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GLOBAL TRENDS IN VALUE-ADDED TAX: THE INCLUSION OF PASSIVE INCOME IN APPORTIONMENT FORMULAE

Name: Tampe Mothibi Seepamore

Student number: THBTAM001

Supervisor: Adjunct Associate Professor Deborah Tickle

Department of Finance and Tax in the Faculty of Commerce

The University of Cape Town

University of Cape Town

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ABSTRACT:

This dissertation explores the inclusion of passive income such as dividends and interest in the Value-Added Tax (VAT) apportionment methods, from a South African VAT perspective. The study aims to determine whether the current approach is distortive for taxpayers and whether it aligns with the VAT guidelines provided by the Organisation for Economic Co-operation and Development (OECD).

The research begins with an overview of the history of VAT and general VAT principles, providing a foundation for understanding the context in which apportionment methods operate. The OECD VAT guidelines are examined in detail to establish the internationally accepted principles of tax policy, including neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.

Drawing on a comparative analysis of VAT regimes in selected countries, including New Zealand, the European Union (EU), and the United Kingdom (UK), the study evaluates how these jurisdictions handle VAT apportionment and the inclusion of passive income in apportionment formulas. Key insights are gained from examining the methodologies and approaches employed by these countries.

The findings indicate that the inclusion of passive dividends and interest in the apportionment calculation causes distortions in the South African VAT system. In contrast, other countries have adopted strategies that reduce the incidence of distortions in their VAT apportionment approaches. For instance, New Zealand focuses on intended use when determining the income to be included in the apportionment formula and excludes dividend income and proceeds from shares from the apportionment calculations as they fall outside the scope of VAT and all distortive supplies. Similarly, the UK determines through case law, how holding companies should incorporate income and excludes distortive supplies in apportionment calculations.

Based on the research findings, several recommendations are proposed. The implementation of these will align the South African VAT system with the OECD guidelines and the apportionment approaches in other jurisdictions.

They include amending the VAT Act to ensure consistency between passive income and the expenses incurred to earn it, adopting an intended taxable use approach similar to New Zealand, exploring zero-rating options for financial services, excluding distortive supplies from the apportionment methodology and addressing the treatment of holding companies for VAT purposes. These recommendations aim to create a fair and accurate apportionment method in South Africa, aligned with international best practices and promoting VAT neutrality.

Continuous research, consultation with stakeholders, and monitoring of global trends are advised to refine and improve the South African VAT system.

PLAGIARISM DECLARATION

I, Tampe Mothibi Seepamore, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole or any part of it has been, is being, or is to be submitted for another degree in this or any other university. I authorise the University to reproduce for the purpose of research either the whole or any portion of the contents in any manner whatsoever.

Signature: Signed by candidate Date: 22 April 2024

ABBREVIATIONS AND TERMINOLOGY

B2B	Business-to-business, referring to a type of transaction that takes place between one business and another.
B2C	Business-to-consumer, as in a transaction that takes place between a business and an individual as the end customer.
GST	Goods and Services Tax
GST Act	Goods and Services Tax Act, 1985
HMRC	Her Majesty's Revenue and Customs
ITA	Income Tax Act 58 of 1962
NZ GST Act	New Zealand Goods and Services Tax Act 1985
OECD	Organisation for Economic Cooperation and Development
Republic	South Africa
SA	South Africa
TAA	Tax Administration Act No. 28 of 2011
VAT	Value-Added Tax
VAT Act	South African Value-Added Tax Act, 89 of 1991
Vendor	Any person who is registered or is required to register for VAT/GST

CHAPTER ONE: INTRODUCTION

BACKGROUND

According to the Organization for Economic Co-operation and Development's ("OECD") Value-Added Tax ("VAT") or Goods and Services Tax ("GST") Guidelines[1] the main goal of a VAT/GST is to impose a general tax on consumption, which refers to a household final consumption. Technically the VAT system's target is private individuals and not businesses. However, in practice, any failure to deduct input tax may have a cascading effect where tax is levied at every stage of the sale. Effectively, in such cases, the business levies VAT on a value that already includes VAT (passes the non-deductible input tax on), thus the consumer ends up paying VAT on already-paid VAT which increases the price charged (consumer cannot deduct the "hidden" input VAT).

The South African Value-Added Tax Act, 89 of 1991 ("VAT Act") allows for a vendor who pays VAT when acquiring goods or services or when importing goods, to make taxable supplies, to claim a refund or deduct input tax against output tax on those purchases. In practice, a vendor may make both taxable and non-taxable, exempt, supplies. Section 17 of the VAT Act requires a vendor that makes both taxable and exempt supplies, to determine the extent to which supplies made to it are used for taxable purposes and to only claim a refund or deduction to that extent. The South African Revenue Service's ("SARS") VAT Guide 404[2] reiterates this requirement when it states "…when goods or services are not acquired exclusively for taxable supplies, you will be required to determine the part that relates to taxable supplies and deduct input tax only to that extent."

Taxpayers can determine the ratio of taxable use by using a methodology determined by the Commissioner in terms of an advance ruling[3] contemplated in Chapter 7 of the Tax Administration Act No.28 of 2011("TAA"). This ruling is a binding general ruling[4] or section 41B ruling that is a VAT class ruling or a VAT ruling. All three are a written declaration from SARS concerning the application of a tax act, in this case the VAT Act.

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[1] OECD. (2017). International VAT/GST Guidelines. Page 4, note 1. https://www.oecd-ilibrary.org/docserver/9789264271401-en.pdf?expires=1712577359&id=id&accname=guest&checksum=D54F53B476444D8E3F0A145F7D22B390 [Accessed June 2023]

[2] https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-VAT-G02-VAT-404-Guide-for-Vendors.pdf [Accessed June 2023]

[3] An advance ruling in section 75 of the Tax Administration Act No.28 of 2011 includes a binding general ruling and the purpose is to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act.

[4] Section 75 of the Tax Administration Act No.28 of 2011 defines it as a written statement issued by a senior SARS official under section 89 regarding the interpretation of a tax Act or the application of a tax Act to the stated facts and circumstances.

The standard turnover method is pre-approved in SARS Binding General Ruling 16 (BGR16)[5] (issue 2), which is an approved ruling as per chapter 7 of the TAA and was brought into effect on 1 April 2015 and is applicable until it is withdrawn. This BGR16, like other BGR's is binding of SARS to the extent that it applies to the taxpayer in accordance with section 83[6].

The calculation is:

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

Where:

"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).

As "b" and "c" are seemingly all-encompassing and, in the absence of a proxy or limitation of the inclusion, vendors are compelled to include all dividends and interest received when calculating their apportionment ratio, which distorts the apportionment calculation and decreases the recoverable ratio[7].

Where an entity earns interest income, there are VAT apportionment methodologies such as the net interest method, which deducts from interest income the interest expense incurred to earn that interest[8].

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[5] https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BGR/LAPD-IntR-R-BGR-2013-05-BGR16-Standard-Apportionment-Method.pdf [Accessed 10 June 2023]

[6] Section 82 of the Tax Administration Act No.28 of 2011 states that SARS is bound by an advance ruling if it applies to a person in terms of section 83 of the Tax Administration Act No.28 of 2011. Section 83 – "Applicability of advance rulings 83. A 'binding private ruling' or 'binding class ruling' applies to a person only if— (a) the provision or provisions of the Act at issue are the subject of the 'advance ruling'; (b) the person's set of facts or 'transaction' are the same as the particular set of facts or 'transaction' specified in the ruling; (c) the person's set of facts or 'transaction' falls entirely within the effective period of the ruling; (d) any assumptions made or conditions imposed by SARS in connection with the validity of the ruling have been specified or carried out"

[7] Where the taxable use is equal to or exceeds 95% of the total use or consumption, the full amount of VAT can be deducted as input tax.

[8] According to the sample of rulings published by SARS an example of which is: SARS. (2024). VR 004 - Apportionment. Retrieved from https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/VR/Legal-IntR-R-VR-004-Apportionment.pdf [Accessed 09 May 2023]

For dividends earned, the proxy that can be used is to limit the inclusion of dividends earned by limiting them to management fees charged by a holding company[9]. In the pre-approved standard turnover method however, an entity is compelled to include all the interest and dividends earned. Vendors generally derive dividend income from equity investments, and the payment of dividends generally depends typically on the availability of distributable reserves of the subsidiary company concerned. For interest, entities sometimes put excess cash in bank deposit (call or fixed term etc.) or even debentures. These savings tools generally require nothing from the investor once established. There are, therefore, little or no specific expenses incurred by the vendor to generate such dividend income.

According to the Davis Tax Committee[10], the formula requires that receipts in respect of which very few, if any, taxable expenses are incurred are included in the apportionment formula, most notably dividends and interest income which is passive in nature. The inclusion of dividends and other passive income like interest in the denominator of the turnover-based apportionment formula is not the general practice globally[11]. Including income that is not a consequence of enterprise activity, compromises the neutrality of VAT which is one of the fundamental tenets of VAT. The VAT deduction aims to relieve entities entirely of the burden of the VAT payable or paid in the course of all its economic activities[12]. The goal of this research project is to evaluate whether the present standard turnover method of apportionment, as pre-approved by SARS, is in line with the OECD guidelines and, if not, to provide suggestions for how it could be amended to do so. In addressing the research question the principles of apportionment and input tax deduction are looked at.

RESEARCH OBJECTIVE

The research objective is to ascertain if including interest, which is a financial service[13] as defined by the VAT Act and is thus exempt[14] from VAT, and dividends, which are outside the scope of VAT, in the denominator of the apportionment calculation causes distortions for South African vendors.

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[9] For instance, a holding company may limit the dividends included in the formula at R100 if it charges R100 in management fees and receives R200 in dividends.

[10] Davis Tax Committee. (2015). VAT Review: First Interim Report. Retrieved from https://www.taxcom.org.za/docs/20150707%20DTC%20VAT%20First%20Interim%20Report%20-%20website.pdf. p 62. (Accessed: [April 2023]).

[11] Ibid p 62.

[12] Costea, I.M., 2013. Jurisprudential accents on the notion of economic activity in value added tax matter. AGORA Int'l J. Jurid. Sci., p.21. -p. 19

[13] VAT Act – Section 2

[14] VAT Act – section 12(a)

The purpose of the study is to ascertain if, in comparison to other regimes, the standard turnover method and other apportionment methodologies, which incorporate dividends and interest into the formula, are unduly restrictive in the South African context. Furthermore, it will be considered whether the difficulties vendors currently face when they are unable to deduct input tax may be solved by applying the OECD standards and the apportionment policies of other jurisdictions.

The questions that the research will answer are:

- Is there an approach that South Africa can adopt to ensure that the inclusion of dividends and interest is commensurate with the expenses and efforts expended to earn this income?
- What do the OECD guidelines say vis-à-vis a vendor's ability to deduct input tax?
- What methodologies are used by jurisdictions outside of South Africa to determine whether or not dividends and interest should be included in apportionment formulae? This will include a review of case law, both South African and outside of South Africa, which deals with the inclusion of dividends and interest and/or the passive nature of earning this income.

RESEARCH METHODOLOGY

The proposed study will involve Doctrinal and comparative legal research with evaluative investigation[15] of how VAT apportionment procedures, specifically concerning the treatment of dividends and interest in those methodologies, evolved into what they are today in South Africa and elsewhere.

This will include analysing the OECD Guidelines that may provide guidance on the rights of vendors to deduct input tax. Then comparing this to apportionment formulae in other jurisdictions whose VAT regimes are similar to South Africa. Specifically, those which operate VAT systems that incorporate the key elements outlined in Chapter 1 of the OECD VAT Guidelines[16] being basically any national tax by whatever name or acronym it is known by that has the basic features of a VAT i.e. a broad-based tax on final consumption.

[15] https://chilot.files.wordpress.com/2011/06/legal-research-methods.pdf. p 102 to 103. Accessed: [April 2023]).

[16] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

These are systems with broad-based taxes on final consumption that are predominantly not borne by enterprises and are collected through a staged collection procedure whether by the invoice credit method or the subtraction method,[17] which methods will be explained in chapter two below. In particular, this study will concentrate on New Zealand, the European Union and the United Kingdom, the justifications for selecting these countries are provided below.

LIMITATIONS OF THE STUDY

Apportionment methodologies include various income and expenses, however this study will focus on dividends and interest and the inclusion thereof. In the quantitative design, the comparative analysis will be limited to countries with 'modern' VAT regimes like South Africa.

BRIEF OVERVIEW OF THE CHAPTERS

In order to achieve the stated objective and answer the research questions this dissertation sets out the following Chapters:

CHAPTER ONE: INTRODUCTION

This chapter sets out the background and purpose of the study. It also describes the research objectives and rationale and the research problem. In addition, the limitations, underlying assumptions, key terms and the research design and methods are also defined.

CHAPTER TWO: THE OECD AND VAT

This chapter focuses on: the history of VAT, technical and policy factors relevant to the research objective, the OECD, its history, the OECD's VAT principles, and a summary of the OECD Guidelines on the deductibility of input tax.

CHAPTER THREE: THE SOUTH AFRICAN LANDSCAPE

This chapter will discuss the South African VAT regime, with an in-depth look at South African VAT legislation, section 17 thereof, Binding General Ruling 16 ("BGR16") and the inclusion of dividend and interest income in apportionment methodologies, as well as relevant South African court cases, and a comparative analyses with the applicable OECD guidelines.

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[17] https://www.oecd.org/tax/consumption/oecd-international-vat-gst-guidelines-2014.pdf. p 6. Accessed: [April 2023]).

CHAPTER FOUR: COUNTRY BY COUNTRY COMPARATIVE STUDY OF DIVIDEND INCLUSION IN APPORTIONMENT METHODOLOGIES

This chapter will discuss the VAT regime in other jurisdictions. New Zealand is selected as South Africa based its VAT regime on New Zealand's then current GST Act of 1985. The European Union ("EU") is selected as it has 27 VAT registered countries and thus analysing the EU approach, with the number of countries within the EU, will likely add significantly to the research. The United Kingdom is selected as it launched VAT in 1973[18] and its approach to the research subject may give valuable insights. The emphasis will be on the countries' VAT legislation, VAT apportionment regulations, pertinent court cases and a comparison to the relevant OECD guidelines.

CHAPTER FIVE: FINDINGS OF THE STUDY

This chapter is a reflective examination of the VAT apportionment approaches used, with particular attention to the incorporation of passive income in these computations. The chapter evaluates how insights from these international practices and legal precedents can be adapted to refine and enhance South Africa's VAT apportionment methods. It will also reflect on the impact of the OECD VAT/GST Guidelines[19], influence on South Africa's apportionment methodology. It will look at the results of the research conducted and the research findings and then consider whether the research objectives have been met.

CHAPTER SIX: RECOMMENDATIONS AND CONCLUSION

This chapter concludes the study by translating the findings into practical recommendations and reflecting on their implications. It underscores the necessity for South Africa to adapt and evolve its VAT apportionment methodology to ensure it remains aligned with the principles of VAT and international best practices.

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[18] https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim31501. (Accessed: [April 2023])

[19] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

CHAPTER TWO: BIRTH OF VAT AND THE OECD's ROLE

INTRODUCTION

This chapter will discuss the origins and development of VAT, the key characteristics that make a good VAT system and what influences VAT policy. The chapter will then look at the role of the OECD in the development of VAT policies and unpack the OECD's International VAT/GST Guidelines[20] ("The Guidelines").

THE EVOLUTION OF VAT GLOBALLY

As of November 2020[21], 170 nations and territories throughout the world have introduced a form of Value-Added Tax (VAT). This includes every OECD country excluding the United States[22].

After the First World War, in 1918, a German businessman Dr. Wilhelm von Siemens ("Von Siemens") recognized the problem of purchasers being unable to claim consumption taxes incurred in the production cycle. This led to an accumulation of taxes at each stage of production, ultimately increasing the prices of goods. To address this issue, Von Siemens developed a "new" tax, which is now referred to as VAT. Through VAT, his aim was to create a tax system that allowed purchasers to recover the taxes incurred during the production process, thereby preventing the continuous increase in prices[23].

On the other hand, in 1921 an American, Thomas S. Adams ("Adams"), came up with a form of a sales tax with a credit or refund for taxes paid by the purchaser on purchases acquired for on-supply to avoid the tax on tax effect. This proposal paved the way for the invoice credit method as we now know it[24]. While their contributions were made independently and in different countries, both Von Siemens and Adams sought to address the issue of tax inefficiency in the production cycle and paved the way for the development of VAT.

The staged collection process has two approaches, the most common is the transaction based invoice-credit method. With this approach each entity in the production chain charges (output) VAT at the applicable rate and issues the purchaser with an invoice.

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[20] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

[21] https://www.oecd-ilibrary.org/sites/1ca62ced-en/index.html?itemId=/content/component/1ca62ced-en (Accessed: [April 2023]).

[22] Grinberg, I., 2009. Where Credit Is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT. Tax L. Rev., 63, p.309.

[23] Ibid p 25

[24] Ibid p 25

The purchaser is able to then reduce the output tax payable, based on their sales, with the input tax incurred on their purchase expenses and only the balance is payable to or receivable from the revenue authority[25]. There are various ways of giving effect to this method with the most popular being, tax (output) less tax (input): which is known as the subtractive-indirect, invoicing, or credit method. Another lesser used approach, is an entity based one known as the subtraction method. Under this method, VAT is calculated by deducting the amount paid for inputs from taxable sales and multiplying it by the applicable tax rate[26]. Japan is one of the few economies that uses some features of this subtraction-method to impose a VAT.

VAT has gained popularity due to its revenue raising capabilities and neutrality. Its broad-based nature makes it an attractive tax[27].

In the book, Tax Law Design and Drafting, Thuranyi details an ideal VAT model as one that describes a broad-based VAT designed to encompass every kind of economic transaction, with limited exceptions. This model involves drafting a comprehensive provision that imposes VAT on a wide range of business transactions and subsequently excludes specific transactions that are not liable for VAT.[28]

In his book "The Wealth of Nations", Adam Smith, a Scottish social philosopher and political economist[29], presented the canons of taxation and defined numerous principles that lead to a good taxation system. The canons are, essentially, amongst others: equity, neutrality, simplicity and efficiency[30]. These are discussed in more detail below.

Although the canons of tax were first stated quite some time ago, the discussion of taxation's guiding principles continues to be built upon these canons.

In October 1998 a Ministerial Conference on Electronic Commerce was held in Ottawa. The generally accepted principles of tax policy were welcomed by OECD Ministers, observers from non-OECD countries, heads of international organisations, business leaders, and representatives of labour, consumer, and social interests present[31].

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[25] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).
[26] Tait, M.A.A., 1988. *Value added tax: International practice and problems* (Vol. 24). International Monetary Fund -p 5
[27] Cnossen, S., 1998. Global trends and issues in value added taxation. *International Tax and Public Finance*, *5*(3), pp.399-428.
[28] Victor Thuranyi, ed Tax Law Design and Drafting, IMF (1996), vol 1, chapter 6, p 20
[29] https://www.britannica.com/biography/Adam-Smith (Accessed: [April 2023]).
[30] http://www.treasury.gov.za/publications/other/katz/3.pdf - p 2 (Accessed: [May 2023]
[31] OECD (2017), International VAT/GST Guidelines, OECD Publishing, Paris - p 17. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

Although the conference's focus was on electronic commerce, it followed the existing VAT principles that were founded on Adam Smith's tax framework and detailed in the OECD' s "Addressing the Tax Challenges of the Digital Economy"[32]:

Neutrality: Taxation should aim to be neutral and fair. A neutral tax will increase productivity by ensuring that the best possible distribution of the means of production is made. When price changes cause different changes in supply and demand than those that would occur in the absence of tax, there will be a distortions. This interpretation of neutrality includes the requirement that the tax system maximise revenue while minimising bias in support of or against any specific economic decision. A tax is said to be neutral, where there are no enticements for businesses or individuals to change: their behaviour, their investment decisions, their working decisions (working more or less), living in one location as opposed to another, employing more or less labour or capital[33].

Efficiency: Taxation should aim to minimize compliance costs for businesses and administrative costs for tax authorities, promoting efficient operations and resource allocation.

Certainty and simplicity: The tax laws must be clear and simple to understand in order for taxpayers to foresee the tax consequences of a transaction in advance. This includes understanding when and how the tax must be accounted for. Understanding one's obligations and entitlements is made simpler for both individuals and businesses by a straightforward tax system. Businesses are therefore more likely to decide wisely and implement planned policy decisions. Complexity can also lead to aggressive tax planning, which could result in economic deadweight losses.

Effectiveness and fairness: To avoid double taxation and unintended non-taxation, taxes should be collected at the right time and the correct amount. It is also important to reduce the chance of evasion and avoidance. The OECD Technical Advisory Groups (TAGs) considered that the general public may see a tax as unfair and ineffective if there is a class of taxpayers that is nominally liable to it but is never obligated to pay it because it cannot be enforced.

[32] OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-en. (Accessed: [May 2023])

[33] https://www.gradingstates.org/the-tax-foundations-state-business-tax-climate-index/the-sbtci-is-a-poor-measure-of-growth-potential/what-tax-neutrality-means-and-why-businesses-dont-care/. (Accessed: [May 2023])

As a result, policymakers carefully consider whether tax rules can actually be enforced. Since it affects how taxes are administered and collected, enforceability is crucial to guaranteeing the efficiency of the tax system.

Flexibility: Taxation systems need to be adaptable and dynamic enough to ensure they keep pace with changes in business, technological and commercial developments. This will allow the tax system to accommodate government's ongoing needs for revenue. This means that the structural features of the system should be resilient in a changing policy context, yet flexible, taking into account that future developments will often be difficult to predict. These should always be the guiding principles when countries establish tax legislation and policy.

EXEMPTIONS AND ZERO RATING

Keen, a former deputy director of fiscal affairs at the IMF and author, writes that a VAT that is well-designed and applied must raise significant revenue while being fair, efficient, and practical. To do this, other than for exports, the tax should avoid zero-rating and have few exemptions[34]. Although having a single uniform rate that applies to all consumption is efficient, no nation currently has such a system[35]. The majority of countries that have a VAT system exclude some goods or services from the VAT net. These exclusions are used by governments and policymakers to address social policy, justice, economic neutrality, reduce administrative burden, and satisfy political objectives. Concessions in the VAT system can weaken the neutrality of VAT, increase the likelihood of tax evasion, and complicate administration[36].

Exclusions from VAT are provided in one of two ways, either exemption or charging that good or service with VAT at the zero rate. Whether a supply is exempt or charged with VAT at a zero rate, there is no VAT applied to the final charge for the good or service to the purchaser thereof.

An exempt supply is where the service is considered not taxable altogether. Exemptions can cause cascading since, whilst the supply is not subject to VAT, the supplier is not permitted to deduct any of the tax levied on the inputs.

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[34] Keen, M., 2009. What Do (and Don't) We Know about the Value Added Tax? A Review of Richard M. Bird and Pierre-Pascal Gendron's The VAT in Developing and Transitional Countries. *Journal of Economic Literature*, *47*(1), pp.159-70.

[35] Davis Tax Committee, 2018. Final report on VAT for the Minister of Finance. – p 19 Available at: https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf. (Accessed: [April 2023]).

[36] National Treasury Republic of South Africa. The VAT Treatment of Merit Goods and Services [online]. http://www.treasury.gov.za/publications/other/vat%20merit%20goods%20final%20report%20%20-%2015%20oct%202007.pdf (Accessed: [April 2023]).

This unclaimed VAT remains in the chain of supply until the end consumer pays VAT on the final product or service. The VAT on the final supply effectively includes VAT paid on VAT from earlier in the chain.[37].

There are two types of goods and services that are typically exempt from VAT: 'merit exemptions' such as healthcare, cultural activities and education services and 'technical exemptions', applied to supplies that are 'difficult-to-tax' and fit into the ordinary VAT regime, like financial and insurance services[38].

As alluded to above, an exempt entity is treated as the end-consumer, where they use inputs of taxable goods and then sell their outputs to taxable businesses for further processing, the effective tax rate on the finished product will exceed the statutory rate and cascading has taken place. Additionally, any mark-up the exempt entity adds is not subject to VAT. This construct disadvantages customers that are VAT registered as they cannot access the VAT that is included in the purchase price. Then the VAT incurred on those expenses becomes a cost for that customer. If a business only makes exempt supplies it would not be required to register for VAT and would operate outside of the VAT net.

Some implications flow from having exemptions, one of these is that VAT exemptions can disrupt the VAT chain, where VAT is imposed on entities down the supply chain, and the non-deductibility of the input tax on the previous link in the chain can thus lead to a net increase in the total price and the concomitant VAT by the final consumer. Economists and authors Crawford, Keen and Smith argue that exemptions undermine the logic of VAT by breaking the chain of credit and refund, introducing an element of production taxation.[39].

On the other hand, zero-rating means the good or service is subject to VAT, albeit at zero per cent or an exemption with an input tax credit[40]. The business would charge VAT at zero per cent, meaning that it has a zero output VAT liability and can claim a refund of the input tax on expenses incurred in earning this zero-rated income. A vendor that makes zero-rated supplies, in excess of that jurisdiction's VAT registration threshold, would be required to register for VAT.

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[37] Keen, M.M. (2013). "Targeting, cascading, and indirect tax design." International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/wp/2013/wp1357.pdf [Accessed June 2023], p. 18.

[38] De la Feria, R., 2013. *VAT exemptions: consequences and design alternatives*. Kluwer Law International p 5

[39] Crawford, I., Keen, M. and Smith, S., 2010. Value added tax and excises. *Dimensions of tax design: the Mirrlees review*, *1*, pp.275-362.

[40] Walter Hellerstein & Harley Duncan, VAT Exemptions: Principles and Practice, 128 TAX NOTES 989, 991–92 (2010) at supra note 11, at 990 n.7.

The underlying effect is thus different for an exempt and a zero-rated supplies as exemption disentitles a VAT-registered person from claiming a deduction of the VAT suffered on acquiring taxable business purchases, while zero-rating does not.

THE OECD VAT GUIDELINES AND VAT FRAMEWORK

The majority of countries have adopted similar principles for the operation of their VAT system, however, even between OECD member countries, there are many differences in the way it is implemented. These differences come from a variety of factors, including the exemptions and unique arrangements that exist in the different jurisdictions due to their unique policy objectives. In some instances, concepts that are the same or similar are interpreted differently[41].

The OECD is a forum where governments collaborate to address the economic, social and environmental challenges brought on by globalisation. The OECD provides a forum for governments with similar challenges to compare their policies more efficiently, which also assists them in identifying best practices and coordinating national and international policies[42]. The OECD currently has 38 member countries and five key partners who represent about 80% of the world's trade and investment[43].

The OECD's work in taxation and taxation policy began in the 1950's, eventually broadening and intensifying in the 1980's, considering bilateral tax treaties and the treatment thereof by some member states[44]. In the late 1990's the OECD Committee on Fiscal Affairs ("CFA"), working with business, revealed that the then existing international consumption tax environment was hampering corporate activity, stifling economic growth, and interfering with competitiveness, particularly concerning trade in services and intangibles. The CFA acknowledged that, amongst others, double taxation and non-taxation were severe enough to require remedies for all affected jurisdictions.

In 2006, the CFA embarked on a project to develop The Guidelines[45]. These guidelines were created to serve as a benchmark for nations in creating and administering domestic legislation.

[41] https://www.oecd.org/ctp/consumption/36177871.pdf - At Preface paragraph 5. Available at: https://web-archive.oecd.org/2012-06-15/146403-36177871.pdf. (Accessed: [May 2023])

[42] OECD. (2014). *Guidelines for Multinational Enterprises - Southern Africa – p 2.* Available at: https://www.oecd.org/daf/ca/SOE-Guidelines-Southern-Africa.pdf [June 2023].

[43] https://www.oecd.org/general/Key-information-about-the-OECD.pdf (Accessed: [June 2023])

[44] Carroll, P. and Kellow, A., 2011. *The OECD: A study of organisational adaptation*. Edward Elgar Publishing.

[45] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

New Zealand is one of the OECD member states[46] and South Africa's VAT system was modelled after the GST model in New Zealand[47]. In 2007, South Africa joined Brazil, China, India, and Indonesia as one of the OECD's five Key Partners following approval at the OECD Ministerial level Council[48]. Key partners make dependable and wide-ranging contributions to the OECD's work. South Africa participates in 15 OECD projects and bodies and is an associate in 6. Additionally, it is also an Associate and key member of the implementation steering group in the Base Erosion and Profit Shifting (BEPS) project it is also part of the African Tax Administration Forum (ATAF) Technical Committee[49].

When the OECD global forum on VAT held its inaugural conference in Paris in November 2012, one of the topics of discussion was how VAT is a type of consumption-based indirect tax. The fact that it is a non-cascading (as far as possible), multi-stage transaction tax is crucial. Although it is a tax on businesses, VAT is only collected when purchases are made, not when they are utilised. The purpose of a VAT is to levy a tax obligation on the ultimate consumer at the point of consumption. Business to consumer ("B2C") sales account for the majority of fiscus revenue for VAT. Business to business ("B2B") sales generate money for the fiscus if "exemptions" apply; otherwise, net tax is collected on B2B sales.[50]

In April 2014, at the second meeting of the OECD Global Forum on VAT held in Tokyo, Japan, SARS' Lesley O'Connell Xego gave a presentation on the impact of the VAT guidelines on South Africa[51] during which she indicated that South Africa was involved as a partner country. The presentation's conclusion stated that South Africa cannot and should not minimise the significance of the rules, their impact on international VAT systems, and their significance for the future growth of SA's VAT.

The OECD Guidelines were completed in 2015, and on July 7, 2015, the CFA accepted them. In November 2015, during the third meeting of the OECD Global Forum on VAT, representatives from 104 countries and international organisations endorsed the Guidelines. On September 27, 2016, the Guidelines were incorporated in the "Recommendation on the Application of Value Added Tax/Goods and Services Tax to the International Trade in Service and Intangibles".

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[46] List of OECD Member countries - Ratification of the Convention on the OECD. Available at: https://www.oecd.org/about/document/ratification-oecd-convention.htm. (Accessed: [April 2023]).
[47] Schenk, A, Oldman, O.2007. *Value Added Tax: A Comparative Approach*. Cambridge University Press p 71
[48] https://www.oecd.org/southafrica/south-africa-and-oecd.htm#:~:text=In%202007%20the%20OECD%20Council,a%20sustained%20and%20comprehensive%20manner.
[49] https://www.oecd.org/southafrica/south-africa-and-oecd.htm
[50] https://www.oecd.org/ctp/consumption/PptpresentationsessionmaterialGFonVAT.pdf
[51] https://www.oecd.org/ctp/consumption/presentation-session-2-lesley-oconnell-south-africa-second-global-forum-on-vat.pdf

The OECD Council urged member and non-member nations to consider its international VAT/GST Guidelines[52].

Most recently, on 30 September 2022, South Africa signed the Multilateral Instrument ("MLI") which is a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("BEPS") which follow the results from the OECD BEPS project[53].

Given South Africa's ongoing relations with the OECD, it is vital to focus on the OECD's recommendations regarding VAT and its implementation in South Africa.

There are several VAT/GST guidelines, but this discussion focuses on those relevant to the research subject.

STRUCTURE OF THE GUIDELINES

The OECD VAT/GST Guidelines comprises four chapters[54]:

Chapter one covers the core features of VAT and includes the purpose of VAT, its central design feature, VAT and international trade and the application of generally accepted tax policy principles for VAT.

Chapter two covers achieving neutrality of VAT in the context of cross-border trade.

Chapter three covers how to determine the place of taxation for cross-border supplies of services and intangibles.

The fourth and final chapter covers the practical aspect of the guidelines and how to support them, including mutual co-operation, dispute minimisation, and application in cases of evasion and avoidance.

Chapters one and two of the Guidelines are relevant to this research paper.

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[52] Walter Hellerstein, An Introduction to the OECD's International VAT/GST Guidelines, 2016 J. Tax'n 256 (2016), Available at: https://digitalcommons.law.uga.edu/fac_artchop/1112 (Accessed: [May 2023]

[53] https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (Accessed: [May 2023]

[54] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

THE MECHANICS OF A VAT ACCORDING TO CHAPTER ONE OF THE OECD VAT GUIDELINES

According to the OECD VAT guidelines[55], VAT is designed to relieve businesses of the burden of the VAT incurred when purchasing goods and services. Essentially the burden of the tax should not fall on businesses. A VAT's main objective is to impose a broad-based tax on the final consumption by households[56]. The basic characteristic of VAT is that it is, amongst other things, an economically neutral[57] tax. Whatever the product, the distribution chain, or the method used for delivery, the purchaser should be able to deduct input tax at all points of the supply chain. Input tax is the VAT that is borne by a vendor when acquiring goods and services from other vendors[58].

A key feature of VAT is its collection in a phased manner. Each entity in the supply chain charges tax proportional to its margin, the difference between the VAT levied on its taxed inputs and the VAT applied on the taxed products. Consequently, the tax is collected by the tax authority on the "value added" at each stage of production and distribution[59].

The most prevalent way of implementing this staged approach of VAT is the invoice-credit method which is a "transaction-based" method. Each trader applies VAT at the applicable rate for the supply they make and issues each customer with an invoice that details the description of the goods or service it renders and the value of the tax levied thereon. The purchaser can, in turn, if applicable, use the VAT reflected on that invoice or VAT incurred on that expense as a credit or input tax against the output tax payable on its sales. The VAT vendor must remit the difference between the output tax and the input tax in any particular tax period to the revenue authorities or receive a refund, whichever is applicable[60].

Charging VAT and claiming input tax by each vendor in the supply chain, except the final consumer, gives VAT its economically neutral nature.

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[55] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris- p 15. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

[56] Ibid p 14

[57] https://www.gradingstates.org/the-tax-foundations-state-business-tax-climate-index/the-sbtci-is-a-poor-measure-of-growth-potential/what-tax-neutrality-means-and-why-businesses-dont-care/

[58] Definition in section 1 Of the VAT Act

[59] OECD (2017), International VAT/GST Guidelines, OECD Publishing, Paris - p 15. Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

[60] Ibid p 15

NEUTRALITY OF VAT ACCORDING TO CHAPTER TWO OF THE OECD VAT GUIDELINES

The various facets of VAT neutrality are introduced in Chapter 2 of the OECD VAT standards. It explains that VAT must be fair, neutral, and impartial and must not burden businesses with extra taxes or compliance costs.[61].

One of the benefits of VAT is its neutrality as relates to decisions made by economic building blocks like capital and labour, consumers, workers and other stakeholders. While external neutrality governs how domestic and international companies interact, in the domestic market neutrality is attained by implementing a multi-stage payment system that enables the deduction of input tax on expenses incurred and the charging of the output tax to customers. This protects the "flow through design" of VAT ensuring that the tax burden is incumbent on the final consumer in the VAT chain.

The OECD guideline 2.1 states "The burden of value-added taxes themselves should not lie on taxable businesses, except where explicitly provided for in legislation"[62]. To meet the requirements of this guideline, at each point in the value chain, the supplier must be permitted to deduct the input tax incurred from its output tax liability[63]. This ability to deduct the input tax deals with the cascading that was discussed at the inaugural Paris conference and is discussed here, above and below.

Due to the inability of exempt businesses to deduct the input tax on expenses incurred to earn their exempt income, the business is compelled to pass the VAT inclusive expense on to the customer through an increased price. To the extent that this customer is not the final consumer, they would also add their value-add and carry this inflated price forward. This introduces a cascading effect when applied in a B2B context. Contrary to the idea of VAT neutrality, this cascading leads to the inclusion of VAT more than once in the cost price of supplies. The competitiveness of enterprises is subsequently impacted by this increase. To achieve VAT neutrality in domestic trade, vendors pay VAT to suppliers on expenses incurred and receive VAT from customers on its outputs. They deduct the amount paid from the amount received and pay only the balance to the tax authority.

[61] Ibid p 15
[62] Ibid p 20
[63] Ibid p 31

While the OECD, in line with Adam Smith's tax framework, detailed in chapter two, advises that a viable alternative to raising VAT rates is to broaden the tax base by cutting the number of exemptions, which improves the tax's efficiency and neutrality[64], the commentary[65] on the rules clarifies that Guideline 2.1's aim is not to prevent nations from passing legislation that limits or prohibits the deduction of input tax and acknowledges that there may be compelling reasons to choose to exempt specific supplies from VAT.

Additionally, it makes clear that the reference to explicit provisions in the legislation in Guideline 2.1 includes detailed provisions made under the law, such as in regulations or as a result of the exercise of administrative powers granted by the legislation, in addition to explicit provisions found in the law itself. Court rulings can also be detailed provisions. All OECD countries have exemptions which are included in the legislation. Examples of these explicit provisions include exemptions imposed for public service-type transactions, such as social, educational, and cultural reasons, or situations where it is difficult to determine the tax base of the outputs, such as in the case of financial services, where some components represent elements of saving or investment rather than immediate consumption. Administrative reasons that may result in input tax not being deducted including where a vendor does not have the necessary documents to substantiate the input tax deduction or where the vendor is incurring expenses outside of their enterprise activity.

Guideline 2.3 [66] states that "VAT rules should be framed in such a way that they are not the primary influence on business decisions."

Several factors inform company decisions including financial, commercial, social, environmental and legal factors. According to this guideline, while VAT is a factor that should be considered, it should not be the major determinant of a business's decisions. The amount of tax ultimately paid to revenue authorities, the compliance costs associated with the collection, payment, or refund of the tax, such as filing tax returns and keeping adequate records, and the financial costs associated with the cash-flow impact of the VAT system are all factors that must be taken into account. VAT regulations must be accessible, understandable and reliable to uphold the neutrality principle[67].

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[64] European Commission (2010), Green Paper on the Future of VAT, "Towards a simpler, more robust and efficient VAT system" – p 10 paragraph 1.5.2. Available at: https://taxation-customs.ec.europa.eu/document/download/494f70a7-9c8f-4549-b5f6-7cc65143d375_en?filename=com%282010%29695_en.pdf. [Accessed 5 June 2023]

[65] OECD. (2012). Tax Challenges Arising from Digitalisation – Economic Impact Assessment Report. Retrieved from [https://www.oecd.org/ctp/consumption/50667035_ENG.pdf] [Accessed 5 June 2023]

[66] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. p 31 Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

[67] OECD (2017). International VAT/GST Guidelines. OECD Publishing, Paris. p 22 Available at: https://doi.org/10.1787/9789264271401-en. (Accessed: [April 2023]).

According to the comments in guideline 2.3, not adhering to the other guidelines such as ensuring that the tax burden lies on end consumers, ensuring similar business are subject to similar tax amongst others, is typically what leads to breaking guideline 2.3. Business decisions are influenced by the amount of tax paid to tax authorities, the compliance difficulties, and the financial expenses related to the cash-flow impact of the VAT system. When jurisdictions set out VAT policies, the policies should not force companies to operate in a particular way.

CHAPTER TWO SUMMARY

The primary objective of this chapter was to describe the formation and historical context of VAT policy. It also examined the fundamental tax principles that guide OECD policy and constitute the core of tax globally.

The OECD recommendations have been reviewed that are pertinent to the research question. The chapter covered the importance of neutrality in taxes and a how a well-designed VAT system should aim to raise significant revenue while maintaining fairness, efficiency, and practicality. Minimizing exemptions and zero-rating, except for exports, is crucial in achieving these objectives. While exemptions can have cascading effects and disrupt the VAT chain, zero-rating allows for refunds of input tax on expenses. The OECD provides guidelines and a framework for VAT implementation, facilitating international collaboration and best practice sharing among member countries and key partners. Understanding these guidelines and implementing them effectively can contribute to the growth and success of a country's VAT system.

CHAPTER THREE: THE SOUTH AFRICAN LANDSCAPE

This chapter will focus on VAT in the South African context. The chapter will first discuss the birth and evolution of VAT in South Africa. Then it will go into the deductibility of VAT with a focus on input tax, direct attribution and VAT apportionment.

EVOLUTION OF VAT IN SOUTH AFRICA

VAT was implemented in South Africa ("SA") from September 1991[68] in terms of Act 89 of 1991. The South African VAT system is a "modern" VAT system that has few exemptions, zero-ratings and exclusions[69]. SA VAT is destination based, it taxes consumption of goods and services within its borders subject to some exceptions[70].

According to the National Treasury's VAT report[71], before the introduction of VAT in SA, a decision was made to introduce minimal VAT exemptions and support the poor as much as possible outside of the tax system.

In SA, some supplies are charged at the standard rate of VAT, currently 15 per cent[72]. Other supplies are charged with tax at the rate of zero per cent subject to compliance with specified requirements, the detail of which is not relevant to this dissertation[73]. Some supplies are exempt from VAT[74].

The following supplies are exempt from VAT in SA: non-fee-related financial services, supplies by associations not for gain made from any donated goods, the supply of land outside the Republic, supplies by a body corporate to its members, educational services provided by an approved educational institution, residential rental housing, supplies by an employee organisation to any of its members, supplies of crèche and after-school care, goods supplied by a non-resident that are not cleared for home consumptions and public road and rail transport[75].

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[68] Davis Tax Committee. (2015). VAT Review: First Interim Report. Retrieved from https://www.taxcom.org.za/docs/20150707%20DTC%20VAT%20First%20Interim%20Report%20-%20website.pdf. p 12. (Accessed: [April 2023]).

[69] Ibid p 13

[70] South African Revenue Service. 2017. VAT 404 Guide for Vendors. Available: http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-VAT-G02%20- %20VAT%20404%20Guide%20for%20Vendors%20-%20External%20Guide.pdf [Accessed 5 June 2023]

[71] National Treasury Republic of South Africa. The VAT Treatment of Merit Goods and Services [online]. http://www.treasury.gov.za/publications/other/vat%20merit%20goods%20final%20report%20%20-%2015%20oct%202007.pdf

[72] Section 7 of the VAT Act

[73] Section 11 of the VAT Act

[74] Section 12 of the VAT Act

[75] https://static.pmg.org.za/docs/Zero-rated%20and%20exempt%20supplies.pdf Available at: https://www.treasury.gov.za/comm_media/presentations/Zero-rated%20and%20exempt%20supplies.pps (Accessed [May 2023]

According to the SA VAT Act, the amount payable per tax period[76] is determined by reducing the output tax payable with the VAT incurred on expenses incurred in the course of making Vatable supplies[77] unless the expense is incurred in acquiring an item that is specifically denied for VAT purposes[78]. Input tax is claimable on expenses incurred to make taxable supplies (both standard rated and zero-rated). However, in line with the OECD VAT Guidelines, registered VAT vendors are not permitted to deduct any input tax in respect of goods or services acquired in the course of making exempt[79] supplies.

INPUT TAX

The VAT Act defines "input tax" as tax charged under section 7 of that Act and payable by a vendor on purchase of goods or services. It is the VAT that is charged by the supplying vendor. It also arises where a vendor pays tax on the importation of products by that vendor[80]. Input tax is essentially the tax owed by a vendor when he purchases items or services only for "consumption, use, or supply" in the course of providing taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent that the vendor acquires the goods or services concerned for such purpose. As a result, the definition of input tax in the VAT Act[81] excludes the tax charged when incurring expenses to make exempt supplies.

DIRECT ATTRIBUTION

Section 16(3)[82] read with section 16(2)[83] as well as the definition of "input tax" in section 1(1)[84] permits the VAT incurred by a VAT vendor on the acquisition of goods or services to be deducted as input tax.

Direct attribution means that the expense is either wholly for making taxable supplies, in which case input tax can be claimed in full; or wholly for making exempt supplies or for other non-taxable purposes, in which case no input tax can be deducted.

Where the expense cannot be attributed to the making of either exempt or non-taxable supplies, or taxable supplies (i.e. "mixed use" expense), the expense must be apportioned in accordance with section 17(1).

[76] Section 1 of the Tax Administration Act No.28 of 2011 read with section 27 Of the VAT Act
[77] Section 16(3) Of the VAT Act
[78] Section 17(2) Of the VAT Act
[79] Section 12 Of the VAT Act
[80] Section 1 Of the VAT Act
[81] Section 1 Of the VAT Act
[82] of the VAT Act
[83] Ibid
[84] Ibid

APPORTIONMENT

The first proviso in section 17(1)[85] contains the *de minimus* rule which permits entities to deduct the full input tax where the intended use of goods or services in the course of making taxable supplies is equal to or exceeds 95 percent of the total use or consumption i.e. where the apportionment ratio is equal to or exceeds 95 percent of the total use or consumption.

Section 17(1)[86] requires that where goods or services are acquired partly for taxable[87] and partly for exempt[88] (or other) purposes, only a portion of the input tax may be deducted. Accordingly, when goods and/or services are not acquired exclusively for the purpose of making taxable supplies (i.e. "mixed use" supplies), a vendor will be required to determine the part that relates to taxable supplies and only deduct input tax to that extent. However, before apportioning the input tax, a vendor must directly attribute the VAT incurred on any expenses, where relevant, according to the intended purpose for which it will be utilised.

An important consideration when establishing the method used in apportioning input tax is that it should objectively reflect a fair and reasonable attribution of input tax related to taxable supplies. The method of apportionment should therefore aim to provide a more accurate result regarding the actual expenditure incurred in relation to taxable supplies made.

Unless specific expenses can be allocated to exempt versus non-exempt supplies, an analysis of the entity's income and expenses must be undertaken to evaluate the appropriate apportionment method to determine an appropriate method of apportionment.

The VAT Act does not set out a method of apportionment to be used, however, in section 17(1) it allows SARS to prescribe a method by issuing a binding general ruling in terms of Chapter 7 of the TAA or section 41B of the VAT Act. In March 2013 (Issue 1) and then updated in March 2015 (Issue 2) the SARS Commissioner issued BGR16 under section 89 of the TAA. In section 75 of the TAA a binding general ruling is defined as a written statement issued by a senior SARS official under section 89 regarding the interpretation of a tax Act or the application of a tax Act to the stated facts and circumstances. An advance ruling is defined in section 75 of the TAA, as well, and is defined as a binding general ruling.

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[85] Section 17(1)(i) Of the VAT Act

[86] Section 17(1) Of the VAT Act

[87] Section 1 Of the VAT Act – "Taxable supply" means any supply of goods or services which is chargeable with tax in terms of the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent under section 11.

[88] Section 1 Of the VAT Act – "exempt supply" means a supply that is exempt from tax under section 12. The SARS VAT 404 – Guide for Vendors defines an exempt supply as a supply on which no VAT may be charged (even if the supplier is registered for VAT). Persons making only exempt supplies may not register for VAT and may not recover input tax on purchases to make exempt supplies.

Section 76 of the TAA determines the "purpose of advance rulings" and the system to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act by creating a framework for the issuance of 'advance rulings'". Section 82 of the TAA confirms that a BGR is enforceable against SARS, subject to section 83 of the TAA and the applicability of an advance ruling to a taxpayer.

Currently, the only method of VAT apportionment pre-approved by SARS, is the turnover-based method of apportionment. This method of apportionment is revenue based and requires the ratio of taxable revenue to total revenue to be applied. The standard turnover-based method suggests that there is a positive correlation between the use of goods and services, and the different categories of income received by an entity.

Standard turnover based method

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

Where:

"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).[89]

The research focus of this dissertation is the inclusion of income that is earned relatively passively or that is not necessarily at the core of a particular entity's enterprise activity such as dividends earned and interest in the above formula (the denominator).

The risks and consequences associated with cascading VAT, have been a subject of concern in tax reform discussions. Cascading introduces complexity and opacity to tax structure and can undermine the transparency and simplicity necessary for an effective tax system.

[89] SARS Binding General Ruling (Vat): No. 16 (Issue 2)

VAT cascading was noted as a crucial issue for discussion in the DTC: First Interim Report on VAT[90] ("DTC Report") which was published in December 2014 and signed by its chair

The Cascading Effect

Action	Cost	10% Tax	Total
Buys raw material	100	10	110
Manufactures @ 40	150	15	165
Adds value @ 30	195	19.5	214.5
Adds value @ 20	234.5	23.45	257.95
Total	190	67.95	257.95

Judge Dennis Davis. In line with the OECD, tax cascading is characterized by taxing items that have already been taxed[91], resulting in a significantly larger tax burden on society. It is where a tax is placed on another tax rather than on specific economic activity (from the table above it can be seen that cascading is the tax charged on the tax amount included at every link in the chain- the table assumes the VAT can't be reclaimed).

About two decades prior to the DTC Report, in 1991, India established a Tax Reform Committee chaired by Raja J.Chelliah.

The ensuing Chelliah Report[92] discussed one of the risks associated with cascading. One of the consequences of cascading is an opaque tax structure that lacks transparency and simplicity, which are essential criteria for an effective tax system. This is because the build-up of tax through the production cycle depends on the input and output flows. The report stated that consumer price increases resulting from cascading exceed the revenue raised by the government, leading to deadweight losses.[93] Simplistically, cascade effects cause consumer price increases that go beyond what the revenue authority collects and the consumer losses outweigh government revenue.

As indicated in chapter two above, the OECD guideline 2 emphasizes that the burden of VAT should not be on taxable business. For example, an entity making exempt supplies incurs expenses in the process of making these exempt supplies.

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[90] Davis Tax Committee. (2015). VAT Review: First Interim Report. Retrieved from https://www.taxcom.org.za/docs/20150707%20DTC%20VAT%20First%20Interim%20Report%20-%20website.pdf page 8. (Accessed: [April 2023]).

[91] Keen, M.M. (2013). "Targeting, cascading, and indirect tax design." International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/wp/2013/wp1357.pdf [Accessed May 2023], p. 4.

[92] Kwatra, G. K. (1993). CHELLIAH COMMITTEE ON TAX REFORMS : A REVIEW. Journal of the Indian Law Institute, 35(1/2), 34–64. http://www.jstor.org/stable/43952324

[93] https://www.imf.org/external/pubs/ft/wp/2013/wp1357.pdf

These expenses likely include VAT but the entity is precluded from deducting the VAT incurred on these expenses because they are incurred for other than taxable purposes. The distortive effects of exemptions depend on where in the supply chain they are applied. If applied before the retail stage, business to customer, then it leads to cascading, as the supplier will not be able to deduct input tax and, subject to demand elasticity, will include the VAT cost in the price and pass it to the customer. Even if the customer was incurring the expense for taxable purpose, it would not be able to deduct the "hidden VAT" that the price was inflated by. Should the exemption be applied at an intermediate stage of the supply chain, then the end consumer will pay a higher effective tax rate than the statutory tax rate. The distortive effects of cascading hinder the efficiency and fairness of the VAT system, highlighting the need for careful consideration of exemption provisions to mitigate these effects.

Another disadvantage of reducing the input tax that an entity can deduct is that it can dissuade businesses from outsourcing services and rather opt to vertically integrate and produce inputs themselves[94]. Although it did not cite any empirical evidence to support the assertion, a New Zealand tax working group discussed this issue in its working paper[95] for taxing financial services. It claimed that disallowing input tax deductions on financial services leads to an "in-source bias" where the institutions that provide financial services avoid using third-party services because of the non-deductible input tax.

The impact of VAT cascading on investment incentives is not a direct one but can be understood within a broader economic rationale. The ability to deduct input tax on expenses incurred to make supplies has the potential to serve as an incentive for investment in specific products or sectors. While empirical evidence may be lacking in the specific context of VAT cascading, there are indications from other discussions and reports. For instance, the decline in global trade growth and the dim investment outlook reported by the OECD[96] suggests a correlation between reduced investment incentives and the disallowance of input tax deductions. Furthermore, taxation policies, including VAT, play a crucial role in promoting the growth of small and medium-sized enterprises (SMEs).

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[94] Keen, M.M. (2013). "Targeting, cascading, and indirect tax design." International Monetary Fund. Available at: https://www.imf.org/external/pubs/ft/wp/2013/wp1357.pdf [Accessed June 2023], p. 21.

[95] Tax Working Group Information Release.* (September 2018). Available at: https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-3961034-taxing-financial-services.pdf [Accessed June 2023], p. 11.

[96] OECD. (2020). *Financing SMEs and Entrepreneurs 2020: An OECD Scoreboard.* OECD Publishing, Paris. Available at: https://doi.org/10.1787/061fe03d-en.

Global surveys of SME development have shown that a supportive legal framework, including taxation policies, plays a crucial role in promoting business growth[97]. To make the point, while this is not specifically related to VAT but incentives in general, business angels that are generally individuals or groups of common investors and not necessarily companies, invest in other businesses (typically start-ups etc. that need cash injections). In South Africa, these angels do not receive any form of fiscal support and do not have the special tax incentives that are available to business angels in other countries[98]. This can reduce the angel investors' enthusiasm to invest.

Investors have internal and external constraints, the internal ones are due to their circumstances and investment needs while the external ones include tax, amongst others[99]. To illustrate that taxes impact businesses, especially small and medium businesses, a table from the 2nd OECD conference of ministers responsible for small and medium-sized enterprises[100] ("SME's) is provided.

Table 1. Ranking: Percentage of Firms that Considered Obstacle to be Major

Rank	All Firms		Small Firms		Medium Firms		Large Firms	
1	Financing	36.5	Financing	38.9	Financing	38.0	Policy instability	29.8
2	Inflation	34.6	Inflation	36.9	Taxes and regulation	37.2	Financing	27.9
3	Policy instability	34.4	Taxes and regulation	35.5	Inflation	36.1	Inflation	26.2
4	Taxes and regulation	33.5	Policy instability	35.0	Policy instability	36.0	Street crime	23.9
5	Exchange rate	28.0	Street crime	30.6	Exchange rate	29.7	Corruption	23.4
6	Corruption	27.7	Corruption	30.1	Corruption	27.4	Exchange rate	22.4
7	Street crime	27.2	Exchange rate	28.9	Street crime	25.5	Organized crime	21.7
8	Organized crime	24.5	Organized crime	26.9	Organized crime	23.4	Taxes and regulation	21.4
9	Anti-competitive practices	21.9	Anti-competitive practices	23.8	Anti-competitive practices	21.9	Infrastructure	18.2
10	Infrastructure	17.0	Infrastructure	16.3	Infrastructure	17.2	Anti-competitive practices	16.9
11	Judiciary	13.7	Judiciary	13.8	Judiciary	14.4	Judiciary	11.6

Note: (a) Major means that firms chose 4, the highest possible obstacle level. Lower obstacle levels are: 3, moderate obstacle; 2, minor obstacle; and 1, no obstacle

Source: Shiffer and Weder (2001).

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[97] Task Group of the Policy Board for Financial Services. (2022). SMEs' Access to Finance in South Africa: A Supply-Side Regulatory Review. Available at: https://www.treasury.gov.za/publications/other/access%20to%20finance%20in%20south%20africa%20-%20a%20supply-side%20regulatory%20review.pdf. [Accessed May 2023], p.22.

[98] Ibid p 59

[99] Laopodis, N.T. (2021) *Understanding Investments: Theories and Strategies* Routledge. p.24

[100] OECD 2004, June. Promoting entrepreneurship and innovative SMEs in a global economy: towards a more responsible and inclusive globalisation. In *Second OECD Conference of Ministers responsible for Small and Medium-sized Enterprises (SMEs), Istanbul*.

From a VAT perspective, the failure to refund excess tax (where input tax exceeds output tax) or the reduction of the apportionment ratio by bulking the denominator with passive income (resulting in a lower apportionment ratio), turns the VAT into a “tax on production”, which is distortive and deters investment and production. The VAT cascades in the production and distribution cycle, depending on market conditions and this inflates consumer prices or reduces business profits.[101]

EXEMPT SUPPLIES IN THE APPORTIONMENT CALCULATION

Paragraph 3 of BGR16[102] states that the "b" in the standard turnover method of apportionment calculation is for the inclusion of all exempt supplies in the denominator.

Section 12 of the SA VAT Act contains 13 exempt supply categories, some of which are listed below:

MERIT GOODS

Prior to the introduction of VAT in South Africa in 1991, lobbying from several lobby groups forced the government to make several concessions[103]. Merit goods are those goods and services that would be under-consumed by indigent households if the only way to access them was through the ability to pay for them[104]. Merit goods or services are those that are in the public interest and are generally provided by governments. These goods or services are essential and the intention is for indigent households not to incur a VAT cost to purchase them. This list is in place because providing targeted fiscal support cannot guarantee that everyone will have access to the goods or services.

Thus, some of the goods and services exempted from VAT are merit goods. These goods are thought to address the regressivity of VAT. Simply put, regressivity is when a VAT is “unfair to lower income individuals and families”[105]. Interestingly, research shows that VAT is determined to be regressive where the analysis is on income vs. VAT spending while it is found to be slightly progressive where the focus is on current expenditure and the VAT incurred.

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[101] Pessoa, M., Okello, A., Swistak, A., Muyangwa, M., Alonso-Albarran, V. and de Paul Koukpaizan, V., 2021. How to Manage Value-Added Tax Refunds. International Monetary Fund. P.3

[102] SARS Binding General Ruling (VAT): No. 16 (Issue 2)

[103] National Treasury Republic of South Africa. The VAT Treatment of Merit Goods and Services [online]. http://www.treasury.gov.za/publications/other/vat%20merit%20goods%20final%20report%20%20-%2015%20oct%202007.pdf (Accessed: [April 2023]).

[104] Soldatos, G., 2020. Merit goods and excise taxation in quasilinear markets for complementary private consumption. Public Sector Economics, 44(4). Available at: https://www.pse-journal.hr/upload/files/pse/2020/4/6.pdf

[105] Carlson, G.N. and Patrick, M.K., 1989. Addressing the regressivity of a value-added tax. National Tax Journal, 42(3), pp.339-351.

This progressivity is caused by the presence of reduced VAT rates and exemptions [106]. Educational services[107] are an example of merit goods in the South African VAT Act.

The IMF, in its working paper[108], attributes the choice to exempt rather than to zero rate primarily to administrative convenience.

GOODS THAT ARE DIFFICULT TO TAX

In its first interim report on VAT, the Davis tax committee highlighted the challenges of taxing financial services under the VAT system as determining the consideration for that supply is difficult. Financial services should, in principle, be subject to VAT as it is a supply of a service, the difficulty arises mostly from the fact that, in most cases there isn't an explicit charge for the supply of the financial service. Financial services have a complicated administration and determining the value contributed in these transactions[109] can be difficult. These services also tread a line between being consumption and being the proceeds of an investment[110].

Section 12(a)[111] of the VAT Act, exempts the supply of any financial services from the VAT imposed in section 7(1) (a)[112]. Financial services[113] are those services that are deemed in section 2[114] to be financial services

The proviso to section 2(1)[115] excludes from this exemption any services where the consideration payable in respect of those services is a fee, commission, merchants discount or a similar charge.

[106] Thomas, A. (2020), "Reassessing the regressivity of the VAT", *OECD Taxation Working Papers*, No. 49, OECD Publishing, Paris, https://doi.org/10.1787/b76ced82-en.

[107] Section 12(h) of the VAT Act

[108] Mackenzie, M.G.A., 1991. Estimating the base of the value-added tax (VAT) in developing countries: the problem of exemptions. International Monetary Fund.pg 1 and 2

[109] IMF. (2004). *Financial Services and the Value-Added Tax.* Available at: https://www.elibrary.imf.org/display/book/9781589063167/ch05.xml.

[110] Slemrod, J., & Velayudhan, T. (2022). The VAT at 100: A Retrospective Survey and Agenda for Future Research. Public Finance Review, 50(1), 4–32. https://doi.org/10.1177/10911421221094595

[111] of the VAT Act

[112] of the VAT Act

[113] Section 1 of the VAT Act

[114] of the VAT Act

[115] of the VAT Act

Section 2[116] includes "active" supplies of exempt items such as the issuing of debt securities[117] such as those issued by financial institutions and participatory securities[118] that are issued by Collective Investment Schemes[119]. The provision of credit[120] and the provision of life insurance policies[121] is also included therein.

Section 2(1)(*c*)[122] which deals with debt securities and section 2(1)(f)[123]which deals with the situation where an individual extends credit to another party through an agreement, involving the provision of money or its equivalent, with the recipient agreeing to repay an amount exceeding the initial sum at a later date. Unlike the active pursuits mentioned above, income earned from debt securities or the extension of credit can be passive, where the vendor merely makes the funds available and receives repayment over time.

INTEREST INCOME

An organisation can generate interest by either extending loans or by employing capital[124]. Some taxpayers receive interest income from surplus funds held by them which are kept in the bank or invested in other investment vehicles. Bank interest on deposits is largely dictated by the quantum of deposits and the prevailing interest rate.

Although it is a guide for Municipalities, SARS Binding General Ruling 4[125] ("BGR4") states that interest earned on day-to-day operations held in, for example, a current account at a bank is excluded from "b" of the standard method of apportionment formula. Including this income would distort an entity's ratio as there is no effort expended to generate this income. This rationale is not, however, followed in BGR16 and the calculation of the apportionment formula.

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[116] of the VAT Act

[117] section 2(1)(*c*) of the VAT Act

[118] section 2(1)(d) of the VAT Act - Per the SARS VAT Guide 404[118] equity or participatory securities are, amongst others, where there is participation in a collective investment scheme, the sale of an interest in a CC, shares in a public or private company.

[119] Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002)

[120] Section 2(1)(f) of the VAT Act - "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;"

[121] Section 2(1)(i) of the VAT Act - The SARS VAT Guide 404[121] determines this to be the provision of life insurance policies and superannuation benefits. Such as, life assurance policies, retirement annuity fund and pension fund policies or disability policies. The management of a superannuation scheme is however chargeable with VAT at the standard rated as entities earn a management fee thereon.

[122] of the VAT Act

[123] of the VAT Act

[124] Haupt, P. and Huxham, K., 2015. *Notes on South African Income Tax 2015* H & H Publications.

[125] Binding General Ruling (VAT): no. 4 Issue 3

The presumption of the standard turnover method is that the same level of overhead costs are incurred to earn income from taxable supplies, and income from exempt and non-supplies. The methodology presumes that the higher the turnover (from both taxable and non-taxable supplies), the more expenses are incurred equally to generate these supplies. However, this assumption cannot be applied where non-vatable (exempt or outside of the VAT net) "income amounts" are earned, without corresponding additional effort or expenditure being incurred to earn this income. It is clear that the inclusion of passive interest income in part 'b' of the apportionment calculation will result in a ratio which is neither fair nor reasonable reflection of business activities and input tax entitlement and SARS in BGR4 agrees with this view.

NON-SUPPLIES - DIVIDENDS

Paragraph 3 of BGR16[126] states that the "c" in the apportionment calculation mentioned above should include all other income, not included in "a" and "b", in the denominator. Note 2 in that BGR stipulates that "c" typically includes dividends.

The term dividend is not defined in the VAT Act. According to the Cambridge dictionary, a dividend is defined as "(a part of) the profit of a company that is paid to the people who own shares in it"[127] However, in the Income Tax Act[128] ("ITA"), it is defined as any amount, other than a dividend in specie that is declared and paid, transferred or applied by a resident company for the benefit or on behalf of any person in respect of any share in that company. A share is defined as "in relation to a company, any unit into which the proprietary interest in that company is divided"[129]. Owning a share[130] qualifies a shareholder to receive a dividend. An entity's board will authorise a dividend[131], subject to liquidity constraints. The shareholder does not influence the dividend's occurrence, timing or quantum.

According to Article 10(3) of the OECD Model Tax Convention, "the term "dividends" refers to income from shares, "juissance" shares or "juissance" rights, mining shares, funders' shares, or other rights participating in profits, as well as income from other corporate rights subject to the same taxation treatment as income from shares by the laws of the resident country of the distributing company"[132].

[126] SARS Binding General Ruling (VAT): No. 16 (Issue 2)
[127] https://dictionary.cambridge.org/dictionary/english/dividend
[128] Section 1 of ITA
[129] Ibid
[130] Definition of shareholder in Companies Act, No. 71 of 2008
[131] Section 46(1)(c) Companies Act, No. 71 of 2008
[132] https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf

In November 2020, KPMG published an article highlighting a viewpoint from SARS regarding the inclusion of dividends. The document stated that SARS states that certain investment activity related to earning dividends must be included in a varied turnover-based calculation. This investment activity, according to SARS, should be included in the calculation by applying a yield to fees/dividends earned by the vendor. The yield is determined by calculating the difference between the prime interest rate and the Johannesburg Interbank Average Rate (JIBAR) (e.g., 7% minus 3.68% = 3.32%), and applying this percentage as follows:

- If a management fee is earned, the yield must be applied to the management fee to determine the amount to be included in the calculation as a deemed dividend (e.g., 3.32% x management fee).
- If no management fee is earned, but a dividend is received, the yield must be applied to the dividend received (e.g., 3.32% x dividend received).
- If no management fee nor dividend is received, but another fee is charged, then SARS will apply the yield to such other fee.[133]"

In November 2020 KPMG retracted[134] the article and released a statement saying their experiences could not be understood or taken to indicate SARS policy. The retracted article still demonstrates KPMG's experiences and has value for this dissertation and whether and to what extent passive income must be included in input tax apportionment methodologies.

The VAT Act defines a "supply" to include a performance in terms of a sale and all other forms of supply, whether voluntary, compulsory or by operation of law..."[135]. Regarding the declaration of cash dividends, differing opinions exist in South Africa. For instance, one perspective[136] suggests that an entity's choice to declare a cash dividend may qualify as a supply given this broad definition of supply.

[133] KPMG (2020). TaxNewsFlash retrieved from https://assets.kpmg.com/content/dam/kpmg/us/pdf/2020/11/tnf-sa-nov9-2020.pdf. Accessed: May 2023

[134] (2020) [Value-Added Tax: Apportionment calculations and dividends (continued)]. Retrieved from [https://saicawebprstorage.blob.core.windows.net/uploads/resources/Value_Added_Tax_Apportionment_calculations_and_dividends__Updated_Newsletter.pdf]. Accessed: May 2023

[135] Definition in section 1 of the VAT Act

[136] https://www.thesait.org.za/news/248749/Considering-the-VAT-effect-of-dividends.htm - "will qualify as a supply and will in effect constitute the supply of money...". Accessed: May 2023

While another perspective is that since dividends are paid out from a company's profits[137] ,and money is not included in the definitions of goods[138] and services[139], there will be no VAT repercussions on the distribution of a cash dividend because neither goods nor services are being supplied. There is therefore another category of transactions which fall outside of being a supply as defined and these are known as non-supplies. Where an entity declares a dividend other than cash, a dividend in specie, it will not be a supply of money and may have a VAT consequence. The focus of this research is from the recipient's perspective; hence, neither a pay-out in cash nor *in specie* is addressed in this research.

The aforementioned deals with dividends from a declaring entity point of view. Section 23[140] of the VAT Act, requires every person who conducts an enterprise to register for VAT at the end of the month where the total value of its taxable supplies made in any consecutive 12 month period exceeds R1 million.

The term enterprise[141] is used to refer to a variety of activities, including commercial, financial, industrial, among others, or any other concern, carried out continuously or on a regular basis by a person in or partially in the Republic and in furtherance of which goods or services are provided to any other person for a consideration, whether or not for profit.

Section 7(1) of the VAT Act[142], requires registered vendors that make taxable supplies of goods or services, to declare VAT at the standard rate[143] unless an exemption[144] or exception[145] applies.

Vendors are then permitted to deduct input tax incurred, which is the tax that is payable when they acquire goods or services, in the course of making these taxable supplies[146]. Where a vendor makes both taxable and exempt supplies (mixed supplies), then the vendor can deduct to the extent of its taxable use as discussed at the beginning of this chapter.

[137] https://www.vanhuyssteens.co.za/newsroom/item/122-the-effect-of-value-added-tax-on-dividends-and-dividends-in-specie-declared-by-a-vat-vendor. Accessed: May 2023
[138] Definition in section 1 of the VAT Act
[139] Ibid
[140] Section 23 of the VAT Act
[141] Definition in section 1 of the VAT Act
[142] Section 23 of the VAT Act
[143] The VAT rate is currently 15 percent in South Africa
[144] Exemption are in section 12 Section of the VAT Act
[145] Zero rated items are in Section 11 of the VAT Act
[146] Silver, M. ed., 2017. *Deloitte VAT handbook*. LexisNexis Butterworths.

Taking the above into account, it is clear that the determination of input tax and the deductibility thereof hinges on marrying expenses a vendor incurs to taxable supplies made, essentially the enterprise activity. For recipients, whether a dividend is considered a supply of goods and/or services or not, when the expenses of an entity that makes both taxable and exempt supplies are analysed, it is clear that very little to no effort is expended in order to earn the exempt interest and dividend income.

Shareholders receive dividends as a result of their shareholding in subsidiaries, and is not representative of any activity carried out by the shareholder. The quantum of the dividends depends on the profitability of the company (over which the shareholders often have little influence). In view of the fact that no activity is carried out to generate the dividend income, there may also be no taxable expenses that are incurred that could be attributed to the dividend income. The shareholder does nothing further than to provide the funds by purchasing shares. Further, the company does not have to declare a dividend, the dividends could be retained and the shareholder then benefits from the increased value of the share.

Using the turnover-based method to calculate the deductible input tax could lead to unintended and distorted outcomes. While a company may earn a significant amount of dividend and interest income, the effort expended by the company to earn this income is not directly proportional to its value.

For example, the interest income is earned by investing cash balances held. These amounts are significant and are kept in high yielding accounts that can be liquidated swiftly when the funds are needed but may remain in place for long periods of time. Insignificant costs, time and expenses are spent on earning this interest.

Similarly, dividends are merely returns on investments in subsidiaries or other entities, with the value depending on the profitability of those companies. Therefore, the costs attributable to earning interest and dividend income are minimal.

PASSIVE INCOME

VAT is calculated on the value that is added to a good or service at each stage of production or distribution. Dividends and some interest earned[147] are not as a result of value added in the process of production or distribution and are typically income generated from investments (cash held in interest earning accounts or shareholding) thus they are examples of passive income.

Depending on the circumstances, exempt and non-supplies can be passive in nature for VAT purposes. As indicated previously there are thirteen exemptions in section 12[148] of the SA VAT Act. Term "b", of the standard turnover method of apportionment, is defined to include "the value of all exempt supplies". Thus, where applicable, all income from the 13 types of supply that are exempt should be included in "b" for taxpayers that earn both taxable and exempt income. The majority of the income that is earned from these 13 exempt supply types comes from active "trades" such as renting out properties, albeit residential; supplying land; providing transport services etc. The services included in the section 12(a)[149] exemption of financial services read with section 2[150], can include some passive or non-trade income. For example, section 2(1)(i)[151] deals with the provision of long-term insurance policies. Life insurers employ extensive resources in order to earn any income that is related to the selling of these policies. The same life insurer could put surplus money, intended for operational costs, in an interest earning investment account to grow it without doing anything more, this still qualifies as a financial service under the same 2(1)(f)[152].

AN INCOME TAX TAKE ON PASSIVE INCOME

From a VAT perspective, in order to deduct input tax, an entity must be incurring the expense in the course of making taxable supplies. As indicated above, the standard turnover methodology includes income that has no active pursuit such as incurring expenses. While the VAT Act does not require a taxpayer to be involved in "trade" when determining input tax to be deducted, understanding whether income is earned actively or passively helps to determine whether expenses incurred in earning that income can be deducted for VAT purposes. To demonstrate the concept of passive and active

[147] Such as interest earned on bank deposits.
[148] Section 12 of the VAT Act
[149] Of the VAT
[150] Of the VAT Act
[151] Of the VAT Act
[152] Of the VAT Act

pursuit, it is also beneficial to look to the Income Tax Act[153] ("ITA") and relevant income tax case law.

The ITA allows taxpayers to deduct qualifying expenditure incurred in terms of section 11(a) of the ITA read together with section 23(g). To qualify as a deduction, section 11(a)[154] read with section 23(g) directs that the expenditure must be incurred in the carrying on of any "trade"[155].

Section 1 of the ITA[156] defines trade as amongst others as "any profession, trade, business, occupation or venture". Despite its broad definition, according to Silke[157] the term "trade" does not encompass all activities that may result in revenue, such as income from interest, dividends, annuities, or pensions, thus technically, expenses incurred to earn this "non-trade" income should not be deductible in terms of section 11(a) of the ITA.

According to Haupt[158], when an entity extends credit and generates interest from that activity, it is classified as trade income for the purposes of income tax. While on the other hand, interest earned from employing capital is generally passive investment income. The distinction is that the former is in the production of income and expenses incurred in earning that income will be deductible for income tax purposes while the latter is not and related expenses will thus not be deductible.

The definition of trade, suggests an action or actively doing something. In Practice Note 31[159] SARS permits the deduction of expenses incurred where "passive" interest income is earned, but states "strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue". Outside of this Practice Note the items would not be deductible. SARS intends to withdraw[160] Practice Note 31.

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[153] ITA
[154] of the ITA
[155] as defined in section 1 of the ITA
[156] Section 1 of the ITA
[157] Silke on South African Income Tax at § 7.2. https://www.mylexisnexis.co.za/Index.aspx
[158] Haupt, P. and Huxham, K., 2015. *Notes on South African Income Tax 2015* H & H Publications. p 509
[159] SARS. (1994, October 3). *Practice Note: No. 31 - Income Tax: Interest Paid on Moneys Borrowed.* Available at: https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-21-Income-Tax-Practice-Note-31-of-1994.pdf.
[160] SARS. (2022, November 15). *Withdrawal of Practice Notes 31 of 1994 and 37 of 1995.* Available at: https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/Legal-LPrep-Draft-2022-67-Withdrawal-of-Practice-Notes-31-of-1994-and-37-of-1995-effective-1-March-2023-15-November-2022.pdf.

Numerous tax cases have opined on what constitutes "trade".[161]
The cases quoted in Interpretation Note 33 (Issue 5)[162] ("IN33") focused on the requirements of 'trade' and income from 'trade'.

In Case 1275[163] the principle of trade not being a passive construct was dealt with. The appellant claimed deductions under section 11(a)[164] on the basis that it was expenditure incurred in the production of income and that expenditure was not capital in nature. The following investments were held by the appellant during the tax year: building society shares, tax-free investments in savings and Treasury bonds, and various other government and tax-free assets. He also owned debentures, one mortgage bond, an unsecured loan to a business, deposits with a bank and a building society, money invested in a bank growth fund, shares in public corporations, a building society, and other securities.

As part of his evidence, the appellant sought to demonstrate how much effort went into earning the investment income citing that he kept a bank account, kept books of account and corresponded with the revenue authority. The appellant indicated that he had dedicated a room in his apartment as an office, where he carried out tasks related to his investments. The appellant further claimed that he had incurred travel and entertainment expenses where he had to socialise with persons such as attorneys accountants etc., which could advance his investing business.

The court ruled that taxpayers who earn investment income are not permitted to deduct expenses incurred in earning that interest. The court said "watching over those investments, however wisely incurred those expenses may be" does not qualify those expenses to be deducted.

In an earlier case 512[165], a taxpayer earned money from auctioneering and farming and also earned interest on bonds and loans. The Commissioner for Inland Revenue excluded the appellant's interest income when determining the amount of capital

[161] This is not a requirement for VAT in South Africa, it is assessed herein to demonstrate what passive income is.
[162] https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-33-Assessed-Losses-Companies-Trade-Income-Requirements.pdf
[163] ITC 1275 (1978) 40 SATC 197
[164] of the ITA
[165] ITC 512(1941) 12 SATC 246(U)

employed in trade when calculating the taxpayer's pre-war standard, on the basis that it was earned from non-trade assets. The taxpayer argued that the income was earned in his capacity as a financier and investor and the lending of money on bonds constituted a trade as defined in the Income Tax Act[166]. The taxpayer contended that he earned money from auctioneering and farming and took surplus money from these and invested it. Thus the interest income was part of his trade. The court ruled that the proposition that his interest income was part of his trade was an absurd one that was not supported by any authority. The court indicated that his interest earning activity was no different from investment on fixed deposit which is not a trade. The case was dismissed and the taxpayers' petition denied.

In 1960, in income tax case no 957[167] the taxpayer had taken over a building contractor's business. The taxpayer used surplus funds to advance and lend money to people, companies and institutions. In the disputed tax year, the taxpayer earned interest from loans advanced to shareholders or their relatives. The taxpayer sought to set-off assessed losses against this interest income. The revenue authority disallowed this set-off on the basis that the taxpayer did not carry on any trade in the year of assessment.

The court indicated that determining that a taxpayer is in the business of money-lending is a question of fact. One of the characteristics of a money-lender is that the frequency of turnover is high and borrowers make regular repayments. Quoting from Challoner and Collins[168], "It is not enough merely to show that a man has on several occasions lent money at remunerative rates of interest; there must be a certain degree of continuity and system about the transactions."
The court went on to quote Hannan[169] who stated that, "Investment by an individual of even large sums on mortgages or real estate is not in itself sufficient to constitute a business.".

The specifics of the facts that led to the court dismissing the taxpayers appeal are not relevant to this research paper. What is key is that the court maintained the principle that 'passive income' is not trade.

[166] ITA
[167] ITC No 957(1960) 24 SATC 637 (O)
[168] Challoner, N.E. and Collins, C.M., 1953. Income Tax Law and Practice (Commonwealth). Law Book Company of Australasia. p 473.
[169] Hannan, J. P., & Farnsworth, A. (1952). The Principles of Income Taxation. London: Stevens & Sons, Ltd. (p. 165). ITC 957(1960) 24 SATC 637

Silke on South African Income Tax[170] captures it by saying “In spite of its wide meaning, the term ‘trade’ does not embrace all activities that might produce income, for example, income in the form of interest, dividends, annuities or pensions.” The watching over of investments does not constitute a trade. The earning of interest on funds advanced by a holding company to its subsidiary was held not to constitute the carrying on of a trade.

From these court cases it is clear that there are justifiably two types of income: active income that flows from trade and passive where little, infrequent or no action is required to earn it. These cases reinforce the principle that "passive income" is not considered trade income. The concept of trade, despite its broad meaning, does not encompass all activities that generate income, specifically including interest, dividends, annuities, or pensions. Watching over investments or earning interest on funds advanced by a holding company to its subsidiary does not constitute a trade.

Similarly in VAT, there are expenses associated with actively pursuing income and there is income that is earned without any continuous and regular pursuit but rather the passing of time or the occurrence of an event.

PROXIES UTILISED IN SA TO LIMIT INCLUSION OF NON-TAXABLE INCOME IN APPORTIONMENT AND OTHER APPORTIONMENT METHODOLOGIES

The apportionment method as prescribed by BGR 16 is subject to the condition that it may only be applied if it is fair and reasonable. BGR 16 is binding on SARS for all qualifying taxpayers. Therefore, SARS may also only apply the prescribed apportionment method if it is fair and reasonable or appropriate.

There is no established legislation that governs apportionment methods, procedures, or circumstances in which a particular apportionment approach may be appropriate. The SARS guide for vendors simply directs that when a taxpayer reflects on the appropriateness of the standard turnover-based method, the vendor must apply a common-sense approach that a reasonable person would employ[171].

[170] De Koker, A.P. and Williams, R.C.(2013). Silke on South African Income Tax. 2013. *Durban: LexisNexis*. Chapter 7 General deductions - § 7.2 Expenditure under s 11 deductible only if trade carried on

[171] SARS. (2022). Guide for Vendors. [Online] Available at: https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-VAT-G02-VAT-404-Guide-for-Vendors.pdf [Accessed 5 June 2023], p. 63.

Other methods used by vendors where the standard turnover method is distortive are analysed below[172]. However even in these examples the inputs utilised to earn dividend and interest income are often negligible and the quantum of this income does not represent the inputs consumed to earn it. These methods can only be used where the vendor has determined that the standard turnover method is not fair and reasonable and the vendor must apply to SARS for these alternative methods[173].

Of note is that, subject to certain exceptions, the standard turnover method of apportionment[174] as well as the ones mentioned below exclude the value of any capital goods or services supplied.

VARIED TURNOVER-BASED METHOD

The varied turnover-based method of apportionment allows for the change or exclusion of the various components included in the standard turnover-based method in determining the input tax apportionment ratio.

Under the varied turnover-based method, vendors are, subject to the facts, permitted to limit the quantum of dividends and interest included in the denominator of the apportionment calculation using certain restrictions.

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

Where:

"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 varied turnover-based method follows the same methodology as the standard turnover-based method of apportionment with certain adjustments. Some of the variations of the inclusion of amounts in "b" and "c" in the above formula are discussed

[172] South African Revenue Service. (2023). VAT Connect Issue 17 (December 2023). Retrieved from [VAT Connect Issue 17 (December 2023) | South African Revenue Service (sars.gov.za)]. (Note: The apportionment methods discussed here are based on the researchers' experience and templates of rulings provided by SARS.)

[173] https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BGR/LAPD-IntR-R-BGR-2013-05-BGR16-Standard-Apportionment-Method.pdf [Accessed 5 June 2023]

[174] Note 3 of paragraph 3 of Binding General Ruling (VAT): No. 16 (Issue 2)

below. This is not an exhaustive list. The income statement example below will be used to illustrate the variations.

Income Statement	
	2021
Income	
Net interest income	
Interest Income	99 000
Interest Expense	(69 000)
Non-interest income	
Fee Income	500 000
Management Fees	285 000
Dividend Income	350 000

Figure A[175]

LIMITING INCLUSION OF DIVIDEND INCOME TO MANAGEMENT FEES EARNED FROM SUBSIDIARIES

A vendor actively providing management services to subsidiaries and other organisations from which it receives management fees may be able to identify the costs, such as telephone, technology, etc. that were incurred to generate this income. As an alternative, in this apportionment method the dividend amount in the formula is limited to the management fees received.

Technically, it is impossible to support using this management fee income as a proxy for calculating the amount of dividends to be included in the apportionment calculation.

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

Where:

y = The input tax recovery rate;

a = The value of all taxable supplies (including deemed taxable supplies);

b = The value of all exempt supplies made during the period;

c = The sum of any other amounts of income not included in 'a' or "b' in the formula which were received or which accrued during the period (whether is in respect of a supply or not). **The inclusion of dividends must be limited to management fees charged to subsidiaries.** As indicated above, dividends are distributions of profits by companies to their shareholders and are outside of the VAT net. On the other hand, management fees are part of a vendor's enterprise and are consideration for services rendered.

[175] Fictitious numbers.

In cases where a shareholder also renders management services and earns management fees therefrom and the company that they provide management services to declares a dividend, then adding the dividend in the apportionment denominator to the extent of the management fee is less distortionary as it represents an active income earning activity.

	Income Statement	
		2021
	Income	
	Net interest income	30 000
b	Interest Income	99 000
	Interest Expense	(69 000)
	Non-interest income	
a	Fee Income	500 000
a	Management Fees	285 000
c	Dividend Income	350 000

Standard turnover

$$y = \frac{500\,000+285\,000}{500\,000 + 285\,000 + 99\,000 + 350\,000} \times \frac{100}{1}$$

y = 63.61%%

Varied turnover method

$$y = \frac{500\,000+285\,000}{500\,000 + 285\,000 + 99\,000 + 285\,000} \times \frac{100}{1}$$

y = 67.15%

Limiting the inclusion of dividends to management fees gives a higher, more equitable apportionment ratio to apply to the input tax total to determine the amount to be deducted. Although it theoretically takes into account how an entity employs its resources to earn income, as indicated above, it is completely arbitrary.

NET INTEREST METHOD

The net interest methodology intends to fairly reflect activity or 'energy expended' when vendors make exempt supplies. It does so by removing the distortion caused by the interest earned and the interest incurred on money borrowed from other lenders. It excludes the entity's financing costs from its interest income and only retains the vendor's margin in the apportionment calculation.

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

Where:

y = The input tax recovery rate;

a = The value of all taxable supplies (including deemed taxable supplies);

b = The value of all exempt supplies made during the period **with the inclusion of net interest (offset interest expense from interest income);**

c = The sum of any other amounts of income not included in 'a' or "b' in the formula which were received or which accrued during the period (whether is in respect of a supply or not).

Net interest method

$$y = \frac{500\,000 + 285\,000}{500\,000 + 285\,000 + 30\,000 + 350\,000} \times \frac{100}{1}$$

$$y = 67.38\%$$

Adjusting for the interest expense leads to a recovery rate based on a more fair and reasonable ratio which takes into account the cost of borrowing. This approach accurately reflects the expenses incurred by an entity that earns its income from its lending activities. It takes the correlation between an entity's interest income and interest expenditure which are both dependent on the extent of funds required by the borrower.

Depending on the taxpayer's circumstances, the varied turnover-based method can include more than one variation. For instance, an entity that has dividend income, management fees, earns interest and has an interest expense can apply to SARS to limit the inclusion of dividends to the management fees **and** to deduct the interest expense from the interest income before including in 'b'.

DIVIDEND INCOME

As already stated above, in considering an entity's activity connected to the earning of dividends, generally dividends are directly related to an entity's shareholding and not due to any activity carried out by that entity in relation to its shareholding. Dividends are merely the return on the investment of this shareholding and the value or extent of the dividend depends on the profitability of those companies.

As there is no activity involved in the generation of dividend income, it is evident that the directly attributable expenses that are incurred would not be for the purposes of earning this dividend.

The purpose for including dividends in the apportionment formula is to serve as a proxy for any non-taxable activities carried out by the shareholder in relation to the investments held as shareholder. Where the taxpayer is not involved in any activities in relation to its shareholding in its subsidiaries, then the dividends will not be representative of any supply made by the taxpayer and would be purely passive in nature.

The inclusion of dividend income in apportionment formulae thus generally distorts the apportionment calculation. In some instances the quantum of the dividend is very high and is not a proper reflection of the manner in which the taxpayer applies its resources in making taxable and non-taxable supplies.

To support this, if a taxpayer's expenses are analysed, the expenses do not fluctuate or are not influenced by the value of dividends received. Generally, taxpayers do not incur any expenditure to earn dividend income.

VARIED INPUT-BASED METHOD

The varied input-based method of apportionment is based on the ratio of VAT incurred that is wholly attributable to the making of taxable supplies to the total VAT incurred to make all supplies but excluding the VAT incurred in relation to making mixed supplies (i.e. taxable supplies and supplies other than taxable supplies). This method also excludes any VAT incurred for capital goods and services.

Input-based method of apportionment as set out below:

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

Where:

y = The input tax recovery rate to be applied to VAT incurred for mixed supplies;

a = VAT on goods or services acquired wholly for the purpose of making taxable supplies;

b = VAT on goods or services acquired wholly for the purpose of making exempt supplies;

c = VAT on goods or services acquired wholly for the purpose of making non-supplies (**i.e. other than exempt or taxable**).

This income statement example below is used to illustrate the methodology:

	Income Statement		
		2021	**Explanation**
	Income		
	Interest Income (bank interest)	99 000	
	Dividend Income	100 000	
	Asset Management Fees	500 000	
	Consultancy Fees	285 000	
	Miscellaneous Sales	26 000	
	Rent Income (residential)	200 000	
	Expenses		
a	Rent Expense	50 000	Office space for asset management business
b	Building and maintenance Costs	30 000	For residential property rental
a	Software	100 000	For asset management and consultancy business.
a	Equipment	200 000	For asset management and consultancy business.
	Telephone	22 000	Used to earn all income.
	Bank Charges	6 000	Used to earn all income.
b	Agents Fee	10 000	For residential property rental

The varied input-based method is appropriate where it is difficult to determine a vendor's turnover for apportionment purposes, or where the turnover is disproportionate in comparison to the manner in which the business uses inputs for purposes of earning taxable turnover.

In the income statement above.

$$y = \frac{50\,000+100\,000+200\,000}{50\,000+30\,000+100\,000+200\,000+10\,000} \times \frac{100}{1}$$ [176]

$$y = 89.74\%$$

The ratio that will be applied to the VAT on expenses incurred to earn both the taxable and exempt income (mixed income) is 89.74%.

Thus for the telephone expense it will be"

R22 000 X 15% X 89.74% = R2 961.42 will be included as input tax claimed in the VAT return.

The majority of the expenses in the aforementioned income statement cannot be attributed to earning the dividend income. To a certain extent, the telephone expense can be linked to receiving the dividends if the taxpayer communicates with the entity the dividend is earned from telephonically. The bank charges are a mixed expense because all earnings will be kept in the bank account.

The effort it takes to earn income from supplying a dwelling[177], selling life policies[178], services to members of a body corporate[179] is aligned with the income earned for rendering those services. This is not true of interest gained in a primarily passive manner from sources other than lending activities, such as dividends and interest from a taxpayer holding money in an interest-bearing account.

[176] From the Income Statement example above – add the rent expense + software expense + equipment expense over all expenses excluding those that are incurred to earn both taxable and exempt income.
[177] Section 12(c) of the VAT Act
[178] Section 12(a) of the VAT Act
[179] Section 12(f) of the VAT Act

FLOOR SPACE METHOD

The floor space method is based on apportioning the input tax in the same ratio as the floor space occupied by income-generating staff involved in exclusively making taxable supplies to the total floor space occupied by all income-generating staff. The floor space-based method is practical where:

- Most of the business's VAT bearing costs relate to its premises; and
- Most of the floor-area in those premises is used for either wholly taxable or wholly non-taxable activities, with only minor areas relating to both.

This approach generally works where the employees that generate taxable income and those that generate dividend and interest income sit in designated areas or where there are employees that exclusively work on activities relating to generating taxable, exempt and other income. If such demarcations are not present, the floor space method would not yield a fair and reasonable result and would therefore not be an appropriate method to utilise.

This method might be effective, for instance, where a business rents out both residential property and commercial accommodation[180]. While some staff members are tasked to service clients that let residential properties which is an exempt supply, other staff members are responsible for commercial property which, subject to meeting certain requirements, is a taxable supply. To earn income from both the taxable and exempt supply, the staff members are actively doing something on a continuous basis. This is not the case if the non-taxable income is interest as an example, as the value of the interest earned is not determined by what the employee does to earn it, such as calling the bank on a regular basis if it is bank interest and making sure the account is in the correct account from the onset. As mentioned above, earning dividends can also be passive, in that the taxpayer simply secures shares and the entity invested in declares dividends. The taxpayer's efforts do not have a bearing on the dividend income earned.

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[180] SARS VAT 409 Guide for Fixed Property and Construction for Vendors-"The term "commercial accommodation"10 includes lodging, or board and lodging supplied together with domestic goods and services in any house, flat, apartment, room, hotel, guest house etc. The total receipts for the supply of such commercial accommodation must exceed or be likely to exceed R120 000 in any consecutive period of 12 months before the activity can qualify as an "enterprise" as defined."

EMPLOYEE TIME METHOD

The employee time spent method is based on the ratio of time spent by employees in making taxable supplies compared to the total time spent by the employees in making all supplies. To substantiate time spent, this method typically requires timesheets or time monitoring.

Depending on the nature of a business, employees can spend considerable time earning taxable income, exempt income or both. The quantum of passive interest and dividends is generally not determined by time spent on these activities. With respect to dividends, the amount distributed as a dividend depends on the performance of the company whose shares are owned. While for interest, it can be based on the length of time the investment is held, the amount of the initial investment and interest rate fluctuations, amongst others. As a result, there is no direct correlation between the passive income generated and the time spent.

CHAPTER THREE SUMMARY

In this chapter the evolution of VAT in South Africa was investigated and South African VAT legislation was analysed as it relates to the deduction of input tax where an entity makes both taxable and exempt supplies. Principles of VAT apportionment were examined including the preapproved standard turnover method of apportionment and other variations. This included discussing the income streams that should be included in the pre-approved standard turnover method as indicted in BGR 16[181] and the nature of that income. The different proxies that can be used to limit the inclusion of the different incomes were also discussed. The active (trade) and passive ways of earning income were discussed by way of South African tax cases.

What the chapter has highlighted is that, in order to choose the optimum apportionment methodology for allocating mixed expenses, it is critical to identify whether money is earned actively or passively. The resultant apportionment ratio is less likely to be distortive if this is done.

[181] https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BGR/LAPD-IntR-R-BGR-2013-05-BGR16-Standard-Apportionment-Method.pdf. [Accessed 5 June 2023]

CHAPTER FOUR: COMPARATIVE STUDY OF SELECTED COUNTRIES INCLUDING PASSIVE INCOME IN APPORTIONMENT METHODOLOGIES

Chapter two discussed the tax framework's essential elements such as neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Additionally, it explored the incorporation of these components in the OECD Guidelines. Building upon this, chapter three delved into the South African landscape, examining the types of transactions that are included in section 12[182] and how actively or passively a taxpayer earns income.

This chapter aims to assess the fairness of South Africa's approach to determining the deductible input tax through the standard turnover method, specifically by including dividends and interest in the denominator. To achieve this, how selected countries interpret and implement these key components within their own Value Added Tax (VAT) frameworks will be analysed. The focus will primarily revolve around VAT apportionment approaches, investigating whether they encompass passive income in their apportionment ratios. Additionally, how other countries achieve neutrality, effectiveness, and fairness will be explored.

To provide further context and insights, reference will be made to a report[183] published by the OECD in 1998. This report extensively covers the indirect taxation of financial services in OECD Member countries. Where relevant and applicable to the country under review, the findings from this report will be incorporated into the analysis.

NEW ZEALAND GST SYSTEM

In analysing New Zealand's approach to determining the apportionment ratio for entities that make mixed supplies, it is important to note that South Africa's VAT regime is based on the New Zealand Goods and Services Tax Act 1985[184] ("NZ GST Act"). Hence, understanding New Zealand's methodology provides valuable insights into South Africa's own approach.

The primary objective of New Zealand's GST system is to establish a simple, broad-based tax on the private consumption of goods and services by New Zealand consumers[185].

[182] Of the VAT Act

[183] Report Of The OECD- Indirect Tax Treatment Of Financial Services And Instruments- 22 October 1998

[184] Davis Tax Committee. (2015). VAT Review: First Interim Report. Retrieved from https://www.taxcom.org.za/docs/20150707%20DTC%20VAT%20First%20Interim%20Report%20-%20website.pdf, footnote 173, page 75. (Accessed: [April 2023]).

[185] https://taxpolicy.ird.govt.nz/publications/2022/2022-ip-gst-apportionment-rules

The definition of input tax in the GST Act, is similar to the South African definition, and is the VAT charged under section 8(1)[186] when a VAT registered person acquires goods and services. Section 8(1) is New Zealand's charging section, and imposes the GST.

In New Zealand, input tax on the acquisition of goods and services can be deducted to the extent that they are utilized for or available for use in making taxable supplies, as stated in section 20(3C) [187].

EXEMPT SUPPLIES

New Zealand has very few exempt supplies[188], including supplies by financial institutions (includes items which are incidental and necessary to that supply of financial services), non-profit bodies of donated goods and services, dwellings and fine metal.

However, certain financial services can still be elected for charging at the zero rate under section 11(A)(1)(q) as discussed below.

DE MINIMUS

New Zealand incorporates a de minimus provision to alleviate the need for apportionment in certain cases. If a registered person makes both taxable and exempt supplies, they are not required to apply apportionment where they reasonably expect their exempt supplies to be below $90,000 or 5% of the total consideration for all their taxable and exempt supplies for the adjustment period per section 20(3D).[189]

APPORTIONMENT

Regarding apportionment, section 20(3G)[190] requires a person to estimate how they intend to utilise the products or services at the time of acquisition in order to establish the amount to which they will be used for making taxable supplies. This selection must yield a fair and reasonable result. The initial apportionment is based on the intended use, but subsequent adjustments are made to reflect the actual use of the expenses incurred for both taxable and non-taxable supplies.

Under the apportionment rules, input tax may be deducted to the extent that the goods and services acquired are used or available for use in making taxable supplies.

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[186] NZ GST Act
[187] NZ GST Act section 20(3C)
[188] NZ GST Act section 14
[189] NZ GST Act section 20(3D)
[190] NZ GST Act section 20(3D)

According to section 20(3H) of the GST Act, the intended taxable use of goods or services will determine the proportion of input tax that can be deducted on expenses incurred. In the event that expenses are incurred to make both taxable and non-taxable supplies, the taxpayer needs to apportion input tax initially, using intended use. Subsequently it must be assessed for actual use and adjustments made to the apportioned deduction.

The deduction of input tax is determined[191] using the formula—

full input tax deduction × percentage intended use.

Where:

- full input tax deduction is the total amount of input tax on the supply.
- percentage intended use is defined[192], for a registered person, as the extent to which the goods or services are intended to be used by the person for making taxable supplies, estimated at the time of acquisition under section 20(3G) and expressed as a percentage of total use.

The formula used to calculate the VAT recoverable on mixed expenses does not include the issue of share capital, dividend income from subsidiaries, gross property sale proceeds, or distorted supplies[193]. The term "distortive supplies" is not explicitly defined in the GST Act.

ZERO-RATING OF SERVICES

The financial services[194] listed in the New Zealand GST Act, are similar to those listed in section 2 of the VAT Act. New Zealand entities can elect to charge some financial services at the zero rate. Section 11A(1)(q)[195] of the GST Act permits registered persons, who makes supplies of goods and services, who have made an election under section 20F[196] for a supply of financial services to be charged at the zero rate.

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[191] NZ GST Act section 20(3H)

[192] NZ GST Act section 21G(1)(b)

[193] INDIRECT TAX TREATMENT OF FINANCIAL SERVICES AND INSTRUMENTS Report of the OECD 22 October 1998

[194] NZ GST Act section 3 - the term refers to any 1 or more of the following activities: the exchange of currency, the issue, payment, collection, or transfer of ownership of a cheque or letter of credit, the issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security; the issue, allotment, or transfer of ownership of an equity security or a participatory security, underwriting or sub-underwriting the issue of an equity security, debt security, or participatory security, the provision of credit under a credit contract, the renewal or variation of a debt security, equity security, participatory security, or credit contract and the provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, the provision, or transfer of ownership, of a life insurance contract or the provision of re-insurance in respect of any such contract, the payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of any debt security, equity security, participatory security, credit contract, contract of life insurance, retirement scheme, financial option, or futures contract.

[195] NZ GST Act section 11A(1)(q)

[196] NZ GST Act section 20F

The policy rationale[197] for the exemption of financial services is that financial services are difficult to integrate into the GST system because the tax obligation is determined by individual transactions along the whole supply and distribution chain. This is due to the fact that it is challenging to calculate the cost of a financial service because the supplier thereof may be paid through a margin or spread rather than an express fee. The next best alternative, given the challenges involved in taxing the value of services rendered by a financial service provider, is thus to effectively tax the supply by preventing input tax deductions.

The customer must make at least 75% taxable supplies or more of their total supplies (excluding zero-rated business-to-business financial supplies) as taxable supplies within a 12 month period or a period determined by the Commissioner. The election is also available where financial services are rendered to members of a group of companies.[198].

The zero rating of these services is to reduce the potential for tax cascading caused by the exempt treatment of financial services. Allowing these supplies to be charged at the zero rate means that the supplier can deduct input tax on expenses incurred in making the supply.

The New Zealand approach to GST displays elements that align with the principles[199] adopted by the OECD. As relates to VAT apportionment the system promotes effectiveness and fairness by allowing certain financial services to be charged with VAT at the zero-rate although, similar to South Africa, financial services are generally exempt there. This helps prevent tax cascading and ensures that taxpayers can deduct input tax on expenses incurred in making those supplies.

Understanding New Zealand's methodology can provide valuable insights into South Africa's approach to VAT implementation, as South Africa's VAT regime is based on the New Zealand GST Act.

[197] IRD New Zealand. (2015). GST – Current Issues: An Officials' Issues Paper. Available at: https://www.taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2015/2015-ip-gst-current-issues/2015-ip-gst-current-issues-pdf.pdf?modified=20200910084944&modified=20200910084944 [Accessed May 2023], p. 3, para. 2.2.

[198] NZ GST Act section 11A(1)(r)

[199] As indicated in chapter two, neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility.

EUROPEAN VAT SYSTEM

Europe was 30 years ahead of South Africa in terms of the introduction of a VAT system. In 1954, France became the first country in Europe to introduce VAT[200]. All members of the European Economic Community followed suit after the Treaty of Rome was ratified in 1957[201].

Given the widespread implementation of VAT across European Union ("EU") states, it is essential to compare South Africa's VAT system to that of the EU. This comparison allows for a comprehensive analysis of different approaches, methodologies, and regulations, thereby facilitating a deeper understanding of international best practices. Examining how the EU harmonizes VAT rules while accommodating variations in rates and interpretations can provide valuable insights for assessing the fairness, effectiveness, and neutrality of South Africa's VAT framework.

Furthermore, understanding the EU's VAT system can help identify potential areas for improvement and inform policy decisions regarding the treatment of passive income, apportionment methodologies, and the achievement of desired tax objectives. By considering the EU's experiences and practices, South Africa can enhance its VAT system to align more closely with international standards and promote a more efficient and equitable tax environment.

European Union States

Since 1957, more states have joined the EU, resulting in the current 27 EU States[202]. VAT[203] is a common and significant form of taxation in the EU. While the EU has established standard VAT rules, each state retains the flexibility to interpret and implement them according to its national interests and budgetary requirements[204].

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[200] European Commission (2010), Green Paper on the Future of VAT, "Towards a simpler, more robust and efficient VAT system" page 3. Available at: [https://taxation-customs.ec.europa.eu/document/download/494f70a7-9c8f-4549-b5f6-7cc65143d375_en?filename=com%282010%29695_en.pdf]

[201] https://www.elibrary.imf.org/view/journals/024/1973/002/article-A002-en.xml. (Accessed: [May 2023])

[202] Keen, M; *The Anatomy of the VAT (*2013) International Monetary Fund

[203] European Commission. (n.d.). "VAT Rules and Rates." Available at: https://europa.eu/youreurope/business/taxation/vat/vat-rules-rates/index_en.htm [Accessed June 2023].

[204] European Commission. (n.d.). "VAT Rules and Rates." Available at: https://europa.eu/youreurope/business/taxation/vat/vat-rules-rates/index_en.htm [Accessed June 2023].

VAT in the EU is a general indirect tax on consumer spending for goods and services in the EU[205]. The framework for a harmonised EU VAT system was initially established by the Council of the European Economic Community in the First Council Directive of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (67/227/EEC)[206]. Subsequently, the EU member states have adopted principally the VAT model that is set out in the Sixth VAT Directive of 1977[207] ("Sixth Directive").

On 1 January 2007, the Sixth Directive and all prior VAT directives were replaced by Directive 2006/112/EU ("The Directive") which became effective in the Member States by 1 January 2008[208].

According to The Directive, VAT is charged on all transactions made in the EU for payment by a taxable person (i.e. an individual or a business that supplies goods and services in the course of their work). Imports by anyone are subject to VAT as well. These are all taxable transactions.

Taxable persons[209] are those who engage in independent economic activities, regardless of the outcome or purpose. The EU's VAT laws apply to taxable persons irrespective of where their activities are conducted or where they are headquartered. The definition of economic activity is broad and encompasses any business activity. Therefore, the EU's VAT rules are applicable to taxable persons within and outside the EU.

INPUT TAX

As stated in article 168[210] of The Directive, a vendor is allowed to deduct the VAT charged on expenses incurred, from the tax which the taxpayer is liable to pay on supplies the taxpayer makes, where the goods and services are used for the purposes of his taxable transactions.

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[205] European Commission. (n.d.). "What is VAT?" Available at: https://taxation-customs.ec.europa.eu/what-vat_en#:~:text=The%20Value%20Added%20Tax%2C%20or,consumption%20in%20the%20European%20Union. [Accessed June 2023].

[206] European Union. (1967, April 11). *FIRST COUNCIL DIRECTIVE of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (67/227/EEC).* Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31967L0227&from=EN [Accessed Day Month Year].

[207] SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (77/388/EEC)

[208] European Commission. (n.d.). "The European Union's common system of value added tax (VAT)" Available at: https://eur-lex.europa.eu/EN/legal-content/summary/the-european-union-s-common-system-of-value-added-tax-vat.html [Accessed June 2023].

[209] Ibid

[210] Article 174 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

EXEMPT SUPPLIES

The Directive caters for several exemptions which include, exemptions for activities in the public interest, exemptions for intra-Community acquisitions of goods, exemptions for certain transport services, exemptions for other activities, exemptions on importation and exemptions on exportation amongst others.

According to Article 135 of The Directive, exempt supplies include items that are included in section 2 of the SA VAT Act[211] such as: insurance and reinsurance transactions; the granting and the negotiation of credit and the management of credit by the person granting it, the management of special investment funds as defined by Member States; the management of special investment funds as defined by Member States; the negotiation of or any dealings in credit guarantees or any other security for money and the management of credit guarantees by the person who is granting the credit.

OPTION TO MAKE EXEMPT SUPPLIES TAXABLE

In accordance with Article 137 of The Directive[212], Member States may provide taxpayers the choice to make some otherwise exempt supplies taxable[213]. The intention of this section is to deal with the "hidden VAT"[214] which comes as a consequence of the financial services being exempt, which leads to irrecoverable input VAT and increases costs for service providers.

Some EU Member States, including Austria, Belgium, Bulgaria, Estonia, France, Germany and Lithuania, give financial institutions the option to treat transactions that would otherwise be exempt supplies to be regarded as taxable transactions[215].

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[211] VAT Act

[212] Article 137(1)(a) in Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

[213] These include, among other things, granting and the negotiation of credit and the management of credit by the person granting it; negotiation of or any dealings in credit guarantees or any other security for money and the management of credit guarantees by the person who is granting the credit; transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection and factoring; transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items; 'collectors' items' shall be taken to mean gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest; transactions, including negotiation, excluding management and safekeeping, in shares, interests in companies or associations, debentures and other securities and the management of special investment funds as defined by Member States.

[214] Deutsche Börse. (2021, May). VAT Rules for Financial and Insurance Services Today and Tomorrow. Available at: https://deutsche-boerse.com/resource/blob/3035902/1765424b2aedcb965ba8dbdfbda2adea/data/may2021_VAT_rules.pdf [Accessed June 2023].

[215] European Commission. (2012). *TAXATION PAPERS WORKING PAPER N.31 - 2012 Review of Current Practices for Taxation of Financial Instruments, Profits and Remuneration of the Financial Sector.* Available at: https://taxation-customs.ec.europa.eu/system/files/2016-09/taxation_paper_31_en.pdf [Accessed June 2023], p. 30, paras. 114-115.

Only services rendered to customers who can deduct the input tax will be opted into this taxable approach and this will free the financial transactions from any burden of VAT. Where services are rendered to customers who cannot deduct the input tax, then the exemption will be applied[216].

Using the Estonian VAT Act[217] as an example of how this provision is legislated, according to subsection 16 (3) of the Estonian VAT Act, a taxpayer may elect to be taxed on financial services and securities. These supplies are typically exempt from VAT under clause 16(2)(6) and paragraph 16 (21) of the Estonian VAT Act. This can be applied on financial services rendered within the same Member State, but not between Member States.

APPORTIONMENT

In the EU, like in South Africa, a business is partly exempt if it makes, or intends to make, both taxable[218] and exempt supplies[219] and incurs tax on costs which relate to both. Partly exempt entities have to use a partial exemption method to work out how much input tax can be recovered[220].

According to Article 174[221], the deductible proportion of input tax is calculated as thus:

"1. The deductible proportion is made up of the following amounts:

(a) The numerator is the total amount of annual turnover, exclusive of VAT, attributable to transactions for which VAT is deductible in accordance with Articles 168[222] and 169[223];

(b) The denominator is the total VAT exclusive amount included in the numerator (a above) and transactions for which VAT is not deductible.

The article[224] continues by stating that, among other things, the computation should exclude from the numerator or denominator, whichever is relevant, turnover attributable to incidental real estate, financial transactions and other exempt income[225].

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[216] European Commission. (2006). VAT Survey Financial Services. The survey was carried out for the European Commission © European Communities. Available at: https://taxation-customs.ec.europa.eu/system/files/2016-09/vat_survey_financial.pdf [Accessed May 2023], p. 7.

[217] Estonian Value Added Tax Act. Available at: https://www.riigiteataja.ee/akt/104062022012

[218] Deductible in terms of Article 168 COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006

[219] Deductible in terms of Article 169 COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006

[220] Partial exemption (VAT Notice 706) online at: https://www.gov.uk/guidance/partial-exemption-vat-notice-706

[221] Article 174 COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006

[222] Article 168 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax – this article allows taxable persons to deduct input tax on: (a) supplies to other taxable persons amongst others.

[223] Article 169 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax – this article allows taxable persons to deduct input tax on certain taxable and exempt supplies.

[224] Article 174(2) COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006

[225] Article 135 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax -

This exclusion prevents the calculation from being distorted by one-time transactions like the selling of a building or shares. These incidental transactions are generally not directly linked to a taxpayer's primary economic activity and requires a negligible portion of that taxpayer's inputs.

Research conducted by the OECD[226] on EU countries highlighted that certain EU countries, such as Ireland and Sweden, excluded passive income from their apportionment calculations. These exclusions encompassed various types of income, including the sale of property, capital assets, **dividend income (but only when the bank is not running the business)**. Although only a small number of EU member states implemented such exclusions at that time, there have been ongoing efforts within the EU aimed to address potential distortions in VAT apportionment practices. While it is important to consider more recent studies for the most up-to-date information, the 2008 OECD research serves as a foundational reference for understanding the historical context of VAT apportionment and the initial steps taken towards ensuring fair apportionment within the EU.

For instance, Belgium's VAT apportionment standards that are discussed below[227].

The aforementioned general apportionment approach is comparable to the South African standard turnover apportionment methodology. The exception is that the incidental financial transactions and other exempt items can be excluded in terms of The Directive, while they are not in the preapproved South African apportionment methodology. Although incidental transactions are not defined in the Directive, it was established in Cabinet A. Forest v Ministre du Budget[228] that they are transactions that do not directly relate to the taxable person's main economic activity and require only a small portion of the resources available for that activity.

(b) the granting and the negotiation of credit and the management of credit by the person granting it;
(c) the negotiation of or any dealings in credit guarantees or any other security for money and the management of credit guarantees by the person who is granting the credit;
(d) transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection;
(e) transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest;
(f) transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities referred to in Article 15(2);
(g) the management of special investment funds as defined by Member States.

[226] Page 28 of INDIRECT TAX TREATMENT OF FINANCIAL SERVICES AND INSTRUMENTS Report of the OECD 22 October 1998

[227] European Commission. (2006). VAT Survey Financial Services. The survey was carried out for the European Commission © European Communities. Available at: https://taxation-customs.ec.europa.eu/system/files/2016-09/vat_survey_financial.pdf [Accessed May 2023] p 20

[228] Regie Dauphinoise—Cabinet A. Forest Sarl v. Ministre du Budget, 1996 E.C.R. I. 3695 (1996).

In the same case it was determined that incidental supplies are not necessarily minor transactions (quantum is not the indicator)[229]. These incidental financial transactions will be excluded from exempt income, which will result in a smaller denominator, a larger apportionment ratio, allowing for a greater recovery of input tax on mixed expenses.

APPLICATION OF APPORTIONMENT TO EU STATES

The focus of this dissertation extends beyond financial services, however some beneficial principles where outlined in the International Bureau of Fiscal Documentation's ("IBFD") 2007 survey, requested by the European Commission, which is the EU's politically independent executive arm and is responsible for proposing new European legislation and implementing the decisions of the European Parliament and the Council of the EU[230], to survey the methods used by member states to deduct input VAT from the VAT charged when taxable and general persons operating in the financial sector, acquire goods and services for both taxable and exempt purposes[231]. The European Commission's request followed PricewaterhouseCoopers finding[232] that the apportionment ratios for financial institutions ranged from 0% to 74% and the European Commission wanted to understand what may affect the input VAT recovery rate and how EU Member States had interpreted Article 17(5)[233] and whether special legislative provisions or administrative practices affect the rate of input.

BELGIUM

The VAT exemptions in Belgium, an EU member, are in Article 39 of the ("Belgian VAT Code") and Article 44 of that code deals with the financial and insurance services exemptions. The input tax on transactions set out in Article 44 is not deductible unless the taxpayer elects to tax these transactions[234] (make them a taxable instead of an exempt supply which then allows the deduction of input tax).

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[229] Ibid at paragraph 48 – "incidental transactions: they have a certain link with the taxable person's other activity but do not form a direct part thereof. They require the use of the relevant business assets only to a slight extent. They may not exceed the extent of the actual activity."

[230] European Union. *European Commission.* Available at: https://european-union.europa.eu/institutions-law-budget/institutions-and-bodies/search-all-eu-institutions-and-bodies/european-commission_en [June 2023].

[231] European Commission. (2006). VAT Survey Financial Services. The survey was carried out for the European Commission © European Communities. Available at: https://taxation-customs.ec.europa.eu/system/files/2016-09/vat_survey_financial.pdf [Accessed May 2023]

[232] PricewaterhouseCoopers. (2006, November 2). *Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services: Final Report.* Final Report to the European Commission. Available at: https://taxation-customs.ec.europa.eu/document/download/151d09b5-32b0-4e9b-96b7-0c97603ecfe6_fr?filename=financial_services_study_managementsummary_en.pdf [Accessed May 2023], Preface.

[233] Article 17(5) of the Sixth Council Directive of 17 May 1977 on the common system of value added tax (1)

[234] Article 44, § 3, 8 ° of the VAT Code - https://www.vatupdate.com/wp-content/uploads/2020/05/2020-06-04-VAT-Commentary-chapter-9.pdf

The apportionment formula[235] that is used for mixed transactions is:

Total amount of turnover from taxable activities
Total amount of turnover from all activities

According to the survey, dividends and interest payments made on one's own stock portfolio are excluded from the numerator and denominator of the apportionment calculation in Belgium under the general pro rata provision of Article 46(1) of the Belgian VAT code. [236].

This exclusion eliminates any distortions that do not demonstrate the relationship between expenses incurred and income earned because the formula (in particular the denominator) is not inflated by interest and dividend income that is not a part of your business or non-passive income, it results in a greater apportionment ratio.

UNITED KINGDOM

The UK was an EU member until 2020. As a former EU member state, the UK's VAT regulations were aligned with EU directives.

In the United Kingdom ("UK") input tax on purchases that are used to produce both taxable and exempt supplies is known as residual input tax. Vendors that make mixed supplies considered partly exempt and are generally not permitted to deduct all input tax. These vendors are required to use a preapproved method of apportionment or may need to apply for a partial exemption method to calculate how much input tax can be deducted.

Her Majesty's Revenue and Customs ("HMRC") has a preapproved method of apportionment known as the standard method. This method is used to calculate how much residual input tax is attributable to taxable supplies and therefore recoverable. Vendors are compelled to use the standard method unless they have obtained approval for another methodology known as a special method[237].

Recoverable % of residual input tax = Value of taxable supplies in the period (excluding VAT) / Total value of supplies in the period (excluding VAT) X 100 [238]

[235] 9 Art. 46(1) of the Belgian VAT code
[236] Coopers, P., 2006. Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services-Final Report to the European Commission. p 20
[237] https://www.gov.uk/guidance/partial-exemption-vat-notice-706
[238] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/727027/partial-exemption2.pdf

In the Sixth Council Directive 77/388/EEC on the harmonisation of the laws of the member states relating to turnover taxes, it states that partially exempt businesses must calculate the deductible portion of input tax by excluding from the denominator of the standard method of apportionment, amounts amongst others, that relate to financial transactions and things that are not a consideration for economic activity[239].

The HMRC Guidance on Partial exemption (VAT Notice 706)[240] states that when a taxpayer uses a partial exemption approach, the outcome must allow the taxpayer to recover input tax in a way that appropriately depicts how much of the purchases were used to make taxable supplies. The approach should be simple and "fair and reasonable" for both the HMRC and taxpayer."

The VAT Notice 706[241] confirms that the following supplies, amongst others, should be excluded from the standard method as they distort the ratio:

- supplies of capital goods (assets).
- incidental financial or real estate transactions, for instance, interest received on a bank account — these arise merely as a consequence of normal business activity rather than being a separate aim in their own right

In the UK dividends are outside the scope of VAT as they do not represent consideration for any supply of goods or services by the holder of the security[242]. Distortive supplies such as off-balance sheet financial instruments, dividends, foreign exchange are excluded from the apportionment formula used to determine the VAT recoverable on mixed expenses[243].

Guideline 2.2 of the OECD VAT guidelines indicates that the burden of VAT should not lie on taxable businesses, except where explicitly provided for in legislation. The explanation to the guideline confirms that case law is also included in the explicit legislative provision. Below various case law is unpacked that deals with the treatment of passive income to determine how it is treated in other jurisdictions.

[239] European Union. (1977). Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment. Retrieved from https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A31977L0388
[240] https://www.gov.uk/guidance/partial-exemption-vat-notice-706#section2
[241] https://www.gov.uk/guidance/partial-exemption-vat-notice-706#section6
[242] https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin4250
[243] INDIRECT TAX TREATMENT OF FINANCIAL SERVICES AND INSTRUMENTS Report of the OECD 22 October 1998

TYPES OF HOLDING COMPANIES

To assist with the interpretation of some of the cases it is necessary to highlight that there are three types of holding companies[244] and it is important to differentiate between these types. Firstly, holding companies that are not taxable persons. Some holding companies solely engage in holding activities and do not perform any other economic activities that would make them taxable persons. As a result, these holding companies are not permitted to deduct VAT incurred on their expenses. Since they are not engaged in taxable activities, there is no right to deduct input tax. Second, holding companies providing only management services for a fee: the management fees received by the holding company are considered taxable activities and, as a result, these entities have the full right to deduct VAT to the extent of their taxable activities i.e. they can claim input tax deductions on expenses related to their management services. Lastly, holding companies with both taxable and exempt/outside the scope activities: These are holding companies that engage in a combination of taxable and exempt or outside the scope of VAT activities. In such cases, the right to deduct input tax is limited to the extent of taxable use. The holding company can deduct VAT on expenses incurred in relation to its taxable activities, but not for those related to exempt or outside the scope activities.

FLORIDIENNE AND BERGINVEST SA [C-142/99

In the Belgian case, Floridienne and Berginvest SA [C-142/99][245], the issue was whether share dividends and interest on loans should be excluded from the denominator of the apportionment calculation, even where the dividends and interest recipient provides management services to the subsidiaries.

A holding company, Floridienne and an intermediary holding company, Berginvest, claimed involvement in the management of subsidiaries which included administrative duties, accounting and information technology services and extending loans. In return, Floridienne and Berginvest received dividends from subsidiaries on their shares as well as interest on the loans.

Floridienne and Berginvest, declared output tax on the income received from the subsidiaries and deducted all input tax on any expenses incurred in earning this income.

[244] Merkx, M., 2016. VAT and Holding Companies: Position Finally Clear. *EC Tax Rev.*, *25*, p.49.
[245] *Floridienne SA and Berginvest SA v Belgian State* [2000] Case C-142/99

The Belgian revenue authorities contended that the input tax should be apportioned on the basis that a portion of the expense was to earn dividend and interest income. On the grounds that it related to a particular professional activity of a financial nature, the revenue authorities sought to include the interest earned on the loans in the denominator of Floridienne and Berginvest's apportionment calculation, whereas for the dividends, they only sought to include the dividends paid by subsidiaries that received management assistance from the holding entities.

Floridienne and Berginvest argued that determining their apportionment ratio was only applicable to transactions that related to their economic activity of providing services and that holding shares did not constitute a taxable activity. They contended that an insignificant portion of their resources were used to earn the dividend and interest income from their subsidiaries and in their opinion, the dividend income produced by that shareholding fell outside of the scope of VAT. Additionally, they argued that the decision to declare a dividend was that of the subsidiary and that their earnings from the company were for services rendered and separate from the dividend declaration.

The Belgian government, on the other hand, believed that Floridienne and Berginvest's engagement in the administration of its subsidiaries was in reality an economic activity because it involved the use of an asset to generate income in the form of dividends. The government was of the view that those dividends were also consideration for the economic activity and should thus be included in the denominator of the apportionment calculation.

The proceedings noted that the court[246] has historically held the position that entities holding shares in subsidiaries without having any involvement (direct or indirect) in the management of the subsidiary were not taxable persons[247] and could not deduct any input tax. The court's view is supported by the fact that the Sixth Directive does not consider the mere acquisition of shares in another entity as an economic activity[248]. The court's view is different where the holder of the shares is also involved in the management of the entity and regards it as an economic activity[249].

[246] In previous cases such as Case C-60/90 Polysar Investments Netherlands v Inspecteur der Invoerrechten [1991] ECR I-3111, paragraph 17; and Case C-333/91 Sofitam [1993] ECR I-3513, paragraph 12

[247] COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006 on the common system of value added tax - 'Taxable person' shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity.

[248] COUNCIL DIRECTIVE 2006/112/EC of 28 November 2006 on the common system of value added tax - Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as 'economic activity'.

[249] Paragraph 19 - *Floridienne SA and Berginvest SA v Belgian State* [2000] Case C-142/99

The court in this case continued by stating that even in cases where a shareholder participates in management, there is an additional requirement that dividends be capable of being regarded as consideration for an economic activity. This view presumes that there is a direct relationship between the activity performed and the consideration received.

The court held that the receipt of dividends is not consideration for any economic activity thus it falls outside the VAT scope. There is thus no input tax deduction linked to dividends earned.

In addition, Floridienne and Berginvest argued that lending money to a third party, can only be considered exploiting assets when it goes beyond merely managing an asset and when it can be connected as a direct, ongoing, or necessary extension of another taxable activity. The court dealt with the fact that a holding company's interest payments on loans extended to its subsidiaries only count as an economic activity that involves the exploitation of assets when they go beyond simple asset management and are linked to another taxable activity. This was not the case in Floridienne as they simply reinvested dividends received from subsidiaries in loans to other subsidiaries. The entity’s main activity was holding shares, which is outside of the VAT net and the interest income earned from the loans was incidental to the main activity. However, when a holding company provides capital to its subsidiaries, the activity of exploiting that capital with the goal of obtaining income by way of interest therefrom may be considered an economic activity if it is done with a business or commercial purpose. The court ultimately found that, in accordance with Article 19 of the Sixth Council Directive 77/388/EEC, dividends declared and paid by subsidiaries to holding companies that are taxable persons and provide management services to those subsidiaries, as well as interest paid by subsidiaries to holding companies on loans that the holding company has made to them, where the loan transactions did not constitute, for Article 4(2) of the Sixth Directive, an economic transaction, must be excluded from the denominator of the apportionment calculation.

This exclusion of the dividends and passive interest, leads to an apportionment ratio that has no distortions and the entity’s income is assessed within the correct context where expenses incurred correlates to income earned.

EMPRESA DE DESENVOLVIMENTO MINEIRO SGPS SA (EDM) CASE C-77/01

In the Empresa de Desenvolvimento Mineiro SGPS SA ("EDM") case, a Portuguese court considered the principles around what constitutes an incidental financial transaction[250] specifically, what they referred to as the first question, whether all the activities that arise when a holding company that grants interest-bearing loans to its subsidiaries, provides management services and stands as guarantor constitute "economic activity" as defined by [Article 4(2) of] the Sixth Directive[251]. Given that the entity in this case was both a member of a consortium and performed management functions, the second question was whether the duties for that consortium beyond its share, constituted "economic activity" under the Sixth Directive. Finally, whether the entity's financial activity could be classified as "incidental" for the purposes of Article 19(2)[252] even if it generated annual income that is higher than its major activity

EDM is a holding company in the mining industry, which sought to discover mineral resources in Portugal. EDM provided a myriad of typical mining services and it also assisted companies within which it held shares to acquire loans from financial institutions by standing as guarantor.

The referring court was of the view that EDM sold its shareholdings in companies occasionally and even though the proceeds of those sales where quite high, EDM's primary activities had always been the management of its shareholdings and scientific and technological research in the mining sector.

The Portuguese tax authorities were of the view that EDM earned non-taxable income such as dividends, interest on loans to entities in which it held shares and the sale of shares[253]. The authorities thus believed that EDM was subject to apportionment and should not have deducted input tax in full and that it should have used an apportionment method in determining the deductible portion of the input tax incurred.

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[250] *Case C-77/01, Empresa de Desenvolvimento Mineiro SGPS SA (EDM), formerly Empresa de Desenvolvimento Mineiro SA (EDM), and Fazenda Pública, intervener: Ministério Público,* (2004).

[251] SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (77/388/EEC)

[252] SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (77/388/EEC)

[253] Which are exempt activities according to Código do Imposto sobre o Valor Acrescentado (CIVA) in Article 9(28)(a) and (f)

The Portuguese court quoted from the case of Régie Dauphinoise[254] (discussed below), where the court acknowledged that including all receipts from a taxable person's financial transactions in the apportionment denominator would distort the calculation of the input tax deduction. Although the profits from financial transactions may be sizable, the court observed that this does not necessarily mean that the transactions are non-incidental. The calculation of the deduction would be distorted if such transactions were included based just on their quantum.

In answering the first question posed to it, the court came to the conclusion that loans made by a holding company to subsidiaries that involve an insignificant use of goods or services subject to VAT should be regarded as incidental transactions under the terms of Article 19(2) of the Sixth Directive, even where the amounts generated are significant.

The court concluded that the answer to the second question posed to it was that if the consortium members performed tasks that corresponded to their allotted shares, then they would not constitute supplies of goods or services "effected for consideration" as defined by Article 2(1) of the Sixth Directive and, as a result, would not qualify as taxable transactions under that directive. Conversely, if a consortium member performed more activities than their allocated portion under the given contract and it involved payment by the other members against the operations exceeding that share, those operations would constitute a supply of goods or services 'effected for consideration'.

It was found that activities that only include the selling of shares do not meet the definition of "economic activities" as defined by Article 4(2) of the Sixth Directive and are therefore not covered by that directive. Additionally, investments in investment funds do not qualify as "supplies of services effected for consideration" under Article 2(1) of the Sixth Directive. As a result, the income from these transactions must be excluded from the calculation of the deductible proportion referred to in Articles 17 and 19 of the Sixth directive.

Contrarily, it found that bank deposits and investments by a holding company on an annual basis constitute economic activities carried out by that holding company acting as such within the meaning of Articles 2(1) and 4(2) of the Sixth Directive but that the transactions are exempt from VAT (under Points 1 and 5 of Article 2(1)).

[254] Regie Dauphinoise—Cabinet A. Forest Sarl v. Ministre du Budget, 1996 E.C.R. I. 3695 (1996).

SOFITAM SA

In the French case of Sofitam SA (formerly Satam SA) ("Sofitam") and Ministre chargé du Budget[255]("Ministre"), the court ruled on whether dividends should be included in the denominator of the apportionment calculation.

Sofitam, a holding company, deducted full input tax on expenses it incurred. Given that Sofitam earned both taxable and non-taxable income (dividends), the French tax authority sought to reduce the input tax deduction that Sofitam had claimed, contending that Sofitam should have applied an apportionment.

Sofitam argued that the Ministre's view was incongruent with Article 19 of the Sixth Directive which detailed how the proportion of the taxable use of goods or services was to be calculated at the time. According to Article 19, the numerator comprised the taxable income, while the denominator was the numerator plus transactions in respect of which VAT is not deductible. Sofitam contended that the denominator should only include amounts received in respect of taxable supplies or those that are exempt from VAT and excluded dividends, as these do not relate to any activity giving rise to turnover and fall outside of the scope of VAT.

In reaching its decision, the court focused on the fundamentals of VAT, beginning with taxable persons and the deduction of input tax. Specifically, that the intention of the deduction system is to relieve the taxpayer of the burden of VAT paid in the course of furtherance of his enterprise. According to the Court, a holding company that only seeks to acquire stakes in other businesses without participating directly or indirectly in their management, without affecting its rights as a shareholder, does not possess the status of a taxable person and is not entitled to the deduction of taxes under Article 17 of the Sixth Directive. As receiving dividends does not constitute the consideration for any economic activity as defined by the Sixth Directive, it is not subject to VAT. As a result, dividends from holdings are not eligible for a deduction[256]. Therefore, to secure the neutrality of VAT, dividends must be excluded from the computation of the deductible proportion referred to in Articles 17 and 19 of the Sixth Directive. For the reason advanced above, the court concluded that share dividends are to be excluded from the denominator of the methodology.

[255] Paragraph 6, Case C-333/91 SATAM.
[256] Paragraph 12, Case C-333/91 SATAM.

REGIE DAUPHINISE

A case that addressed what incidental financial transactions are and whether they should be included in the denominator for determining the input tax deductible as required by article 19(2) was heard in France's Cour Administrative d'Appel[257].

Régie[258] was a property management company whose operations included managing rental property on behalf of the owners. The property owners made advance payments to Régie. Régie had an agreement with the property owners that Régie would invest those advance receipts with financial institutions, for its own account, Régie afterwards was entitled to keep the interest earned on those deposits.

Even though Régie earned this interest income, it deducted all input tax on expenses incurred, on the basis that it was attributable to the property management fees it earned. Taking a different stance, the French tax authority claimed that Article 212 of Annex II to the French General Tax Code, as created by Decree No. 1163 on December 29, 1979, applied. According to this article, "Taxable persons who do not carry out exclusively transactions in respect of which value added tax is deductible are authorised to deduct a fraction of the value added tax charged on goods constituting fixed assets equal to the amount of that tax multiplied by the ratio between the annual amount of receipts attributable to transactions in respect of which value added tax is deductible and the annual amount of receipts attributable to all transactions carried out ...".

The tax authority argued that only a pro rata deduction could be allowed because the interest on Regie's treasury deposits was free from VAT under Article 26lC(1)(a) and (d) of the General Tax Code, which translated Article 13B(d)(1) and (3) of the Sixth Directive into French law. Additionally, the tax authority believed that the turnover associated with the investment transactions could not be excluded from the calculation of the deductible proportion as "incidental financial transactions" within the meaning of Article 19(2) of the Sixth Directive because the receipts from that activity exceeded a threshold of 5% of Regie's total receipts (the Administrative Instruction 3D of 18 February 1981, in effect at the material time)[259]."

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[257] *SIXTH COUNCIL DIRECTIVE of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (77/388/EEC)*

[258] *Regie Dauphinoise—Cabinet A. Forest Sarl v. Ministre du Budget*, 1996 E.C.R. I. 3695 (1996).

[259] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61994CJ0306&from=EN at paragraph 9

Under Article 4(1) of the Sixth Directive, a taxable person is any person who independently carries out one of those economic activities. According to Article 4(2), "economic activities" include all production, trading, and service-providing activities, particularly the use of physical or intangible property for the aim of generating ongoing income. Finally, it follows from Article 2(1) that in order for a transaction to be liable to value added tax, the taxable person must be acting "as such."
According to the facts, the money that the owners of the managed properties had given to Régie was, in effect, transferred into Régie's ownership. As they are continuous deposits, the court found that Régie's bank account balances were largely stable. Because of the regularity of these deposits, the court was of the view that the Régie's was rendering a service to the financial institutions which involved making money loans for a fixed period to the lending institutions in exchange for interest payments.

In the aforementioned Sofitam case, it was decided that receiving dividends by a holding company did not qualify as consideration for an economic activity and was therefore not subject to VAT, while in this case Régie received interest as a property management company, on investments made for Régie's own account using the owners deposits and this activity could not be excluded from the scope of VAT as the interest did not arise simply from passive ownership of the asset, but was the consideration for a supply, being the placing of capital at the disposal of banks. The court ruled that Régie's receipt of income from investments made with money it received from clients while managing their properties constituted a direct, necessary, and permanent extension of the taxable activity in this case, establishing the manager's status as a taxable person.

From this case, it can be concluded that the distinction between passive and active income earning is a crucial factor in determining whether an amount must be included in the apportionment calculation or not. Passive income typically refers to earnings generated from investments or assets without or with negligible active involvement from the recipient of the income. In the Sofitam case, the dividends received by Sofitam were deemed to be non-taxable because they were viewed as passive income, not directly linked to a service or economic activity.

The court's ruling in the Régie case establishes that income earned from continuous investments, or making funds available to financial institutions, even if it is made with clients' funds, cannot be considered passive income.

This is not merely owning or holding of an asset, but a continuous and regular provision of a service which forms part of your enterprise activity.

In the EU, case law has addressed how holding companies should be treated for VAT purposes, particularly regarding apportionment formulas. The apportionment formulas are used to determine the extent to which input tax can be deducted on expenses incurred by holding companies that make both taxable and non-taxable supplies.

Case law has provided guidance on how income earned by holding companies is categorized as either passive or active and whether it should be included in the apportionment formulas. Typically, revenue from sources other than active business operations and active sales is referred to as passive income. Revenue from sources other than active business operations or client services is referred to as passive income. Examples of such income are dividends and interest, On the other hand, active revenue is produced during business activities through the sale of goods or the provision of services.

Case law in the EU has established that passive income should not be taken into account in the apportionment methods when determining how much input tax can be deducted.

Similar to New Zealand, in line with the principle of effectiveness and fairness, EU Member States have the option to allow taxpayers to make some otherwise exempt supplies taxable. This addresses the issue of irrecoverable input VAT and reduces costs for service providers. Financial services, in particular, may be subject to this option in certain EU countries, ensuring fairness and effective VAT treatment.

In light of the analysis above, it is imperative that South Africa considers reforming its VAT apportionment approach by considering alternative apportionment methods and drawing insights from the practices adopted in other jurisdictions such as New Zealand, the EU, and the UK. These jurisdictions have demonstrated that focusing on the intended taxable use of goods and services and excluding distortive elements like passive income in the apportionment formula can lead to a fairer and reasonable apportionment ratio. South Africa should also contemplate introducing flexibility in the treatment of financial services, akin to New Zealand's approach, where there is an option to treat otherwise exempt financial services, as taxable.

Aligning with these international standards would not only enhance the integrity and fairness of the VAT system but also reduce administrative burdens as less taxpayers would approach the Commissioner for apportionment rulings and provide clarity to taxpayers and businesses operating within the country's VAT system.

In addition to improving the integrity and fairness of the VAT system, aligning with these international standards would also reduce administrative burden on SARS as fewer taxpayers would seek apportionment rulings.

CHAPTER FOUR SUMMARY

This chapter focussed on VAT apportionment in some other jurisdictions with a focus on the inclusion of passive income, the research examined how selected countries interpret and implement VAT, specifically focusing on VAT apportionment approaches and the inclusion of passive income in apportionment formulas. The VAT regimes of New Zealand, the European Union (EU), and the United Kingdom (UK) were explored to gain insights into their practices.

While the treatment and case precedents in these countries provide no precedent in South Africa, they offer valuable guidance and insights for the development of policies and legislation related to VAT apportionment methods. South Africa can examine the diverse approaches taken by these countries and the scenarios involving dividends and interest in curbing distortions in VAT apportionment approaches.

In line with New Zealand's approach to VAT apportionment, South Africa can consider allowing taxpayers to estimate the expected use of goods and services before including them in the apportionment calculation. This method contributes to ensuring that apportionment methods are fair and reasonable by focusing on intended taxable use and automatically excluding quantities that can distort the apportionment ratio. As dividends are outside the scope of VAT in New Zealand and interest is exempt, these otherwise distortive amounts are excluded. The determination of the VAT recoverable on mixed expenses is thus fair and reasonable.

Subject to some requirements, another option that New Zealand affords its vendors, is to elect to charge some financial services at the zero rate instead of exempt. Meaning that if this was the case in South Africa, the numerator of the standard turnover method would increase rather than the denominator, which treatment results in a higher apportionment ratio.

The EU has standardized VAT rules, but each member state can interpret and implement them differently. Similar to New Zealand, vendors can opt to make some exempt financial services taxable. Drawing from the European example, South Africa could provide taxpayers with the flexibility to make certain transactions taxable like some European countries do with financial services. Additionally, the partial exemption method of some EU territories specifically excludes certain financial and exempt income transactions. Example of countries with such an exclusion are Ireland, Sweden and Belgium which exclude some dividends received. The UK has a standard turnover method that is similar to South Africa's one, however the UK excludes distortive supplies such as off-balance sheet financial instruments, dividends and foreign exchange from the methodology.

The primary goal of VAT's deduction system, as recognized through established case law, is to relieve businesses of the burden of VAT incurred while making taxable supplies. The common VAT system aims to ensure impartial taxation of all economic activities. Additionally, the right to deduct VAT must be implemented in a manner that aligns with the scope of the taxable person's enterprise activity. This ensures that the right to deduct input tax corresponds with the taxable person's enterprise activity.

The UK has also addressed the treatment of holding companies for VAT purposes through case law and South Africa can gain from considering and implementing the findings in its VAT apportionment approaches. For example European case law has dealt with VAT apportionment in the context of holding companies. Holding companies are classified into different types based on their activities, including those that are not taxable persons, those providing management services for a fee, and those engaged in both taxable and non-taxable activities. Drawing from the European cases discussed, it is evident that holding companies that only hold shares in companies, without managing them, are not considered taxable persons and are thus ineligible for input tax deductions. This exclusion safeguards the integrity of the VAT system's objective of a wholly neutral tax that is focused on the supply of goods and services.

Case law has similarly established that passive income should be excluded from apportionment formulas, ensuring that input tax deductions are calculated accurately and fairly.

In the Floridienne case, the court ruled that certain transactions must be excluded from the denominator of the apportionment calculation.

These transactions include when a holding company that is a taxable person provides management services to a subsidiary and receives dividends from that subsidiary as well as when the holding company receives interest on loans extended to subsidiaries when those loans do not constitute an economic activity of the holding company.

In the Empresa de Desenvolvimento Mineiro SGPS SA (“EDM”) case, the court found that loans made by a holding company to subsidiaries that involve insignificant use of goods or services should be regarded as incidental transactions even if the amounts generated are significant.

In the Sofitam case, it was decided that receiving dividends by a holding company did not qualify as consideration for an economic activity and was therefore not subject to VAT. While in the Régie case, the court held that the property manager placed capital at the disposal of banks and the income it earned from this was from a direct, necessary, and permanent extension of the entity’s taxable activity which establishes the manager's status as a taxable person. The income earned was not passive in nature and the court ruled for it to be included in apportionment calculation.

The specific court cases[260] dealt with in the chapter, provide further insights into the treatment of dividends and interest, passive income for VAT purposes. The complexities and nuances of VAT apportionment methodologies across different countries are illuminated, ultimately enriching understanding of this subject matter.[261].

Ultimately, the chapter provides valuable insights into the complexities and nuances of VAT apportionment methodologies in different countries.

[260] Such as Floridienne and Berginvest, Sofitam, and Régie dealt with earlier in the chapter.
[261] Merkx, M., 2016. VAT and Holding Companies: Position Finally Clear. *EC Tax Rev.*, *25*, p.49.

CHAPTER FIVE: FINDINGS OF THE STUDY

In chapter one, the study commenced with a review of the history of VAT and general VAT principles. In chapter two, the study delved into the specifics of the OECD VAT guidelines. In Chapter three, the South African VAT landscape was unpacked with a focus on apportionment and the inclusion or limitation of various values in the apportionment formulae. Chapter four delved into the VAT apportionment methodologies adopted by New Zealand, the EU and the UK. This analysis was done to determine how the South African VAT rules compared to those of other jurisdictions in terms of VAT apportionment and the inclusion of dividends and interest in apportionment formula compared to other jurisdictions.

Building upon this analysis, this chapter presents the findings of the comparative analysis.

The VAT Act in section 17(1), directs that an entity that makes both taxable and exempt supplies should, after applying direct attribution, apply apportionment to mixed expenses. This apportionment ratio must be determined using the pre-approved standard turnover method of apportionment unless it leads to a distortion such as where the expenses incurred are not proportional to the income earned.

The objective of this study was to determine whether there is an approach that South Africa can adopt to ensure that the inclusion of dividends and interest is commensurate with the expenses and efforts expended to earn this income. To study the OECD guidelines and what they say vis-à-vis a vendor's ability to deduct input tax. Finally, to explore the methodologies that are used by jurisdictions outside of South Africa to determine whether or not dividends and interest should be included in apportionment formulae. It included review of case law that deals with the inclusion of dividends and interest and/or the passive nature of earning this income.

In South Africa, the application of the apportionment method as per BGR 16 is conditioned upon it being fair and reasonable. The SARS guide for vendors emphasises that a common-sense approach, akin to what a reasonable person would employ, must be applied in considering the appropriateness of the standard turnover-based method. The study found that South Africa's pre-approved standard turnover method of apportionment is potentially distortive. The amounts that BGR 16 compels you to include in in "b" and "c" of the denominator can include amounts that are earned passively, are incidental to your core enterprise and distortive.

Subject to the nature of an enterprise, this approach can fall foul of the OECD VAT/GST Guidelines that were dealt with in Chapter two. The principles that have been adopted the OECD include – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility. The OECD Guidelines provide a comprehensive framework for understanding the mechanics and principles of VAT. According to chapter one of the Guidelines, one of the core features of VAT, is to relieve businesses of the burden of VAT incurred during the purchase of goods and services in the course of making taxable supplies. VAT is designed to be economically neutral, ensuring that the burden of the tax does not fall on businesses but is ultimately borne by the final consumer. The collection of VAT occurs in a phased manner throughout the supply chain, with each entity deducting input tax on their expenses and charging output tax to customers. Including passive income, that is not related to a taxpayer's enterprise activity, in the denominator of the standard turnover method decreases the apportionment ratio and their ability to deduct input tax incurred on expenses. This is contrary to the OECD Guidelines.

The OECD Guidelines also deal with the concept of VAT neutrality, emphasizing that VAT should not discriminate, impose unnecessary tax burdens, or create excessive compliance costs for businesses. The ability for vendors to deduct input tax at each stage of the value chain is crucial to achieving neutrality. This deduction mechanism prevents cascading effects and ensures that the ultimate consumer pays the VAT, regardless of the product or the length of the supply chain. Moreover, the guidelines stress that VAT should not be the primary influence on business decisions. While VAT is a factor to be considered, it should not dictate a business's operations. Compliance costs, cash-flow impacts, and the overall tax burden are important considerations that should be balanced when making business decisions.

The ability for businesses to deduct input tax on costs incurred plays a central role in achieving VAT neutrality.

Overall, the OECD VAT/GST Guidelines provide valuable guidance on the mechanics and principles of VAT, emphasizing the importance of VAT neutrality, the ability to deduct input tax, and the consideration of various factors in making business decisions. These guidelines serve as a useful reference for countries like South Africa in developing and refining its VAT system.

In order to determine whether there is an approach that South Africa can adopt to ensure that the inclusion of dividends and interest is commensurate with the expenses and efforts expended to earn this income the study analysed the VAT apportionment methods of other jurisdictions including New Zealand, the European Union (EU), and the United Kingdom (UK), with a focus on the inclusion of passive income in the apportionment formulas.

New Zealand provides an option to estimate the expected use of goods and services for their intended taxable use, at the time of acquisition, before incorporating them into the apportionment calculation. This is seen as fair and reasonable since it focuses on intended taxable use and excludes dividends which are outside the scope of VAT in New Zealand and interest which is exempt, which can distort the apportionment ratio. Additionally, vendors have the option to elect to charge some financial services at zero rates instead of exempt, subject to certain requirements.

Subject to some requirements, another option that New Zealand affords its vendors, is to elect to charge some financial services at the zero rate instead of exempt. If this was given as an option in South Africa, the numerator of the standard turnover method would increase rather than the denominator, which would result in a higher apportionment ratio and a higher input tax claim for the taxpayer.

The UK employs a standard turnover method akin to South Africa's but excludes distortive supplies such as off-balance-sheet financial instruments, dividends, and foreign exchange.

The EU has standardized VAT rules but allows member states the flexibility in interpretation and implementation. Some EU territories exclude certain financial and exempt income transactions from the apportionment method. For example, Ireland, Sweden, and Belgium exclude some dividends received. While, similar to New Zealand, some states allow vendors to opt to make some exempt financial services taxable.

Certain European cases offer insights into the treatment of passive income in VAT apportionment. Through this case law, the treatment of holding companies for VAT purposes is classified into different types based on their activities, including those that are not taxable persons, those providing management services for a fee, and those engaged in both taxable and non-taxable activities. Case law has established that passive income should be excluded from apportionment formulas, ensuring that input tax deductions are calculated accurately and fairly.

One of the cases confirmed that a holding company that is a taxable person and provides management services or loans to subsidiaries, where the loan transactions do not constitute

an economic activity of that holding company, must exclude the dividends and interest income earned from the denominator of the apportionment calculation. Another principle that was introduced by case law is that holding companies that extend loans to subsidiaries that involve insignificant use of goods or services should be regarded as entering into incidental transactions even if the amounts generated are significant.

An additional principle is that dividends received by a holding company do not qualify as consideration for an economic activity and are thus not subject to VAT unless the dividend income it earned from a direct, necessary, and permanent extension of the entity's taxable activity which establishes the manager's status as a taxable person. In this case, it was established that the income earned was not passive in nature and the court ruled for it to be included in apportionment calculation.

These cases set the precedent in the EU that holding companies supplying management services are taxable persons eligible for input tax deductions, while those merely holding shares without management activities are not. Thus, where a taxpayer merely holds shares the dividends income is not included in the apportionment calculation. This exclusion prevents the distortion of the apportionment ratio and ensures that input tax deductions correlate more accurately with the taxable use of inputs.

The research questions have been addressed through the comparative analysis and case law review. South Africa can indeed adopt an approach that ensures a more commensurate inclusion of dividends and interest by considering international practices, particularly New Zealand's approach of estimating the taxable use of goods and services, and the flexibility and exclusions adopted in the EU and the UK. Additionally, South Africa should consider aligning its VAT apportionment methods with international best practices to ensure that input tax deductions are in line with the taxable use of goods and services.

CHAPTER SIX: RECOMMENDATIONS

VAT is a tax on the value-added at each stage of the production or distribution of goods and services. The VAT system is designed to tax the value added to a product or service as it progressed through the production and distribution cycle, from raw materials to the final sale to the end consumer. The research findings indicate that the inclusion of passive income such as dividends and interest in VAT apportionment calculations does not accurately reflect the value-added nature of the tax. Value-added is typically understood to be the difference between the cost of inputs and the price of the output. For goods, the value-added includes the cost of the raw materials, labour, and overhead expenses involved in converting those raw materials into finished goods. For services, value-added includes the cost of labour, materials, and other expenses incurred in providing the service. Contrarily, passive income, is income generated from investments, such as interest earned on savings accounts or dividends paid for holding shares. This income is not generated through the production or distribution of goods or services but by investing and thus does not contribute to the value of a good or service. Taking these passive amounts into consideration when determining the input tax to be deducted does not properly demonstrate how expenses are incurred to earn income for an enterprise and is thus distortive.

South Africa should revisit the preapproved standard turnover VAT apportionment method in order to reduce distortions and with it the administration burden of taxpayers approaching SARS for suitable apportionment methodologies. Having studied the VAT apportionment methods in South Africa and compared them to approaches in New Zealand, the European Union, and the United Kingdom, this research has illuminated several areas where improvements can be made. Only income that is earned actively, such as life insurance policy sales where there is a correlation between expenses incurred and income earned should be included in the standard turnover calculation. Similar to the EU, where a taxpayer merely holds shares the dividends income should be excluded from the apportionment calculation.

South Africa can also adopt New Zealand's approach which estimates the expected use of goods and services for taxable purposes, excluding dividends and interest which can distort the apportionment ratio. This is seen as fair and reasonable as it correlates the deductible input tax to the taxable use of the inputs, the actual use can be updated and declared once it has occurred.

In addition, South Africa should establish comprehensive legislation or guidelines for VAT apportionment can offer greater clarity and certainty for taxpayers and businesses. This would not only improve the fairness and accuracy of VAT apportionment but can also reduce the administrative burden on both taxpayers and the tax authority, as taxpayers would have clear guidance and would less frequently approach the Commissioner for apportionment rulings.

Implementing these recommendations can significantly reduce distortions in the pre-approved VAT apportionment method and others in South Africa. It will also preserve the integrity of VAT, upholding what Von Siemens sought to do in developing VAT which was to allow taxpayers to claim taxes and what Thomas S. Adams with the credit for input tax incurred.

It will reinforce the VAT principles such as fairness, neutrality, minimize administrative costs for SARS and the tax payer which is efficient, effectiveness. This would reduce distortions and ambiguities, providing clarity and certainty to taxpayers and businesses operating within South Africa's VAT system.

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APPENDIX A

Current

Value-Added Tax Act No. 89 of 1991

Section 1 – Definitions

(1) "input tax", in relation to a vendor, means -

(a) tax charged under section 7 and payable in terms of that section by -

(i) a supplier on the supply of goods or services made by that supplier to the vendor; or

(ii) the vendor on the importation of goods by that vendor; or

(iii) the vendor under the provisions of section 7(3);

(b) an amount equal to the tax fraction (being the tax fraction applicable at the time the supply is deemed to have taken place) of the lesser of any consideration in money given by the vendor for or the open market value of the supply (not being a taxable supply) to him by way of a sale on or after the commencement date by a resident of the Republic (other than a person or diplomatic or consular mission of a foreign country established in the Republic that was granted relief, by way of a refund of tax as contemplated in section 68) of any second-hand goods situated in the Republic;

(c) an amount equal to the tax fraction of the consideration in money deemed by section 10(16) to be for the supply (not being a taxable supply) by a debtor to the vendor of goods repossessed under an instalment credit agreement or a surrender of goods: Provided that the tax fraction applicable under this paragraph shall be the tax fraction applicable at the time of supply of the goods to the debtor under such agreement as contemplated in section 9(3)(c),

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;

Section 17 - Permissible deductions in respect of input tax

(1) Where 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 the supply to the vendor or the importation by the vendor, as the case may be, of such goods or services or 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: Provided that -

(i) where the intended use of goods or services in the course of making taxable supplies is equal to not less than 95 percent of the total intended use of such goods or services, the goods or services concerned may for the purposes of this Act be regarded as having been acquired wholly for the purpose of making taxable supplies;

(ii) where goods or services are deemed by section 9 (3) (b) to be successively supplied, the extent to which the tax relating to any payment referred to in that section is input tax may be estimated where the calculation cannot be made accurately until the completion of the supply of the goods or services, and in such case such estimate shall be adjusted on completion of the supply, any amount of input tax which has been overestimated being accounted for as output tax in the tax

period during which the completion occurs and any amount of input tax which has been underestimated being accounted for as input tax in that period; and (iii) where a method for determining the ratio referred to in this subsection has been approved by the Commissioner, that method may only be changed with effect from a future tax period, or from such other date as the Commissioner may consider equitable and such other date must fall-

(aa) in the case of a vendor who is a taxpayer as defined in section 1 of the Income Tax Act, within the year of assessment as defined in that Act; or

(bb) in the case of a vendor who is not a taxpayer as defined in section 1 of the Income Tax Act, within the period of twelve months ending on the last day of February, or if such vendor draws up annual financial statements in respect of a year ending other than on the last day of February, within that year,

during which the application for the aforementioned method was made by the vendor.

In 1991

17(1) Where 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 and tax has 45 become payable in respect of the supply to him or the importation by him, as the case may be, of such goods or services or in respect of such goods under section 7(3), the extent to which such tax is input tax as contemplated in the definition of "input tax" in section 1 shall be an amount which bears to the full amount of such tax the same ratio as the intended use of such goods or services in 50 the course of making taxable supplies bears to the total intended use of such goods or services: Provided that-

(i) where the intended use of goods or services in the course of making taxable supplies is equal to not less than 90 per cent of the total intended use of such goods or services, the goods or services concerned shall for 55 the purposes of this Act be deemed to have been acquired wholly for the purpose of making taxable supplies; and 70 No. 13307 GOVERNMENT GAZETTE, 12 JUNE 1991 Act No. 89, 1991 VALUE-ADDEDTAXACf,l991

(ii) (ii) where goods or services are deemed by section 9(3)(b) to be successively supplied, the extent to which the tax relating to any payment referred to in that section is input tax may be estimated where the calculation cannot be made accurately until the completion of the supply of the goods or services, and in such case such estimate shall be adjusted on completion 5 of the supply, any amount of input tax which has been overestimated being accounted for as output tax in the tax period during which the completion occurs and any amount of input tax which has been underestimated being accounted for as input tax in that period.

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