



# VAT Apportionment in South Africa

Does your income streams include dividend income, interest income, foreign exchange gains/losses, gains or losses from sale of crypto currency? If yes, be careful as there may be a need to apportion input VAT claims.

## Introduction

Generally, the full amount of VAT on goods or services acquired locally or imported for the purposes of making taxable supplies can be deducted as input tax. However, if goods or services are imported or purchased locally partly for taxable and other non-taxable purposes (mixed purpose), only a portion of the VAT or notional input tax may be claimed. If goods or services are not acquired exclusively in the course of making taxable supplies, the taxable portion and claimable input tax must be determined i.e. VAT apportionment must be considered.

Before applying VAT apportionment, the first step is to determine whether direct attribution can be used to determine the VAT input. Direct attribution means that the VAT expense will have to be attributed according to the intended use or purpose of the goods or services acquired. This will be the case where permissible expenses are incurred either wholly for the making taxable supplies, in which case the VAT can be deducted in full or wholly for the making exempt supplies or other non-taxable purposes, in which case no VAT can be claimed as an input tax deduction.

VAT apportionment only applies to expenses that have been incurred partly for the purpose of consumption, use or supply in the course of making taxable supplies and partly for exempt or other non-taxable purposes. If it is clear that the expense must be apportioned, the next step is to calculate the proportion of VAT which may be claimed as an input tax deduction. This is termed the apportionment ratio and is expressed as a percentage. The most common VAT on expenses incurred that needs to be apportioned are general business overhead expenses.





### Apportionment Ratio Calculation

If it is clear that the expense cannot be directly attributed wholly to a taxable, exempt or other non-taxable purpose, the second level of enquiry is to determine the portion of VAT which qualifies as input tax, based on the extent to which the intended use is for taxable purposes. The apportionment ratio must be determined by using an approved apportionment method to produce a fair and reasonable proportion of VAT that can be claimed as an input tax deduction.

It is important that vendors assess the appropriateness of various methods of apportionment to ensure equity. Methods of apportionment which, at least, should be considered include the:

- Turnover-based method (discussed in detailed below).
- **Employee numbers method:** Need to determine the number of employees on income categories. The number of employees to generate taxable income is then calculated as a percentage of the total number of employees. May be complicated if employees are required to perform both taxable and non-taxable services.
- **Time spent basis method:** Need to determine the time spent by employees on income categories. The time spent by employees to generate taxable income is then calculated as a percentage of the total number of employees. This method may be complicated if employees are required to perform both taxable and non-taxable services. SARS is reluctant to approve this method where employee are not required to keep a record of their time spent.
- **Floor space-based method:** Required to calculate the percentage of floor space used solely to generate taxable income as a percentage of total floor space. If employees are required to perform activities which either relate to taxable income or exempt supplies and occupy space which correlate to taxable or exempt purpose, the distinction need to be made. This method, might get complicated during the COVID-19 pandemic and post the pandemic where some of the adjustments that the world has had to make remain, i.e. limiting the number of employees physically present at work.
- **Transaction-based method of apportionment:** Need to calculate the ratio which the number of taxable transaction bears to the total number of transaction
- **The varied input-based method of apportionment:** Calculates the VAT on expenses incurred wholly for taxable purposes as a percentage of VAT incurred for taxable and exempt purposes; or
- A hybrid of the methods.

**The turnover-based method** calculates the total value of all taxable supplies as a ratio of total value of all income received. The turnover-based method of apportionment formula is set out in Binding General Ruling 16. The turnover-based method is the only pre-approved VAT apportionment method, which does not require prior written approval from the Commissioner. If the turnover-based method is inappropriate as it produces an absurd result, is impossible to use, or does not yield a fair approximation of the extent of taxable application of the enterprise's VAT-inclusive expenses, the client must request SARS to allow a more suitable alternative method.

For example: The core business for most companies in the financial services sector is to provide financial and technical assistance to their clients. Notwithstanding the fact that these companies are not banks in terms of the South African Banks Act and are furthermore not members of the Banking Association of South Africa (BASA), they therefore may not utilize the alternative VAT Apportionment method allowed to BASA members. These companies may however render very similar services which the members of BASA render. In this regard it would not be fair and equitable for such financial services companies to calculate their input tax apportionment ratio using the standard turn over based method.

Another example may relate to dividend Income: Dividend income is passive in nature. The amount of costs and resources utilised in the earning of this type of income is minimal. Consequently, it cannot be reasonably construed that the intended use of a significant portion of existing operational expenses will be applied for the purpose of earning dividends.

The same could be said about Interest Income. The most persuasive argument to exclude passive interest income lies in the fact that the clients incur minimal costs in respect of the earning the interest income. The interest earned from the positive bank balance, unit trust or money market is entered into the system once a month based on bank statements. It cannot therefore be said that the standard turnover method yields an accurate ratio which is representative of the applicant's taxable activities on the basis that the inclusion of interest would not be reflective of the use of resources in the same way income is earned.

If a specific ruling is granted which is found to be inappropriate at a later stage, the client may not revert to the turnover method without a specific ruling from SARS. In deciding the appropriateness of the turnover method, the client must apply a reasonable approach. The method must be "fair and reasonable" and properly reflect the manner in which the client's business inputs are applied to make taxable and non-taxable supplies.

Although the term "fair and reasonable" is a subjective concept, clients applying the turnover method should aim to be objective to obtain a "fair and reasonable" result, also from the Commissioner's perspective.

The result must also be justified as appropriate in the client's circumstances.

If a company applies an apportionment and undergoes a major restructuring, or the nature of the business and taxable and non-taxable supplies change, the client must approach the Commissioner to confirm the appropriateness of the current method.

### **de Minimis Rule**

If the apportionment ratio (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. The calculation must exclude the value of goods or services supplied in respect of which an input tax deduction was specifically denied. The apportionment percentage should be rounded off to two decimal places.

### **Adjustments**

The turnover-based method is generally calculated using information extracted from the financial statements. The financial statements may not always specify the information required to accurately calculate the turnover method (i.e. the income statement reflects income comprising of both taxable and exempt supplies or other non-taxable receipts). It is advisable that you maintain adequate accounting records to establish the actual value of taxable supplies, exempt supplies and other non-taxable receipts.

The apportionment ratio may be determined for every tax period. It is not always practical to accurately determine the apportionment ratio in terms of the turnover method in every tax period. Vendors are permitted to calculate the estimated percentage using the turnover figures from the previous year's financial statements, and to apply that percentage to claim input tax deductions in every tax period for the current year. **An adjustment must be made for shortfalls or over-estimations in the percentage used, when the audited financial statements for the current financial year become available, and the actual percentage can be calculated.** This is a practical administrative arrangement and does not alter the provisions of the VAT Act. As part of the review of the accuracy and completeness of the VAT provision in the financial year under audit it is therefore important to do a comparison of the recalculated VAT apportionment ratio for prior period to the VAT apportionment ratio actually used.

New enterprises with no past financial statements, may use an estimate based on **expected taxable turnover** in terms of the enterprise's business plan or forecasts for every tax period. An adjustment will still be required within six months of the financial year-end to account for differences between the estimated apportionment percentage used, and the actual extent of taxable supplies as determined from the audited financial statements.

### **Backdating Method and SARS' discretion**

If the turnover method may not always produce an equitable result vendors can apply to SARS to use a different method. These methods are often only granted with prospective effect, which seems counter-intuitive and unfair, especially if the circumstances of the client have not changed. However, there may be ample time to consider a voluntary disclosure relief application to SARS for the period that is not being back-dated.

### **Conclusion**

If the VAT is not apportioned where apportionment was supposed to be applied, there will be a non-disclosed liability to SARS for the over-statement of VAT input which will lead to an administrative non-compliance penalty equal to 10%, plus an understatement penalty which may go up to 200%. In addition to the penalties, interest at the applicable rate will be levied. In certain instances, the Commissioner may pursue criminal prosecution for a tax offence arising from the 'default'.

### **How can we assist you?**

- Analysis of your income streams to identify if VAT apportionment is applicable
- Check for a more appropriate methods that will yield a better result
- Apply to SARS for an alternative apportionment method
- Check if apportionment was meant to be applied for prior years and come up with solutions that will help waive all or part of applicable penalties as a result of over claimed input VAT
- Help with a system review to consider transactions that will attract apportionment

Article by



**Bongji Jembula**  
Senior Manager: VAT



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