible result. In such cases, the SARS would argue that the multiple method of apportionment is not the most appropriate method to use.

Stellenbosch University http://scholar.sun.ac.za

It is submitted by this research assignment that the multiple method of apportionment would be a fair and reasonable method of apportionment where the business can be divided into different divisions where the divisions does not provide the same type of supplies. The vendor would be in a position to ring-fence the divisions and apply different apportionment methodologies to the divisions.

However, the vendor will have to apply to the SARS for a special apportionment in terms of section 41B. The SARS will only approve the method if the SARS is convinced that the method provides a fair and reasonable method of apportionment.

4.7 Varied-turnover-based method of apportionment

The varied turnover-based method of apportionment is the normal turnover-based method as discussed in section 4.3 of this research assignment, with various inclusions, exclusions of supplies or the inclusion of supplies on a net basis. These elements include, amongst others, the inclusion or exclusion of dividend income, the treatment of incidental supplies, the exclusion of passive interest and the inclusion of interest on a net basis. This research assignment will discuss these elements in sections 4.7.1, 4.7.2 and 4.7.3.

4.7.1 Dividend income

The inclusion of dividend income in the turnover-based method of apportionment is a highly debated and complex issue. This research assignment will focus on the nature of dividends in South Africa, the treatment of dividend income in the apportionment method in various other jurisdictions and the current treatment in South Africa with regard to dividend inclusion in the turnover-based method which results in an inappropriate method.

4.7.1.1 General essentials of dividends in South Africa

A person invests in the capital of a company with the view to make a profit on the investment. The profit or return of the investment is in the form of capital growth on the share and the dividend income when holding such share as an investment.

The role of the directors in managing the company is of critical importance. For instance, where the directors of the holding company is also the directors of the subsidiary, the

Stellenbosch University http://scholar.sun.ac.za

question to be answered is, in which capacity do they manage the subsidiary and the effect thereof on dividend declarations.

Van Dorsten (1993: 5) states that a company is managed by the directors in a fiduciary capacity. The directors act autonomously and are not regarded as employees of the company. Where external transactions are entered into by the directors, they act as either an agent or as management organ of the company.

Van Dorsten (1993: 6) further states that the company has executive and non-executive directors. The executive directors work on a full time basis for the company in terms of service agreements where the day-to-day operations are performed. The non-executive directors are not employed by the company, and only attend and vote at board meetings.

The manner in which dividends are declared or paid is governed by the *articles of association.* Van Dorsten (1993: 9) states that:

> *[t]he articles constitute a contract between the members themselves and between the company and its members in their capacity as members. The articles do not constitute a contract between the directors and the members or the company. Directors will be contractually bound by the articles only if they are also shareholders or employees under service agreements which incorporate the articles.*

Van Dorsten (1993: 11) points out that *"a company is for legal purposes an independent legal person and separate from its shareholders or directors".* This clearly indicates that the director and shareholders are entirely separate from the company and thus no influence on dividend payments except that the article of association governs the treatment thereof.

Note that currently the article of association is referred to as the memorandum of incorporation by the Company Act No. 71 of 2008. This is important parameters in view of the discussion regarding the inclusion of dividend income in the apportionment calculation with regard to management activities or services performed by the directors of the company and the declaration of dividends by the company. The payment of dividends and the management services or activities is not related to each other.

Stellenbosch University http://scholar.sun.ac.za

4.7.1.2 The working of dividends

It is important to discuss the working of a dividend as it will impact on whether any effort or management services by the directors of the company are performed in earning such dividend. This will have an effect on whether any general overhead costs can be attributable to the earning of the dividend in the same proportion as the normal taxable supplies made by the vendor or whether the cost attached to the earning of such dividend income is insignificant.

Van Dorsten (1993: 26) highlights the following with regard to the right of a shareholder pertaining to a dividend in the case *Hood-Barrs v Commissioner of Inland Revenue, Lord Greene MR* that:

> *[h]e has no property in, nor right to, any particular asset. He has only the right to have all assets administered by the directors in accordance with the constitution of the company, and his right to a dividend only arises when the dividend is declared.*

Van Dorsten (1993: 26-27) further states that:

> *[t]he company owns the distributable profits until such time as they are paid over to the shareholders. The declaration of a dividend does not cause ownership to pass. Ownership in money passes when delivery takes place. The shareholders therefore become owners of the money only when their individual shares of the dividend are paid to them.*

From the above, it is clear that a dividend will only accrue to a shareholder when the company pay a dividend. The shareholders have no rights to the assets or profits of a company prior to the payment of a dividend.

Stellenbosch University http://scholar.sun.ac.za

4.7.1.3 The role of directors with regard to dividends

Van Dorsten (1993: 115-116) states that directors are bound by various duties imposed by the common law and the company's memorandum and articles of association. The common law duties include the following:

- *Care, skill and diligence;*
- *Fiduciary duty of good faith and honesty;*
- *Fiduciary duty to act in the interests of the company*

With regards to care, skill and diligence, Van Dorsten (1993: 116) maintains that the director must make an effort to understand the business and exercise his own judgment based on his own knowledge and experience. This indicates that he must act according to his own judgment when decisions are made and cannot be influenced by various parties to achieve another result.

According to Van Dorsten (1993: 119), a director in his fiduciary capacity must act in good faith and be honest. This gives rise to the following duties:

> *[…] exercise their powers independently and may not limit or restrict them;*
> *[…] exercise their powers for the purpose for which they were conferred;*
> *[…] exercise their powers within limits of their authority;*
> *[…] must act within the powers of the company.*

In *Fisheries Development Corporation of SA Ltd v Jorgensen and Another 1980 (4) (SA) 156 (W) at 165-6,* Margo J states the following that:

> *[a] director is in that capacity not the servant or agent of the shareholder who votes for or otherwise procures his appointment to the board… The director's duty is to observe the utmost good faith towards the company, and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal.*

Van Dorsten (1993: 120) concludes that the directors may not exercise their dividend powers in favour of one class of shareholders when it would be unfair to another class. Van Dorsten (1993: 121) highlights that:

> *[t]he interest of the company are the interest of the shareholders in their capacities as shareholders, including the interests of future shareholders. The interests of the company do not include the interests of a class of shareholders or the interests of shareholders in a capacity other than shareholders.*

The above indicates that a shareholder cannot manage a company. Directors are appointed to manage the company completely separate from the shareholders. A shareholder only has a right to a dividend once it has been declared.

The directors in their fiduciary capacity must manage the company to their best knowledge, and cannot be influenced by the shareholder regarding the management of the company. With this as background, this research assignment will now focus on whether the inclusion of dividend income in the apportionment method in the South African context is appropriate and whether it provides a fair and reasonable apportionment method.

The directors cannot influence the dividend payment to the shareholders as it is governed by the memorandum and the articles of association. Furthermore, the dividend payment cannot be regarded as a payment in lieu of management services being provided by the shareholder. The dividend is linked to the shareholding of the shareholder and the quantum of the divided is determined on that basis. It does not provide any link to the management of the company.

4.7.1.4 The inclusion of dividend income in an apportionment method

As discussed in section 4.3 of this research assignment, the inclusion of dividend income in the denominator of the turnover-based method is prescribed by the SARS. The SARS is of the view that dividend income must be included in the apportionment calculation and can only be excluded by way of an application for a ruling.

This view leads to the inappropriateness to apply the turnover-based method, for instance where dividends are merely received by virtue of a company structure and no effort and

Stellenbosch University http://scholar.sun.ac.za

activities are performed to earn the dividend income. The vendor is then required to search for an alternative method of apportionment. As mentioned in sections 4.4 and 4.5 of this research assignment, the alternative methods will only operate when direct attribution to taxable and exempt supplies is possible.

In an article by Ensight (Edward Nathan Sonnenbergs, 2007: 1) it is stated that:

> *[t]he formula for the turnover-based method was described in SARS Guide for Vendors to be the ratio of the total value of taxable supplies to the value of all supplies… but uncertainty remained as to the inclusion or exclusion of incidental receipts and receipts resulting from non-supplies.*

This approach by the SARS remained an uncertainty and the inclusion of dividend income is still a concern for all the vendors. Vendors are still compelled to include dividend income in the apportionment method as no alternative methods are available.

Ensight (Edward Nathan Sonnenbergs, 2007: 2) further states that the main aim of an apportionment method is to attribute VAT on inputs to the extent that the vendor makes taxable supplies. The method must reflect *the use to which inputs are put, and also the vendor's activities.*

Ensight (Edward Nathan Sonnenbergs, 2007: 2) mentions that:

> *[t]he turnover-based method severely distorts the attribution of VAT to taxable supplies by including amounts in the denominator which do not result from any substantial activity of the vendor or the use of goods or services.*

The above clearly indicates that the inclusion of dividend income in the apportionment method is not reflective of the effort expended in producing such dividend income. Furthermore, that dividend income does not carry the same ratio to expenses as the ratio of expenses for the making of taxable supplies if such supplies are the main business of the vendor.

In the case *Mobile Telephone Networks Holdings (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case No. A 5033/10) the court held that *"the facts as*

Stellenbosch University http://scholar.sun.ac.za

proven i.e. the amount of work done must remain the yardstick or benchmark and not the value of the dividend payments". The court had to determine to which extend the audit fees were incurred in the production of income and the amount of audit fees that had to be disallowed on the basis it was incurred in producing dividend income, which constituted an exempt income.

This test could equally be applied where dividend income are part of the apportionment method. This research assignment is of the view that the effort and activity performed in producing the dividend income is insignificant in most instances. For instance, where the nature of the business is that of an investment company, the expenditure incurred would be linked to those activities. In such cases, the exclusion of dividend income will not be appropriate in the circumstances. Various foreign jurisdictions in the European Union have conceded on the inclusion of dividend income in the turnover-based method of apportionment.

In an article by Swinkels (2008: 344) the treatment of dividend income in the turnover-based method of apportionment was discussed. This article discussed the European Court of Justice (ECJ) judgment in *Sofitam (Satam) SA v Ministre du budget,* Case C-333/91, [1993] ECR I-3513 where the court concluded that share dividends received are not subject to VAT in respect of all its transactions and must be excluded from the denominator. The reason put forward by the court was that dividends are not consideration for any economic activity.

Swinkels (2008: 344) states:

> *[t]hat the conclusion is plausible because it is based on the idea that share dividends derived from the mere holding of shares cannot be attributed to any transaction.*

In another case *Floridienne SA, Berginvest SA v Belgian State,* Case C-142/99, [2000] ECR I-3513, Swinkels (2008: 344) mentions that:

> *the ECJ reiterated that share dividends paid by subsidiaries to their holding company, which is a taxable person in respect of other activities and which supplies*

management services to those subsidiaries, must not be included in the denominator of the pro rata […]

In the context of the European Countries, dividend income is not regarded as a supply. Similarly, in South Africa, dividends are also not regarded as a supply. Note 2 to the turnover-based method in section 4.3 of this research assignment states that dividends are regarded as a non-supply and must be incorporated in "c" in relation to the formula. However, the SARS remains of the view that dividends should be included in the turnover-based method of apportionment irrespective of the treatment in the foreign jurisdictions.

The following example is used to illustrate the effect of dividend income exclusion or inclusion on the apportionment ratio or percentage.

Example 1

Company A makes taxable supplies in the amount of R 100 000. Company A also receives a dividend from its subsidiary in the amount of R 10 000. Company A does not have a specific ruling from the SARS and is therefore required to use the turnover-based method of apportionment.

The formula for the turnover-based method as mentioned in section 4.3 is as follows:

$$y = \frac{a}{(a + b + c)} \times \frac{100}{1}$$

[w]here:

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 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).

The calculation is as follows:

$$\frac{100\,000}{100\,000 + 10\,000} \times \frac{100}{1}$$

= 90.9%

The above indicates that Company A will have an apportionment problem and will have to apportion all its goods or services acquired for purposes other than making taxable supplies, for instance, general overhead expenditure.

In the event where dividend income is excluded from the denominator, the calculation will be as follows:

$$\frac{100\,000}{100\,000} \times \frac{100}{1}$$

= 100%

Company A will therefore not be required to apportion its expenditure. This indicates that the dividend income has an insignificant influence on the expenditure incurred by Company A.

In another case dealing with the exclusion of dividend income from the apportionment method, the ECJ considered in *Cibo Participations SA v Directeur regional des impôts du Nord-Pas-de-Calais,* whether the receipt of dividends falls within the scope of VAT and therefore, whether the dividend income should be included in the calculation of the apportionment method by applying the turnover-based method. The court held in paragraph 41 that:

> *[…] since the receipt of dividends is not the consideration for any economic activity, it does not fall within the scope of VAT. Consequently, dividends resulting from shareholding fall outside the deduction entitlement […]*

The court further stated in paragraph 42 that:

Stellenbosch University http://scholar.sun.ac.za

[c]ertain features of dividends account, in particular, for their exclusion from VAT. […] the existence of distributable profits is generally a prerequisite of paying dividends and that payment is thus dependent on the company's year-end results. […] the propositions in which the dividend is distributed are determined by reference to the type of shares held, in particular by reference to classes of shares and not by reference to the identity of the owner of a particular shareholding. […] dividends represent, by their very nature, the return on investment in a company and are merely the result of ownership of that property.

Further in paragraph 43 of the judgment, the court stated that:

[i]n view, specifically, of the fact that the amount of the dividend thus depends partly on unknown factors and that entitlement to dividends is merely a function of shareholding, the direct link between the dividend and the supply of services, which is necessary if the dividends are to constitute consideration for services, does not exist even where the services are supplied by a shareholder who is paid dividends.

In paragraph 44 of the judgment, the court went on to say that:

[…] it is appropriate to emphasise that, since the receipt of dividends does not fall within the scope of VAT, dividends paid to subsidiaries to their holding company which is a taxable person in respect of their other activities and which supplies management services to those subsidiaries must be excluded from the denominator of the fraction used to calculate the deductible proportion […]

From the above, a dividend is not regarded as consideration for any economic activity and therefore fall outside the scope of VAT. Furthermore, a dividend is therefore not regarded as a supply for VAT purposes. Moreover, the existence of distributable profits is a prerequisite for paying dividends to the shareholders of the company. Dividends by its nature are a return on the investment in the company and merely as a result of ownership of the shares. A dividend is a function of shareholding and the direct link between the dividend and the supply of services does not exist. Since the dividends do not fall within the scope of VAT, the dividend income should be excluded from the turnover-based method of apportionment.

This judgment is equally applicable in the South African context because the SARS is of the view that dividends are also regarded as a non-supply for VAT purposes. Although the SARS includes dividends in the turnover-based method of apportionment, this research assignment is of the view that the expenditure attached to the earning of the dividend is insignificant in most instances.

Dividends in South Africa are a short term return on the investment (Van Dorsten, 1993: 1). The dividend receipt is determined by the shareholding in a specific company. If the shareholding is substantial, the dividend can also be a substantial sum.

The inclusion of the dividend would impact the denominator of the turnover-based method. The presumption of the turnover-based method of apportionment is based on the fact that the total goods or services acquired by the vendor are applied to support taxable supplies in the same ratio as taxable supplies bear to the total supplies made by the vendor.

Apportionment needs to be performed where the expenses cannot be directly attributed to the making of taxable or exempt supplies. These expenses are classified as mixed expenses, which are used in making partly taxable and exempt supplies. The types of expenses that are classified as mixed expenses are, for instance, general overhead expenses. These, amongst others, include telephone-, office-, rental of premises- and bank charges expenses.

The abovementioned expenses are incurred in the normal business activities of the enterprise which can consist of various taxable and exempt supplies. At this stage it is important to mention that the SARS views dividend income to be a non-supply for VAT purposes. Dividend income is received merely as a result of the shareholding in a company and the quantum of the dividend is determined by the interest held in the company by the shareholder.

Following the foreign precedent with regards to the treatment of dividend income in the apportionment of mixed expenses, it would result in an inappropriate method if dividend income shares in the same ratio to expenses as the normal supplies made by the business. Dividend income cannot taint all the overhead expenses as no economic activity are attached to the earning of the dividend income.

Stellenbosch University http://scholar.sun.ac.za

Very little expenses can be attributed to the earning of dividend income. Expenses that could have a direct relationship to the dividend income would for instance be bank charges. If one considers all of the above, the contention is that it would make sense for the SARS to exclude dividend income in the turnover-based method of apportionment due to the inequitable result that source of income could have.

This research assignment is therefore of the view that the inclusion of dividend income in the turnover-based method of apportionment would therefore not result in a fair and reasonable method of apportionment. The SARS should therefore issue some form of directive or ruling to address the issue of dividend income.

It is proposed by this research assignment that the SARS must issue a Binding General Ruling in terms of section 89 of the TA Act to the effect that all dividends must be excluded from the turnover-based method of apportionment in most instances. This would result in a fair and reasonable method of apportionment. It would also solve the issue surrounding the application for alternative methods of apportionment. As stated above in sections 4.4 and 4.5, the alternative method can only function where direct attribution is possible.

It is further proposed by this research assignment that it is also of critical importance that the SARS specifically deals with dividend income as the result of an on-going investment business, where the enterprise (if registered for VAT purposes) are disqualified from relying on the exclusion of dividend income in accordance with the Binding General Ruling issued in terms of section 89 of the TA Act. Where these vendors are an investment business, they must still apply to the SARS to have dividend income excluded from the turnover-based method of apportionment.

Stellenbosch University http://scholar.sun.ac.za

4.7.2 Incidental supplies

Incidental supplies is a concept that is not applied in the South African context. The HM Revenue & Customs defined incidental as a once-off situation where the activity is not sufficient to be regarded as a business activity or passive income such as interest earned from bank deposits. This research assignment is of the view that such a concept is plausible in the South African context, but it needs to be legislated or a ruling needs to be issued by the SARS to clarify the position.

The Partial exemption (HM Revenue & Customs, 2009: 21), which applies to United Kingdom vendors, discusses the concept of incidental supplies. The treatment of incidental supplies are eliminated from the turnover-based method of apportionment. Incidental supplies can be viewed in two ways consisting of:

> *[…] a once off situation such as the sale of 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.*

The VAT Partial Exemption (HM Revenue & Customs, 2009: 21) further states that when considering whether a supply is incidental, vendor must identify all the business activities. When a supply is distortive, it does not indicate that the supply is incidental. Various cases by the VAT Tribunal in the European Union decided what is meant by the term *incidental.*

In *CH Beazer (Holdings) Plc* (QB decision [1989] STC 549) the court decided that the term incidental means "*occurring or liable to occur in fortuitous or subordinate conjunction".* In a further case *Empresa da Desenvolvimento Mineiro SGPS SA* (ECJ decision C 77/01) three tests were formulated to define what is meant by *incidental*:

> *[t]hey have a certain link to a main activity but do not form a part of it;*
> *[t]hey require only a slight use of the business assets;*
> *[a]n incidental activity cannot exceed a main activity in its extent.*

The ECJ rejected the last test and put greater emphasis on the distortive nature of the transaction and the very limited used of taxed inputs. These court cases formulated different tests to be applied by the vendor to ascertain whether a supply would be regarded as an incidental supply. The court concluded that the supply requires very limited use of the business assets and that it does not form part of the main activity of the business. Furthermore, the expenses incurred in making the supply are insignificant.

The term *incidental supplies* is not used in the South African VAT context, but as mentioned above, this research assignment supports the view of foreign jurisdictions that *incidental supplies* must be incorporated when the turnover-based method is considered by the vendor. This will alleviate the pressure on vendors to search for an alternative method where it is virtually impossible that an alternative method does exist. The SARS needs to issue a Binding General Ruling in terms of section 89 of the TA Act, where incidental supplies may be eliminated from the turnover-based method of apportionment.

4.7.3 Inclusion of interest in the turnover-based method

Interest received is regarded as an exempt supply in terms of section 12(*a*) read with section 2(1)(*f*). Section 2(1)(*f*) reads as follows:

> *the provision by any person of credit under an agreement by which money or money's worth is provided by that person to another person who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth.*

Therefore, the gross amount of interest constitutes the exempt supply for VAT purposes. With regard to the apportionment of mixed expenses, a vendor that earns interest on investments will have to include the full amount of interest in the denominator.

In Ensight (2007: 1) it was mentioned that the Banking Association of South Africa can use net interest income and that dividends may be excluded from the turnover-based method of apportionment. However, other vendors are required to include the gross amount of interest and dividends in their apportionment calculation.

Ensight (2007: 2) continues to state:

Stellenbosch University http://scholar.sun.ac.za

> *[that] the Guide for Vendors does not make any mention of the treatment of incidental income such as interest which is occasionally levied on overdue debtors accounts or interest earned on the investment of surplus cash.*

The inclusion of interest sometimes leads to an absurd result in that the expenses attributable to the earning of interest income are far more than actually expended to produce such interest income. This research assignment therefore agrees with the above statement that interest earned occasionally must be excluded for the turnover-based method of apportionment. The reason for the exclusion of interest income earned occasionally is linked to the actual expenditure incurred in earning such interest income. If the interest income remains in the apportionment calculation, the expenditure allocated by virtue of the apportionment method would be far more than the actual expenses. This would lead to an absurd result and the apportionment method would not reflect a fair and reasonable basis of apportionment.

The VAT Partial Exemption (HM Revenue & Customs, 2009: 21) states that the earning of interest income from deposits held in a bank account which are received passively, where little or no related input tax are incurred, are classified as incidental supplies. This part was discussed in section 4.7.2 above.

Swinkels (2008: 344) states that in *Floridienne SA, Berginvest SA v Belgian State,* Case C-142/99 [2000] ECR I-9567

> *the same applies to interest paid by subsidiaries to the holding company on loans it has made to them, where the loan transactions do not constitute an economic activity.*

It seems that foreign countries treat passive income differently than the SARS. Foreign countries exclude passive interest in the apportionment method on the basis that no economic activity is present with regards to earning passive interest income. Their reasoning is that limited or virtually no expenses are incurred in producing such income.

Stellenbosch University http://scholar.sun.ac.za

This research assignment supports the view that passive income should not be included in the turnover-based method of apportionment. It is recommended that the SARS issues a Binding General Ruling in terms of section 89 of the TA Act to exclude passive income.

Moreover, the passive income should be defined and limited for instance to interest earned on bank accounts and investment accounts that occasionally pay interest with little intervention to produce such interest. Interest which is *worked for* should not be excluded as this would not fall within the ambit of "*passive".*

An area that has been addressed by the SARS is the inclusion of *net interest* in certain instances. The Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (Republic of South Africa, 1995: 34) investigated the apportionment regime with regards to the financial services industry. Although it focussed on the fee based structure, it also provided clarity on the *net interest* inclusion in the apportionment method. It stated the following in this regard:

> *[a] system whereby only fee based financial services are subject to VAT, and interest and trading as a principal remain exempt, the problem of the apportionment of input tax remains.*
>
> *It appears inequitable to simply continue with a turnover-based method of apportionment which, inter alia, takes into account the net interest earned by banks where:*
>
> *(a) it is accepted that only a portion of interest income constitutes intermediation-type services and represents value-added; and*
>
> *(b) it is accepted that only that portion of intermediation services rendered to households should impact on the VAT base*
>
> *Only that portion of the net interest margin that represents an exempt intermediation service should result in an input tax restriction for the banks*
>
> *[…] the basis of apportionment of the "melting pot" should be carefully reviewed and amended to take this issue into account.*

Stellenbosch University http://scholar.sun.ac.za

The Commission of Enquiry suggested that the SARS review the apportionment methodology for the financial sector and only include the *net interest margin* in the apportionment calculation. An article by Schneider (KPMG, 2010: 1) confirmed these principles which stated that:

> *[a] Council of South African Banks (COSAB), now the Banking Association South Africa (BASA), ruling (May 1998) which clarified that the net interest represents consideration for intermediation services which should be included in the denominator as gross interest results in double taxation.*

The abovementioned refers to financial institutions where money is borrowed and on-lend to clients. The principle in this regard is that the transaction in borrowing the funds cannot be separated from the transaction whereby the funds are lend to the clients of the financial institution. As a result, the borrowing and lending of the money is considered to be one transaction and thereby constitutes a single activity. This is the reason why the interest paid cannot be separated from the interest received. Furthermore, the financial institution's most important activities are the management of the net interest margin. This margin reflects the profit of the transaction.

The SARS' policy is therefore, that where "borrow to on-lend" principles are evident, the *net interest* margin is the correct consideration for the service of intermediation. The reason is that it constitutes a single activity. The inclusion of net interest is therefore only applicable in specific situations and the SARS will only apply *net interest* inclusion in the denominator when "borrow to on-lend" principles are present.

It must be noted further that only interest paid which is thereafter on-lend to customers qualifies for off-set of interest income to reflect the net position. It is the SARS practice that any interest borrowed to fund its own operational activities may not be used to reduce the interest income.

The SARS has alleviated gross interest income inclusion when it comes to "borrow to on-lend" principles. However, the SARS should also take cognisance of the possibility to exclude passive interest as incidental receipts. The reason is that minimal expenses are incurred in producing the passive interest income. This would solve various issues for a

Stellenbosch University http://scholar.sun.ac.za

vendor receiving passive investment income and are required to apportion their mixed expenses.

The effect of non-enterprise activities as discussed in section 2.2 will now be discussed and how these activities influence the apportionment of expenses. It will also focus on the applicability of the turnover-based method of apportionment when enterprise and non-enterprise activities are performed by the business.

4.8 The effect of non-enterprise activities on apportionment

In Chapter 2, section 2.2 of this research assignment, enterprise versus non-enterprise activities were discussed. The non-enterprise activities are those which cannot be attributed to the enterprise as a whole. It involves activities far removed from the normal activities which the enterprise is involved in, leading to the making of taxable supplies together with those indirectly associated with the enterprise.

Where a business is involved in different activities, a distinction between the activities carried on in the course or furtherance of the enterprise and those activities that are removed from the enterprise (which constitute the non-enterprise activities of the business) has to be made for VAT purposes.

The effect of non-enterprise activities for a vendor is that the tax incurred would not qualify for an input tax deduction and will therefore be a VAT cost to the vendor. The vendor therefore has applied direct attribution with regards to the VAT incurred for non-enterprise activities.

The effect of non-enterprise activities with regards to mixed expenses has not been addressed in Chapter 2. Where a vendor is involved in non-enterprise activities, the overhead costs or mixed expenses would be impacted in relation to the non-enterprise activities.

The turnover-based method operates on the presumption that supplies must be made by the vendor. In the case of, for instance dividend income, which is considered to be a non-supply for VAT purposes, the dividend has an attached value to it. This might not be the

case with regards to non-enterprise activities, as the associated supply does not have any valuation attached to it.

In *Income Tax Case No. 1841* (72 SATC 92: 93) an association not for gain made certain taxable supplies when it supplied goods or services otherwise than for a profit or consideration, which were made in the furtherance of its aims and objectives. The supplies was made for *no consideration* and were distributed free of charge. These supplies did not qualify as taxable supplies and were therefore regarded as non-taxable supplies.

The above clearly indicates that *no value* was attached to the supplies made by the vendor. The turnover of the vendor will therefore not reflect the supplies made for no consideration.

This provides a considerable problem in applying the turnover-based method of apportionment to mixed expenses where non-enterprise activities are also present. An excessive deduction of input tax will be claimed by the vendor because the non-enterprise activities are ignored when calculating the turnover of the vendor. Therefore no input tax in respect of mixed expenses would be attributed to the non-enterprise activities of the vendor.

In Binding General Ruling (VAT) No. 16 (Legal and Policy Division, 2013: 2) the following condition is attached to the application of the turnover-based method of apportionment:

> *[t]he vendor may only use this method if it is fair and reasonable. Where the method is not fair and reasonable or inappropriate, the vendor must apply to SARS to use an alternative method.*

The above indicates that where the turnover-based method of apportionment is not reflective of the activities performed by the vendor, the vendor must approach the SARS for an alternative method of apportionment. With regards to non-enterprise activities, the turnover-based is not an appropriate method to use in these circumstances as the method does not take cognisance of mixed expenses attributable to the non-enterprise activities.

The SARS has stated in the Binding General Ruling No. 16 (Legal and Policy Division, 2013: 2) that an alternative method should be applied for by the vendor. This research

Stellenbosch University http://scholar.sun.ac.za

assignment is of the view that the turnover-based method of apportionment is not fair and reasonable where non-enterprise activities are present.

This research assignment is further of the view that the varied input-based method would in all probability be more appropriate to use as an alternative method of apportionment. The reason is that direct attribution of expenses will be carried out by the vendor as discussed in Chapter 2 of this research assignment.

It is further suggested by this research assignment that the SARS clarifies the position with regards to the non-enterprise activities when apportionment is considered. It is suggested that the Binding General Ruling No. 16 is updated with a note that the turnover-based method is not appropriate when non-enterprise activities are present in the enterprise.

4.9 Conclusion

This chapter focussed on the apportionment of mixed expenses for VAT purposes. Binding General Ruling No. 16 (Legal and Policy Division 2013: 2) states that the turnover-based is the only method that may be applied by the vendor without prior approval by the SARS.

In the event that the turnover-based method of apportionment does not result in a fair and reasonable method of apportionment, the vendor may approach the SARS for an alternative method of apportionment under section 41B. Some of the alternative methods were discussed in sections 4.4, 4.5 and 4.6 of this research assignment.

In section 4.6 of this research assignment, the varied turnover-based method of apportionment was examined. In particular, the exclusion of dividend income in the apportionment method was discussed. The nature of dividends in South Africa formed the basis with regards to the inclusion or exclusion of dividend income in the turnover-based method of apportionment.

This research assignment also compared foreign jurisdictions' treatment of dividend income in the turnover-based method of apportionment. The foreign jurisdictions eliminated dividend income form the apportionment method based of the fact that no

Stellenbosch University http://scholar.sun.ac.za

economic activity is attached to the earning of dividend income. Very little or even any expenditure are attached to the earning of dividend income.

This research assignment is therefore of the view that VAT in South Africa is comparable with foreign jurisdictions and that dividend income should be excluded for the turnover-based method of apportionment. The reason is that very little expenses are attributable to the earning of such dividend income. It will further alleviate the issue for vendors that cannot apply any alternative method of apportionment, because no direct attribution of expenses to non-supplies is possible.

It is also suggested by this research assignment that the SARS should issue a Binding General Ruling to include incidental supplies. Incidental supplies are those supplies that happen occasionally. It is also suggested that passive income be excluded from the turnover-based method of apportionment. The reason is similar to the exclusion of dividend income that no or very little expenses are affected by the passive income.

This research assignment contends that the turnover-based method of apportionment is not appropriate when the enterprise is involved with non-enterprise activities. In such a case, the vendor needs to approach the SARS for an alternative method of apportionment. The following chapter will concentrate on whether the apportionment method is *fair and reasonable*. In this regard it will focus on what is meant by *fair and reasonable*.

Chapter 5: A reasonability test when an apportionment method is applied by the registered vendor

5.1 Introduction

In the previous chapter of this research assignment the various apportionment methods were discussed. The apportionment method proposed and applied by the vendor must be *fair and reasonable.* In this chapter the emphasis will be whether the method applied by the vendor is *fair and reasonable*. This chapter will investigate the meaning of *fair and reasonable* and focus on the factors the vendor needs to apply to ascertain whether the apportionment method is *fair and reasonable.*

In chapter 4 of this research assignment it was stated that the turnover-based method is the only method that may be applied without prior approval from the SARS. It must be further noted that in the event that the turnover-based method is not appropriate or does not provide a *fair and reasonable* method of apportionment, the vendor must apply to the SARS for a special dispensation in terms of section 41B.

5.2 Requirements for the apportionment method must be fair and reasonable

In terms of section 17(1), the apportionment method used by the vendor must reflect that only a *fair and reasonable* proportion of VAT is deducted as input tax. The Guide for Vendors (VAT 404) (Legal and Policy Division, 2013: 49) states that the vendor must apply a common-sense approach which would normally be applied by a reasonable person.

The VAT 404 (Legal and Policy Division, 2013: 49) mentions that:

> *[t]he 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.*

The words *fair and reasonable* are not defined in the VAT Act or in any document issued by the SARS. It is therefore important to ascertain the dictionary meaning of the words. The Oxford Dictionaries (2013) defines *fair* to mean *"treating people equally without favouritism or discrimination".*

If this definition is applied in the context of the VAT Act, it could be interpreted to mean that the vendor and the SARS must agree a method that reflects as close as possible the VAT incurred in the making of taxable supplies. Both the SARS and the vendor should believe that the method is appropriate and reflects the correct result. The method should not be more favourable to one party and less favourable to the other.

Merriam-Webster (2013) defines *fair* as *"agreeing with what is thought to be right or acceptable"*. In the VAT context, it seems that the apportionment method is not an exact science but as close to the truth as possible. The method must therefore reflect the taxable use of the input tax deduction.

The Oxford Dictionaries (2013) define *reasonable* to *"have a sound judgement"* or *"as much as is appropriate or fair".* Therefore, the method must be an appropriate method to use which reflects the correct proxy which needs to be applied to the mixed expenses.

Merriam-Webster (2013) also defines *reasonable* as *"possessing sound judgement".* The method should reflect the most accurate result in a VAT context. This research assignment is further of the view that according to the definitions of *fair and reasonable,* the method is subjective in nature.

The VAT 404 (Legal and Policy Division, 2013: 49) also substantiates the view that the method is a subjective concept and states that:

> *[…] 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" for SARS's perspective as well. The result must also be capable of being justified as appropriate in the vendor's circumstances.*

The VAT 404 (Legal and Policy Division, 2013: 49) also mentions that where an extreme result is achieved, it is an indication that the method is inappropriate or the method is not being applied correctly. The VAT 404 (Legal and Policy, 2013: 49) provides an example to illustrate the inappropriateness of a method of apportionment by indicating that

Stellenbosch University http://scholar.sun.ac.za

[…] it would generally be unreasonable to conclude that a vendor whose principle business is the financing of motor vehicle purchases under instalment credit agreements will achieve a de minimis apportionment percentage of 95% or more. […] the vendor would have some difficulty in explaining why the method is "fair and reasonable" where the norm for vendors in that industry ranges, for example, between 50% and 60%. Unless the vendor can explain why its business is so significantly different from the industry norm that its position can be justified, SARS would consider applying a method which is used in that industry. […] another method which is more in line with the industry norm would be "fair and reasonable" in the circumstances.

The above clearly indicates that a vendor should use circumstantial evidence in determining whether the method is appropriate and whether the method provides for a *fair and reasonable* method of apportionment. The evidence gathered by the vendor, for instance, industry methods, will substantiate that the method proposed by the vendor is *fair and reasonable*.

In *Starck v Commissioner for Inland Revenue* (5 SATC 296: 314-316) it was stated that

[…] in a trial for murder, based on circumstantial evidence, when all the facts are proved, the inference to be drawn from them as to the accused being the murderer, remains a question of fact. But to my mind, when certain facts are proved, the question whether they constitute something which is "reasonable" or "fair and reasonable", is a question of law. […] the distribution actually made, and the circumstances of the company, are facts which have been found for us. I think it is competent for us to consider, as a question of law, whether that distribution, in those circumstances, was fair and reasonable, or whether, having regard to those circumstances, it was fair and reasonable for the Commissioner to make a further allocation. Now from what aspect must the Commissioner look at this question of what is fair and reasonable? […] It may be fair and reasonable, from the point of view of the State that shareholders in a company, making such huge profits should contribute more largely to the revenues of the State. But that, to my mind, is not the proper point of view. We must look, not at the equities of the case, or to the proper apportionment to the State's burdens, but, as the Act has it, "to the circumstances of the company". We must see whether in its circumstances a larger distribution is

Stellenbosch University http://scholar.sun.ac.za

> *called for. […] A company cannot be heard to say that it would not be fair and reasonable to make a larger distribution, because the result thereof would be to increase the super tax of its shareholders. I think a fair question to put in cases of this sort – I do not by any means say that it is a conclusive test – is, what would the company have done, if there had been no income tax or super tax? If one comes to the conclusion that it would have distributed its profits […]*

In summary, when the facts of the case are proven, then the question whether they constitute to be fair and reasonable is a question of law. The case focussed on a distribution made by the company which was not considered to be fair and reasonable by the Commissioner for Inland Revenue. The court stated that the distribution actually made constituted the facts before it. As mentioned, the court had to decide whether the distribution made was fair and reasonable or whether the further allocation made by the Commissioner for Inland Revenue constituted a fair and reasonable distribution. It may be fair and reasonable form the point of view of the State that a company making massive profits should make larger contributions. The court did not agree with this view. The court formulated a test that could be used in deciding whether the distribution made was considered to be a fair and reasonable distribution of profits. The test considered whether the distribution would have been performed if there had been no income tax or super tax. If the distribution would have been made irrespective of the tax consequences, the distribution was considered to be fair and reasonable.

The above mentioned passage can equally be applied to the question whether a method of apportionment in a VAT context, is *fair and reasonable*. The issue that requires consideration is whether the apportionment method proposed by the vendor would have been used if it did not have an influence on the deductibility of input tax for VAT purposes.

If the proposed method would have been used by the vendor, irrespective of whether it had any influence on the input tax deduction, the test would probably have been satisfied. The proposed method would probably result in a *fair and reasonable* method. The above also indicates that the *fair and reasonable* test is subjective in nature and that the apportionment method must be *fair and reasonable* for both the vendor and the SARS.

In *Income Tax Case No 1589* (57 SATC 153: 158) the court stated that it could not lay down any general rules on how an apportionment should be made. Having regard to the

Stellenbosch University http://scholar.sun.ac.za

circumstances of the case, an important fact is that the apportionment of expenditure must be *fair and reasonable*.

Income Tax Case No 1589 (57 SATC 153: 158) also provides examples in support of the notion that a method would be *fair and reasonable* to one party but grossly unfair to another, where:

> *[...] an apportionment based on the proposition which the different types of income bear to the total income might be proper […]. In another case, however, such an apportionment might be grossly unfair […].*

The above substantiates that a method of apportionment must be determined based on the facts of each case. There are no hard or fast rules when an apportionment method is proposed by a vendor.

The SARS and the vendor must both be of the opinion that the apportionment method does result in a *fair and reasonable* basis. Both the SARS and the vendor should agree that the method reflects the extent to which the expenses are incurred for the making of taxable supplies. It should reflect the position as close as possible to the actual input tax deduction.

As mentioned in Chapter 4 of the research assignment, the turnover-based method of apportionment is the only method that can be applied by the vendor without specific approval from the SARS. Where the turnover-based method does not result in a *fair and reasonable* approximation of an input tax deduction, the vendor may apply to the SARS for an alternative method.

It must be borne in mind that the onus is on the *vendor* to prove that the turnover-based method is not a *fair and reasonable* method of apportionment. *Income Tax Case No 1589* (57 SATC 153: 159) supports this view by stating that:

> *[…] in all cases dealing with apportionment, the objective is to reach a solution which is fair and reasonable in the circumstances of the particular case. If the taxpayer in not satisfied with the apportionment made by the Commissioner of*

Taxes, the onus is on him to establish that the apportionment is not fair and reasonable.

The vendor and the SARS must be satisfied that the apportionment method does result in a *fair and reasonable* basis of apportionment. It must also be noted that a method may be *fair and reasonable* to one particular vendor but would be grossly unfair to another vendor. The *fair and reasonable* concept was considered by foreign jurisdictions and various policy documents were issued by the United Kingdom in considering whether the method of apportionment is *fair and reasonable.* This research assignment will focus on the treatment of the *fair and reasonable* concept in foreign jurisdictions which could be used in the South African context in determining whether the method proposed by the vendor is considered to be *fair and reasonable.*

5.3 The application of the fair and reasonable test in other jurisdictions

The Partial Exemption Special Methods (PE3040): Fair and reasonable (HM Revenue & Customs, 2013: 1) which applies in the United Kingdom states that the method of apportionment produces a *fair and reasonable* attribution of input tax to taxable supplies if it satisfies the principle of use. The principle of use entails *"that input tax is attributed in accordance with the 'use or intended use' of input tax bearing costs in making taxable supplies".*

The above clearly indicates that the proxy for an apportionment ratio is that the input tax must be attributed in accordance with the intended use in making taxable supplies. This would imply that the method is *fair and reasonable*.

The Partial Exemption Special Methods (PE3040): Fair and reasonable (HM Revenue & Customs, 2013: 1) also mentions that the principle of use means examining the main categories of the business expenditure and to determine how they relate to business supplies. It also states that a *fair and reasonable* method should take risks and potential events into account, otherwise the method's effectiveness would be compromised.

The Partial Exemption Special Methods (PE3040): Fair and reasonable (HM Revenue & Customs, 2013: 1) confirms that:

Stellenbosch University http://scholar.sun.ac.za

> *[f]air and reasonable does not mean that there is only one acceptable method for a business, rather there are likely to be a number of fair and reasonable methods that are equally acceptable. They may give different tax results, although variances are unlikely to be large. The business can choose between them and will probably do so with regard to the complexity and compliance cost, as well as the tax result.*

From the above, various methods may provide an equitable method of apportionment. It must, however, be noted that it must be *fair and reasonable* to all the parties. Where the method provides a more advantageous result to the vendor, the method must still be *fair and reasonable* from a SARS perspective.

The Partial Exemption Special Methods (PE3600): Directing a special method (HM Revenue & Customs, 2013: 1) states that in the event that the Commissioners for HM Revenue & Customs make a direction regarding a special method of apportionment, it would be necessary to demonstrate to the Court that the directed method did secure a *fair and reasonable* attribution of input tax to taxable supplies. The fact that the method proposed by the Commissioners for HM Revenue & Customs is more suitable and reflects a better level of use does not imply that the Commissioners for HM Revenue & Customs had sufficiently justified that the method is more appropriate. The Commissioners for HM Revenue & Customs have to substantiate that the method is a *fair and reasonable* one and will need to demonstrate this by providing sufficient evidence.

It is submitted that the aforementioned is equally applicable within the South African context. Where the SARS is of the view that the method is not appropriate, the SARS will have to demonstrate why the method is not an appropriate method. Although the onus is on the vendor to prove the appropriateness of the apportionment method as decided in *Income Tax Case No 1589* (57 SATC 153: 159), the SARS will also have to demonstrate why the method is not appropriate. The method must be *fair and reasonable*, and both parties should be agreed to the appropriateness of the method.

The Eligibility and Refusal to allow use of retail scheme (VRS2360): Fair and reasonable (HM Revenue & Customs, 2013: 1) for use in the United Kingdom provided some useful comments with regards to whether a method is considered to be *fair and reasonable*. In *Merchant Navy Officers Pension Fund Trustees Ltd* [LON/95/2944], a case decided in the United Kingdom, it was stated that:

> *[w]hat is fair and reasonable is not an absolute concept and will frequently depend on the alternatives. He considered that the phrase applies not only to the result produced by the method but the method itself. The method must be reasonable for the trader to operate, in that is does not involve disproportionate or unreasonable resources, and it should be capable of being checked by the Commissioners again without unreasonable effort.*

The *method* proposed by the vendor should be *fair and reasonable.* The method should be *fair and reasonable* to both the Commissioner and the vendor. A *fair and reasonable* method does not mean that the result of the method is more favourable to the one party than the other. As mentioned above, the method proposed by the vendor must be substantiated by pertinent information to conclude that the method provides a *fair and reasonable* basis of apportionment.

The Partial Exemption Special Methods (PE3600): Directing a special method (HM Revenue & Customs, 2013: 2) also referred to *BMW (GB) Ltd* (VTD 14823) where the following actions should be contemplated:

> *[…] carefully considered a number of proposed methods put to them, explained why they were unacceptable and invited new proposals;*
> *[…] entered into discussions and correspondence with the applicant in relation to their proposals;*
> *[…] indicated that unless they could agree a method they would be prepared to make a direction and waited before making the direction;*
> *[…] the commissioners acted reasonably throughout, exercising patience and tolerance in the discussions and correspondence.*

The aforementioned case confirms that where a vendor applies for a method of apportionment, a process of consultation is important to agree the method of apportionment. This will also indicate that the proposed method is fair and reasonable to both parties. It is also important that the Commissioners for HM Revenue & Customs needs to explain why the proposed method is not considered to be appropriate and invite any other proposals.

Stellenbosch University http://scholar.sun.ac.za

The above would also be applicable in the South African context. The SARS is obligated by law to engage the vendor to search for a method of apportionment that produces a *fair and reasonable* basis of apportionment. As mentioned in Chapter 4 of this research assignment, the vendor must apply for a binding private ruling in terms of section 41B for an alternative method of apportionment.

Where the SARS is of the opinion that the proposed method is not an appropriate method, the SARS must discuss the outcome of the negative ruling with the vendor and afford the vendor an opportunity to remedy the concerns of the SARS in terms of section 79(7) of the TA Act.

In *St Helen's School Northwood Ltd v HMRC* [2006] (EWHC 3306: 27), a case decided in the United Kingdom, the following quote from the judgement is important:

> *[that] a tribunal can substitute its own view for that of Customs in deciding whether proposed special method is fair and reasonable. If on an appeal by a taxable person from a refusal of Customs to allow a proposed special method the tribunal decides that the method is fair and reasonable and also that it is more fair and reasonable than the method in operation (be it the standard method or some other special method), the appeal should be allowed. But if the tribunal thinks that both the existing method and the proposed method are unfair or unreasonable, it could not allow the appeal even if it considers that the proposed special method is less unfair and unreasonable than the existing method.*

The above would also be applicable in the South African context. Where the vendor proposed a method of apportionment which was considered by the SARS to be an unfair and unreasonable method of apportionment, it is submitted by this research assignment that the court will determine whether the proposed method of the vendor is *fair and reasonable*. If the court decides that the method is *fair and reasonable*, the court would further determine whether the proposed method is more *fair and reasonable* than the method proposed by the SARS. If neither method is *fair and reasonable*, the court will not decide in favour of a vendor because the method proposed by him is less unreasonable and unfair than the method proposed by the SARS.

5.4 Conclusion

Fair and reasonable is not defined in the VAT Act. The VAT 404 (Legal and Policy Division, 2013: 49) requires that the method of apportionment must be *fair and reasonable.*

Merriam-Webster (2013) defines *fair* as *"agreeing with what is thought to be right or acceptable".* A *fair* method of apportionment in the VAT context would be a method which is applied by the vendor to claim an input tax deduction on mixed expenses that reflects as close as possible the extent to which an acquisition is used in making taxable supplies. This means that the VAT incurred for mixed purposes should be apportioned on a basis that approximate as close as possible, the real attribution of input tax to the making of taxable supplies.

The Oxford Dictionaries (2013) define *reasonable* to *"have a sound judgement".* Applying the definition in a VAT context, the method must be appropriate in the circumstance of the business. The vendor must evaluate the business as a whole, understand the supplies made by the business and what expenses are incurred for both taxable and exempt supplies. This exercise must be comprehensive.

The vendor should use circumstantial evidence in determining whether the method is *fair and reasonable.* For instance, industry methods would be an added advantage to prove that the method proposed is *fair and reasonable.*

In *Starck v Commissioner for Inland Revenue* (5 SATC 296: 316) the court laid down a test which suggested that a company should determine if it would have used the apportionment method if there had been no income tax or super tax. This is equally applicable in the determination whether the method proposed by the vendor would have been used if it did not depend on the input tax deduction. This would be an indication whether the method proposed by the vendor is *fair and reasonable.*

Income Tax Case No 1589 (57 SATC 153: 158) confirmed that a method of apportionment must be determined based on the facts of each case. Both the vendor and the SARS should be in agreement that the *method* results in a *fair and reasonable* basis.

Stellenbosch University http://scholar.sun.ac.za

Foreign jurisdictions also apply the principle that a method of apportionment needs to be *fair and reasonable*. These principles can be used in the South African context to determine the appropriateness of the method of apportionment.

The Partial Exemption Special Methods (PE3040): Fair and reasonable (HM Revenue & Customs, 2013: 1) states that the method of apportionment produces a *fair and reasonable* basis if it satisfies the principle of use. This means that input tax is attributed in accordance with the use or intended use in making taxable supplies.

The Partial Exemption Special Methods (PE3040): Fair and reasonable (HM Revenue & Customs, 2013: 1) also mentions that the method should be *fair and reasonable* to the SARS and the vendor. It confirms the view of this research assignment that the *method* must be *fair and reasonable*. *Fair and reasonable* does not mean a *fair and reasonable* person, but a *fair and reasonable method*.

The case *St Helen's School Northwood Ltd v HMRC* [2006] (EWHC 3306: 27) is definitely relevant in the South African context. Where the vendor proposed a method of apportionment which was considered by the SARS to be an unfair and unreasonable method of apportionment, it is submitted by this research assignment that the court will determine whether the proposed method of the vendor is *fair and reasonable*.

If the court decides that the method is *fair and reasonable*, the court would further determine whether the proposed method is more *fair and reasonable* than the method proposed by the SARS. If neither method is *fair and reasonable*, the court will not decide in favour of a vendor because the method proposed by him is less unreasonable and unfair than the method proposed by the SARS.

The above clearly indicate that *fair and reasonable* is subjective in nature. The vendor and the SARS should apply a common-sense approach to determine whether the method is appropriate in the circumstances and whether it results in a *fair and reasonable* basis of apportionment.

Chapter 6: Conclusion

6.1 Introduction

This research assignment focussed on the amount of input tax deductible by a registered vendor from expenditure incurred whilst making taxable, exempt, non-supplies or from non-enterprises activities. It further concentrated on the process the vendor needs to follow to determine the input tax deduction.

Before the primary question regarding the input tax deduction for a vendor could be answered, the research assignment had to address the following secondary questions:

- What is meant by an enterprise activity and a non-enterprise activity?
- To what extent can the vendor perform direct attribution with regard to the different supplies being made to the enterprise?
- Which method of apportionment is the most appropriate method to use by the vendor to determine the input tax claimable in respect of goods and services acquired partly for making taxable supplies?
- Whether the method considered to be the most appropriate method of apportionment is fair and reasonable?

6.2 The distinction between enterprise and non-enterprise activities and the effect thereof in claiming an input tax deduction

In chapter 2 the effect of enterprise activities and non-enterprise activities relating to input tax were discussed. The concept of enterprise activities was examined and whether expenditure incurred in relation to such activities would be classified as in the *course or furtherance* of the enterprise.

The different components which constituted an enterprise as defined in section 1(1) were identified. The elements consisted of a *business* or *activity* carried on in the Republic on a *continuous or regular* basis where goods or services are supplied in the *course or*

Stellenbosch University http://scholar.sun.ac.za

furtherance of the enterprise. The VAT payable on the acquisition of goods or services which are performed by the enterprise in the *course or furtherance* of making any taxable supplies will be regarded as input tax that is claimable for VAT purposes. The tax payable will therefore qualify for an input tax deduction.

Where the goods or services were acquired for the purposes of making other than taxable supplies, the tax payable will not be regarded as input tax. The vendor will therefore not be able to claim the said tax as an input tax deduction.

The vendor will have to determine whether the activities performed are connected to the normal objectives of the enterprise (*enterprise activities*) or whether they are far removed from the normal objectives (*non-enterprise activities*). In the first instance, where the expenditure relates to the normal objectives of the enterprise, the goods or services acquired by the enterprise will be regarded in the *course of furtherance* of such enterprise.

Conversely, where the expenditure are removed from the normal business activities of the enterprise, the goods or services acquired for that purpose will fall out of scope for VAT. These activities were classified as *non-enterprise activities*. The tax payable on these activities would not be deductible by the enterprise as input tax.

The Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited (503/2011 [2012] ZASCA 103 confirmed this approach that a vendor needs to determine whether the tax payable concerned the *enterprise activity* or the *non-enterprise activity*. If the tax payable relates to the *non-enterprise activities* of the business, the tax payable will not qualify for an input tax deduction.

6.3 The extent to which the vendor can perform direct attribution with regard to the different supplies being made to the enterprise

Chapter 3 concentrated on the components of the “input tax” definition in section 1(1). These requirements included the following:

- The goods and services need to be *acquired* by the vendor in order to qualify as input tax;
- The purpose for which the acquisition was made;

Stellenbosch University http://scholar.sun.ac.za

- The goods and services need to be acquired in the course of making taxable supplies.

If these requirements are met, the tax payable will be regarded as input tax. The most important requirement is whether the acquisition was made in the *course of making taxable supplies*.

In *Income Tax Case 1744* (65 SATC 154), the *direct and immediate link* test were used in determining whether the tax charged can be regarded as input tax. The test is relevant in the South African context to determine if the tax charged is input tax as defined in section 1(1) and whether the acquisition was made in the *course of making taxable supplies.*

This research assignment is of the opinion that the *De Beers Consolidated Mines Limited* (503/2011 [2012] ZASCA 103 *case* also applied the *direct and immediate link test* to determine whether the expenses were linked to the *enterprise activities* or whether it constituted a *non-enterprise activity*.

The acquisition of goods or services which consist of a *single, composite* and *a multiple supply* was also evaluated with a view to what extent it would be possible to attribute the supply to the various supplies made by the vendor. This research assignment is of the view is that a *multiple supply* can be attributed to taxable, exempt supplies but in the case of a *composite supply* it will not be possible. This is due to the fact that the supply cannot be artificially split into its various components.

6.4 The apportionment method applied by the vendor must be the most appropriate method to use in order to determine the input tax claimable in respect of goods and services acquired partly for making taxable supplies

Chapter 4 focussed on the apportionment of mixed expenses for VAT purposes. Binding General Ruling No. 16 (Legal and Policy Division 2013: 2) states that the turnover-based is the only method that may be applied by the vendor without prior approval by the SARS. In the event that the turnover-based method of apportionment does not result in a *fair and reasonable* method of apportionment, the vendor may approach the SARS for an alternative method of apportionment under section 41B.

Stellenbosch University http://scholar.sun.ac.za

The *varied turnover-based method* of apportionment was considered and in particular, the *exclusion of dividend income* in the apportionment method was discussed. The nature of dividends in South Africa formed the basis with regards to the inclusion or exclusion of dividend income in the turnover-based method of apportionment.

Various foreign jurisdictions' treatment of dividend income in the turnover-based method of apportionment was considered. The foreign jurisdictions eliminated dividend income form the apportionment method based on the fact that no economic activity is attached to the earning of dividend income. Very little or even no expenditure are attached to the earning of dividend income.

This research assignment is therefore of the view that VAT in South Africa is comparable with foreign jurisdictions and that dividend income should be excluded for the turnover-based method of apportionment. The reason is that very little expenses are attributable to the earning of such dividend income.

The exclusion of dividend income from the turnover-based method of apportionment will alleviate the problem for vendors where the vendor cannot apply any alternative method of apportionment, because no direct attribution of expenses to non-supplies is possible. It is suggested by this research assignment that the SARS issue a Binding General Ruling to address this issue.

It is further suggested by this research assignment that the SARS should issue a Binding General Ruling to include *incidental supplies*. *Incidental supplies* are those supplies that happen occasionally. It is also suggested that *passive income* be excluded from the turnover-based method of apportionment. The reason is similar to the exclusion of dividend income that no or very little expenses are affected by the *passive income*.

This research assignment contends that the turnover-based method of apportionment is not appropriate when the enterprise is involved with *non-enterprise activities*. In such a case, the vendor needs to approach the SARS for an alternative method of apportionment.

Stellenbosch University http://scholar.sun.ac.za

6.5 The method of apportionment must be fair and reasonable

The outcomes of the research conducted in chapter 5 can be summarised as follows:

- The SARS requires that the method of apportionment must be *fair and reasonable.*

- A *fair* method of apportionment in the VAT context would be a method which is as close as possible the extent to which an acquisition of goods and services is used in making taxable supplies.

- *Reasonable* on the other hand means, in a VAT context, that the method must be appropriate in the circumstance of the business.

- The vendor should use circumstantial evidence in determining whether the method is *fair and reasonable.*

- An indication that a method is *fair and reasonable* is to determine whether method would have been used if it did not depend on the input tax deduction.

- Both the vendor and the SARS should be in agreement that the *method* results in a *fair and reasonable* basis.

- The method of apportionment produces a *fair and reasonable* basis if it satisfies the principle of use. This means that input tax is attributed in accordance with the use or intended use in making taxable supplies.

- The method should be *fair and reasonable* to the SARS and the vendor. *Fair and reasonable* does not mean *fair and reasonable* to one party but unfair to the other party.

- Where the vendor proposed a method of apportionment which was considered by the SARS to be an unfair and unreasonable method of apportionment, it is submitted by this research assignment that the court will determine whether the proposed method of the vendor is *fair and reasonable*. If the court decides that the method is *fair and reasonable*, the court would further determine whether the proposed method is more *fair and reasonable* than the method proposed by the

Stellenbosch University http://scholar.sun.ac.za

SARS. If neither method is *fair and reasonable*, the court will not decide in favour of a vendor because the method proposed by him is less unreasonable and unfair than the method proposed by the SARS.

- *Fair and reasonable* is subjective in nature. The vendor and the SARS should apply a common-sense approach to determine whether the method is appropriate in the circumstances and whether it results in a *fair and reasonable* basis of apportionment.

6.6 Summary

To conclude, the vendor needs to ascertain whether the tax payable is connected to the normal business objectives of the enterprise. If so, the tax payable on the acquisition of goods and services will be regarded in the course or furtherance of the enterprise. If the tax payable relates to the non-enterprise activities of the business, the tax payable will not be regarded as input tax.

Where the tax payable relates to the enterprise activities, the vendor will have to determine whether the tax payable on goods and services are acquired wholly for the making of taxable supplies. In that case, the tax payable will constitute input tax and the vendor will qualify for a full deduction of the tax paid. Furthermore, where the acquisition of goods and services are used partly for the making of taxable supplies, an apportionment of the tax paid needs to be made by the vendor. The turnover-based method is the only method that the vendor may apply without prior approval from the SARS. The exclusion of dividend income from the turnover-based method of apportionment was supported by this research assignment. Lastly, the apportionment method must provide a fair and reasonable result both to the vendor and the SARS.

Stellenbosch University http://scholar.sun.ac.za

Reference list

Badenhorst, G. 2007. *Tax Ensight. The VAT apportionment debate continues.* [Online]. Available: http://www.ens.co.za/newsletter/briefs/taxApr07apportion.html [2013, August 20]

Badenhorst, G. 2009. *Tax Ensight, VAT blow for associations not for gain.* [Online]. Available: http://www.ens.co.za/newsletter/briefs/taxOct09vat.html [2012 September 20]

Badenhorst, G., Vogelman, G., Fakir, V. 2010. *Tax Ensight, entitlement to claim input tax deductions: the debate continues.* [Online]. Available: http://www.ens.co.za/newsletter /briefs/taxFeb10entitlement.html [2012, August 05]

BLP Group Plc ECJ decision C4/94

BMW (GB) Ltd VTD 14823

Botes, M.C. & De Wet, C.G. 2012. *Commentary on Value-Added Tax.* Juta Law Publishers.

British Airways Plc v Customs and Excise Commissioners [1990]

Canada Revenue Agency. 2004. *Single and Multiple Supplies (P-077R2).* [Online]. Available: http://www.cra-arc.gc.ca/E/pub/gl/p-077r2 [2013, March 05]

CH Beazer (holdings) Plc QB decision [1989] STC 549

Cibo Participations SA v Directeur regional des Impôts da Nord-Pas-de-Calais

College of Estate Management v Commissioners of Customs and Excise [2005]. [Online]. Available: http://www.legal500.com/developments/100 [2013, March 05]

Commissioner for Inland Revenue, New Zealand. 1995. *Tax Information Bulletin: Volume 7, No. 3.* [Online]. Available: http://www.ird.gov.nz/aboutir/newsletters/tib/vol-7/03 [2012, August 05]

Commissioner for Taxation, Australian Taxation Office, Australian Government. 2001. *Goods and Services Tax Ruling (GSTR 2001/8).* [Online]. Available: http://law.ato.gov .au/ atolaw/view.htm?docid=GST/GSTR20018/NAT/ATO/00001 [2013, March 05]

Commissioner for Taxation, Australian Taxation Office, Australian Government. 2006. *Goods and Services Tax Ruling (GSTR 2006/3).* [Online]. Available: http://law.ato.gov. au/atolaw/view.htm?docid=GST/GSTR20063/NAT/ATO/00001 [2012, April 10]

Commissioner for Taxation, Australian Tax Office, Australian Government. 2008. *Goods and Services Tax Ruling (GSTR 2008/1).* [Online]. Available: http://law.ato.gov.au/at olaw/view.htm?DocID=GST/GSTR20081/NAT/ATO/00001 [2012, September 25]

Commissioner for the South African Revenue Service v De Beers Consolidated Mines Limited 503/2011 [2012] ZASCA 103

Commissioners of Customs and Excise v Plantiflor Limited [2002] UKHL 33. [Online]. Available: http://www.publications.parlement.uk/pa/ld200102/ldjudmnt/jd020725/plant-1. htm [2013, March 05]

Company Act No. 71 of 2008

De Koker, A. & Kruger, D. 2007. *Value-Added Tax in South Africa.* Durban: LexisNexis.

Empresa da Desenvolvimento Mineiro SGPS SA ECJ decision C-77/01

Emslie, T.S. 2012. *The Taxpayer.* [Online]. Available: https://www.exacteditions .com/read/the-taxpayer/april-2012-34273/5/2 [2013, November 02]

Fisheries Development Corporation of SA Ltd v Jorgensen and Another 1980 (4) (SA) 156 (W)

Floridienne SA, Berginvest SA v Belgian State Case C-142/99 [2000]

HM Revenue and Customs. 2009. *Partial exemption v1-15.* [Online]. Available: http://www.hmrc.gov.uk/manuals/pemanual

HM Revenue and Customs. 2013. *Partial exemption basics and the standard method (PE1300): Attribution case law.* [Online]. Available: http://www.hmrc.gov.uk /manuals/pemanual/pe1300.htm [2013, March 28]

HM Revenue and Customs. 2013. *Partial exemption special methods (PE3600): Directing a special method.* [Online]. Available: http://www.hmrc.gov.uk/manuals/pemanual /pe3600.htm [2013, September 26]

HM Revenue and Customs. 2013. *Partial exemption special methods (PE3040): Fair and Reasonable.* [Online]. Available: http://www.hmrc.gov.uk/manuals/pemanual/pe3040.htm [2013, September 26]

HM Revenue and Customs. 2013. *Partial exemption special methods (PE3200): Sectorisation.* [Online]. Available: http://www.hmrc.gov.uk/manuals/pemanual/pe3200.htm [2013, September 26]

HM Revenue and Customs. 2013. *The eligibility and Refusal to allow use of retail scheme (VRS2360): Fair and Reasonable.* [Online]. Available: http://www.hmrc.gov.uk/manuals /vrsmanual/vrs2360.htm [2013, September 26]

Irish Tax and Customs Authority. 2001. *Value-Added Tax: A guide to apportionment of input tax.* [Online]. Available: http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=3&ved=OCDkQFjAC&url=http%3A%2F%www.revenue.ie%Fen%Ftax%2Fvat%Fleaflets%Fguideapp.doc&ei=vv2SUoblDK217Aa4i4D4Dg&usg=AFQjCNE-L3HI_z2ILSa21NCnucyR3yzTsQ

Irish Tax and Customs Authority. 2006. *Mixed Supplies of Goods and Services.* [Online]. Available: http://www.revenue.ie/en/tax/vat/leaflets/mixed-supplies-goods-services.html [2013, August 20]

ITC 1589 57SATC 153

ITC 1744 65 SATC 154

ITC 1841 72 SATC 92

Kruger, D. 2012. *Business Tax & Company Law Quarterly, VAT incurred in relation to M&A activity revisited-The dragons rejoice. Volume 3, Issue2.*

Legal and Policy Division, South Africa Revenue Service. 1999. *VAT News Issue 13.* [Online]. Available: http://www.sars.gov.za/Legal/Archive/Pages/VATNews.aspx [2012, April 15]

Legal and Policy Division, South African Revenue Service. 2006. *Interpretation Note No. 30 (Issue 2).* [Online]. Available: http://www.sars.gov.za/Legal/Interpretation-Rulings/Interpretation-Notes/Pages/Numbers_21-40.aspx [2012, September 25]

Legal and Policy Division, South African Revenue Service. 2008. *VAT News Issue 32.* [Online]. Available: http://www.sars.gov.za/Legal/Archive/Pages/VATNews.aspx [2013, August 13]

Legal and Policy Division, South African Revenue Service. 2010. *VAT News Issue 35.* [Online]. Available: http://www.sars.gov.za/Legal/Archive/Pages/VATNews.aspx [2012, September 15]

Legal and Policy Division, South African Revenue Service. 2011. *The Guide for Fixed Property and Construction (VAT 409).* [Online]. Available]: http://www.sars.gov.za/Pages/See-More.aspx?pageid=C62 [2012, April 11]

Legal and Policy Division, South African Revenue Service. 2011. *VAT News Issue 37.* [Online]. Available: http://www.sars.gov.za/Legal/Archive/Pages/VATNews/aspx [2012, April 15]

Legal and Policy Division, South African Revenue Service. 2012. *Binding General Ruling No. 10.* [Online]. Available: http://www.sars.gov.za/Legal/Interpretation-Rulings/Published-Binding-Rulings/Binding-General-Rulings/Pages/BGR-1-20.aspx [2012, April 10]

Legal and Policy Division, South African Revenue Service. 2007. *Guide for Vendors (VAT 404).*

Stellenbosch University http://scholar.sun.ac.za

Legal and Policy Division, South African Revenue Service. 2012. *Guide for Vendors (VAT 404).*

Legal and Policy Division, South African Revenue Service. 2013. Personal interview. 30 September, Cape Town.

Legal and Policy Division, South African Revenue Service. 2013. *Guide for Vendors (VAT 404).* [Online]. Available: http://www.sars.gov.za/Tax Types/VAT/Pages/default.aspx

Legal and Policy Division, South African Revenue Service. 2013. *Binding General Ruling (VAT) No. 16.* [Online]. Available: http://www.sars.gov.za/Legal/Interpretation-Rulings/Published-Binding-Rulings/Binding-General-Rulings/Pages/BGR1-20.aspx [2013, August 04]

Merchant Navy Officers Pension Fund trustees Ltd [LON/95/2944]

Merriam-Webster. 2013. [Online]. Available: http://www.merriam-webster.com

Meyerowitz, D. 2004. *Meyerowitz on Income Tax 2003-2004.* Cape Town: Creda Communications (Pty) Ltd.

Mobile Telephone networks Holdings (Pty) Ltd v The Commissioner for the South African Revenue Service (Case no. A5033/10)

Oxford Dictionaries. 2013. [Online]. Available: http://www.oxforddictionaries.com

R v Peters [1886] 16 QBD 636

Republic of South Africa. 1995. *Third Interim Report of the Commission of Enquiry into certain aspects of the Tax Structure of South Africa.* Pretoria: Government Printer

Schneider, F. 2010. *Net interest (or interest factor) to vary the VAT standard method of apportionment in South Africa.* [Online]. Available: http://www.kpmg.com/za/en/issueand

insights/articlepublications/tax-and-legal-publications/pages/vat-method-of-apportionment.aspx [2013, November 04]

Sofitam (Satam) SA v Ministre du budget Case C-333/91 [1993]

Starck v Commissioner for Inland Revenue 5 SATC 296

Stephan v Commissioner for Inland Revenue [1919] WLD 1 32 SATC 54

St Helen's School Northwood Ltd v HMRC [2006] EWHC 3306

Swinkels, Dr Joep J.P. 2008. *Some Aspects of Input Tax Deduction under the Pro Rata of the EU VAT System*

Tax Administration Act 2011 Act No. 28 of 2011

Value-Added Tax Act 1991 Act No. 89 of 1991

Van der Zwan, P. & Stiglingh, M. 2011. *The deductibility of value-added tax on cost incurred to raise share capital: A critical analysis of the ITC 1744 case.* [Online]. Available: http://www.dejure.up.ac.za/index.php/en/volumes/44-vol-2-2011/articles/van-der-zwan-p.-a-stiglingh-m.html [2013, April 05]

Van Dorsten, J.L. 1993. *The law of dividends in South Africa.* Cape Town: Obiter Publishers CC

Wilson,F., Williams, R.C., Penny, C., PricewaterhouseCoopers. 2009. *Synopsis, Associations not for gain-Giving away more than you bargained for.* [Online]. Available: http://www.pwc.co.za/en/publications/synopsis.jhtml-nov-dec-2009-pdf [2012, September 20]