

VAT PRACTICE NOTE NO 14

20 JANUARY 1995

Going concerns (section 11(1)(e) of the Act)

1. Introduction

The supply to a registered vendor of an enterprise, or of a part of an enterprise, which is capable of separate operation, which takes place on or after 25 November 1994 (ie the date of coming into operation of the amendment to section 11(1)(e) of the Act) is, in terms of section 11(1)(e), subject to VAT at the zero rate where the supplier and the recipient have agreed in writing that such enterprise or part, as the case may be, is disposed of as a going concern.

The requirements of section 11(1)(e) are discussed in this practice note. Any reference hereinafter to an "enterprise" disposed of as a going concern includes a reference to any separate part of an enterprise which is disposed of as a going concern.

2. Requirements for applying the zero rate

2.1 The seller must be a vendor

As only a vendor can make a taxable supply, an enterprise can be supplied as a going concern at the zero rate only if the seller is a vendor.

A "vendor" is a person who carries on an enterprise and whose annual total value of taxable supplies exceeds or will exceed R300 000. A person will not be obliged to register as a vendor if the total value of his taxable supplies in a twelve month period will exceed the R300 000 limit merely as a result of the sale of his business (refer to paragraph (i) of the proviso to section 23(1)).

The term "vendor" is defined in section 1 also to include a person who is required to be registered as a vendor, but has not applied for registration.

2.2 The purchaser must be a registered vendor

If the recipient (purchaser) of the supply of an enterprise as a going concern is not a registered vendor, the zero rate cannot apply. To substantiate for the purposes of section 11(3) that the supply is made to a registered vendor and to protect himself from incorrectly applying the zero rate, the seller must obtain and retain a copy of the purchaser's Notice of Registration (form VAT103). If the purchaser is not yet registered as a vendor at the time of conclusion of the agreement, it is advisable that the agreement provide for the application of a zero rate being subject to the purchaser being a registered vendor on the date the supply takes place, and to the furnishing of such copy of the VAT103 to the seller as soon as it is available.

The time when the purchaser should be registered as a vendor, is the time when the supply of the enterprise takes place.

(a) Time of supply

As the disposal of an enterprise as a going concern is a supply of goods (even if fixed property forms part of the enterprise), the time of the supply is determined in section 9(1), ie the earlier of the time an invoice is issued in respect of the supply, or any payment of consideration is received by the supplier.

An "invoice" is defined in section 1 as a document notifying an obligation to make payment. A purchase agreement will, consequently, constitute an invoice only if it contains no suspensive conditions regarding payment. If it contains any such suspensive conditions, the fulfilment thereof will, notwithstanding the fact that the agreement may then be regarded as an "invoice", not trigger the time of the supply as the agreement was not an invoice when issued. It should be borne in mind that the term "consideration" does not include any deposit (not being a deposit in respect of a returnable container) in respect of the purchase price.

(b) Date of registration

Where a going concern is supplied by a vendor to a person on or after the commencement date of his enterprise but prior to his registration as a VAT vendor, the date of registration can, in terms of section 23(4), be backdated to the date on which the going concern was supplied. This ensures that the supply can qualify for the zero rate and will be done where the Receiver of Revenue is satisfied that the purchaser was, due to ignorance or an oversight, not registered but that he qualified for registration and that the parties have agreed in writing that the enterprise is disposed of as a going concern at the zero rate, subject to the registration of the purchaser with effect from the time of the supply of the enterprise.

Similarly, where a trustee acts for a company to be formed in the purchase of a business as a going concern, the company, when formed, can be registered with retrospective effect to the time of the supply of the going concern.

(c) Registration numbers

The new owner of the business will receive a new VAT registration number (unless such person is already registered) - the supplier's registration number cannot be allocated to him.

2.3 Agreement between the parties

The parties must agree in writing that the enterprise is disposed of as a going concern. If the parties have not agreed about this aspect in writing, the zero rate cannot apply, even if the enterprise is indeed transferred as a going concern. This eliminates disputes about the VAT rate after conclusion of the contract.

Where the contract specifically states that an enterprise (for example, a property leasing enterprise) is disposed of as a going concern at the zero rate and it is subsequently found that the enterprise was not indeed disposed of as a going concern (as, for example, the sale agreement provides for the transfer of a vacant building which cannot constitute an income-earning activity), the zero rate cannot apply. In such a case there can be no argument between the parties as to whether the purchase price includes VAT or not, or the rate of VAT provided for. As the parties reached agreement on the purchase price based on an incorrect rate of VAT, the purchase price should be adjusted accordingly, without any party being disadvantaged, as the amount paid by the purchaser would be accounted for as output tax by the seller and claimed as input tax by the purchaser.

Where an agreement for the sale of an enterprise as a going concern was concluded before, on or after 25 November 1994, but the parties did not agree in writing that the enterprise is disposed of as a going concern (as they were unaware of the amendment to section 11(1)(e)) they may enter into a separate agreement - based on the original contract

- regarding this aspect (refer also to paragraph 2.4.1)

The written agreement(s) must, together with any other written agreements or documents relating to the sale, be retained for purposes of section 11(3).

2.4 The enterprise must be a going concern

The term "going concern" is effectively defined in paragraph (i) of the proviso to section 11(1)(e).

2.4.1 Supply of an income-earning activity

The contracting parties must, at the conclusion of the contract, agree in writing that the enterprise will be an income-earning activity on the date the ownership of the enterprise is transferred. This must, to eliminate any uncertainty, be stated specifically in the agreement. Such a statement must, of course, be supported by the provisions of that or any other written agreement or document relating to the sale. If the agreement does not contain such a specific statement, (as, for example, the parties were unaware of the amendment to section 11(1)(e) - refer also to paragraph 2.3) the fact that an income-earning activity will be transferred must be evident from such agreements and documents.

As transfer of the enterprise might take place only in the future, there can be no certainty at the time of signing the agreement and fixing the VAT inclusive price whether the enterprise will in fact be an income-earning activity when transfer takes place. The parties' intention to transfer an income-

earning activity is thus sufficient. If, for whatever reason, the enterprise is eventually not transferred as an income-earning activity, the zero rate will apply if the parties in fact agreed to dispose of the enterprise as an income-earning activity.

The agreement must provide for the sale of an income-earning activity and not merely a business structure. The intention should be that the new owner must be placed in possession of a business which can be operated in that same form, without any further action on his part. The parties must, therefore, agree that the enterprise will remain active and operating until its transfer to new ownership. It is, however, not necessary that the purchaser indeed intends to carry on the particular activity of the enterprise - the contract must merely create a "capacity to continue". A business need not necessarily be profitable or prosperous to be "income-earning".

The following examples provide guidelines as to what will constitute an income-earning activity.

(a) Farming activities

The mere sale of a farm property constitutes the supply of the capital assets structure of a business and not the farming enterprise. In order to supply a farming enterprise as a going concern, the seller and the purchaser must agree that an operative income-earning activity in the form of the farm, its equipment, grazing, cropping etc. will be transferred.

(b) Leasing activities

Where a leasing activity is conducted by the seller in respect of fixed property, the contract must provide for the leasing activity to be disposed of together with such fixed property in order to constitute an income-earning activity. If the agreement does not provide for a tenanted property to be transferred, an asset is merely sold. The question then arises as to the agreed occupancy level which will give rise to the supply of a going concern. It has previously been accepted by Inland Revenue that the property could be regarded as income-earning if tenanted 80 per cent or more. Presently an occupancy level of more than 50 per cent is accepted.

(c) Fixed property sold to tenant

An agreement to sell a tenanted property to the tenant does not constitute the disposal of a going concern, as the income-earning activity (being the leasing activity) is not sold to the purchaser - he obtains a capital asset without the capacity to continue the leasing activity.

(d) Seller leases back building

There is no agreement to sell an income-earning activity where the agreement provides that the seller-occupier of a commercial building will lease it back.

(e) Usufruct and bare dominium

The bequest of the usufruct of an asset can qualify as the supply of an income-earning activity if the same enterprise which was carried on or in respect of the asset, can be carried on by the usufructuary. As there will in such a case normally be no agreement between the deceased vendor and the legatee, the executor, as representative vendor of the estate (which is in terms of section 53(1) deemed to be one and the same person as the deceased vendor) and the heir or legatee must agree in writing that the enterprise will be disposed of as a going concern and will be an income-earning activity on the date of transfer thereof. Where the value of the supply of the usufruct is in terms of section 10(23) nil and section 10(4) is not applicable, the going concern provisions will, however, not apply.

As the person to whom the bare dominium of an asset is bequeathed cannot, on transfer, proceed with the activities of the enterprises, the supply of the bare dominium cannot be zero-rated.

(f) Two or more contracts

The mere fact that the sale of an enterprise is effected by two or more contracts between the same supplier and recipient does not, as such, have the effect that an income-earning activity cannot be supplied. Where the effect of the agreements, read together, is that the parties agree in writing that the enterprise will be an income earning activity on the date of transfer thereof, this requirement has been met.

(g) Business yet to commence or dormant business

Property which is merely capable of being operated as a business does not constitute an income-earning activity - an actual or current operation is required. For this reason the agreement to dispose of a business yet to commence or a dormant business does not comply with the requirement.

As the parties must agree that the enterprise will on the date of transfer thereof be an income-earning activity, the zero rate can apply where the supplier is in terms of the contract obliged to get the business going and income-earning before transfer thereof. Where, however, the contract provides for the disposal of property, but as a result of the fact that the purchaser takes possession thereof prior to the date of transfer, the enterprise is income-earning on the date of transfer thereof, the zero rate will not apply.

(h) Sale of shares in a company

There is no supply of a going concern where ownership of an enterprise changes through the sale of shares in a company. The supply of shares is, in terms of section 12(a), read with section 2(1)(d), exempt from VAT.

(i) Sale of share block shares

Where a vendor who has applied his share block share for purposes of making taxable supplies sells such share to another registered vendor, the supply will be zero-rated if the parties agree that the enterprise carried on in relation to such share block is disposed of as an income-earning activity by way of the supply of the share.

2.4.2 Disposal of the assets which are necessary for carrying on the enterprise

The assets which are necessary for carrying on such enterprise must be disposed of by the supplier to the recipient (refer to paragraph (i)(bb) of the proviso to section 11(1)(e)). All the assets of the enterprise need not be disposed of. The supplier can, for example, decide to keep certain assets or the recipient can decide not to purchase certain old stock or book debts. If the purchaser of a bakery, however, decides to purchase new ovens and electrical equipment and the bakery's ovens and equipment are excluded from the sale agreement, the assets which are necessary for carrying on the enterprise disposed of are not disposed of by the supplier to the recipient and, consequently, the zero rate cannot apply. Where all the assets used by the vendor in an enterprise, except the premises from which the enterprise is conducted, are disposed of, it must be determined whether the premises is necessary for carrying on the enterprise disposed of.

2.5 Supply of part of an enterprise

The supply of part of an enterprise which is capable of separate operation is zero-rated where the requirements discussed above are met. The transfer of a "stand-alone" division of a business or of some of the outlets of a business which is operated at more than one geographical location will normally qualify for zero-rating in this regard.

Section 8(15) provides for a supply to be apportioned into zero-rated and fully taxable components where, if separate considerations had been payable, a single supply would be taxable partly at the standard rate and partly at the zero rate. Such apportionment requires a sufficient distinction between the alleged parts of the supply to make it reasonable to sever them and apportion accordingly. Where a contract for the sale of an enterprise is concluded in circumstances where the entire enterprise is not disposed of as a going concern, but certain of its separate activities are going concerns and the parties agree in writing that such activities are disposed of as going concerns, an apportionment may, therefore, be made and the supply of the activities which are disposed of as a going concerns be zero rated.

3. The supply of goods or services used only partially for purposes of a going concern

3.1 General

The supply of goods or services which were applied partially for taxable and partially for non-taxable purposes is deemed to be made wholly in the course of an enterprise and is, therefore, fully taxable (refer to section 8(1)). The supply of the "portion" of such goods or services used for exempt purposes is thus also subject to VAT. The vendor making such supply may make a deduction in respect of the "non-taxable" portion of the supply in accordance with section 16(3)(h).

3.2 Goods or services used mainly for purposes of a going concern

Where goods or services which were prior to the supply of the enterprise as a going concern used mainly (ie more than 50 per cent) for the purposes of such going concern enterprise and partly for other purposes, are supplied as part of the supply of a going concern, such goods or services are deemed to form part of the going concern (refer to paragraph (ii) of the proviso to section 11(1)(e)).

Example: A farm which was used by B for taxable purposes (farming), exempt purposes (provision of accommodation to labourers) and private purposes (the farm house) is sold to Z. The farming enterprise entails mainly crop farming and to a lesser extent cattle farming. The parties agree that the crop farming part of the enterprise will be transferred as an income-earning activity at the zero rate. (The rest of the farm is not sold as a going concern.)

As the farm was used mainly for purposes of the going concern, the total purchase price of the farm may be zero-rated, even though the farm was used partially for non-going concern purposes.

Refer to paragraph 4 in respect of the adjustment to be made by the purchaser in such a case.

3.3 Goods or services not used mainly for purposes of a going concern

Where goods or services were used partially for purposes of a going concern, but not mainly for such purposes, only that portion of the selling price which relates to the going concern may be zero-rated. The seller must make an apportionment in accordance with section 8(15) and charge VAT at the standard rate in respect of the non-going concern portion.

4. Going concern acquired wholly or partly for purposes other than making taxable supplies

4.1 Section 18A

In terms of section 18A, an adjustment must be made by a registered vendor who acquires an enterprise as a going concern, but wholly or partly for purposes other than making taxable supplies. After the acquisition of such a going concern, the purchaser (the registered vendor) is deemed to have supplied the enterprise or any goods or services which formed part of such enterprise by way of a taxable supply. In essence, the value of the supply is the cost to the vendor of acquiring such enterprise or goods or services, to the extent that they are acquired for purposes of use or application otherwise than for making taxable supplies (refer to section 18A(2)).

Example: X sells a commercial building which is 70 per cent tenanted to a pension fund which is a registered vendor in respect of its property rental activities. As the requirements of section 11(1)(e) have been met, the supply is zero-rated.

The pension fund, however, acquires the property with the intention of using the vacant space for purposes of administering its pension fund, which is an exempt activity. The pension fund must, therefore, account for VAT in respect of 30 per cent of the purchase price. The adjustment places the pension fund in the same position as it would be, had it not acquired the enterprise as a going concern.

4.2 The 90 per cent/10 per cent rule

Where the intended use of such enterprise in the course of making taxable supplies is equal to no less than 90 per cent (calculated on value) of the total intended use thereof, the enterprise may be regarded as having been acquired wholly for the purpose of making taxable supplies (refer to the proviso to section 18A(1)). In such a case the vendor acquiring the enterprise is not deemed to make such taxable supply and does not have to make the section 18A adjustment.