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TAX & EXCHANGE CONTROL **ALERT**

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VAT apportionment v direct attribution: A (preliminary) win for the taxpayer

The debate between taxpayers and the South African Revenue Service (SARS) as to what constitutes a fair and appropriate apportionment formula to determine the deductible value added tax (VAT) incurred on expenses where the taxpayer makes both taxable and exempt supplies, is ongoing. However, it is up to the taxpayer to determine whether an expense incurred is wholly attributable to making taxable supplies, in which case the total amount of VAT incurred is deductible. SARS cannot rule beforehand on whether an expense is directly attributable to taxable supplies, by virtue of a notice published in terms of section 80(2) of the Tax Administration Act 28 of 2011 (GN No. 748 24 June 2016), known as the so-called *"no-rulings"* list.

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The debate between taxpayers and the South African Revenue Service (SARS) as to what constitutes a fair and appropriate apportionment formula to determine the deductible value added tax (VAT) incurred on expenses where the taxpayer makes both taxable and exempt supplies, is ongoing. However, it is up to the taxpayer to determine whether an expense incurred is wholly attributable to making taxable supplies, in which case the total amount of VAT incurred is deductible. SARS cannot rule beforehand on whether an expense is directly attributable to taxable supplies, by virtue of a notice published in terms of section 80(2) of the Tax Administration Act 28 of 2011 (GN No. 748 24 June 2016), known as the so-called "*no-rulings*" list.

The Tax Court (Megawatt Park, Sunninghill) was recently called upon in the case of *ABC (Pty) Ltd v The Commissioner for the South African Revenue Service* (Case No: VAT 1626 – 3 March 2020) to determine whether the VAT on certain expenses incurred by the taxpayer were wholly attributable to making taxable supplies and therefore fully deductible as input tax, or whether the expenses were subject to apportionment. The Tax Court found in favour of the taxpayer and held that the VAT was fully deductible as input tax.

The facts and issues considered

The taxpayer carries on business as a *bureau de change* in the course of which it exchanges travellers' cheques and currencies for inbound and outbound travellers. It carries on business in three separate divisions, being the head office, treasury and a branch network of 52 branches. The treasury division is responsible for setting exchange rates for buying and selling foreign currencies to the customers and sets the rate of the currency and adds a margin thereon. The branch network is responsible for the exchange and sale of foreign currencies to customers. The branch processes the currency exchange transactions of customers and charges the customer a commission or fee for its services.

The taxpayer argued that its branch network only makes taxable supplies for which it charges commissions or fees to customers, and that the total amount of VAT incurred on expenses by its branch network is deductible as input tax.

The Tax Court had to consider whether the branch network only made taxable supplies, or whether it was involved in making both taxable and exempt supplies.

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The Tax Court stated that the taxpayer's treasury division is responsible for buying and selling the foreign currency and sets the daily buy and sell rates for the branches.

Legal framework

The relevant provisions of the Value Added Tax Act 89 of 1991 (VAT Act) which were considered by the Tax Court in deciding the matter, are the following:

Section 2(1)(a) deems the activity comprising of the exchange of currency to be a financial service. Section 12(a) exempts from VAT the supply of a financial service.

The proviso to section 2(1) excludes from "*financial services*" the activity comprising of the exchange of currency to the extent that the consideration payable for the activity is any fee or commission.

The definition of the terms "*goods*" and "*services*" both exclude money. "*Money*" is defined to include any bill of exchange. This definition is similar to the definition of "*currency*" in section 2(2), which defines the word to mean any banknote or other currency of any country.

The term "*consideration*" is defined to mean, in relation to the supply of goods or services by any person, any payment made or to be made in respect of, in response to or for the inducement of the supply of any goods or services.

Judgment

The case concerns the exchange of currency, which involves the buying and selling of currency against the payment of a commission or fee. The Tax Court stated that the taxpayer's treasury division is responsible for buying and selling the foreign currency and sets the daily buy and sell rates for the branches. The services rendered at the branches involve customers buying and/or selling foreign currency notes in person at the branch, for which the branches charge a commission or fee.

The taxpayer led evidence that the services rendered at the branches are administratively intense and time-consuming, as forms need to be

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The Tax Court seems to have accepted the taxpayer's arguments that the profit margin was not a payment made in respect of, in response to, or for the inducement of, the exchange of currency.

completed, data needs to be captured in systems, and cash needs to be counted. FICA compliance must be ensured and SARB requirements must be met.

The judgment turned on the interpretation of the proviso to section 2(1)(a) to determine whether the taxpayer only made taxable supplies at the branches, which justified the direct attribution applied by the taxpayer. The issue was whether the exchange of currency falls within the definition of "*financial services*", the supply of which is exempt under section 12(a) of the VAT Act.

The Tax Court considered the contractual arrangement under which the supply is made. The agreements provide for the exchange of specified currencies at a particular rate of exchange nominated by the taxpayer, and the payment by the customers of a commission. The margin at which the taxpayer purchases and sells foreign currency is not part of the agreements, as it is not known by the treasury division or the customer when the transaction is closed at the branch.

The Tax Court commented that it will be absurd and untenable to decide VAT consequences of transactions with reference to margins or profits earned by vendors as opposed to relying on the true nature of the rights and obligations arising from a particular contract.

The Tax Court found on the facts and the evidence that the only payment that the customer makes for the exchange of currency is the commission or fee. The consideration in the form of a commission removes the activity of the "*exchange of currency*" from being a deemed financial service. The margin which the taxpayer made when buying or selling foreign currency was not considered to be relevant for purposes of deciding the case. The Tax Court seems to have accepted the taxpayer's arguments that the profit margin was not a payment made in respect of, in response to, or for the inducement of, the exchange of currency. The margin was part and parcel of the exchange, of which the customer was ignorant. The margin was further not a term of the contract, but was a consequence for the taxpayer of the terms of the contract, because it produced a profit for the taxpayer.

The Tax Court concluded that the only consideration charged for the exchange of the currency was the taxable commission or fee, and that the branches therefore only made taxable supplies. The VAT incurred by the branches on their expenses was consequently directly attributable to such taxable supplies, and as such the VAT qualified in total as input tax.

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The appeal court will have to determine, amongst others, whether the Tax Court was correct in finding that the exchange of currency is neither the supply of goods nor services; whether the charging of a commission or fee removes the exchange of currency completely from being a financial service; and whether the margin earned by the taxpayer is irrelevant for determining the VAT status of the supplies.

Costs

Section 130(1) of the Tax Administration Act allows for an order for costs to be made in certain specific circumstances. However, it is rarely the case that an order for costs is made by the Tax Court.

In this case the Tax Court considered the grounds of assessment and the decision of SARS to disallow the input tax deduction to be unreasonable, *"especially for insisting that the appellant reverts to and must continue to use the apportionment method and not the direct attribution method without any legal justification in circumstances where it was reasonable to expect it to"*. Consequently, SARS was ordered to pay the costs of the taxpayer.

Appeal

In view of the significance of the judgment and the implications thereof, it is not surprising that SARS has applied for leave to appeal, which we understand has been granted. The appeal court (the Supreme Court of Appeal or the High Court) will have to determine, amongst others, whether the Tax Court was correct in finding that the exchange of currency is neither the supply of goods nor services; whether the charging of a commission or fee removes the exchange of currency completely from being a financial service; and whether the margin earned by the taxpayer is irrelevant for determining the VAT status of the supplies.

Vendors who operate on a similar basis as the taxpayer in this case should consider the judgment with caution, as an appeal court could interpret the relevant provisions of the VAT Act differently and overturn the judgment of the Tax Court.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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