DRAFT

DRAFT BINDING GENERAL RULING (VAT) 16 (Issue 3)

DATE:

ACT	**:**	**VALUE-ADDED TAX ACT, NO. 89 OF 1991 (the VAT Act)**
SECTION	**:**	**SECTION 17(1) – APPORTIONMENT**
SUBJECT	**:**	**STANDARD TURNOVER-BASED METHOD OF APPORTIONMENT**

Preamble

For the purposes of this ruling –

- **"BGR"** means a binding general ruling issued under section 89 of the Tax Administration Act 28 of 2011;
- **"capital asset"** means the asset described in E3 in the Annexure;
- **"extraordinary income"** means the income defined in E4 in the Annexure;
- **"ICA"** means an instalment credit agreement as defined in section 1(1) and includes a floorplan which complies with this definition;
- **"Income Tax Act"** means the Income Tax Act 58 of 1962;
- **"JIBAR"** means the Johannesburg Interbank Average Rate;
- **"section"** means a section of the VAT Act unless otherwise stated;
- **"STB"** means the standard turnover-based method of apportionment;
- **"TA Act"** means the Tax Administration Act 28 of 2011;
- **"VAT"** means value-added tax;
- **"VAT Act"** means the Value-Added Tax Act 89 of 1991;
- **"ZARONIA"** means the South African Overnight Index Average;
- any other word or expression bears the meaning ascribed to it in the VAT Act.

1. Purpose

This BGR prescribes the method to be used in determining the ratio contemplated in section 17(1).

2. Background

Section 17(1) provides that the extent to which a vendor may deduct tax payable in respect of goods or services acquired partly for the purpose of making taxable supplies and partly for some other purpose (for example, exempt supplies, private use or other non-taxable purposes) is determined by means of a ratio determined by the Commissioner in terms of a ruling contemplated in Chapter 7 of the TA Act (that is, a binding general ruling) or a ruling under section 41B (that is, a VAT class ruling or a VAT ruling).

3. Ruling

The formula set out below, being the STB and the default method to all vendors in the absence of an alternative method approved by the Commissioner in terms of a ruling as described above, constitutes a BGR under section 89 of the TA Act.

Formula:

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

Where, having regard to the exclusions and adjustments listed below, –

"y" = the apportionment ratio/percentage.

"a" = the value of all taxable supplies (including deemed supplies) made during the period.

"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" which was received or accrued during the period, whether in respect of a supply or not.

The following are **excluded** from the formula set out above:

E1	Foreign exchange differences that do not form part of any hedging activities.
E2	Accounting entries, such as fair value adjustments, resulting in income reflected in the AFS[1] to ensure compliance with relevant Regulatory Frameworks.
E3	The sale of capital assets.
E4	Extraordinary income.
E5	The value of any goods or services supplied where input tax on those goods or services was specifically denied under section 17(2).
E6	Specific to the provision of finance: • The cash value of goods supplied under an ICA. • The portion of a rental payment relating to the capital value of goods supplied under a rental agreement which is entered into as a mechanism of finance. • Capital value of loans.
E7	Change-in-use adjustments under sections 18, 18A, 18C and 18D.
E8	Indemnity payments received as envisaged under section 8(8) to the extent that the indemnity payments relate to extraordinary income or capital assets.

[1] Annual Financial Statements, generally compiled to comply with relevant regulatory requirements as set out in the Companies Act 71 of 2008.

E9	Manufactured interest and dividends received by the borrower of a securities lending transaction.
E10	The value of equities or derivatives issued as a manner of raising funds.
E11	Interest earned from – • the vendor's current account (meaning, the account used for day-to-day business operations); and • the South African Revenue Service (SARS).

Adjustments to the value of certain income streams included in the formula set out above:

A1	Interest, other than the interest excluded from the formula in E11: • Interest from sections 8F and 8FA[2] instruments must be regarded as dividends for apportionment purposes and be included in the formula by applying the (prime rate − JIBAR) proxy as set out in A3 below. • Net interest must be included where funds are borrowed with the objective to on-lend. Refer to the discussion on A1 in Annexure A on what "net interest" entails. Notes to the net interest adjustment: 1) If actual values are not available to determine the net interest value to be included, the following proxies must be used: a) Proxy 1 – If no interest is received on the loan – then use loan value × prime interest rate b) Proxy 2 – If there is no interest paid value – then use loan value × JIBAR 2) If the lending arrangement is between "connected persons" – then use the higher of the interest using actual values or the loan value × (prime rate − JIBAR) must be used. • Interest received on any investments, including savings accounts, must be included as follows: Interest received for the year × (prime rate − JIBAR)
A2	Trading in financial assets Include a 3-year moving average of the gross trading margin (selling value − buying value) on the trading of financial assets.
A3	Dividends • Sections 8E and 8EA[3] instruments must be regarded as interest for apportionment purposes and be included in the formula by applying the (prime rate − JIBAR) proxy as set out in A1 above.

2 Of the Income Tax Act.
3 Of the Income Tax Act.

	• Dividends received from investment activities (including investments held in subsidiaries, associates, ad-hoc or minority investments) must be included by applying the following formula: Dividends received during the year × (prime rate − JIBAR)
A4	Debt securitisation transactions The amount to be included in the formula must be determined using the following formula: Proceeds on the sale of debts under a securitisation transaction during the year × (prime rate − JIBAR) Note to this adjustment: A proxy equal to the origination fees charged on the loan must be included in the apportionment formula to ensure that the exempt supply of granting credit is appropriately reflected, only where the loan is sold immediately after origination and before the vendor earning any interest or other consideration in relation to this exempt supply.

General notes for using the formula set out above:

N1	The exclusions and adjustments to the formula are subject to the further explanations and discussions as set out in Annexure A.
N2	"c" in the formula will typically include items such as dividends and statutory fines (if any).
N3	The prime rate to be used for all the adjustments listed above is the applicable prime rate at the end of the financial year. The JIBAR rate to be used for all adjustments listed above is the 12-month term rate quoted on the last day of the financial year. Where more appropriate for the vendor, or should the JIBAR no longer be applicable, the ZARONIA may be used; the rate being the equivalent to the above stated JIBAR. For ease of reference, the reference to JIBAR in this document includes reference to the ZARONIA. Where it is applies to loans, the relevant ratio must be applied to the loan balance on a monthly basis. Should this be impractical, the vendor may use an average value of the loan over the year and apply such average value to the relevant ratio stated above.
N4	The term "value" excludes the VAT component of the supply.
N5	The apportionment ratio must be rounded off to two decimal places.
N6	If the formula yields an apportionment ratio of 95% or more, the full amount of VAT incurred on mixed expenses may be deducted (referred to as the *de minimis* rule and effected under proviso (i) to section 17(1)).
N7	Vendors using their previous year's turnover to determine the current year's apportionment ratio are required to make an adjustment (that is, the difference in the ratio when applying the current and previous year's turnover) within nine

	months after the end of the financial year, that is, the adjustment must be made in the VAT201 return submitted at the latest nine months after the financial year end.
N8	This formula may only be used in the following circumstances: • If the method is fair and reasonable to the vendor's business activities. It is the vendor's responsibility to first determine this. If the method is not fair and reasonable, it is the vendor's further responsibility to approach the Commissioner for an alternative method.[4] The Commissioner is unable to retrospectively approve an alternative apportionment method and will only approve the method from a prospective date or such other date falling within the limitations set out in proviso (iii) to section 17(1). • The vendor submits to **vatrulings@sars.gov.za** the following information on an annual basis at the time the annual adjustment referred to in N7 is reflected in the VAT201 return: ➢ The vendor's name ➢ VAT registration number ➢ Apportionment method and formula used ➢ Apportionment ratio for the year. The first time that this formula is applied, the method and apportionment ratio for the past three (3) years must be submitted.
N9	The STB may not be used by a vendor if – • such vendor operates in an industry for which an alternative apportionment method has been approved (and that method is specified as the default method for that industry); and • an alternative apportionment method has been approved for the vendor, whether by way of a VAT ruling or VAT class ruling.

4. Period for which this ruling is valid

This BGR applies with effect from all financial years commencing on or after 1 January 2024 and will apply until it is withdrawn, amended or the relevant legislation is amended. The apportionment formula as set out in in Issue 2 of this BGR (the Issue 2 formula) is withdrawn effective from the aforementioned date.

5. Transitional rules

The Issue 2 formula applies to all financial years preceding those financial years commencing on or after 1 January 2024. If an alternative apportionment method has been approved for use by a vendor in a VAT ruling or VAT class ruling and the vendor regards the apportionment formula set out in this BGR to be fair and reasonable, that vendor can approach the Commissioner to have the VAT ruling or VAT class ruling to be withdrawn from the financial year commencing on or after 1 January 2024. The

[4] Refer to the VAT Rulings Process Guide for the process of application.

request for withdrawal must be submitted to **vatrulings@sars.gov.za** before the end of the financial year commencing on or after 1 January 2024.

The provisional ratio to be applied for the financial year commencing on or after 1 January 2024 may be based on the actual financial results of the preceding financial year using the Issue 2 formula. The adjustment to be made in the tax period, which ends no later than nine months after the end of the 2024 financial year must be based on the actual financial results of such financial year using the apportionment formula set out in this BGR.

Senior Manager: Leveraged Legal Products
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Annexure – Application of the exclusions and amendments to the apportionment formula as set out in paragraph 3 of the Ruling

<u>Exclusions:</u>

E1	**Foreign exchange differences that do not form part of any hedging activities** Due to the ever-changing nature of the economy, it is becoming more prevalent for vendors to trade with customers or suppliers in currencies other than the South African Rand (ZAR). Due to the differing currencies used by the relevant parties for purposes of accounting records and financial transacting, foreign exchange differences must be accounted for to ensure that the accounting records of a vendor reflect the correct value of each transaction entered into. In these circumstances, the foreign exchange difference that is reflected is merely an accounting entry (refer also to the discussion in E2 below) to properly reflect the sale transaction and does not arise of any further activity by the vendor. As such, these foreign exchange differences must be excluded from the apportionment formula. The exclusion above is limited to a foreign exchange difference that is a natural consequence of a sales transaction and requires no additional effort from a vendor. Should a vendor decide to hedge its risk against foreign currency exposure, such decision would require the vendor to enter into another transaction and apply resources in developing the most effective hedging strategy whilst continuously developing and ensuring proper implementation of said strategy. Hedging foreign exchange transactions are used to address various risks identified (such as the risk of future or short-term cash flows, or the risk of income) and could take many forms, including forward contracts or options. In order to ensure that the use of resources and all transactions are properly reflected in the apportionment formula, any foreign exchange differences that result from a hedging transaction must be included in the formula. As hedging in essence is a form of trading in financial instruments, the manner of inclusion in the apportionment formula should be in line with A2 below.
E2	**Accounting entries, such as fair value adjustments, resulting in income reflected in the AFS to ensure compliance with relevant Regulatory Frameworks** The International Financial Reporting Standards (IFRS) require certain value adjustments to be made in the accounting records of a person to ensure the true economic value of assets or liabilities are reflected in that person's AFS. From a VAT apportionment perspective, the value adjustments made are not income intended to be included in the formula – no actual income will be received by the vendor as the adjustment is merely a revaluation of an asset or liability at a specific point in time and not consideration for any activity as a result of a separate supply of goods or services. For this reason, any value adjustment made for IFRS purposes is excluded from the apportionment formula. Examples of accounting entries are as follows: • Revaluation of a transaction in foreign currency (also refer to E1 above, (excluding hedges); and • Fair value adjustment of fixed and/or intangible assets.

E3	**The sale of a capital asset** The VAT incurred on capital expenditure is generally deducted as a once-off at the time when a vendor acquires the said asset. Although the asset is used throughout the trading process, it is not one of the resources that, on an on-going basis, forms part of the pool of expenses that are subject to the apportionment ratio. It is also accepted that vendors earning trading income are not in the business of selling off their capital assets on an on-going basis, as that would be un-business like and would severely influence the ability of the vendor to continue trading. Therefore, the sale of capital assets is generally an extraordinary event that is not expected to occur continuously. Having regard to the extraordinary nature of the sale of capital assets together with the possible substantial values attached thereto, the inclusion of the income earned on the sale of capital assets in the apportionment formula would distort the apportionment ratio in that it would not fairly reflect the use of those resources to which the apportionment ratio is applied. It is worth highlighting that, due to the significant costs involved in acquiring capital assets, it may be necessary for vendors to determine whether an alternative apportionment method is required for specific capital assets. The vendor must evaluate the specific circumstances and intended use of the capital asset to determine the most appropriate method for the specific asset and, if need be, apply for an alternative method. *What is a capital asset?* In short, a capital asset is an asset that enables a vendor to trade but is not the trade itself. Consider a vendor selling ovens. To this vendor, the ovens are the trade itself and therefore constitute trading stock which is not capital of nature. However, should a bakery buy the oven, the oven enables the bakery to produce baked goods; the baked goods being its trade. To the bakery, the oven is a capital asset. The circumstances of each case must be evaluated to determine the nature of a specific asset. The most important factor to consider is the intention of the vendor when acquiring and subsequently using the asset. As intention is a very subjective test, various factors must be used to determine and substantiate that intention. Some factors that may assist in determining whether an asset is capital in nature, is as follows: • Trading stock is not a capital asset. • The asset is held with a certain degree of permanency. • Linked to the above, the asset is held for a lengthy period of time. Although this test is not conclusive on its own, it could be convincing when deliberated with other factors. • The type of asset is not commonly bought and sold by the vendor on a regular basis. • An asset which stays mostly intact, and which is rather used to produce wealth. The distinction between trading income and income of a capital nature is not a new concept in tax and has been the subject of various disputes and court cases over the years. Chapter 2 of the *Comprehensive Guide to Capital Gains Tax* provides in-depth examples and discussions on how to distinguish between income and capital. These principles can also be applied as guidance in determining whether an asset is capital in nature for VAT apportionment purposes.

E4	**Extraordinary income** Extraordinary income is non-recurring income received due to exceptional circumstances that are unlikely to be repeated. From a VAT apportionment perspective, extraordinary income would have a significant impact on the quantum of income received by a vendor without affecting the normal expenses incurred year on year. The inclusion of such income in the apportionment formula would therefore severely distort the apportionment ratio as there would be a material fluctuation from one year to another whilst the mixed expenses, and the use thereof in the vendor's business, would have remained unchanged. Based on the above, extraordinary income should be excluded from the apportionment formula. In order to give effect to this, "extraordinary income" is defined for VAT apportionment purposes as non-recurring income received due to exceptional circumstances that are unlikely to be repeated. An example of extraordinary income is dividends received as a result of a re-organisation or liquidation of a company under sections 44, 46 or 47 of the Income Tax Act (see also the discussion on dividends in A3 below).
E5	**The value of any goods or services supplied where input tax on those goods or services was specifically denied under section 17(2)** A vendor is prohibited from deducting input tax on certain items listed in section 17(2). These include, among others, the following: • Goods or services acquired for purposes of entertainment; and • The acquisition of "motor vehicles" as defined in section 1(1). In both the above instances, those vendors that do not generally supply entertainment or "motor car" as defined (and are therefore allowed the deduction), would not normally buy and sell the items on a regular basis. The goods or services purchased would be of a capital nature and the subsequent supply thereof would automatically be excluded from the apportionment formula as a result thereof. In addition, it would be inequitable to include the income on the sale of such goods or services (or any indemnity payment received therefrom) where the vendor was originally disallowed (by legislation) any input tax deduction in relation thereto.
E6	**Specific to the provision/receipt of finance** • <u>The capital value of loans</u> *Receipt of finance* Vendors often obtain finance from financiers such as banks, as a mechanism to raise funds for future business operations or expansions. The receipt of the funds is not regarded as "income" for apportionment purposes and should therefore not be included in the apportionment formula. *Provision of finance (section 2(1)(f))* Any finance given, regardless of the form of the agreement entered into, must be repaid by the borrower[5]. A finance agreement typically makes provision for the original lending amount (the capital amount) to be repaid at a later date as a once-off amount or by way of instalments, together with interest and/or fees. The interest is typically the lender's[6] consideration for granting the borrower the use of the funds for a specific period of time, whilst the fees are charged by the lender for the administrative functions associated with the granting of finance. Both the interest and fees are charged periodically. The income earned by a vendor for the provision of finance is therefore interest and fees which are included into the apportionment formula as and when they are charged to the

5 A "borrower" means a person that obtains finance from a lender.

6 A "lender" means a vendor that provides finance to a borrower.

	borrower to appropriately represent the different activities of the lender in providing finance to the borrower (refer to A1 for a more in-depth discussion on the value of the interest to be included). Each repayment made by the borrower may therefore consist of three parts: the capital portion of the loan, interest and fees. As the income earned from the provision of finance is already included in the apportionment formula, the repayment of the loan must be excluded from the formula. • <u>The cash value of goods supplied by a financier under an ICA</u> It is common practice for retailers to offer goods or services to their customers on credit. To reduce their risk, retailers outsource the provision of credit to financiers. Financiers would then purchase the goods or services from the retailer and immediately on-supply the said goods or services to the customer (at the exact same price) by way of an instalment credit agreement. The financier does not enter into these agreements to make a profit, but rather to provide finance to the customer on which interest and fees will be charged. The supply of the underlying goods or services by the financier is therefore merely a facilitating supply; meaning, the financier is required to buy and sell the underlying goods in order to enable the provision of credit. In order to recognise the financier's purpose/intent of entering into these agreements, the sale of the underlying goods or services must be excluded from the apportionment formula. The financier as a result, will apply net interest as set out in A1. It is important to note that this exclusion does not apply where the retailer also fulfils the role of the financier; meaning, the retailer supplies the goods or services directly to the customer by way of an ICA. In these circumstances, the retailer's main purpose is to make a profit on the sale of the underlying goods or services by adding a specific profit margin, unlike the financier's purpose explained above. As the retailer is allowed to include the value of the gross sales in the formula in full, the net interest is not justified and the gross interest must be included (also refer to A1). • <u>The portion of a rental payment relating to the capital value of goods supplied under a rental agreement which is entered into as a mechanism of finance</u> Any arrangement which falls within the ambit of a "rental agreement" which is entered into as a mechanism of finance must, for apportionment purposes, abide by similar rules to that of an ICA. That means that the value of the supply (the value of the rental payments) to be included in the apportionment formula must be reduced by the value of the underlying asset. Only the interest and fees charged on the finance arrangement must be included in the formula (refer to A1 for a more in-depth discussion on the value of the interest to be included in the formula). Following the logic of net interest in A1, the rental payment must further be reduced by the cost of funding relating to the rental agreement. Any rental agreement entered into which involves the letting of goods owned by the lessor and which is not entered into as a mechanism of providing finance to a customer (such as a normal operating lease with no financing element), does not form part of the exclusion. The full rental value must be included in the apportionment formula.
E7	**Change-in-use adjustments under sections 18, 18A, 18C and 18D** A change-in-use adjustment adjusts the input tax deducted to reflect the actual use as opposed to the intended use of goods or services. Change-in-use adjustments should be excluded from the apportionment formula.
E8	**Indemnity payments received as envisaged under section 8(8) to the extent that the indemnity payments relate to extraordinary income or capital assets**

	Subject to certain exceptions, a vendor is deemed to make a supply of services upon receipt of an indemnity payment (or indemnification of a loss paid to a third party) from an insurer[7]. Section 8(8) further deems that supply to be made in the furtherance of the vendor's enterprise. Any indemnity payment received as a result of a capital asset (such as a factory) or extraordinary income should not be included in the formula in keeping with the exclusions in E3 and E4.
E9	**Manufactured interest and dividends received by the borrower of a securities lending arrangement** Securities lending arrangements[8] are becoming more prevalent as a manner for vendors to make a profit on the buying and selling of securities (which includes equity shares). This means that the borrower borrows the security with the intention to almost immediately on-sell. The borrower may be in possession of the security for a period, however small, before the security is on-sold. A borrower is required to make manufactured payments to the lender to ensure the lender is placed in the same position had the securities lending transaction never taken place. Should the borrower receive any interest or dividends on the security in the short period that the security is held, such interest and dividends are not really the borrower's as it must, contractually, be paid to the lender. As the manufactured payments are not included as part of the profit and loss on the trading transaction, any dividends or interest received on these lending arrangements should also be excluded from the formula by the borrower. The lender of the securities must include the manufactured interest or dividends received from the borrower in its apportionment formula as follows: Manufactured interest/dividend × (prime rate − JIBAR)

[7] See section 8(8).

[8] As defined in Binding General Ruling 62 "Value-Added Tax Implications of Securities Lending Arrangements". All terminology in this paragraph follows the terminology of the said ruling.

E10	**The value of equities or derivatives issued as a manner of raising funds** One of the methods of raising funds is to increase an entity' s equity, generally by way of issuing equities or certain derivatives. Under section 2, the issuing of these instruments is deemed to be financial services, being an exempt supply under section 12(*a*). It is not common for an entity to issue new equity on a regular basis as this is generally a very expensive form of raising capital and there is a risk attached to diluting the value of that entity's share capital. As this is regarded as being extraordinary, the income derived from the issuing of equity should not be included in the apportionment formula.
E11	**Interest** • <u>Earned from the vendor's current account (meaning, the account used for day-to-day business operations)</u> It would be hard for any business to function without a bank account used every day to both receive and make payments. The vendor's intention when opening a transactional bank account is therefore never to earn the interest thereon, but rather to facilitate transactions within its business. The income in this account is generally as a result of payments received from third parties or customers as a result of trading activities and not investment activities by the vendor. As the interest rates on a transactional account is very low, businesses rarely hold money in a transactional bank account for earning interest. A vendor would rather transfer any excess funds to a call or similar account where the interest rates are much higher. The business decision to effect such transfer reflects a vendor's purpose of earning investment income in the form of interest. It is for this reason that any interest earned from a call or other investment account is included in the apportionment formula (refer also to A1). • SARS Interest.

<u>**Adjustments** to the value of certain income streams included in the formula set out above:</u>

A1	**Interest, other than the interest excluded from the formula in E11** Interest is generally earned as a result of one of the following activities: • Investment activities • Lending activities These activities are more often than not conducted by a vendor on a continuous basis, even though it might not be a vendor's main purpose. To ensure that the purpose for which the VAT incurred on goods or services is fairly reflected in the apportionment formula, one must have cognisance of the wholistic purpose of the entity, and all activities associated in achieving that purpose. For this reason, interest must be included in the formula. It is however accepted that interest received is dependent on external factors, such as external interest rates, a customer's risk profile and macro-economics to name but a few. These external factors can result in material fluctuations in interest received from year to year even though a vendor's expenses in earning that interest have not significantly changed. For this reason, the interest to be included in the formula must be determined using the guidelines below. • <u>Interest deemed to be dividends</u> The purpose of sections 8F and 8FA of the Income Tax Act is to give effect to the creation of certain equity instruments that may be disguised as debt. In this regard, the relevant provisions consider the nature of the instrument itself as well as the nature or character of the yield resulting from the instrument. Based on the provisions and requirements set out in sections 8F and 8FA of the Income Tax Act, any –

- interest received from a "hybrid debt instrument" (section 8F of the Income Tax Act); and
- "hybrid interest" from an "instrument" as defined (section 8FA of the Income Tax Act),

will be deemed to be dividends *in specie* for purposes of the apportionment formula (refer to A3).

- Net interest

Where a vendor provides finance, the vendor acts as an intermediary between lenders and borrowers. Its main objective in this regard is the borrowing and lending of money (which constitutes a single activity) for a profit. This single activity can fairly be reflected in the apportionment formula by including a net interest rather than the gross interest received by the vendor.

"Net interest" refers to interest received from lending *less* interest paid on funds borrowed to on-lend and the interest portion of bad debts written off. No other expenses may be deducted from the net interest received. For instance, where a vendor offers a product that consists both of a lending and trading element, each of these elements should be included separately in the formula regardless of the fact that the ultimate profit made by the vendor is the net of the two activities.

The following is applicable in respect of the net interest to be included in the apportionment formula:

Limited to borrow to on-lend

The interest paid to be deducted from interest received must be in respect of funds borrowed that are used to on-lend. Should borrowed funds be partly applied towards the funding of a vendor's business operations itself (meaning, not used for the lending of funds), an appropriate method must be applied to determine the portion of the interest paid that relates to funds being on-lent by the vendor. This is achieved by multiplying the capital amount on-lent to the interest rate the funds were borrowed at to determine the interest paid to be applied in the formula.

Negative net interest margin

Where the net interest amount is a negative for a specific year, a vendor must include the value as an absolute value in the formula.

Zero-rated interest income

The principle of net interest is extended to offshore lending where a vendor earns zero-rated interest. This means that the interest paid in relation to the funds used to provide offshore lending may be used to reduce the interest received from such activities.

Where a vendor is unable to directly identify and allocate interest paid to the respective interest income streams (that is, either taxable or exempt), a formula must be applied to determine the value of the interest paid relating to zero-rated interest income. This formula can either be based on the interest income values earned by the vendor during the year, or the value of the respective loans from which the interest is earned, granted by the vendor during the year.

Where the value of the loans is used as basis, and either the exempt or zero-rated net interest margin is a negative value, the inclusion of an absolute value will create a distortion. In this instance, the following formula may be used to split the net interest margin between exempt and zero-rated interest:

$$c = d \times \frac{e}{(e + f)}$$

where –

"c" = The portion of the net interest margin to be included in "A" of the formula.

"d" = The total net interest margin (expressed as an absolute value where applicable).

"e" = The net interest margin relating to zero-rated interest (expressed as an absolute value where applicable).

"f" = The net interest margin relating to exempt interest (expressed as an absolute value where applicable).

Bad debts/Impairments

Having regard to the fact that a lender incorporates a risk element into the interest charged to a customer, the actual amount of bad debts written off during a year (not an estimated amount) may be used to reduce income already included in the apportionment formula (whether current or previous years) as follows:

- The interest portion of the bad debts written off must be applied towards reducing the net interest income (exempt and zero-rated interest respectively) included in the formula; and
- The portion of the bad debts written off relating to fee income must be applied towards reducing the fee income included in "A" in the formula.

No portion of the capital amount written off as bad debts may be applied towards reducing income included in the apportionment formula. This is on the basis that the capital value of loans is excluded from "A" and "B" in the formula (see E7).

In the event that bad debts are recovered by the vendor, and the bad debts were used to reduce the interest and fee amounts in the formula whether in the same or previous years, the vendor must include the portion of the bad debts recovered that relates to interest and fees accordingly.

Proxies for interest received/paid

The prime rate to be used for all the adjustments listed above is the applicable prime rate at the end of the financial year.

The JIBAR rate to be used for all adjustments listed above is the 12-month term rate quoted on the last day of the financial year.

- Where a vendor provides interest-free funding to another entity (generally within a group scenario), there is still a lending activity to be reflected in the formula regardless of the fact that no income is received therefor. For this reason, a proxy of interest income to be determined using the formula set out below, must be used:

  Loan value × prime rate

  This does not apply to extended payment terms for the supply of goods or services, such as where a retailer allows a customer to pay for his or her goods within 30 or 60 days with no liability for paying interest. This is subject to the relevant contractual terms and conditions of the retailer specifying this fact.

- Where a vendor provides finance from its own cash reserves or borrow on an interest-free basis it will not have any interest paid to reduce the interest income in the formula. A proxy must then be used to ensure that these vendors are not disadvantaged in the calculation of an appropriate apportionment ratio:

  Loan value × JIBAR

- It goes without saying that where a vendor lends funds to a borrower interest-free from its own cash reserves, the proxy to be included in the formula will be calculated as follows:

  Loan value × (prime rate − JIBAR)

- Where a vendor lends funds to a “connected person” as defined in section 1(1), the higher of the actual interest values received and paid, or the loan value × (prime rate − JIBAR) must be included in the formula.

- <u>Investment interest</u>

  All investment activities of a vendor, whether investing in cash, equities or other instruments, must be appropriately reflected in the apportionment formula. As previously mentioned, it is acknowledged that the gross interest received is not reflective of how a vendor applies its resources. For this reason, any interest received from investments not otherwise specifically mentioned in the formula, must be included as follows:

  Interest received for the year × (prime rate − JIBAR)

  The interest received includes interest on any cash investment placed by a vendor, such as a savings, cash management or fixed deposit account.

- <u>Debtor interest</u>

  Any vendor selling goods or services to a customer on credit, being a section 2(1)(*f*) supply, includes the gross sale value of such goods or services in its apportionment formula. In order to ensure equity in the manner of which these income streams are included in the formula, the gross interest levied on the debtors’ accounts must be included in the formula. This extends further to any “penalty interest” charged to a customer that does not fall under section 2(1)(*f*), to be included in “c” of the formula.

A2 Trading in financial assets

“Financial asset” refers to any commodity and other financial asset which can be traded on an exchange or over the counter and includes, but is not limited to, repurchase agreements, debt securities, equity securities and derivatives.

“Trading” refers to the continuous buying and selling of financial assets by a vendor and does not include the selling of an investment held as a capital asset (refer to E3).

“Gross trading margin” refers to the gross profit of buying and selling financial assets, being the selling value *less* the buying value of the said assets, as recorded in the accounting records as being realised (where the vendor is unable to determine the realised gross trading margin, the values may include both realised and unrealised profit/loss for the year). No other expenses may be deducted from the said margin. Furthermore, any income received on the financial assets while held in trading stock (such as dividends or interest) must be regarded as a separate transaction and be included in the apportionment formula based on the principles set out in A1 and A3.

The objective of a vendor that trades in financial assets is to make the highest profit possible. Due to the fact that there is a continuous sale of financial assets, and the value of those supplies will be significant in comparison to the activities of trading, the purpose of the vendor will not be fairly reflected should the gross selling amount of all the trades be included in the formula. For this reason, the gross trading margin must be included in the formula. Furthermore, the value of financial assets is significantly influenced by external factors such as market value, economics etc. In order to address a possible significant fluctuation in the value of the gross trading profit from year to year (which could adversely affect the apportionment ratio of a vendor), a 3-year moving average of the gross trading margin must be included in the formula. This means that the gross trading margin for the current year and two previous years must be calculated individually, and then averaged to determine the value to be included in the formula.

Negative gross trading margin

Should a vendor’s gross trading margin for any of the 3 years be a loss, the absolute value of that loss must be included in the calculation of the 3-year moving average.

Due to the interconnectivity of local and foreign trading activities, difficulties may arise in splitting local (exempt) and foreign (zero-rated) profit and losses. The following formula may be used to split the net trading margin between trading activities with local and foreign counterparties:

	$$c = d \times \frac{e}{(e + f)}$$ where − "c" = The portion of the net trading margin to be included in "A" of the formula. "d" = The total net trading margin (expressed as an absolute value where applicable). "e" = The net trading margin in relation to trading with non-resident counterparties (expressed as an absolute value where applicable). "f" = The net trading margin in relation to trading with local counterparties (expressed as an absolute value where applicable).
A3	**Dividends** In order to ensure financial security, entities invest in various instruments both for the yield and financial growth associated with certain markets. Dividends, including dividends *in specie*, are the yield paid on investments in equity and similar instruments. In keeping with the principle of reflecting all investment activities in the formula as set out in A1, dividends received must be included in the formula to reflect the investment activity in said instruments (even though dividends are not consideration for any supply made by a vendor). • <u>Dividends deemed to be interest</u> The purpose of sections 8E and 8EA of the Income Tax Act is to give effect to the substance of certain share transactions which may contain certain characteristics usually associated with debt. As a result, dividends received from preference shares or any other similar instrument complying with the criteria as set out in the aforementioned sections, are deemed income for income tax purposes unless the consideration is applied towards a qualifying purpose (i.e. the direct or indirect acquisition of equity shares in an operating company). Based on the provisions and requirements contained in sections 8E and 8EA of the Income Tax Act, dividends received from shares which fall within the ambit of a – • "hybrid equity instrument" (section 8E of the Income Tax Act); • "preference share" (section 8EA of the Income Tax Act); or • "third-party backed share" (section 8EA of the Income Tax Act) will be deemed to be "interest received" for purposes of the apportionment method (refer to A1). • <u>Investment dividends</u> The investment activity associated with the holding of investments (whether in subsidiaries, associated companies or minority shareholdings held through an asset manager), must be fairly reflected in the formula. Having regard to the fact that an entity declares and pays dividends based on various requirements and factors (such as a group's dividend policy or economic and market conditions), it is accepted that the quantum of dividends does not fairly reflect the investment activity of holding the investments as capital assets. In addition, significant fluctuations may be experienced in the value of dividends declared from year to year. Similarly, as was explained in A2, instruments held for trading have a different purpose than for earning a yield and financial growth; the purpose being reflected in the formula based on the principles set out in A2. Any dividends received while holding the instruments as trading stock should not be included in the formula in full. In order to appropriately reflect a vendor's investment activity in the formula, the value of dividends to be included in the formula must be determined as follows: 3-year moving average of dividends received × (prime rate − JIBAR)

	• The 3-year moving average is determined by calculating the average of dividends received during the current financial year and two immediately preceding financial years. • If a vendor does not receive dividends during the current financial year, a 3-year moving average of the 3 preceding years may be used as proxy. • If a vendor receives no dividends for at least 2 out of the 3 years, a 5-year moving average must be used instead of the 3-year moving average where dividends were received for at least 2 of the 5 years. • If a vendor has not received dividends for 2 out of the 5 years as required above, and the vendor is a holding company charging management fees to its subsidiaries, the vendor must include a value equal to the management fees charged for that financial year in the formula as proxy for dividend income. No 3-year moving average will be applied in this instance. • If a vendor has not received dividends for 2 out of the 5 years as required above, and the vendor is not a holding company charging management fees to its subsidiaries, the vendor must approach the Commissioner for an alternative manner of determining a value to be included in the formula that appropriately reflects its investment activities. The application must comply with the time limitations set out in the proviso to section 17(1).
A4	**Debt securitisation transactions** A "debt securitisation transaction" is a mechanism of raising capital that typically involves the transfer of a debt security book to a separate legal entity, a special purpose vehicle (SPV) specifically created to acquire the said book, generally by way of sale of the debt. The sale is generally done at the market value of the book debt, being the face value of the assets transferred (that is, the risk adjusted aggregate value of the cash balance of the securitised debt security) (the capital value of the loans). The amount received from the securitisation transaction does not constitute additional turnover for the vendor. Essentially, the proceeds are seen as payment for previous supplies or repayment of existing advances, although not received from the original borrower. Notwithstanding the purpose for which securitisation transactions are entered into by vendors, the full exclusion of the capital value of debt sold in a securitisation transaction will not fairly reflect the activities and resources incurred in the sale of these debts to the SPV. As all the activities associated with the sale of the debts collectively constitute a separate "financial service", the supply of which under section 2(1)(*c*), is exempt under section 12(*a*). This exempt supply must be fairly reflected in the apportionment formula. It is however acknowledged that the inclusion of the full sale value of the debts sold by a vendor in the formula is distortive and the following formula must be applied to determine a suitable value in the formula to appropriately reflect the activities associated with debt securitisations: Capital value of debts sold under a securitisation transaction during the year × (prime rate − JIBAR) <u>Interest on debts sold immediately after origination</u> The origination of a debt, such as a loan, is a financial service under section 2(1)(*f*), and therefore the supply is exempt under section 12(*a*). Generally, the interest received from the granting of credit over a time period is sufficient to reflect this exempt activity in the apportionment formula. However, where a debt is sold immediately after origination, no amount of income relating to the granting of credit, being the exempt supply of financial services, is earned by the vendor. As a result, this activity relating to the making of the exempt supply is not sufficiently reflected in the apportionment formula. Having regard to the above, a proxy equal to the origination fees charged on the debt (and which is included in "a" in the formula) must be included in "b" of the apportionment formula to ensure that the exempt supply of granting credit is appropriately reflected, <u>only</u> where the debt is sold

	immediately after origination and prior to the vendor earning any interest or other consideration in relation to this exempt supply.