VAT 419

Value-Added Tax

Guide for Municipalities

SARS

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FOREWORD

This guide is a general guide concerning the application of the VAT Act in respect of municipalities in South Africa. Although fairly comprehensive, the guide does not deal with all the legal detail associated with VAT and is not intended for legal reference. Technical and legal terminology has also been avoided wherever possible. For details in respect of the general operation of VAT, refer to the *VAT 404 - Guide for Vendors* which is available on the South African Revenue Service (SARS) website.

All references to "the VAT Act" or "the Act" are to the Value-Added Tax Act 89 of 1991, and references to "sections" are to sections in the VAT Act, unless the context otherwise indicates. The terms "Republic", "South Africa" or the abbreviation "RSA", are used interchangeably in this document as a reference to the sovereign territory of the Republic of South Africa, as set out in the definition of "*Republic*" in section 1 of the VAT Act. The terms "Commissioner" and "Minister" refer to the Commissioner for SARS and the Minister of Finance respectively, unless otherwise indicated. A number of specific terms used throughout the guide are defined in the VAT Act. These terms and others are listed in the **Glossary** in a simplified form to make the guide more user-friendly.

The information in this guide is based on the VAT legislation (as amended) as at the time of publishing and includes the amendments contained in the *Taxation Laws Amendment Act 7 of 2010* and the *Voluntary Disclosure Programme and Taxation Laws Second Amendment Act 8 of 2010* both of which were promulgated on 2 November 2010 (as per GG 33726 and GG 33727 respectively). In particular, the contents of this guide focuses mainly on the amendments contained in the *Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006*, which deals with the significant changes to the VAT treatment of supplies made by municipalities which came into effect on 1 July 2006.

This guide is issued for guidance only and does not constitute a binding general ruling as contemplated in section 76P of the Income Tax Act 58 of 1962, and sections 41A and 41B of the VAT Act unless otherwise indicated.

The previous edition of this guide has been withdrawn with effect from 31 March 2011.

The following guides have also been issued and may be referred to for more information about specific VAT topics:

- AS-VAT-08 - Guide for Registration of VAT Vendors
- Trade Classification Guide (VAT 403)
- Guide for Vendors (VAT 404)
- Guide for Fixed Property and Construction (VAT 409)
- Guide for Accommodation, Catering and Entertainment (VAT 411)
- Share Block Schemes (VAT 412)
- Deceased Estates (VAT 413)
- Associations not for Gain and Welfare Organisations (VAT 414)
- Diesel Guide (VAT 415)
- Small Vendors Guide (VAT 417)
- AS-VAT-02 – Quick Reference Guide (Diplomatic Refunds) (VAT418)
- Guide for Motor Dealers (VAT 420)

Should there be any aspects relating to VAT which are not clear or not dealt with in this guide, or should you require further information or a specific ruling on a legal issue, you may –

- contact your local SARS branch;
- visit the SARS website at *www.sars.gov.za*;
- contact your own tax advisors;
- if calling locally, contact the SARS National Call Centre on 0860 12 12 18; or
- if calling from abroad, contact the SARS National Call Centre on +27 11 602 2093.

Comments and/or suggestions regarding this guide may be emailed to: *policycomments@sars.gov.za*.

Prepared by:
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31 March 2011

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Since the inception of VAT in 1991, municipalities (previously known as "local authorities") were required to register as VAT vendors, and special rules were applicable in respect of supplies made by municipalities. The main difficulties which gave rise to the special rules were that municipal property rates charges were not taxable for VAT purposes and that a profitability or breakeven test was applied in respect of certain activities to determine whether the supplies concerned were taxable or not. These special rules proved to be somewhat complicated and resulted in municipalities having to face significant apportionment difficulties and administrative problems. Due to these challenges and uncertainties, numerous applications for rulings from tax consultants and municipalities were submitted to SARS requesting clarification of the law.

It was therefore proposed in the Minister's Budget Speech in February 2006, that certain changes in regard to the VAT treatment of municipalities be made, including that municipal property rates be zero-rated for VAT purposes with effect from 1 July 2006. The primary objectives of these proposals were –

- to increase the extent of taxable supplies made by municipalities so that municipalities could be treated the same as any other business;
- to unlock the input tax incurred in connection with non-taxable or "out-of-scope" supplies made which could not previously be deducted; and
- to simplify the accounting and tax administration of municipalities.

Various amendments were therefore introduced in the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006 to give effect to these objectives. One of the most important changes was that the VAT law no longer referred to a *"local authority"*, but rather to a *"municipality"*. The other important change was that charges for municipal property rates became taxable at the zero rate. These changes to the law came into effect from 1 July 2006.

In addition to the main changes to the law which came into effect from 1 July 2006, it should also be noted that, the receipt of certain payments from government which are made under the annual Division of Revenue Act are subject to VAT at the zero rate with effect from 1 April 2005.

The main purpose of this guide is therefore to provide guidance and clarity on the VAT treatment of supplies made by municipalities from 1 July 2006.

1.2 GENERAL OVERVIEW OF VAT PRINCIPLES

Paragraphs 1.2.1 *and* ***1.2.2*** provide a brief overview of the general principles of the VAT treatment of supplies made by municipalities before and after 1 July 2006.

A more detailed discussion on the various types of supplies and the impact of the amendments to the law in connection with the general principles and VAT treatment of supplies made by municipalities can be found in ***Chapters 3*** *to* ***7***.

1.2.1 Before 1 July 2006

Before 1 July 2006, the levying of municipal property rates by a local authority did not form part of the local authority's taxable activities for VAT purposes. The goods and services which a local authority provided to the general public which were funded from the rates account (that is, from municipal property rates income) were regarded as being "out-of-scope" supplies for VAT purposes. In effect, this meant that supplies made to the general public for little or no consideration were treated the same as exempt supplies. Consequently, local authorities could not deduct any input tax on expenses incurred to provide services such as fire and ambulance services, street lighting, municipal road infrastructure, metropolitan police services, public amenities such as parks and gardens, and the maintenance of those facilities. *Refer to* ***Annexure A*** *– Government Notice No. 2570, dated 21 October 1991 (Regulation 2570)* which set out the *"enterprise"* activities of a municipality before 1 July 2006.

Certain supplies of goods or services were explicitly included as taxable supplies within the ambit of *"enterprise"* as defined in section 1. Accordingly, the following supplies were subject to VAT at the standard rate without applying any further tests:

- Electricity.
- Gas or water.
- Drainage.
- Removal or disposal of sewage or garbage.
- Goods and services incidental to, or necessary for, the making of the above supplies.

Other types of supplies of goods or services were regarded as taxable supplies **only if all of the following conditions were met**:

- The supplies were of the **same kind or similar to taxable supplies** made by any other person or vendor.
- **The income derived from the activity was sufficient to cover all the costs** of conducting that activity (including a reasonable provision for depreciation and any grant or subsidy received for conducting that business, but excluding capital expenditure) (that is, a business "breakeven test" was applied).
- **The business activity had to fall within a category of businesses determined by the Minister** and listed in *Regulation 2570* (*refer to* ***Annexure A***), or, if the activity was not listed therein, the Minister must have advised the specific local authority that it should treat the business activity concerned as an enterprise activity.

An exception in this regard was where the local authority charged a flat rate consideration for rates **and** all other charges for goods or services supplied to property owners. In such a case, the local authority would be required to levy VAT on the full amount charged and it would be able to deduct input tax on all the VAT-inclusive costs that it incurred in making taxable supplies, including supplies made to the general public for which no specific consideration was charged. Although the application of this method is being phased out, there are apparently still some municipalities which operate in this manner (referred to as the "old system"). The amendments which came into effect from 1 July 2006 would therefore not have much of an impact on municipalities that still operate on this old system.

1.2.2 On or after 1 July 2006

As mentioned in ***paragraph 1.1***, significant changes to the law were implemented to give effect to the economic and tax objectives referred to in that paragraph. Some of the main amendments included the following:

- The definition of *"local authority"* in section 1 was deleted and replaced with the definition of "*municipality*".
- Paragraph (*c*) of the definition of *"enterprise"* in section 1 which dealt with the activities of municipalities was deleted. The effect of this amendment is that –
  - the activities carried on by a municipality now fall within the normal rules contained in paragraph (*a*) of the definition of *"enterprise"* in section 1;
  - the extent of taxable supplies made by municipalities is substantially increased;
  - activities carried on by a municipality which were not specifically exempt under the VAT Act, and where no specific consideration is charged for the provision of goods or services are automatically included in a municipality's *"enterprise"* activities as a whole and allows input tax to be deducted on the related VAT-inclusive costs incurred to provide those goods and/or services;
  - the breakeven test and list of categories of business activities in *Regulation 2570* are no longer applicable; and
  - the apportionment ratio applied by municipalities to deduct input tax on "mixed use expenses" (expenses incurred for both taxable and non-taxable supplies) is significantly increased.
- A definition of a *"municipal rate"* was inserted in section 1 which refers to a rate levied, in terms of section 2 of the Local Government: Municipal Property Rates Act 6 of 2004, by a municipality on "rateable property" of an "owner" as defined in section 1 of that Act. The definition intends to make it clear that only a *"municipal rate"* levied by a municipality on fixed property within its jurisdiction may be subject to VAT at the zero rate. Any other separate charges for services or surcharges levied by a municipality are subject to VAT at the standard rate of 14%.

- Since municipal property rates are now viewed as charges in respect of taxable supplies made by a municipality to customers at the zero rate, this allows the municipality to deduct input tax on VAT-inclusive expenses incurred to make those supplies, even where there might be no explicit or direct charge to the customer or general public. (For example, the supply of parks and gardens, street lighting, municipal roads etc.)

Chapters 2** to **7 discuss further how the above principles are applied with effect from 1 July 2006, as well as how goods or services held by a municipality before 1 July 2006 are treated when they are applied, supplied, or otherwise disposed of after that date.

IMPORTANT NOTES

1. For the purposes of this guide, it should be assumed that the municipality or local authority discussed in any chapter or example, is a registered VAT vendor.

2. This guide deals primarily with the application of the law to municipalities on or after 1 July 2006, however, the term: *"local authority"* is used where it refers to supplies made for the period before 1 July 2006.

3. As municipalities are treated as ordinary VAT vendors with effect from 1 July 2006, the general VAT rules as set out in the *VAT 404 - Guide for Vendors* will apply. Therefore, information on topics which are dealt with in sufficient detail in the VAT 404, will not be repeated in this document unless it is for purposes of clarifying the VAT treatment of supplies made to, or by, municipalities.

4. For detailed information on the VAT treatment of grants, refer to *Interpretation Note No. 39 – VAT Treatment of Public Authorities, Grants and Transfer Payments* which is available on the SARS website*: www.sars.gov.za*.

CHAPTER 2

CONCEPTS AND DEFINITIONS

2.1 ACCOUNTING BASIS

The general rule is that all vendors are required to account for tax payable on the invoice basis. This means that a person has to declare output tax and deduct input tax in the tax period in which the time of supply in respect of a transaction occurs – regardless of whether payment for the supply has been made or received. *Refer to **paragraph 2.2**.*

However, the Commissioner may upon application allow a vendor to account for tax payable on the payments basis. Where the Commissioner allows a vendor to account for VAT on the payments basis, the vendor declares output tax and deducts input tax in the applicable tax period only to the extent to which payment of the consideration is received or made in that tax period.

In terms of the VAT law, only certain categories of persons are allowed to account for VAT on the payments basis, for example –

- natural persons;
- partnerships consisting of only natural persons;
- public authorities;
- municipalities; and
- municipal entities which make supplies of water, electricity, gas and refuse removal.

In practice it will be found that most municipalities account for VAT on the payments basis. One of the reasons for this is that municipalities have a vast customer base to which they supply many types of goods and services and often carry a large amount of debtors which have unpaid and arrear accounts in respect of these supplies. *Refer to **paragraph 5.3** for more in this regard*.

Example 1 – Payments basis of accounting

Scenario

ABC Municipality accounts for VAT on a monthly basis (Category C tax period). ABC Municipality supplies electricity to Mr V for an amount of R570 (including VAT) on 25 January 2010 and invoices Mr V for this amount on 28 February 2010. Mr V pays the amount to ABC Municipality in two equal instalments of R285 on 7 March 2010 and 7 April 2010 respectively.

When is ABC Municipality required to account for output tax on the payments received from Mr V, if it accounts for VAT on the payments basis?

Implications for ABC Municipality

ABC Municipality will account for output tax for the payment received on 7 March 2010 in the tax period ending March 2010. The output tax to be declared in this tax period is R35 (R285 x 14/114). In addition, ABC Municipality will account for output tax for the payment received on 7 April 2010 in the tax period ending April 2010. The output tax to be declared in this tax period is R35 (R285 x 14/114).

Note:

The same principle as set out above will apply to the input tax which may be deducted by ABC Municipality. Where goods or services are acquired in one tax period and only paid for in another tax period, it is only in the tax period in which payment occurs that the deduction of input tax will be allowed (limited to the extent of the actual payment made).

2.2 TIME AND VALUE OF SUPPLY

The purpose of determining the time of supply for goods or services is to determine the date when a supply is regarded as being made for VAT purposes. The time of supply therefore establishes the date that the supplier is required to declare the VAT charged on any supply made, and the date that the recipient becomes entitled to deduct input tax on goods or services acquired (provided that the requirements of the Act for deducting input tax have been met). The output tax and input tax is declared and deducted by the vendor on a VAT 201 return at the end of the applicable tax period covering the time of supply.

The general rule for the **time of supply** is determined as being the date when an invoice is issued in respect of a supply, or the date that payment of the consideration for the supply is received, whichever date is the earlier. This general rule will apply in most cases, but some supplies have a special time of supply rule which may deviate from the general rule. For example, the time of supply for fixed property is the earlier of the date that any payment of the consideration for the supply is made to the supplier, or the date that the property is registered in the name of the purchaser in a deeds registry.

It is important to note that the payments basis (or cash basis) uses the same general time of supply rule mentioned above, but the vendor only **accounts** for VAT on actual payments made and actual payments received in respect of taxable supplies during the period.

The general rule for the **value of supply** is that it is equal to the price charged for the supply of goods or services less the VAT included in the price. Therefore, the value of the supply of goods or services is an amount that excludes VAT. The amount that includes VAT is referred to as "*consideration*". The calculation of the value of supply and the consideration (including standard-rated VAT charged at 14%) can be illustrated by using the formula:

VALUE + VAT = CONSIDERATION

therefore

CONSIDERATION - VAT = VALUE

As with the time of supply, there are also special rules which may apply in certain cases for determining the value of the supply or the consideration. For example, where the supplier and the recipient in a transaction are related (connected persons) and the recipient is not a vendor or not able to deduct the full input tax on a supply received, the consideration for the supply is determined as being equal to the open market value of the supply. *For more details on these special cases, refer to the VAT 404 - Guide for Vendors*.

2.3 ENTERPRISE

The term *"enterprise"* is of paramount importance in the context of the VAT Act, because –

- a person that does not conduct an enterprise cannot register for VAT;
- only supplies made in the course or furtherance of carrying on an enterprise (referred to as taxable supplies) are subject to VAT;
- only VAT on expenses incurred which can be directly attributed to the purpose of consumption, use or supply in the course of making taxable supplies, can be deducted as input tax; and
- where the VAT on expenses cannot be directly attributed to the making of taxable supplies, only a fair and reasonable proportion thereof can be deducted as input tax. *Refer to* ***Chapter 5***.

When a person conducts an enterprise and the value of taxable supplies made for any 12-month period exceeds the VAT registration threshold of R1 million[1], or is likely to exceed this amount, that person is obliged to register for VAT. In cases where the value of taxable supplies is less than the registration threshold, but more than R50 000[2], the person may apply for voluntary registration.

[1] The compulsory VAT registration threshold of R1 million came into effect from 1 March 2009. Previously, the threshold was R300 000.
[2] This amount was increased from R20 000 to R50 000 with effect from 1 March 2010.

2.3.1 Carrying on an enterprise

A person will generally be considered to be carrying on an *"enterprise"* if **all** of the following requirements are met:

- An ***enterprise or activity*** is carried on ***continuously or regularly*** by a ***person in the Republic*** or partly in the Republic.
- In the course of carrying on the enterprise or activity, ***goods*** or ***services*** are ***supplied*** to another person.
- There is a ***consideration*** payable for the goods or services supplied.

At this stage, the most critical elements to discuss are the words "continuously" or "regularly". "Continuously" is generally interpreted as meaning ongoing, that is, the duration of the activity has neither ceased in a permanent sense, nor has it been interrupted in a substantial way. An activity can be regular if it is repeated at reasonably fixed intervals taking into consideration the type of supply and the time taken to complete the activities associated with making the supply.

2.3.2 Non-enterprise activities

Specifically excluded from the definition of *"enterprise"* is any activity that involves the making of exempt supplies, for example, the letting of a dwelling or the provision of passenger transport by road or rail to fare - paying passengers. A person that only makes exempt supplies, will not be able to register for VAT. Similarly, if a person is registered for VAT in respect of a taxable activity, and also conducts an exempt activity, output tax cannot be charged on the supplies made in the course of carrying on the exempt activity. It follows that no input tax can be deducted on expenses incurred in conducting the exempt activity.

Municipalities also receive payments in the form of fines and penalties imposed, or dividends from investments might be received in the course of carrying on investment activities. These receipts, although not specifically exempt under section 12, are nevertheless non-taxable since they do not fall within the ambit of the VAT Act and are not in respect of any goods or services supplied. These payments are sometimes referred to as "out-of-scope" receipts.

2.4 MUNICIPALITY

The definition of the term *"municipality"* in the VAT Act[3] refers to the definition as contained in section 1 of the Income Tax Act 58 of 1962, which in turn, makes reference to section 12(1) of the Local Government: Municipal Structures Act 117 of 1998. In effect, the term *"municipality"* means Category A, B and C municipalities as contemplated in section 155 of the Constitution of the Republic of South Africa (the Constitution), which deals with the establishment of municipalities. The different types of municipalities are classified as follows:

Category A: A municipality that has exclusive municipal executive and legislative authority in its area.
Category B: A municipality that shares municipal executive and legislative authority in its area with a Category C municipality within whose area it falls.
Category C: A municipality that has municipal executive and legislative authority in an area that includes more than one municipality.

2.5 MUNICIPAL ENTITY

A municipal entity is an entity created by one or more municipalities to carry on certain activities which would otherwise be conducted by the municipalities concerned. As a municipal entity is a separate juristic person from the municipality by which it was created, it will have to register separately for VAT if it makes taxable supplies in excess of the compulsory VAT registration threshold. As a general rule a municipal entity does not conduct activities on behalf of a municipality, but rather for its own account. *Refer to **paragraph 7.8** for more details on municipal entities*.

[3] An entity which qualified before 1 July 2006 as a *"local authority"* will not necessarily be a *"municipality"* on or after that date. Tribal authorities, water boards, and other associations of persons which previously qualified as local authorities are not included in the term *"municipality"*. A municipal entity is also not regarded as a municipality.

2.6 MUNICIPAL RATES

"Municipal rate" is defined in the VAT Act as follows:

> *"means a rate levied by a municipality in terms of section 2 of the Local Government: Municipal Property Rates Act, 2004 (Act No. 6 of 2004), on "rateable property" of an "owner" as defined in section 1 of that Act respectively: Provided that a municipal rate does not include—*
>
> *(a) a single charge levied by that municipality for rates and other supplies of goods or services such as—*
> *(i) electricity, gas, water; or*
> *(ii) drainage, removal or disposal of sewage or garbage; or*
> *(iii) goods or services that are incidental to, or necessary for the supply of those goods or services, to that owner; or*
> *(b) a rate levied in respect of supplies of goods or services contemplated in paragraph (a);"*

In other words, a *"municipal rate"* is a charge levied by a municipality on owners of property in the municipality's demarcated area. The charge is in lieu of facilities provided by the municipality to the general public in its area, and in respect of which it does not, or is unable, to charge a specific consideration. For example, street lighting, municipal roads and gardens, cleaning of streets etc.

Since a municipal rate is charged for facilities and services provided to the general public, the term specifically excludes charges in respect of the supply of electricity, gas, water, drainage, removal or disposal of sewage or garbage; or goods or services that are incidental to, or necessary for making those supplies. It also excludes the situation where a municipality charges a single charge (a "flat rate" or an all-inclusive rate) for **municipal rates *and* the supplies of goods or services** mentioned above.

Charges for municipal rates are subject to VAT at the zero rate, but the zero rate does not apply when there is no separate charge for goods or services such as water and electricity.

2.7 SUPPLY

The term is defined very broadly and includes all forms of supply and any derivative of the term, irrespective of where the supply is effected. The term includes performance in terms of a sale, rental agreement, instalment credit agreement or barter transaction. The term also includes supplies which are made voluntarily (for example, a donation of goods or services) and those supplies which take place by operation of law (forced sales, expropriation etc).

Apart from the supplies mentioned above, section 8 also provides for certain "deemed supplies". These are events or transactions which are regarded as being included in the meaning of *"supply",* for example –

- the receipt of a grant from a public authority for the purposes of making taxable supplies;
- the receipt of an indemnity payment under a contract of insurance; and
- assets retained for non-enterprise purposes when a vendor deregisters for VAT.

For the purpose of this guide, it is necessary to distinguish between a "*taxable supply*" and an "*exempt supply*". These concepts are explained below.

2.7.1 Taxable supply

The term *"taxable supply"* includes all supplies of goods or services made by a vendor in the course or furtherance of an *"enterprise".* Section 7(1)(*a*) prescribes that VAT must be levied at the standard rate (presently 14%) on a taxable supply, except where the type of supply is listed in section 11, in which case VAT is levied at the zero rate (0%).

Where VAT is incurred by a municipality and the expense is directly attributable to making taxable supplies (including zero-rated supplies), the VAT incurred may be deducted as input tax.

2.7.2 Exempt supply

Exempt supplies are not taxable supplies and VAT may therefore not be levied on any exempt supplies. Similarly, input tax may not be deducted on any expenses incurred to make exempt supplies. If the person is registered for VAT and makes both taxable and exempt supplies, only the VAT incurred on any expenses to make taxable supplies may be deducted as input tax.

The value of exempt supplies does not form part of the taxable turnover and is not used to determine whether a person is liable to register for VAT or not. If a person makes only exempt supplies, that person cannot register as a vendor for VAT purposes. Examples of exempt supplies include –

- financial services (for example, interest on a loan);
- renting of a dwelling for use as a residence (excluding commercial accommodation); and
- transport of fare-paying passengers within South Africa by taxi, bus, or train.

2.8 OUTPUT TAX

Output tax refers to the tax levied at the standard rate by a vendor on the supply of goods or services. The output tax is determined by applying the VAT rate of 14 per cent to the value of a supply of goods or services. In instances where the amount charged (consideration) for the supply of goods or services includes VAT, the output tax is determined by applying the tax fraction (14/114) to the consideration. For example, where the charge including VAT is R500, the output tax included in the amount is R500 x 14/114 = R61.40.

*Refer to **Chapter 4** for more details.*

2.9 INPUT TAX

Input tax refers to the tax paid by a vendor on the acquisition of goods or services that are to be consumed, used or supplied by that vendor either wholly or partly in the course of making taxable supplies. In cases where goods or services are acquired partly for taxable purposes, input tax is limited to that extent. The VAT incurred in the course of making exempt or other non-taxable supplies does not fall within the definition of input tax.

Input tax may be deducted in the following circumstances where the goods or services are acquired for the purpose of making taxable supplies:

- Where VAT is charged at the standard rate by a vendor supplying goods or services.
- Where VAT is paid to SARS Customs & Excise on the importation of goods into the Republic.
- Where second-hand goods situated in the Republic (not being fixed property) are acquired under a non-taxable supply from a resident of the Republic.
- Where fixed property is acquired under a non-taxable supply and transfer duty or stamp duty was paid (or would have been payable had an exemption not been applicable).

*See **Chapter 5** for more details.*

2.10 ADJUSTMENTS

An adjustment normally arises because of a change in the extent to which goods or services are applied. For example, an output tax adjustment must be made when goods or services acquired wholly for making taxable supplies are subsequently applied wholly for making exempt supplies. Similarly, when goods or services acquired wholly for exempt supplies are subsequently applied wholly for making taxable supplies, an input tax adjustment will be allowed on the change in use. Subject to certain exceptions, there are also other adjustments which may be required or allowed where there is a change in the extent of the taxable application of capital goods or services in the municipality's enterprise.

*See **Chapter 6** for more details.*

CHAPTER 3

AGENT vs. PRINCIPAL

3.1 INTRODUCTION

Before determining the VAT consequences of a transaction, it is necessary to establish the relationship between the parties. This is to determine if the vendor is acting as an agent on behalf of another person or as principal. Section 54 contains special provisions to deal with the VAT consequences arising from an agency relationship. This chapter aims to provide clarity regarding the VAT treatment of supplies where an agent/principal relationship exists and specific examples are provided to illustrate these concepts.

3.2 LEGAL PRINCIPLES OF AGENCY

In order to correctly apply the VAT legislation to the concept of agents, it is necessary to identify and understand the concept of an "agent" as understood in common law.

An agency is a contract whereby one person (the agent) is authorised and required by another person (the principal) to contract or to negotiate a contract with a third person, on the latter's behalf. The agent in representing the principal, creates, alters or discharges legal obligations of a contractual nature between the principal and the third party. The agent therefore provides a service to the principal and normally charges a fee (generally referred to as "commission" or an "agency fee") but does not acquire ownership of the goods and/or services supplied to or by the principal.

This agent/principal relationship may be expressly construed from the wording of a written agreement or contract concluded between the parties. Where a written agreement or contract does not exist, the onus of proof is on the agent who seeks to bind the principal in a contract to demonstrate that an agency agreement exists between the agent and another person who is the principal for the purposes of the supply. An understanding of the relationship between the parties is therefore a requirement in understanding the VAT treatment of supplies made by the parties.

Some of the differences between an agent and a principal are summarised below:

Agent	Principal
The agent is not the owner of any goods or services acquired on behalf of the principal.	The principal is the owner of the goods or services acquired on the principal's behalf by the agent.
The agent will not alter the nature or value of the supplies made between the principal and third parties.	The principal may alter the nature or value of the supplies made between the principal and third parties.
Transactions on behalf of the principal do not affect the agent's turnover, except to the extent of the commission or fee earned on such transactions.	The total sales represent the principal's turnover. The commission or fee charged by the agent forms part of the principal's expenses.
An agent only declares the commission or fee for Income Tax and VAT purposes.	The principal declares gross sales as income for Income Tax and VAT purposes, and may be allowed to claim a deduction for the commission or fee charged by the agent.

In essence, the differences indicate that the principal is ultimately responsible for the commercial risks associated with a transaction, and that the agent is trading for the principal's account. The agent is appointed by and takes instruction from the principal regarding the facilitation of transactions as per the principal's requirements and generally charges a fee or earns a commission for that service.

To correctly apply the VAT legislation, it is necessary to identify and understand the contractual relationship between the parties. The VAT treatment of supplies proceeds from the fact of whether a person is acting on their own behalf, or on behalf of another person. In essence, section 54 provides that where a vendor employs the services of an agent to acquire goods or services, or to make supplies on the vendor's behalf, the supplies are made to, or acquired by, the principal (as the case may be). There are also special provisions dealing with the receipt and issuing of tax invoices. *Refer to **paragraph 3.3** below.*

As an agent merely acts on behalf of the principal, any output tax and input tax in relation to the underlying supplies made or received on behalf of the principal must be accounted for on the VAT return of the principal (if the principal is a vendor). The agent will only declare output tax and input tax in relation to the agency services supplied (if the agent is a vendor).

3.3 TAX INVOICES, CREDIT NOTES AND DEBIT NOTES

The normal rule is that any tax invoice, credit note or debit note relating to a supply by, or to the agent, on the principal's behalf should contain the principal's particulars. However, the VAT Act does provide that if an agent (being a vendor) makes a supply on behalf of another vendor (the principal), the agent may issue a tax invoice or a credit or debit note relating to that supply as if the supply had been made by the agent. In such a case, the agent's details may be reflected on the tax invoice, credit note or debit note and the principal may not also issue a tax invoice or credit or debit note in respect of that same supply. The VAT Act also makes provision for the agent to be provided with a tax invoice, credit note or debit note as if the supply is made to the agent.

When a tax invoice, credit note or debit note has been issued by or to an agent in the circumstances described above, the agent must maintain sufficient records so that the name, address and VAT registration number of the principal can be ascertained.

In addition, the agent must, for supplies made on or after 1 January 2000, notify its principal within 21 days of the end of each month in writing of –

- a description of the goods supplied;
- the quantity or volume of the goods supplied; and
- either –
  - the value of the supply, the amount of tax charged and the consideration for that supply; or
  - where the amount of tax charged is calculated by applying the tax fraction to the consideration, the consideration for the supply and either the amount of tax charged, or a statement that it includes a charge in respect of the tax and the rate at which the tax was charged.

In these circumstances, the agent is required to retain the original tax invoices, credit notes or debit notes (if these documents are to be retained on the principal's behalf) and sufficient records should be maintained to enable the name, address and VAT registration number of the principal to be ascertained.

3.4 APPLICATION OF AGENCY PRINCIPLES

In terms of the Constitution, national and provincial governments are mandated to perform activities in certain functional areas, for example, vehicle licensing, road traffic regulation, provincial roads and traffic and primary health care services. Municipalities have the right to administer certain local government activities, for example building regulations, fire fighting services, municipal public transport, municipal roads, street lighting, traffic and parking, environmental health services, billboards and the display of advertisements in public areas.

National and provincial governments may assign, by agreement and subject to certain conditions, any of the activities mandated to them to a municipality, if the matter would be most effectively administered locally, provided that the municipality has the capacity to administer it. In addition, the provincial government may appoint a municipality as agent to carry on certain activities where the provincial government may need assistance to carry out its mandated activities. *Refer also to **paragraph 7.3** and to **Annexure F**.*

Based on the discussion under ***paragraphs 3.2*** and ***3.3*** above, it is imperative that agreements, usually referred to as Service Level Agreements (SLAs), are formalised between municipalities and provincial government where functions are assigned to municipalities, or where a municipality acts as agent of the national or provincial government to execute certain tasks.

An understanding of the relationship between the parties is therefore a requirement in understanding the VAT treatment of a supply by a municipality, as the accounting for VAT follows from the role, function and contractual capacity in terms of which the parties to a transaction carry out their activities.

Therefore, where the municipality itself has been assigned the responsibility of supplying certain goods or services (being taxable supplies) **as principal** –

- the activity and the supplies made will form part of the municipality's taxable activities, and the fees or other charges in respect of the supply of those goods or services will be subject to VAT at either the standard rate of 14% or the zero rate; and
- the municipality is entitled to deduct input tax on the goods or services acquired for the purposes of making those taxable supplies.

Where the municipality is merely acting as **an agent** for the provincial government, in assisting the provincial government to deliver on its mandate, the following applies:

- The actual fees charged by the municipality as agent on behalf of the provincial government in respect of the underlying supply will not be subject to VAT. The reason for this is that the provincial government is a *"public authority"*, and as a general rule may not register for VAT, or charge VAT on goods or services supplied (unless that public authority is notified by the Minister to register for VAT).
- The municipality must account for output tax at the standard rate of 14% on the commission or agency fee, and any other charge made for the supply of the agency services (for example, collecting licence fees and issuing licenses or permits on behalf of the provincial government).
- Any VAT charged by the municipality on the agency fee/commission and any other elements of consideration charged (or cost recoveries made) by the municipality cannot be deducted as input tax by the provincial government as it is not a vendor. The VAT charged by the municipality therefore becomes part of the overall costs of the provincial government for providing the goods or services and should be budgeted for accordingly.

The following examples illustrate the agent/principal relationship in respect of municipalities. Assume for the purposes of these examples that the municipalities concerned are registered as VAT vendors:

Example 2 – Municipality acts as principal

Scenario

Province Y provides primary health care (PHC) services within Municipality X's demarcated area. Province Y's fees are based on a standard charge of R100 per patient. Municipality X is not involved in the provision of the PHC service itself, but rents a commercial building to Province Y for R20 000 per month (including VAT) from where the PHC services are supplied.

Implications for Province Y and Municipality X

Province Y is not a vendor, therefore when the fee of R100 is charged to patients by Province Y, no VAT may be charged. Furthermore, Province Y may not deduct any VAT (input tax) on expenses incurred to provide the PHC services, for which it is the principal. Province Y will be charged VAT at the standard rate on the supply of the building by Municipality X under the rental agreement, as Municipality X is the principal in respect of the supply of the building to Province Y. This VAT may also not be deducted as input tax by Province Y. It follows that Province Y must budget on the basis that any VAT incurred in connection with the provision of PHC services is an accounting and actual "cost" of Province Y. Municipality X must declare output tax at the standard rate (R20 000 x 14/114 = R2 456.14) on the rental received for the supply of the building and it may deduct input tax on the VAT-inclusive expenses incurred on maintaining the building.

Example 3 – Municipality acts as agent and principal for different supplies

Scenario

Assume the same facts as in **Example 2**, except that Municipality X, in addition to supplying the building, also acts as the agent of Province Y in overseeing and managing the activity on behalf of Province Y. Municipality X calculates the fee for the agency service as 30% of the charge per patient per month by Province Y.

Implications for Province Y and Municipality X

The implications are the same as in **Example 2** except that Municipality X will also charge VAT on its agency fee of R30 (R100 x 30%) per patient per month. (The SLA should determine whether the 30% includes VAT, or whether it must be added.) The fact that Municipality X chooses to base the calculation of its agency fee (consideration) on a VAT-exclusive amount (R100), does not change the fact that the agency services constitute a taxable supply. As in **Example 2**, the VAT charged on the agency fee will also be a "cost" to Province Y. Where the SLA is silent on VAT, the amount charged will be deemed to include VAT.

Example 4 – Sub-contracting of municipal services

Scenario

Municipality A is required to perform refuse removal services in its demarcated area, but due to a strike of municipal employees, it does not have the capacity to carry out this responsibility for the months of July and August 2010. Municipality A enters into an agreement with Rapid Garbage Removal CC (a private contractor and a vendor) to perform the services on its behalf for the period. Municipality A continues to bill its clients as normal, and as if it had performed the refuse removal services itself.

Implications for Rapid Garbage Removal CC (Agent)

Rapid Garbage Removal CC (the agent) will only account for output tax on the amount charged to Municipality A (principal) for performing the necessary refuse removal services on Municipality A's behalf.

Implications for Municipality A (Principal)

Municipality A is the principal for the purposes of the supply of refuse removal services to its customers. It must therefore account for output tax on the full consideration charged, as it would have done, had it actually performed the services itself. The VAT charged by Rapid Garbage Removal CC may be deducted as input tax by Municipality A, as the expense is incurred in the course of Municipality A's enterprise activities.

Example 5 – Vehicle licensing: Municipality acts as agent for provincial government

Scenario

Province Y enters into an SLA in terms of which Municipality X is appointed to collect vehicle licensing fees and to issue vehicle licences on its behalf.

Implications for Municipality X (Agent)

The vehicle licensing fees charged by Municipality X as agent on behalf of Province Y are not in respect of a taxable supply, whereas the agency fee charged by Municipality X to Province Y for collecting the vehicle licensing fees and issuing the licences on Province Y's behalf is a taxable supply at the standard rate. Municipality X is not entitled to deduct input tax in respect of any of the goods or services acquired on behalf of the principal in this regard. However, Municipality X will be entitled to deduct input tax in respect of any goods or services acquired in order to perform the agency services, (for example, computer systems maintenance, stationery, office rental, electricity etc).

Implications for Province Y (Principal)

The vehicle licensing fees are charged by Municipality X as agent and do not constitute consideration charged in respect of a taxable supply. As Province Y is not a vendor, any VAT incurred on Municipality X's agency fee and any expenses incurred by Municipality X in acquiring goods or services on Province Y's behalf in regard to the activity of vehicle licensing, cannot be deducted as input tax and therefore becomes a cost to Province Y.

Example 6 – Township development: Municipality acts as principal

Scenario

Municipality A budgeted R10 million for its own township development project and will sell the housing units for a total of R12 million. Province B provides Municipality A with a subsidy (grant) of R8 million to assist it to develop the township.

Implications for Municipality A

The R8 million received from Province B is a *"grant"* and the receipt is subject to VAT at the zero rate as Province B does not receive any goods or services in return for the payment. The sale of the housing units constitutes taxable supplies and therefore Municipality A will have to charge VAT at the standard rate on the sale of the units. The VAT-inclusive costs of developing the housing units may be deducted as input tax.

Example 7 – Township development: Municipality acts as agent

Scenario

Assume the same facts as in **Example 6**, except that it is Province B's housing development project and Municipality A merely acts as the agent of Province B in overseeing and managing the activity on Province B's behalf. Municipality A charges a 4% VAT-inclusive fee (R400 000) based on the total development cost of R10 million. Municipality A also pays the following expenses on Province B's behalf:

Roads, water and other infrastructure	R2 600 000 (VAT-inclusive)
Construction cost of housing units	R5 000 000 (VAT-inclusive)
Provincial government employee salaries & wages	R2 000 000 (no VAT included)

Implications for Municipality A and Province B

Municipality A must account for output tax of R49 122.81 in respect of the R400 000 VAT-inclusive agency fee charged to Province B for overseeing and managing the project on Province B's behalf.

The VAT charged to Province B which is embedded in the infrastructure and housing development costs as well as the agency fee charged by Municipality A is a cost to Province B. Where the land for the development is acquired from a vendor, the VAT charged will also be a cost for Province B. Where the land is acquired from a non-vendor, Province B (being part of the government) will be exempt from transfer duty. When Province B sells the housing units, it will not charge VAT, because it is not a vendor. Since the salaries and wages of the provincial employees do not include VAT, Province B does not incur a VAT cost in this regard.

Notes:

1. Had Province B requested Municipality A to use its own employees to carry out the development, the salaries and wages paid by Municipality A to its own employees cannot be regarded as a disbursement on behalf of Province B. This is because the provision of labour by Municipality A would constitute a taxable supply and the consideration charged would attract VAT at the standard rate (regardless of the fact that the consideration is determined on the basis of a recovery of Municipality A's "costs"). Since the "cost" of R2 000 000 in this case represents the actual salaries and wages paid by Municipality A to its own employees, it would have to charge an additional amount of R280 000 VAT, otherwise the output tax which has to be declared on the supply would be a cost to Municipality A instead of Province B. This example illustrates how important it is to carry out the budgeting exercise correctly for projects of this nature.
2. For an explanation regarding the VAT treatment of low cost housing and land reform grants, refer to *Interpretation Note No. 39 – VAT Treatment of Public Authorities, Grants and Transfer Payments* and the *VAT 409 - Guide for Fixed Property and Construction*. Both of these documents are available on the SARS website: *www.sars.gov.za*.

CHAPTER 4

TYPES OF SUPPLIES

4.1 INTRODUCTION

Municipalities have the right, in terms of section 156(1)(*a*) of the Constitution, to administer certain local government activities listed in Part B of Schedule 4 and Part B of Schedule 5 to the Constitution. (*Refer to **Annexure F**.*) Municipalities are therefore involved in making many different types of supplies. Before 1 July 2006, where a municipality/local authority made a supply which was not exempt or did not constitute a taxable supply of electricity, gas, water, drainage or the removal or disposal of sewage or garbage, a "breakeven test" had to be applied to determine whether the supplies were taxable or not. The effect of the changes in the VAT law which came into operation on 1 July 2006 meant that the extent of taxable supplies made by municipalities was significantly increased. Municipalities are now treated for VAT purposes in the same manner as any other vendor, although there are some unique aspects which are dealt with in ***Chapter 7***.

For the purposes of completing the VAT 201 return and accounting for VAT, it is necessary for a municipality to split the receipts in connection with its activities into –

- standard-rated taxable supplies (electricity, water, refuse removal and supplies which are taxable at the standard rate with effect from 1 July 2006 – refer to ***Annexure B*** for examples);
- zero-rated supplies (municipal rates charges and grants received for the purposes of making taxable supplies);
- exempt supplies (rental of dwellings and transport of fare-paying passengers by road or rail); and
- "out-of-scope" supplies and non-supplies (for example, fines and penalties).

These distinctions are explained further in ***paragraphs 4.2** to **4.5*** below.

It should be noted that receipts in respect of exempt supplies and other non-taxable receipts must be added together and reported as a single amount in Field 3 of the VAT 201 return.

4.2 TAXABLE SUPPLIES

The term *"taxable supply"* includes all supplies of goods or services made by a vendor in the course or furtherance of an *"enterprise"*. VAT must be levied at either the standard rate or the zero rate on a taxable supply. With the deletion of paragraph (*c*) of the definition of "*enterprise*" and the inclusion of the activities conducted by a municipalitiy under paragraph (*a*) of that definition, most of the supplies made by a municipality with effect from 1 July 2006 will constitute taxable supplies. *Refer to **Annexure B** for examples*.

Consequently in conducting *"enterprise"* activities, municipalities will supply goods or services subject to VAT at the standard rate, except where the supplies are specifically zero-rated (section 11), exempt (section 12), or out-of-scope for VAT purposes.

4.2.1 Standard-rated supplies

In performing the various *"enterprise"* activities, a municipality will make taxable supplies of goods or services for a consideration which are subject to VAT at the standard rate of 14% in terms of section 7(1)(*a*). (*Refer to **Annexure B** for examples.*) Before 1 July 2006, this would have been limited to the supply of water and electricity, refuse removal services and supplies made in connection with the business activities listed in *Regulation 2570* (*refer to **Annexure A***). However, with the amendments to the law and the broadening of the scope of taxable supplies, almost all supplies made by municipalities will now constitute taxable supplies.

The following examples illustrate the application of the standard rate of VAT to certain goods or services supplied by a municipality on or after 1 July 2006.

Example 8 – Supplies made to the general public

Scenario

Municipality A provides the following to the general public:

- Street lighting.
- Municipal roads.
- Fire brigade services.
- Parks and recreational facilities.

Implications for Municipality A

As the supply of these goods and services are not specifically exempt or zero-rated in terms of the VAT Act, they constitute taxable supplies at the standard rate and form part of Municipality A's *"enterprise"* with effect from 1 July 2006. Municipality A must account for output tax at the standard rate on any specific consideration charged for these supplies. It follows that input tax may be deducted where VAT is incurred on goods or services acquired in order to make these supplies. Where municipal rates are levied on property owners to cover the expenses of making these supplies, the amount of municipal rates charged to the property owner is subject to VAT at the zero rate.

Example 9 – Supplies which are taxable for the first time from 1 July 2006

Scenario

Forestry activities carried on by Municipality B in its demarcated area were not regarded as part of the municipality's "*enterprise*" before 1 July 2006 (and hence were not taxable), as they did not fall within the list of business activities in Regulation 2570 (*refer to **Annexure A***). Municipality B converts the forest into a commercial area and in the process it supplies the following:

- Pine trees.
- Firewood.
- Various plants (not being fruit or vegetables).
- Animals and fish.

Implications for Municipality B

As Regulation 2570 is no longer applicable with effect from 1 July 2006, and since the goods supplied are not specifically exempt or zero-rated in terms of the VAT Act, the supplies are taxable at the standard rate. The activities and supplies form part of Municipality B's *"enterprise"* and therefore output tax must be accounted for at the standard rate on the supplies made.

4.2.2 Zero-rated supplies

As is the case with any other vendor, if a municipality supplies any of the goods or services listed in section 11, the zero rate of VAT will be applicable. This is subject to the requirement that documentary proof substantiating the municipality's entitlement to apply the zero rate, must be obtained and retained.

With effect from 1 July 2006, municipal property rates levied on property in terms of the Local Government: Municipal Property Rates Act 6 of 2004 (the Rates Act), are subject to VAT at the zero rate. Before 1 July 2006, the receipts from municipal property rates were exempt. It is important to note that the zero-rating does not extend to other charges, surcharges or fees for services provided by the municipality. *Refer to **paragraph 2.6**.*

Municipalities had until 1 July 2009 to implement new rules in terms of section 3 of the Rates Act which requires municipalities to adopt a market value-based rates policy. Municipal property rates levied in a municipality's area will therefore be based on the market value of the land and buildings, and not just on the land. Sectional title units are now also subject to municipal property rates charges on an individual basis. Previously, these charges would have been levied against the body corporate in regard to the entire property under that sectional title scheme.

Further examples of zero-rated supplies applicable to municipalities include –

- grants received from public authorities, other municipalities or constitutional institutions for the purpose of making taxable supplies, such as, equitable share and SETA training grants which are for the purpose of making taxable supplies (*refer to* ***paragraph 4.5***); and
- international transport of fare-paying passengers by road or rail.

Note that a "*grant*", is subject to VAT at the zero rate only where the municipality has not actually supplied any goods or services to the public authority, municipality or constitutional institution making the payment. Where there is an actual supply of goods or services by the municipality, the supply will be subject to VAT at the standard rate.[4] Furthermore, where payment is made directly to third party suppliers who are vendors, the vendors are not automatically entitled to zero rate the supply. *Refer to* ***paragraph 7.6*** *for more information on this aspect.*

Example 10 – Municipal property rates

Scenario

Municipality D issues a tax invoice for supplies made to Mr K, as follows:

Rates on property	R450
City cleaning charge – domestic	R 20
Waste removal charge – domestic	R 10
	R480

Implications for Municipality D

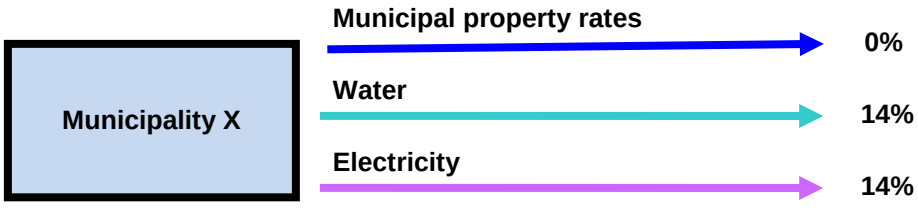
As municipal rates on property are zero-rated in terms of section 11(2)(*w*), Municipality D will account for a zero-rated consideration of R450. However, as the city cleaning and waste removal charges are levied in respect of separate standard-rated supplies, Municipality D must account for VAT at the standard rate on those services (R20 + R10 = R30 x 14/114 = R3.68).

4.2.3 Flat rate charge for all services

Normally where a single consideration is charged for various supplies in respect of which different tax rates apply, section 8(15) requires a split to be made in the consideration so that tax can be levied correctly on each part of the consideration relating to the individual supplies. However, this rule does not apply to municipal rates charges. Therefore, where a municipality charges a single consideration (referred to as a "flat rate") and the charge is in respect of municipal property rates **and** other goods and services such as electricity, gas, water, drainage or the removal or disposal of sewage or garbage, the flat rate charge for all services is taxable at the standard rate.

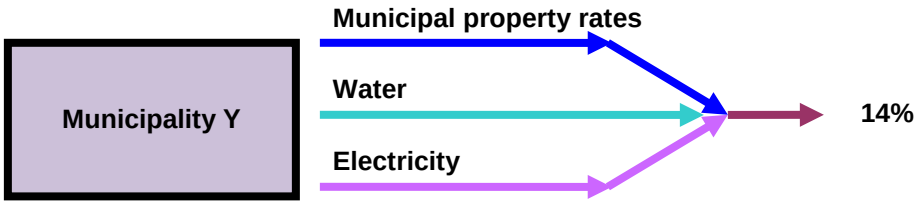
This concept is illustrated in the following diagrams:

Each supply itemised separately on the bill



[4] Whether or not an actual supply is made to the municipality will depend on the facts and circumstances of the particular case. As the meanings of *"supply"* and *"services"* in the VAT Act are very wide, it will include the performance of any contractual obligations in terms of which the municipality receives something in return for making the payment. In such cases the payment will constitute consideration for an actual supply of the goods or services which is subject to VAT at the standard rate and will not be a zero-rated *"grant"*.

Single charge for all supplies including municipal rates (flat rate)



4.2.4 Adjustments

In certain instances, an adjustment to input tax or output tax may be required or allowed on the change of use of goods or services, or where the extent of application of capital goods or services for taxable purposes has increased or decreased. *Refer to **Chapter 6** for more details.*

4.3 EXEMPT SUPPLIES

The making of exempt supplies as envisaged in section 12, is specifically excluded from the definition of "*enterprise*" and is therefore not subject to VAT. Accordingly, no output tax must be levied on exempt supplies made and input tax may not be deducted on any expenses incurred to make those supplies.

Examples of exempt supplies made by municipalities include –

- the levying of interest on unpaid municipal water and electricity accounts;
- interest earned on credit balances of municipal funds in a bank account or interest earned on investments;
- rental income earned on the supply of a dwelling under a rental agreement; and
- fares earned in respect of the supply of public passenger transport services in the Republic by bus or by train.

Example 11 – Standard-rated and exempt supplies

Scenario

Municipality E receives the following amounts from activities carried on for the month ended January 2010:

Public passenger transport (bus service)	R1 000 000
Signage and advertising on buses/bus shelters	R 250 000
Interest received – water and electricity debtors	R 100 000
Interest received – investment held at ABC Bank	R 10 000

Implications for Municipality E

Municipality E will account for an exempt amount of R1 110 000 (R1 000 000 + R100 000 + R10 000) in Field 3 of the VAT 201 return in respect of the income from public passenger transport and the interest received. However, the consideration of R250 000 received in respect of signage and advertising on buses and bus shelters is earned in respect of a taxable supply at the standard rate. Municipality E must therefore account for output tax of R30 701.75 (R250 000 x 14/114) thereon.

4.4 OTHER NON-TAXABLE SUPPLIES AND RECEIPTS

A municipality may also receive other payments which are non-taxable. These are receipts which are either in respect of supplies which do not fall within the ambit of the VAT Act, or are receipts which are not in respect of any supply of goods or services made by the municipality. These receipts are sometimes called "out-of-scope" receipts and not subject to VAT at either the standard rate (14%) or the zero rate (0%), nor are they exempt in terms of section 12.

Examples include –

- statutory fines and penalties which are regulated in terms of statute, such as, fines for speeding, parking violations, littering, late return of library books etc;
- any grants (including capital grants) received for the purpose of making exempt supplies (*refer also to **paragraph 4.5** below*);
- any donations (unconditional gifts) from charities or inheritances from individuals, provided there is no *quid pro quo* consisting of a supply of goods or services in return for the donation or inheritance to that person (or a connected person in relation to that person); and
- dividends received.

4.5 GRANTS

4.5.1 Introduction

Before 1 April 2005, the term *"grant"* was not defined in the VAT Act. Instead, the VAT legislation referred to, and defined, the term *"transfer payment"*. One of the main issues faced by municipalities was that the appropriations (grants) made to them by government under the annual Division of Revenue Act, for example, equitable share grants, did not comply with the definition of *"transfer payment"*. Therefore, these receipts did not qualify for the zero rate under section 11(2)(*p*) as it read at the time. This created a problem in that, public authorities and municipalities were generally under the impression that such payments qualified to be zero-rated and did not budget for the VAT, which should have been included at the standard rate.

The VAT law was therefore amended with effect from 1 April 2005 as follows:

- The definition of *"transfer payment"* was deleted and replaced with the definition of *"grant"*. The definition of *"grant"* included in its meaning any appropriations made by government under the annual Division of Revenue Act.
- The section 8(5) deeming provision was amended so that it only applied to a *"designated entity"*, and section 8(5A) was introduced to create a deemed supply where a person receives a grant from a public authority, constitutional institution or municipality.[5]
- The zero-rating provision for transfer payments under section 11(2)(*p*) was deleted and replaced with section 11(2)(*t*). This provision allows the deemed supply which arises under section 8(5A) in respect of grants made **to** municipalities or grants made **by** municipalities to be zero-rated.
- Sections 8(23) and 11(2)(*s)* were introduced to zero rate certain housing subsidy payments made to vendors on behalf of beneficiaries for the construction of certain low cost housing projects.
- Section 40B was introduced to deal with the past incorrect treatment of transfer payments by municipalities. The effect of this provision was to provide some relief to those municipalities who had been assessed for unpaid VAT in this regard which had not yet been paid as at 1 April 2005. *Refer to **paragraph 7.4** and **Annexure H** for more details.*

A grant constitutes assistance from the State or a municipality (usually in the form of money) being a gratuitous or "unrequited" payment by the grantor, where no reciprocity is expected from the recipient in the form of a supply of goods or services of corresponding value. Where the recipient is required to perform minor actions in regard to the grant, such as providing the grantor with a report or information on how the grant funds were spent, those actions are not regarded as constituting an actual taxable supply of *"services"* by the grantee to the grantor in terms of section 7(1)(*a*). However, where the municipality is actually making a supply of goods or services to the person making the payment, the municipality is liable to account for VAT at the standard rate in respect of the supplies. For example, where a municipality supplies electricity or water to a public authority, or charges an agency fee for collecting vehicle license fees on behalf of a public authority, the payment received in respect of those supplies does not constitute a *"grant"* in the hands of the municipality. Similarly, where a municipality makes a payment to a private vendor, that receipt will not constitute a *"grant"* if it is in fact payment for any goods or services actually supplied by that vendor to the municipality.

[5] The deeming provision does not apply in the case where an actual supply of goods or services is made to the public authority, constitutional institution or municipality in return for the payment. *Refer also to **footnote 4***.

A payment is therefore excluded from qualifying as a zero-rated *"grant"* where –

- it constitutes payment for the actual supply of goods or services by the person making the payment;
- it constitutes a conditional loan which must be repaid to the lender either in the form of money, or in the form of a supply of goods or services upon the happening of a future event;
- the payment is made in exchange for the supply of shares in a public entity, municipal entity or other juristic person.

It should also be noted that where the grantor pays a supplier of goods or services directly on behalf of the grantee, this does not mean that the supplier may charge the zero rate on the supply made to the grantee. *Refer to* ***paragraph 7.6*** for more details.

Housing subsidy scheme payments in respect of low cost housing schemes are excluded from the definition of *"grant"*, but these payments qualify for the zero rate in terms of sections 8(23) and 11(2)(s).

4.5.2 Grants to municipalities

When a grant is received by a municipality from a public authority, constitutional institution, or another municipality, this gives rise to a deemed supply of services in terms of section 8(5A) which is zero-rated in terms of section 11(2)*(t)*, provided that the grant is for the purpose of assisting the municipality to make taxable supplies of goods or services in the course of its enterprise. If a grant is received for the purposes of exempt or other non-taxable supplies, it does not result in a deemed supply in terms of section 8(5A). The municipality will not be entitled to deduct any input tax for goods or services acquired to carry on the non-taxable activities for which those funds were intended.

A *"grant"* must be attributed and declared on the VAT 201 return according to whether it relates to taxable, exempt or other non-taxable supplies. Where the grant is for both taxable and non-taxable purposes, the receipt must be attributed accordingly. For example, if 30% of a grant is for subsiding the municipality's public transport business (exempt supply) and 70% is for subsidising the supply of water and electricity to customers (taxable supplies), 30% of the grant will not be taxable, and the other 70% will be subject to VAT at the zero rate.

Example 12 – Grant received by a municipality

Scenario

On 1 August 2010, Public Authority A makes a payment of R5 000 000 to Municipality B in terms of the Division of Revenue Act to enable Municipality B to construct a dam. In constructing the dam, Municipality B incurs construction costs which include VAT at the standard rate. Public Authority C also pays R200 000 to Municipality B to subsidise the provision of a bus service (passenger transport) in Municipality B's demarcated area.

Implications for Municipality B

Municipality B does not supply any actual goods or services to Public Authority A or Public Authority C in return for the payments. However, a deemed service arises in respect of the receipt of the R5 000 000 grant payment under section 8(5A). The deemed supply made by Municipality B to Public Authority A is zero-rated in terms of section 11(2)(*t*). The VAT incurred on the construction costs in building the dam may be deducted as input tax. However, no deemed supply arises in respect of the R200 000 received from Public Authority C and Municipality B will reflect this amount as an out-of-scope receipt in Field 3 of the VAT 201 return.

The table below lists some examples of the different types of grants which may be made by national or provincial government to municipalities, and their respective purposes:

Grant	Purpose
Local Government Financial Management Grant	To promote and support reforms in municipal financial management by building capacity to implement the Local Government: Municipal Finance Management Act 56 of 2003.
Rural Households Infrastructure Grant	To provide specific capital finance for the eradication of rural sanitation backlogs targeted at existing households without access to sanitation and water.
Municipal Systems Improvement Grant	To assist municipalities in building in-house capacity to perform their functions and stabilise institutional and governance systems as required in the Local Government: Municipal Systems Act 32 of 2000.
Municipal Infrastructure Grant (MIG)	To provide specific capital finance for basic municipal infrastructure backlogs for poor households to micro enterprises and social institutions servicing poor communities.
Equitable Share	This grant is determined in terms of a formula and is paid annually in three tranches in terms of the Division of Revenue Act and in accordance with section 214 of the Constitution. The formula is based on various factors such as the number of households in a municipality's demarcated area and the poverty level or demographic profile of the residents. Although the funds are generally regarded as being allocated on an unconditional basis, section 277 of the Constitution provides that a municipality is entitled to the equitable share so that it may "*provide basic services and perform the functions allocated to it*." It is therefore expected that municipalities will utilise these funds to provide and maintain basic facilities for the operation of local government and that they will provide an essential minimum package of services to all indigent households on a sustainable basis.
Integrated National Electrification Programme (INEP) (Municipal) Grant	To implement the INEP by providing capital subsidies to municipalities to address the electrification backlog of permanently occupied residential dwellings, the installation of bulk infrastructure and the rehabilitation and refurbishment of electricity infrastructure to improve supply quality.
Water Service Operating Subsidy Grant	To subsidise water schemes owned and/or operated by the Department of Water Affairs or by other agencies on behalf of the Department of Water Affairs and to transfer these schemes to local government.
Public Transport Infrastructure and Systems Grant	To provide for accelerated planning, establishment, construction and improvement of new and existing public transport and non-motorised transport infrastructure and systems.
Neighbourhood Development Partnership Grant (Capital Grant)	To support neighbourhood development projects that provide community infrastructure and create the platform for other public and private sector development, towards improving the quality of life of residents in targeted underserved neighbourhoods.

4.5.3 Grants by municipalities

Before 1 April 2005, it was not possible for a municipality to make a zero-rated *"transfer payment"* to another municipality, or to a private vendor. The reason for this is that only a *"public authority"* could make a "transfer payment". But with effect from 1 April 2005 a municipality may make a grant to another municipality or to a private vendor (not being a *"designated entity"*) which will qualify to be zero-rated in the hands of the recipient. However, the same rule as discussed in ***paragraph 4.5.1*** will apply in this regard in that the amount paid should not constitute payment for the actual supply of goods or services, or be a payment to a *"designated entity"* such as a municipal entity. Any payment made to a municipal entity by a public authority will also be taxable at the standard rate. *Refer also to* ***footnotes 4 and 5****.*

For a detailed explanation regarding the VAT treatment of grants, refer to Interpretation Note No. 39 – VAT Treatment of Public Authorities, Grants and Transfer Payments which is available on the SARS website: www.sars.gov.za.

CHAPTER 5

INPUT TAX

5.1 INTRODUCTION

In order for a municipality to deduct input tax, goods or services must be acquired for the purpose of consumption, use or supply in the course of making taxable supplies. No input tax may be deducted in respect of goods or services acquired for the purposes of making exempt or other non-taxable supplies.

Input tax may be deducted –

- where VAT is charged at the standard rate by a VAT-registered supplier of goods or services;
- where VAT is paid on the importation of goods into the Republic;
- where second-hand goods situated in the Republic (not being fixed property) are acquired under a non-taxable supply from a resident of the Republic; and
- where fixed property is acquired under a non-taxable supply and transfer duty or stamp duty was paid (or would have been payable had an exemption not been applicable).

However, there are a number of **conditions** which must be met, namely –

- input tax may only be deducted if the goods or services are acquired for making taxable supplies, and the recipient is in possession of the relevant documentation, for example, a tax invoice or a bill of entry (together with proof of payment of the tax);
- where goods or services are acquired only partly for the purpose of making taxable supplies, an apportionment of input tax must be made; and
- no input tax may be deducted where the goods or services are acquired for making exempt or other non-taxable supplies, or where the input tax is specifically denied in terms of section 17.

Where **second-hand goods** are acquired under a non-taxable supply, there are a number of **other limitations and conditions** which apply, for example –

- the recipient must retain the relevant supporting documentation prescribed under section 20(8)[6] in order to deduct input tax (commonly referred to as “notional input tax”);
- the deduction for input tax is limited to the extent that a monetary payment is made for the supply;
- the input tax deduction is further limited to the open market value of the second-hand goods; and
- where the second-hand goods constitute **fixed property** the following **further conditions** apply:
  - Input tax may only be deducted after the transfer duty or stamp duty has actually been paid (or the exemption has been granted) and it is limited to the relevant tax that was payable (or which would have been payable had an exemption not been applicable).
  - Input tax may only be deducted once the time of supply rule under the VAT Act has occurred, which is the earlier of the date of payment of the consideration, or the date of registration of transfer of the property in the relevant deeds registry.

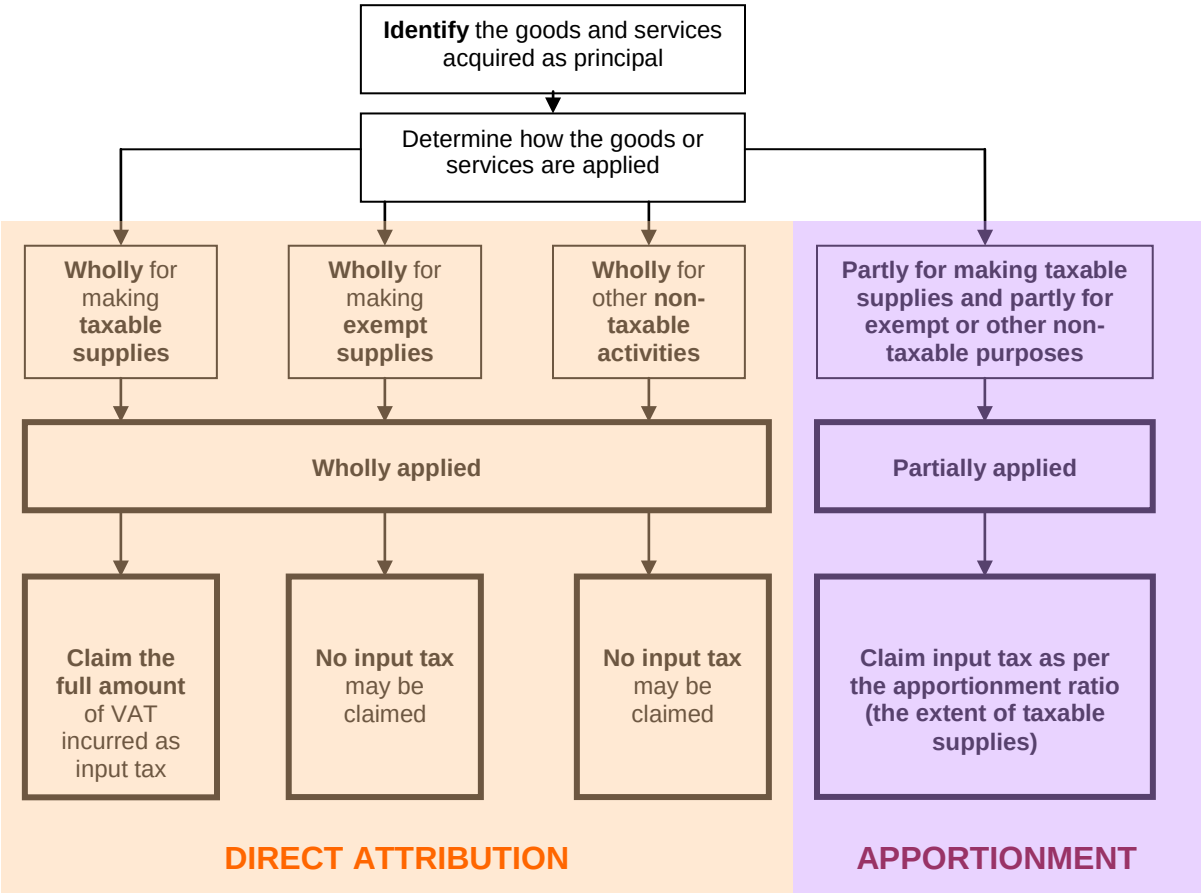
5.2 DIRECT ATTRIBUTION vs. APPORTIONMENT

In establishing the amount of input tax that may be deducted, the principle of **direct attribution** is used. Therefore, where goods or services are acquired —

- wholly for making taxable supplies, input tax can be deducted in full;
- wholly for making exempt supplies or other non-taxable purposes, no input tax can be deducted because the VAT is directly attributable to the municipality’s non-enterprise activities; and
- for making both taxable and exempt supplies or other non-taxable purposes (commonly referred to as “mixed supplies”), only a fair and reasonable proportion of input tax may be deducted.

[6] This includes obtaining a completed declaration by the supplier (form VAT 264) as well as proof of payment. Before 2 November 2010, the declaration was only required where the amount paid for the goods exceeded R1 000.

The diagram below illustrates the concepts of direct attribution and apportionment:



5.2.1 Direct attribution

As shown above, where the acquisition of goods or services can be identified as being **exclusively or wholly** for a particular purpose, the VAT incurred on those supplies can either be deducted in full (wholly for taxable supplies), or input tax may be not be deducted at all (exempt or other non-taxable purposes).

In applying the concept of direct attribution, the manner in which expenses are incurred and the actual application of the goods or services in the business must be examined. Where a vendor makes only taxable supplies, this is a simple exercise in that the VAT incurred will usually be exclusively for taxable supplies, and the input tax can be deducted in full. However, in most cases, a municipality will make both taxable and exempt supplies. This does not mean that when a municipality incurs an expense that it should apply an apportionment ratio to deduct input tax without first investigating whether the expense is directly attributable to exempt or other non-taxable supplies, or to taxable supplies. **Remember that apportionment of input tax only applies where the expense cannot be directly attributed. In other words, apportionment only applies where the expense is incurred for mixed use purposes, that is, taxable and non-taxable purposes.**

The process of applying direct attribution can be facilitated by the way in which a municipality organises its different activities into divisions or business units. For example, where the individual divisions or business units have control over their own budgets and expenditure decisions, and if they are structured on the basis of exclusively taxable or exclusively exempt activities, it is much easier to apply direct attribution.

*This concept is illustrated in **Examples 13** to **15** on the following page.*

Example 13 – Direct attribution: Taxable supplies

Scenario

ABC Municipality buys a truck costing R342 000 (including VAT) for the removal of garbage from the properties of all owners residing within its demarcated area. The removal of garbage qualifies as an "*enterprise*" activity, which is a taxable activity.

Implications for ABC Municipality

As the truck was acquired exclusively for making taxable supplies, the expense is **wholly attributable to making taxable supplies** and ABC municipality can therefore deduct the full amount of VAT charged as input tax (R342 000 x 14/114 = R42 000).

Example 14 – Direct attribution: Exempt supplies

Scenario

ABC Municipality runs a fleet of buses which are used exclusively to provide local public passenger transport. The municipality imports a new bus for the purposes of its passenger transport business and pays an amount of R32 000 VAT on the value of the bus on importation.

Implications for ABC Municipality

Since the business of local transportation of fare-paying passengers in a bus is exempt from VAT in terms of section 12(*g*), the VAT paid is **wholly attributable to making exempt supplies**. ABC Municipality can therefore not deduct any input tax in respect of the VAT paid on the importation of the bus.

Example 15 – Direct attribution vs. apportionment

Scenario

On 1 November 2010, ABC Municipality rents a two-storey building under a single lease agreement which houses its public passenger transport and municipal rates divisions. The divisions occupy the ground floor and first floor of the building respectively. The divisions utilise the same software which has been implemented across all of ABC Municipality's different divisions and it gets a single telephone account each month for telephone usage from the building address. The municipality does not maintain separate cost accounts for each division.

Implications for ABC Municipality

The public passenger transport division makes only exempt supplies and the municipal rates division makes only taxable supplies. Although the divisions are organised along the lines of wholly taxable and wholly non-taxable activities, ABC Municipality has not arranged its contracts or implemented accounting methods to specifically allocate costs incurred by each division. Furthermore –

- the lease agreement does not provide for separate rental amounts for each division;
- the cost of the computer software relates to the organisation as a whole; and
- the account for the use of telephones is not billed to each division separately.

It follows that ABC Municipality would have to apportion all of its input tax in relation to these expenses, since it cannot directly attribute the expenses wholly to taxable or wholly to exempt supplies.

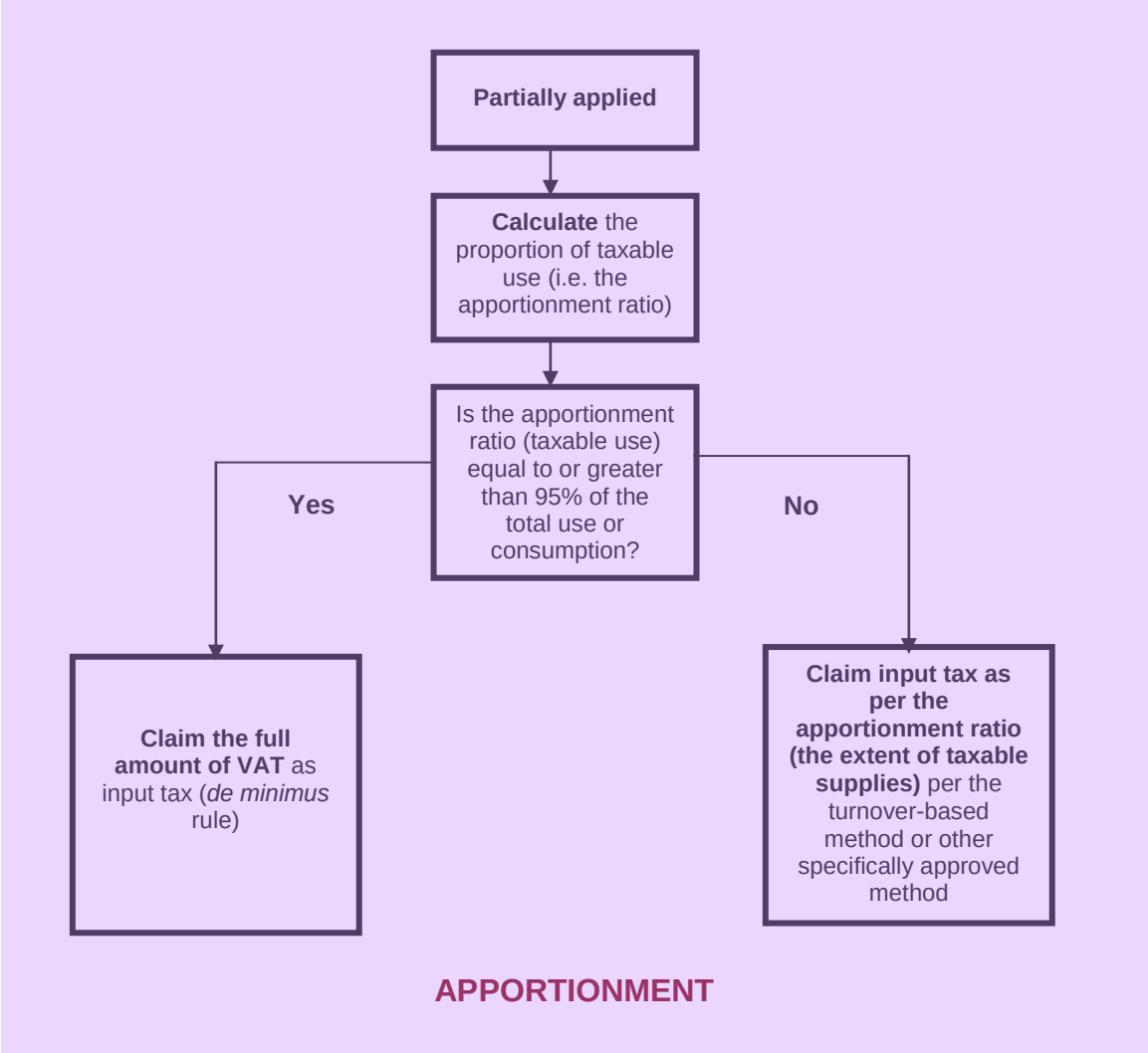
Had ABC Municipality conducted its business in such a manner that separate lease agreements were entered into (or separate rental amounts specified in the lease), and separate telephone accounts been arranged for each division, it would have been able to directly attribute these expenses if it maintained appropriate cost centre accounts for the different divisions.

In either case, the input tax in relation to the expense for the computer software would have to be apportioned since the expense would have been incurred partly for taxable supplies, and partly for exempt or other non-taxable supplies.

5.2.2 Apportionment

Once it has been established that the expense cannot be directly attributed wholly to taxable purposes or wholly to exempt or other non-taxable purposes, the second level of enquiry is to determine the portion of input tax which may be deducted, **based on the extent to which the intended use is for taxable purposes.**

Following on from the diagram on ***page 28***, the second level of enquiry in establishing the apportionment percentage is illustrated in the diagram below:



The intended use for taxable purposes (apportionment ratio) is determined by using a formula or method which is approved by the Commissioner. As from the November 2000 tax period, the only standard approved apportionment method which may be used to determine the apportionment ratio, is the turnover-based method. This method applies by default in the absence of a specific ruling obtained by the municipality to use another method. *See **paragraph 5.2.4** for more on the apportionment method for Category A municipalities.*

The turnover-based method is generally calculated using information extracted from the financial statements of the vendor's enterprise. However, there could be a situation where the financial statements do not specify the information that is required for the purposes of calculating the turnover-based method (that is, the income statement reflects an amount of income that is made up of both taxable and exempt supplies). Municipalities should therefore ensure that if this is the case, adequate accounting records are maintained to establish the actual value of taxable supplies, exempt supplies and other non-taxable receipts.

The formula for the turnover-based method which is to be applied by all vendors, being municipalities, is as follows:

FORMULA: TURNOVER-BASED METHOD OF APPORTIONMENT

The formula set out below in respect of the turnover-based method of apportionment constitutes a binding general ruling issued in accordance with section 76P of the Income Tax Act, 1962 (Act No. 58 of 1962), read with section 41A of the VAT Act. This binding general ruling is **effective from 1 April 2007** and will remain in force until withdrawn or replaced.

Formula: $y = \frac{a}{(a + b + c)} \times \frac{100}{1}$

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).

Notes:
1. The term "value" excludes any VAT component.
2. "*c*" in the formula will typically include items such as dividends and statutory fines (if any).
3. Exclude from the calculation the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease or instalment sale agreement).
4. Exclude from the calculation the value of any goods or services supplied where input tax on those goods or services was specifically denied.
5. The apportionment ratio/percentage should be rounded off to two decimal places.
6. Where the formula yields an apportionment ratio/percentage of 95% or more, the full amount of VAT incurred on mixed expenses may be deducted (referred to as the *de minimis* rule).

Example 16 – Calculation of the apportionment ratio using the turnover-based method

ABC Municipality makes taxable and exempt supplies. ABC Municipality is required to calculate its apportionment percentage based on the following information recorded in the financial statements for the year ending 30 June 2010:

Income from activities		***Grant income***	
Water & electricity	R5 500 000 (14%)	*Grants for making taxable supplies*	
Rates	R6 500 000 (0%)	- For providing free water & electricity	R2 000 000 (0%)
Other	R1 700 000 (14%)	- For general supplies in the public interest*	R4 000 000 (0%)
Bus service	R 500 000 (Exempt)	*Grants for making exempt supplies*	
Interest	R 10 000 (Exempt)	- For public transport (bus service)	R 400 000 (out-of-scope)

* **Note:** The grant is exclusively for taxable supplies, as ABC Municipality does not make any other exempt supplies.

a = R5 500 000 + R6 500 000 + R2 000 000 + R4 000 000 + R1 700 000 = R19 700 000
b = R500 000 + R10 000 = R510 000
c = R400 000

Formula: $y = \frac{a}{(a + b + c)} \times \frac{100}{1}$ … therefore $y = \frac{R19\,700\,000}{R20\,610\,000} \times \frac{100}{1}$ … **therefore y = 95.58%**

Note:

As "*y*" is greater than 95%, the *de minimis* rule enables ABC Municipality to deduct input tax in full on all supplies acquired for mixed purposes (partly for taxable supplies and partly for exempt or other non-taxable purposes).

Example 17 – Application of the turnover-based method of apportionment

On 1 July 2006, ABC Municipality buys computer software for R456 000 (including VAT). ABC Municipality's apportionment ratio is determined to be 60% based on the turnover-based apportionment method. The software is used to administer the supplies of all the taxable and exempt divisions of the municipality. The software is therefore used by ABC Municipality partially in the course of making taxable supplies and partially for making exempt supplies. In this case, 60% of the VAT incurred on the acquisition of the computer software (R33 600) may be deducted as input tax.

Calculation:
[R456 000 x 14/114] X 60%
= R56 000 x 60%
= R33 600

Example 18 – Application of the *de minimis* rule

On 1 July 2006, ABC Municipality buys computer software for R456 000 (including VAT). The apportionment ratio is determined to be 96% (that is, the intended use for the purpose of making taxable supplies) based on the turnover-based method of apportionment. The software is used to administer the supplies of all the taxable and exempt divisions of the municipality. The software is therefore used by ABC Municipality partially in the course of making taxable supplies and partially for making exempt supplies. However, since the apportionment ratio is calculated as being 96%, the full amount of input tax may be deducted. This is because the *de minimis* rule (where the ratio is 95% or more) may be applied so that the entire expense is regarded as being in respect of making taxable supplies. As a result, the full amount of R56 000 VAT incurred on the acquisition of the computer software may be deducted as input tax.

Calculation:
[R456 000 X 14/114] x 100%
=R56 000

For more information on input tax and apportionment, including year-end adjustments which may be required, refer to paragraph 7.4 of the VAT 404 - Guide for Vendors which is available on the SARS website: www.sars.gov.za.

5.2.3 Transitional rules

In order to assist municipalities with the VAT implications resulting from the legislative amendments referred to in ***paragraph 1.1*** above, certain transitional arrangements were made and set out in *Government Gazette* No. 29741, dated 28 March 2007 (*Regulation 270*). Regulation 270 and the accompanying *Explanatory Memorandum* deal with (amongst others) the apportionment of input tax during the transition period (1 July 2006 to 30 June 2007) and provides –

- that **a municipality must apply the standard turnover-based method of apportionment from 1 July 2006** (refer to page 31) to determine input tax that is deductible on any goods or services acquired partly for making taxable supplies and partly for other non-taxable purposes;
- clarification on how certain items which are unique to municipalities feature in the formula; and
- that where a municipality is **unable to apply** the standard turnover-based method of apportionment, application had to be made in writing to the Commissioner for approval to use another method.

*Refer to paragraph 3 of **Regulation 270** and the **Explanatory Memorandum** in **Annexures C and D**.*

5.2.4 Binding General Ruling for Category A Municipalities

In paragraph 4 of Binding General Ruling (VAT) No. 4 (BGR 4), dated 21 January 2010, the Commissioner sets out the **specific turnover-based apportionment method** to be applied by **Category A municipalities** and provides guidance as to specific items that must be included in, or excluded from, the formula. Paragraph 5 of BGR 4 also withdraws any ruling issued to a Category A municipality approving a method of apportionment other than the one contained in BGR 4.

*For more detail in this regard, refer to **paragraphs 4 and 5** of **Annexure G**.*

5.3 ACCOUNTING BASIS

Municipalities can qualify to be registered on the **payments basis** for the purposes of accounting for VAT. Where a municipality applies the payments basis method of accounting, input tax may only be deducted to the ***extent*** that –

- payment for the taxable supply of goods or services acquired has been made by the municipality; and
- the VAT was incurred for the purpose of consumption, use or supply in the course of making taxable supplies.

Where payment is made by a municipality on or after 1 July 2006 in respect of the accrued expense (on which input tax will be allowed), the following will apply:

- To the extent that the expense as at the time of the supply was wholly and directly attributable to the making of taxable supplies as contemplated under the VAT Act as it read before 1 July 2006, the full amount of input tax may be deducted.
- To the extent that the expense was partly attributable to the making of taxable supplies and partly for other non-taxable purposes, a portion of the input tax may be deducted according to the apportionment percentage which was applied by that municipality before 30 June 2006 (the apportionment percentage for the financial year 2004/2005). Where the application of the apportionment percentage for the financial year 2004/2005 results in an apportionment percentage of more than 95%, the municipality is entitled to deduct the full amount of input tax concerned.
- To the extent that the expense as at the time of the supply was wholly and directly attributable to the making of exempt or other non-taxable purposes, as the VAT Act read before 1 July 2006, no input tax may be deducted.

*Refer to **Annexures C** and **D** for more details.*

5.4 DENIAL OF INPUT TAX

5.4.1 Entertainment

The general rule regarding entertainment is that when a vendor incurs expenses relating to entertainment, the VAT included in that expense may not be deducted as input tax. There are some exceptions to this rule which are generally applicable to all vendors including municipalities. For example, one of the exceptions is that a vendor will be entitled to deduct input tax where it supplies entertainment for a charge which covers all the direct and indirect costs of making the supply of entertainment.

Another exception which applies specifically to municipalities and not to other vendors is that a municipalty is allowed to deduct input tax where it incurs entertainment expenditure for the purpose of providing sporting or recreational facilities or public amenities to the general public. *(Refer to proviso (v) to section 17(2)(a).*) A municipality will therefore be able to deduct input tax in regard to creating or maintaining those recreational facilities, but where entertainment goods or services are acquired for the purpose of hosting an event at sporting or recreational facilities or public amenities must be considered under section 17(2)(*a*)(*i*).

*Refer to **paragraph 7.5** of the VAT 404 - Guide for Vendors which is available on the SARS website: www.sars.gov.za for more information in this regard.*

Example 19 – Denial of input tax (entertainment – staff refreshments)

Scenario

ABC Municipality acquires tea and coffee to supply to their staff free of charge.

Implications for ABC Municipality

As the provision of tea and coffee falls within the ambit of *"entertainment"* as defined in section 1, and as the municipality does not supply the entertainment for a charge which covers all the direct and indirect costs of providing the entertainment, it will not be entitled to deduct any input tax.

Example 20 – Exception to the denial of input tax (entertainment – public recreation facilities)

Scenario

ABC Municipality incurs expenses (including VAT) to develop a public park which includes amenities, such as swings, slides and other playground facilities, including a sports field, for the entertainment of children. The facilities are made available free of charge to the general public.

Implications for ABC Municipality

Proviso (*v*) to section 17(2)(*a*)(*i*) allows the municipality to deduct input tax on the entertainment expenses which were incurred to provide the playground and sports facilities, even though it does not supply the entertainment for a charge which covers all the direct and indirect costs of providing that entertainment.

5.4.2 Motor cars

As a general rule, vendors are not entitled to deduct input tax on the acquisition of any motor cars. This rule applies equally to municipalities. The deduction of input tax is prohibited even in instances when the motor car is acquired by the municipality wholly for purposes of making taxable supplies. The subsequent sale of the motor car by the municipality will not be subject to VAT.

Example 21 – Denial of input tax (motor cars)

Scenario

ABC Municipality acquires a motor car for the electricity department. The motor car will be used by the electricity department wholly for purposes of travelling to the premises of various customers in order to take meter readings.

Implications for ABC Municipality

The input tax on the acquisition of the motor car is specifically denied and is therefore not deductible by ABC Municipality even though it will be used wholly for purposes of making taxable supplies. If the motor car is subsequently sold by ABC Municipality, it will not charge VAT on the supply.

5.4.3 Agent vs. Principal

The municipality will not be entitled to deducted any input tax on goods or services it acquired as agent on behalf of another person (the principal). Therefore, it is important to determine whether the municipality is the principal or the agent in respect of the acquisition of goods and/or services. *Refer to **Chapter 3** for more details.*

5.4.4 Adjustments

In certain instances, an adjustment to input tax may be allowed on the change of use of goods or services from exempt to taxable purposes, or where the extent of application of capital goods for taxable purposes has increased. *Refer to **Chapter 6** for more details.*

CHAPTER 6

ADJUSTMENTS

6.1 INTRODUCTION

For an ordinary vendor who is registered on the invoice basis of accounting, certain adjustments to output tax or input tax may arise, for example –

- where an irrecoverable debt is written off;
- where a debit or credit note is issued or received;
- where early payment of an account gives rise to a settlement discount;
- where a customer returns faulty goods to the municipality;
- **where a change in use from wholly or partially taxable consumption, use or application to wholly non-taxable use occurs;**
- **where a change in the extent of taxable consumption, use or application of capital goods or services occurs;**
- **where an adjustment in respect of the apportionment percentage is required to correct past deductions of input tax.**

However, as most municipalities account for VAT on the payments basis, a municipality should not be required to make many adjustments to output tax or input tax, except perhaps for the last three bullet points above (in bold).

Adjustments are discussed in detail in Chapter 13 of the *VAT 404 - Guide for Vendors*, including adjustments which may, or may not be applicable to municipalities in certain instances. For the purpose of this guide, only those adjustments which involve the change in consumption, use or application after they have been acquired by a municipality are discussed in this chapter.

6.2 CHANGE IN USE FROM WHOLLY OR PARTIALLY TAXABLE PURPOSES TO WHOLLY NON-TAXABLE PURPOSES

There are two main aspects to consider with regard to a situation where a municipality applies goods or services for a wholly non-taxable purpose after it was originally acquired wholly or partly for making taxable supplies.

The first aspect is that where this situation occurs, the municipality is regarded as having made a supply of those goods or services and will have to declare output tax on the open market value of the supply.

The second aspect is that where those goods or services were originally applied only partially for taxable supplies, the municipality would have been able to deduct only a portion of the input tax. Therefore, when the goods or services are applied wholly for non-taxable purposes, a "claw-back" input tax credit (section 16(3)(*h*)) applies so that input tax is allowed on that portion which could not previously be deducted.

This "claw-back" provision does not, however, apply in respect of goods or services which were originally acquired and used partially for "out-of-scope" supplies before 1 July 2006. [The "out-of-scope" supplies referred to here are all the supplies which before 1 July 2006 would not have qualified as taxable supplies because they were not listed as taxable business activities in *Regulation 2570* (*refer to* ***Annexure A***).] Similarly, where a municipality sells or otherwise disposes of any goods or services which were acquired and applied in the course of making both taxable and out-of-scope supplies before 1 July 2006, output tax will be payable on the full consideration charged, but no "claw-back" input tax credit will be allowed. (See Proviso (*iii*) to section 16(3)(*h*).)

Example 22 – Change in use from wholly taxable to wholly non-taxable purposes

Scenario

ABC Municipality acquired a bus on 1 October 2006 and used the bus wholly for taxable supplies in that the bus was hired out to schools and other customers on a regular basis. On 1 November 2007 the municipality decided to use the bus exclusively in its passenger transport division to provide public transport.

Implications for ABC Municipality

ABC Municipality can deduct the VAT incurred on the bus as it was initially acquired wholly to make taxable supplies. However, from 1 November 2007 the bus was applied wholly for exempt supplies and therefore output tax on the open market value of the bus must be declared in the tax period within which 1 November 2007 falls [section 18(1)].

If ABC Municipality had acquired the bus before 1 July 2006 for purposes of hiring out, that activity would not have constituted a taxable supply at the time (*refer to* ***Annexure A*** *– Regulation 2570*) and it would not have been able to deduct any input tax at the time of the original acquisition. When the law changed so that the activity became taxable on 1 July 2006, ABC Municipality would not have been able to deduct an input tax adjustment on the application of the bus for making taxable supplies (proviso (*v)* to section 18(4)), even though output tax must be declared on the change in use on 1 November 2007.

6.3 CHANGE IN USE FROM EXEMPT OR OUT-OF-SCOPE PURPOSES TO TAXABLE PURPOSES

A vendor will be permitted an input tax deduction where goods or services are held for exempt purposes and subsequently applied for consumption, use or supply in the course of making taxable supplies. The deduction will not apply in respect of any goods or services for which a deduction of input tax is specifically denied (for example, a motor car or goods acquired for entertainment purposes). The full adjustment must be made in the tax period in which the goods or services are applied for taxable purposes, whether the vendor accounts for VAT on the invoice or payments basis.

The amount of the adjustment is calculated by applying the tax fraction (14/114) to the lesser of the adjusted cost or the open market value of the goods or services (including VAT). However, the deduction of input tax will not be allowed where the goods or services were originally acquired and applied for "out-of-scope" supplies before 1 July 2006. [The "out-of-scope" supplies referred to here are all the supplies which before 1 July 2006 would not have qualified as taxable supplies because they were not listed as taxable business activities in *Regulation 2570* (*refer to* ***Annexure A***).] This is because proviso (*v*) to section 18(4) was inserted to deny input tax in such cases and is similar to the amendment to section 16(3)(*h*) which was mentioned in ***paragraph 6.2*** above. These provisions are consistent with the amendments which came into effect on 1 April 2005 in respect of the VAT treatment of public entities.

Example 23 – Change in use from exempt to taxable use or application

Scenario

Municipality Q, purchased a single cab bakkie on 1 March 2006 for exclusive use in the passenger transport division in connection with the maintenance of buses used for transporting fare-paying passengers (wholly exempt supplies). The bakkie cost R228 000 (including VAT). On 1 April 2008, Municipality Q decided to use the bakkie exclusively in the township development division for purposes of transporting building equipment to the various building sites (wholly for taxable supplies). At the time of the change in use the bakkie had an open market value of R171 000.

Implications for Municipality Q

Municipality Q will be entitled to an input tax deduction of R21 000 (R171 000 x 14/114) in the April 2008 tax period on the change of use to taxable purposes. However, had the bakkie originally been applied for "out-of-scope" supplies (being before 1 July 2006), no input tax would be allowed on the change in use.

6.4 CHANGE IN EXTENT OF TAXABLE USE OF CAPITAL GOODS OR SERVICES

The general rule is that where a vendor increases or decreases the extent of use of capital goods or services to make taxable supplies, an adjustment must be made to output tax or input tax, as the case may be [sections 18(2) and 18(5)]. An adjustment to **output tax** will be required where there is a *decrease* of more than 10% in the extent of taxable use or application by the vendor of capital goods and services which have an adjusted cost of R40 000 or more when compared to the previous financial year. Similarly, an adjustment to **input tax** may be permitted where there is an *increase* of more than 10% in the extent of taxable use or application by the vendor when compared to the previous financial year of capital goods and services which have an adjusted cost of R40 000 or more.

These rules also apply to municipalities and they are aimed at ensuring that where capital goods and services are used for mixed use purposes, the input tax which may be deducted must be in proportion to the extent to which those assets are applied for taxable use in the municipality's *"enterprise"* over the lifetime of the assets. However, these adjustments (input tax and output tax) will not apply in the case of a municipality where the capital goods or services were acquired before 1 July 2006 and applied for "out-of-scope" supplies before 1 July 2006. [The "out-of-scope" supplies referred to here are all the supplies which before 1 July 2006 would not have qualified as taxable supplies because they were not listed as taxable business activities in *Regulation 2570* (*refer to* ***Annexure A***).]

The effect of this provision is therefore to treat the capital goods and services which were acquired before 1 July 2006 and used partially for taxable supplies after 1 July 2006 in such a way that the annual variation in the extent of taxable use will not create an output tax or input tax adjustment event. An output tax liability will only arise when the asset is eventually sold, donated, exchanged or where there is a change in use to a wholly exempt purpose (section 18(1)).

Example 24 – Capital goods or services: Increase/decrease in the extent of taxable use or application

Scenario

On 1 December 2007, ABC Municipality buys a computer system for R456 000 (including VAT). ABC Municipality's apportionment ratio is determined to be 90% (that is, the intended use for purposes of making taxable supplies) based on the turnover-based apportionment method. The computer system is used to administer the supplies of all the taxable and exempt divisions of the municipality. On 1 July 2008 ABC Municipality determined its apportionment ratio to be 75% and the open market value of the computer system on that date was R342 000.

Implications for ABC Municipality

The computer system is used by ABC Municipality partially in the course of making taxable supplies and partially for making exempt supplies. Therefore, an amount of R50 400 ((R456 000 x14/114) x 90%) may be deducted as input tax in the tax period within which 1 December 2007 falls. As there is a subsequent change in the extent of taxable use of more than 10% of the capital asset (decrease), ABC Municipality will be required to make an output tax adjustment calculated as follows:

Output tax adjustment = 14/114 x R342 000 x (90% - 75%)
= R42 000 x 15%
= R6 300

Notes:

1. Had the apportionment percentages for the respective financial years been reversed (that is, 75% in the first year which increased to 90% in the second year), the same calculation would be used to calculate the **input tax adjustment** on the **increase** in the extent of use for taxable purposes.
2. If the computer system was bought before 1 July 2006 the adjustment will not be required, whether it is in respect of an increase or a decrease in the extent of application for taxable supplies.

CHAPTER 7

MISCELLANEOUS ISSUES

7.1 INTRODUCTION

Although the VAT Act was amended to make the administration of VAT easier for municipalities, the unique nature of their activities and their relationship with government on the one hand, and businesses and customers on the other, means that the VAT administration of municipalities remains fairly complex.

In addition, certain supplies for which no direct consideration is charged, or which are subsidised through the levying of rates on property owners, are now regarded as taxable supplies. The levying of rates on property owners is a unique situation, which will not be encountered by other vendors.

Some of these issues are therefore highlighted in ***paragraphs 7.2 to 7.9*** below to provide clarity.

7.2 METRO POLICE

Police and law enforcement services such as those provided by the South African Police Service (SAPS) are not specifically exempt under section 12. However, as the SAPS is a public authority and may not register for VAT, the same effect of an exemption on the provision of those services is achieved. Similarly, metropolitan police and traffic control services provided by municipalities are also not exempt under section 12. The difference is that a municipality will normally be registered for VAT and with effect from 1 July 2006 these activities will be included in paragraph (*a*) of the definition of "*enterprise*".

In terms of section 156(1)(*a*) of the Constitution, a municipality administers municipal roads and traffic and parking, which are local government activities listed in Part B of Schedule 4 and Part B of Schedule 5 to the Constitution. It follows that the activities performed by a municipality in connection with metropolitan police and traffic control matters will, by default, become taxable "*enterprise*" activities with effect from 1 July 2006.

It is important to note that even though the metro police division of a municipality might not necessarily charge a specific consideration for most of its services, the activity is still regarded as being a part of the municipality's "*enterprise*" as a whole. Therefore, where any consideration is charged in respect of such services it will be subject to VAT at the standard rate, unless expressly provided for elsewhere in the VAT Act, for example –

- zero-rated in terms of section 11 (for example a *"grant"*);
- exempt in terms of section 12 (for example, fare-paying passenger transport services); or
- "out-of-scope" or non-supplies (for example, statutory fines and penalties).

Consequently, with effect from 1 July 2006, any income from parking meters which represents charges for street parking and fees for escorting abnormal vehicles must be declared as standard-rated supplies and output tax must be paid thereon. Similarly where the metro police division of a municipality sells or otherwise disposes of any goods or services which were acquired and applied in the course of making "out-of-scope" supplies before 1 July 2006, output tax will be payable on the full consideration charged, but no input tax credit will be allowed. For example, if the metro police division acquires new office furniture, it may deduct input tax to the extent that the furniture is used to make taxable supplies, but the sale of the old furniture (acquired before 1 July 2006) will attract VAT at the standard rate, and no input tax credit (adjustment) would be allowed thereon. *Refer to* ***paragraph 6.3*** *above for more information in this regard.*

Income from statutory fines for speeding and other traffic violations will not attract VAT, since those amounts are not in respect of any supply of goods or services by the municipality. Note that a municipality is only entitled to deduct input tax in respect of the VAT incurred on goods or services acquired which relate to the taxable enterprise activities of the metro police division of a municipality.

It follows that any VAT incurred which is directly attributable to non-enterprise activities may not be allowed as input tax. For example, the VAT incurred on the rental or purchase of cameras used for the administration of speeding fines is regarded as being directly attributable to non-supplies (speeding fines) and may not be deducted as input tax. In addition, any VAT attributable to expenses incurred for making "mixed supplies" may be deducted to the extent of the apportionment ratio determined for the municipality as a whole by using the turnover-based apportionment method (or other special apportionment method approved for that particular municipality by the Commissioner).

The normal input tax denials in respect of entertainment expenses and motor cars will apply.

7.3 ASSIGNMENT OF FUNCTIONS, AGENCY SERVICES AND UNFUNDED MANDATES

As mentioned in ***paragraph 7.1*** above, national and provincial governments are mandated to perform certain activities in the functional areas which are listed in Part A of Schedule 4 and Part A of Schedule 5 to the Constitution and municipalities have the right to administer the local government activities listed in Part B of Schedule 4 and Part B of Schedule 5 to the Constitution (*refer to **Annexure F***).

National and provincial governments may also assign certain of the activities mandated to them to a municipality (by agreement and subject to any conditions), if the matter would be most effectively administered locally, and if the municipality has the capacity to administer it. As a result, it sometimes happens that the activities which are mandated to provincial government are assigned to a municipality. In such cases, the municipality conducts the activity and not the provincial government.

Alternatively, the provincial government may appoint a municipality as its agent to carry on certain activities to assist it in carrying out its mandate. For example, municipalities are often involved in the collection of motor vehicle licence and registration fees on behalf of provinces. The VAT effects of these two scenarios (that is, being agent or principal) are vastly different and will be discussed further below. *Refer also to **Chapter 3** where the VAT implications of agents and principals are discussed in detail.*

In addition, there are situations in which a municipality may have no involvement in the province's activity, or where it merely acts as agent of the province, but it is nevertheless expected to contribute financially to assist the provincial government to carry out its mandate. Municipalities refer to these activities as "unfunded mandates" because, in terms of the Constitution, they are expected to contribute financially to the provision of goods or services, when these activities are actually the mandate of the provincial government.

In a sense, these are activities where both provincial governments and municipalities have a shared constitutional responsibility to deliver goods and/or services to the general public. Examples of these "unfunded mandate" activities include the provision of primary health care (PHC) services in provincial hospitals and municipal clinics, and the activities associated with the administration and maintenance of certain museums and libraries.

In establishing which scenario is applicable in any particular case, the SLA between the municipality and provincial government should be examined. Sometimes the SLA may not be so clear, and in other cases there may not even be an SLA in writing to examine. However difficult it may be to determine the contractual relationship, this is something which is essential to establish, as the VAT treatment of the supplies between the parties will follow accordingly. Ideally, the SLA should clearly indicate the relationship between the parties and the nature of the supplies concerned. Alternatively, in the absence of a written SLA, the parties should at least have a clear understanding of the contractual rights and obligations which are created by the arrangement in terms of which the underlying activity is conducted by the parties.

Three main situations may arise as set out below:

- ***Where the provincial government assigns the activity to a municipality***

  Output tax - In this case, the municipality is regarded as the principal in respect of the assigned activity and it forms an integral part of the municipality's *"enterprise"* activities as a whole. Therefore, when the municipality makes supplies of goods or services in regard to activities which have been assigned to it, these constitute taxable supplies and output tax must be accounted for by the municipality, where there is a consideration charged. Where the provincial government provides the municipality with financial assistance to enable it to carry on the assigned activities, the payment received is regarded as a zero-rated deemed supply (that is, a *"grant"*) and not as a standard-rated consideration for actual services provided by the municipality to the provincial government.

  Input tax - The normal rules for the deduction of input tax will apply, as the municipality (as principal) is entitled to deduct input tax in respect of the VAT incurred on goods or services acquired which relate to the taxable "*enterprise*" activities of the municipality.

- ***Where the provincial government appoints a municipality as agent***

  Output tax - In this case, the activity remains that of the provincial government. The municipality merely acts as the legal agent of the province in assisting it to fulfil its mandate. If the municipality charges the provincial government an agency fee, or other amount for goods or services supplied, the amount constitutes consideration for a taxable supply by the municipality at the standard rate. In some cases the agency fee or other charge is determined with reference to another amount – for example, a certain percentage of salaries. Note that it is not the manner of calculating the fee which is important, but rather whether the final amount payable to the municipality is in respect of a taxable supply (for example, agency services, rental etc). Furthermore, where the underlying provincially mandated activity (for example, PHC services) has not been assigned to a municipality, any payment by the province to the municipality for goods or services supplied cannot qualify as a zero-rated "*grant*".

  Input tax - The normal rules apply in that the municipality is entitled to deduct input tax in respect of VAT incurred on goods or services acquired which relate to the provision of taxable agency services, or other taxable supplies made by the municipality – as the case may be.

- ***Where the municipality has an "unfunded mandate"***

  With effect from 1 July 2006, municipalities are allowed to deduct input tax where they make a financial contribution by acquiring goods or services in connection with the carrying out of activities falling within the mandate of provincial government, for example, PHC services, or the provision of museum or library facilities.

  Any VAT incurred and paid for directly by the municipality in respect of these provincial mandates is regarded as being incurred by the municipality in the course or furtherance of the municipality's own *"enterprise"* (unless the activity itself is exempt, for example, educational services). The input tax deducted must be supported by tax invoices issued to the municipality, for example, medicines purchased to supply PHC services, insurance cover in respect of medical staff involved in supplying PHC services, purchase of library books, maintenance costs of museum buildings etc.

The following examples illustrate the points made above with reference to the VAT treatment of PHC services which are the mandate of the provincial government in the first instance, but where a municipality may have some role in making the supplies. For example, where it acts as agent, has been assigned the activity, or where it has to make a financial contribution towards making the supplies.

Example 25 – PHC services assigned to a municipality

Scenario

Province Y assigns the activity of providing PHC services within Municipality X's and Municipality Z's demarcated areas to Municipality X. Municipality X charges a standard amount of R100 per patient and must carry out the functions as set out in the SLA.

Implications for Municipality X

As Municipality X has been assigned the activity as provided for in the Constitution, it is regarded as the principal for the purposes of the PHC services supplied in terms of the SLA. Therefore, all expenses incurred in carrying on the activity are for Municipality X's account and it may deduct input tax thereon under the normal rules for the deduction of input tax. Similarly, VAT must be charged at the standard rate on the R100 charged to patients as PHC services do not constitute exempt supplies (section 12), nor are they subject to the zero rate (section 11). Where Province Y provides Municipality X with a subsidy to enable it to carry on the activity of providing PHC services (taxable supplies), the receipt constitutes a *"grant"* and the deemed supply which arises in respect thereof is subject to VAT at the zero rate in the hands of Municipality X.

Example 26 – Municipality acts as agent and has an unfunded mandate

Scenario

Province Y provides PHC services within Municipality X's demarcated area and charges R100 per patient. Municipality X acts as the agent of Province Y in overseeing and managing the activity on behalf of Province Y under an SLA. Municipality X charges an agency fee of R50 per patient per month (including VAT). In addition Municipality X purchases medicines and pays R20 000 (inclusive of VAT) to the supplier as its financial contribution towards Province Y's activities ("unfunded mandate").

Implications for Municipality X

The agency fee charged by Municipality X to Province Y is in respect of a taxable supply of agency/management services and is subject to VAT at the standard rate. The VAT charged by Municipality X is therefore a cost to Province Y as it is not a vendor. The SLA between Municipality X and Province Y should state that this fee is inclusive of VAT at the standard rate, but where the agreement is silent on this aspect, the fee will be deemed to be inclusive of VAT at the standard rate. The medicines are regarded as having been acquired in the course or furtherance of Municipality X's own enterprise, as this financial contribution is part of their "unfunded mandate". Consequently, Municipality X may deduct input tax of R2 456.14 (R20 000 x 14/114) provided that the supplier makes the supply of the medicines to Municipality X and provides the required tax invoice in the name of Municipality X.

7.4 INCORRECT TREATMENT OF CERTAIN PAYMENTS FROM GOVERNMENT

As a result of uncertainty in the past as to whether a payment qualified as a *"transfer payment"*, some municipalities incorrectly applied the zero rate of VAT to certain payments received from government. In many of these cases, the incorrect application of the law meant that a number of municipalities were issued with assessments to correct the situation. In order to address the inconsistent application of the law and the potential circular flow of funds within the government sphere which would occur in making funds available to municipalities to pay the tax concerned, a relief measure in the form of section 40B was introduced. The idea behind this provision was to provide SARS and local authorities (municipalities) with a mechanism which would facilitate the resolution of past disputes on the VAT treatment of certain payments from government.

To qualify for the relief provided in section 40B –

- application must be made in writing by the vendor to the SARS office where the vendor is on register;
- the goods or services must have been supplied (or deemed to have been supplied) on or before 31 March 2005;
- on or before 31 March 2005, the supplier must be a *"local authority"* as defined in section 1 before the deletion of that definition; and
- the entity (local authority) must have an existing or potential liability for VAT in accordance with the specific conditions contained in sub-paragraphs 40B(2), (3) and (4).

In essence, the provision deals with the incorrect VAT treatment of certain receipts from government in the specific conditions contained in section 40B as follows:

- *Where VAT was declared at the zero rate instead of at the standard rate* –
  - Relief may be sought with regard to certain assessments which were raised before 1 April 2005, where the VAT was either wholly or partly unpaid as at that date.
  - Where there is a potential liability for VAT before 1 April 2005 in respect of which there has not been an assessment, automatic relief applies in that SARS will not raise any assessment for that potential liability.
- *Where VAT was declared at the standard rate instead of at the zero rate* –
  - The local authority or municipality will not be permitted to claim a refund in connection with the overpayment of VAT on certain payments received before 1 April 2005.

Section 40B therefore provides municipalities with an opportunity to start with a clean slate and to clear any VAT assessments which arose as a direct result of the uncertainty regarding grants and whether they qualified as zero-rated transfer payments or not. On the other hand, those municipalities which accounted for VAT at the standard rate on those receipts cannot apply for a refund of the output tax (whether the amount was correctly or incorrectly declared).

The relief under section 40B is very specific and does not extend to any of the following situations –

- where the VAT was merely not paid in respect of any particular tax period;
- where there was a failure to submit a VAT 201 return and as a result, an estimated assessment was issued in respect of that tax period; or
- where an assessment was issued in respect of any tax period where the output tax was under-declared (other than in the specific circumstances provided for in section 40B), or where the input tax was overstated.

A further part of the overall problem relating to the incorrect treatment of payments received from government is the manner in which municipalities dealt with the recording and application of **equitable share payments**. Some municipalities distinguished between the receipt of the equitable share payment and the subsequent application thereof. In particular, the problem relates to that part of the equitable share payment which is paid to a municipality to cover the costs of providing a certain amount of "free" water and electricity to customers.

In this regard, it is important to note that –

- the equitable share payment is a *"grant"* for VAT purposes with effect from 1 April 2005, and it is this **receipt** that is subject to the zero rate of VAT in terms of sections 8(5A) and 11(2)(*t*);
- with regard to the VAT consequences of how the municipality **applies** those funds, the following two possibilities need to be considered, namely :
  - The funds could be spent on acquiring goods or services to enable the municipality to supply water and electricity to more customers (for example, the construction of more facilities and amenities). In this case, the normal rules with regard to input tax will apply.
  - In some cases the funds are applied directly to the accounts of individual customers. Where this occurs, the amount should be regarded as a discount of the consideration charged to a customer so that only the VAT on the net (discounted) consideration is accounted for by the municipality. Where the amount is not reflected on the account as a discount, the full consideration is taxed at the standard rate and the amount is used to reduce a customer's outstanding debt.

For more information on the application of section 40B refer to ***Annexure H*** and the Explanatory Memorandum to the Small Business Amnesty and Amendment of Taxation Laws Act which is available on the SARS website: *www.sars.gov.za*.

7.5 TRANSITIONAL ARRANGEMENTS

For various reasons, including capacity and timing issues faced by municipalities, and for the purposes of the general administration of the VAT Act regarding the implementation of the changes to the VAT law which came into effect on 1 July 2006, certain transitional arrangements were instituted. These arrangements are set out in *Regulation 270* which applies to municipalities, as well as to entities which complied with the definition of "*local authority*" before 1 July 2006.

The main objective of the arrangements was to provide municipalities with a time period within which they would be able to put in place the necessary administrative and accounting mechanisms so that they would be in a position to fully comply with the law after the expiration of that period. In addition, interim relief from penalty and interest was provided where there was unintentional non-declaration of output tax on supplies which became taxable for the first time on or after 1 July 2006.

In brief, the transitional arrangements include the following:

- A period of one year (1 July 2006 to 30 June 2007), known as the "*the transition period*", was granted to put the necessary administrative and accounting mechanisms in place.
- Where any output tax on supplies which became taxable for the first time during the transition period had been omitted in error from any VAT 201 return, the tax thereon could be accounted for in a later return which was due for payment at any time during the transition period without any additional tax, penalty or interest being imposed. The VAT had to be paid by no later than 25 July 2007. [*See Binding General Ruling (VAT) No: 3 for different payment dates which apply where the vendor pays by debit order, or was registered as an e-Filer, or was registered under Category A tax period.]*
- All municipalities had to use the turnover-based method of apportionment with effect from 1 July 2006 using a prescribed formula which included certain prescribed adjustments. At the end of the transition period, a revised apportionment percentage had to be calculated with reference to the actual value of supplies of goods or services made during the transition period and any difference had to be accounted for in the September 2007 return, which was due for payment on 25 October 2007.
- Where a municipality accounts for VAT on the payments basis, it was required to treat payments made or received by it on or after 1 July 2006 in respect of the supply of goods or services before that date, as if that payment had been made or received before that date.

*For further details in respect of the transitional matters see Regulation 270 (**Annexure C** and **Annexure D**) and Binding General Ruling (VAT) No: 3 (**Annexure E**).*

7.6 PAYMENTS TO SUPPLIERS ON BEHALF OF GRANTEES

In ***paragraph 4.5***, it was mentioned that where the grantor pays a supplier of goods or services directly on behalf of the grantee (municipality), this does not mean that the supplier may charge the zero rate on the supply made to the grantee. Public authorities should therefore take note of the direct effect of making such payments which are as follows:

- The grantee is still deemed to make a zero-rated deemed supply to the grantor in respect of the payment.
- The supplier must still charge VAT on the actual supply at the standard rate (if it is a taxable supply).
- The supplier must still issue a tax invoice to the recipient (being the municipality).

Following on from the direct effects mentioned above, there are further effects which need to be considered, for example:

- The supplier might be under the impression that the supply is made to the public authority and might issue the tax invoice to the public authority instead of the municipality which means that the municipality might not be able to deduct input tax.
- The municipality may omit to include the receipt in its records which, in turn, will mean that its taxable supplies (zero-rated) may be understated.

- The municipality may receive an unintended additional subsidy where the VAT element was included in the payment to the supplier, and where the municipality deducts the VAT charged as input tax when it receives the tax invoice from the supplier (sometimes referred to as "double-dipping").
- Where the grantor did not intend to allow the municipality to "double-dip", but merely to be able to cover the VAT-exclusive "cost" of a supply, the grantor may request for the VAT which has been deducted as input tax to be repaid.

Therefore, where payment is made directly to suppliers on behalf of municipalities instead of paying a grant to a municipality –

- the public authority should be mindful of the "cost" which it intends to cover by the payment and whether the "double-dipping" effect is of concern for budgeting purposes or not;
- the municipality should ensure that it records the amount paid on its behalf as a receipt of a zero-rated grant; and
- it should be clear to the supplier as to whether the public authority making the payment or the municipality (grantee) is the recipient of the supply so that the tax invoice can be issued to the correct person.

Example 27 – Effect of payments made to third parties on behalf of municipalities

Scenario

Public Authority X has budgeted for a grant of R5 000 000 to be made to Municipality Y to cover the "cost" of installing water pipes and other infrastructure in a township in its demarcated area. Municipality Y engages a private VAT-registered contractor who quoted R5 700 000 (including R700 000 VAT) to carry out the work (therefore a "cost" of R5 000 000 to Municipality Y). The infrastructure will be owned by Municipality Y and is for the purposes of supplying water to Municipality Y's customers (taxable supplies). However, as the contractor has complained that Municipality Y is six months in arrears with its progress payments, Public Authority X decided to pay the progress payment of R3 420 000 (including R420 000 VAT) directly to the contractor. Six months later, the contractor approaches Public Authority X again for payment of the balance of the progress payments in respect of the contract price of R2 280 000 (including R280 000 VAT).

Implications for Municipality Y and Public Authority X

Municipality Y must report the full grant payment of R3 420 000 as being a receipt in respect of a deemed taxable supply at the zero rate and the contractor must issue a tax invoice in the name of Municipality Y for a VAT-inclusive amount of R3 420 000. Upon receipt of the tax invoice, Municipality Y will deduct input tax of R420 000 (R3 420 000 x 14/114). Note at this point that Municipality Y has deducted R420 000 as input tax, so its infrastructure "cost" so far is R3 000 000, whereas Public Authority X has outlaid R3 420 000.

As it is clear in this example that Public Authority X only intended the grant to cover the VAT-exclusive "cost" of the installation (R5 000 000), it is only required to pay the balance of R1 580 000 (being R5 000 000 minus R3 420 000) six months later being the balance of the "cost". However, this creates a problem in that –

- the contractor seeks payment of the full balance of the contract price of R2 280 000 (including VAT); and
- if Public Authority X paid the full VAT-inclusive amount of R2 280 000 again to the contractor it would have in fact paid R5 700 000 in total to the contractor on behalf of Municipality Y.

Therefore, if the fact that Municipality Y can deduct input tax of R700 000 on the full contract price has not been taken into account by Public Authority X, the effect is that it would have granted funds to Municipality Y in excess of what it had intended. Similarly, if the full VAT-inclusive amount of R5 700 000 was paid to Municipality Y without requiring the VAT component of R700 000 to be refunded at a later stage, it would have paid a grant amount of R700 000 more than it had intended. However, if Public Authority X had only paid the "cost" amount to the supplier, or to Municipality Y, Municipality Y would have to outlay the VAT charge temporarily from its own cash resources before deducting it as input tax.

This example demonstrates once again how important it is to carry out the costing and budgeting exercise properly for projects of this nature.

7.7 JSBs, RSCs AND TMCs

Regional Service Council (RSC) and Joint Services Board (JSB) levies were abolished with effect from 1 July 2006. However, as these charges were previously levied by local authorities/municipalities at the standard rate before 1 July 2006, a municipality must continue to declare VAT at the standard rate on any arrear levies received on or after that date.

Where several local authorities have either merged with, or been taken over by another local authority, Transitional Metropolitan Council (TMC) or municipality, the disestablished entity and the newly established municipality (or existing municipality) which takes over the activities are treated as one and the same for VAT purposes. In terms of section 8(6), the transfer of all the assets and liabilities to the municipality which takes over the activities is deemed not to be a supply. Where this occurs, it will probably mean that the municipality will have to recalculate its apportionment percentage.

7.8 MUNICIPAL ENTITIES

A municipal entity is not a *"municipality"*, nor does it qualify as a *"local authority"* before the deletion of that definition on 1 July 2006. Over the past few years, there has been a trend (particularly in the metropolitan areas) for municipalities to create municipal entities for the purpose of conducting certain activities, where the municipality is of the view that the aim of better service delivery to the community will be achieved.

In terms of the Local Government: Municipal Systems Act 32 of 2000 (the Municipal Systems Act), a municipality may establish the following (municipal) entities:

- A private company in which a municipality, or two or more municipalities collectively, have effective control.
- A service utility which is a juristic person under the sole control of the municipality which established it.
- A multi-jurisdictional service utility which is a juristic person under the shared control of the parent municipalities (the two or more municipalities who established the service utility by written agreement).

It follows that:

- A municipal entity is a separate juristic person to the municipality which created the entity, and will have to register separately for VAT if it makes taxable supplies in excess of the compulsory VAT registration threshold. *Refer to the definition of "enterprise" in **paragraph 2.3** for more in this regard.*
- As a general rule a municipal entity does not conduct activities on behalf of a municipality, but rather for its own account. A municipal entity is therefore usually the principal for the purposes of the supplies which it makes, and must account for VAT accordingly (unless it is specifically appointed as the agent of the municipality, in which case the rules of agency apply – *refer to **Chapter 3***).
- A municipal entity falls within the meaning of the term *"designated entity"* as defined in section 1. Therefore, any payments made to a municipal entity by either a municipality or a public authority will include VAT at the standard rate to the extent that the payment relates to taxable supplies made by the municipal entity.

Only certain municipal entities, namely those supplying electricity/power, gas, water or refuse removal are allowed to account for VAT on the payments basis on or after 1 July 2006.

7.9 WATER BOARDS

Water boards are neither municipal entities, nor are they municipalities. Water boards are public entities and are listed separately under Schedule 3B of the Public Finance Management Act 1 of 1999 as National Government Business Enterprises. Before 1 July 2006, a water board also qualified as a *"local authority"* as well as a *"public entity"*. However, as amendments in regard to the VAT treatment of public entities came into effect from 1 April 2005, where there is any doubt as to the VAT treatment of water boards, the public entity status will prevail. A water board also falls within the definition of *"designated entity"* and therefore the VAT treatment of these entities is very similar to municipal entities *as discussed in **paragraph 7.8** above*. Water boards are also allowed to account for VAT on the payments basis on or after 1 July 2006.

GLOSSARY

Consideration

Means the total amount of money (including VAT) received for a supply.

"Consideration" is widely defined to include any form of payment and any act or forbearance, whether or not voluntary, for the inducement of a supply of goods or services.

Where the consideration is not in money, (for example, in the case of barter transactions), the consideration is the open market value of the goods or services (including VAT) received for making the taxable supply.

Section 10 determines the value or the consideration of a supply for VAT purposes in respect of various different types of supplies.

The term *"consideration"* excludes –

- any donation made to an association not for gain; and
- a deposit which is lodged to secure a future supply of goods or services, which has not yet been applied as payment (for example, a deposit held in trust until the time of the supply is triggered in terms of section 9), or which has not yet been forfeited.

Enterprise

Includes any business or activity in the broadest sense. The enterprise or activity must contain the following crucial elements:

- It must be carried on continuously or regularly.
- By any person.
- In or partly in the Republic.
- In the course of which goods or services are supplied for a consideration, that is, some form of payment.
- Whether or not for profit.

The following are some examples of activities which are not "*enterprise*" activities and which will accordingly not attract VAT :

- Services rendered by an employee to an employer, for example, salary/wage/remuneration earners (excluding independent contractors).
- Any activity involving the making of exempt supplies (that is, those listed in section 12).

Exempt supplies

Refers to 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 deduct input tax on expenses incurred for the purpose of making these supplies.

Section 12 contains a list of exempt supplies. Some examples are –

- the supply of certain financial services;
- rental of accommodation in any "*dwelling*", including employee housing;
- the transport of fare-paying passengers and their personal effects by road or railway; and
- certain educational services.

Goods

Includes –

- corporeal (tangible) movable things, goods in the ordinary sense (including any real right in those things);
- fixed property, for example, land and buildings;
- any real right in fixed property, for example, servitudes, mineral rights, notarial leases etc;
- sectional title units (including timeshare);
- shares in a share block company;
- electricity;
- postage stamps; and
- second-hand goods.

The term excludes –

- money, that is, notes, coins, cheques, bills of exchange etc (except when sold as a collectors item);
- value cards, revenue stamps etc which are used to pay taxes (except when sold as a collector's piece or an investment article); and
- any right under a mortgage bond or pledge.

Input tax

Includes –

- VAT payable by the recipient to a vendor in respect of the acquisition of goods or services;
- VAT on the importation of goods by a vendor;
- VAT payable on the pro-forma excise duty leviable on goods manufactured within South Africa; and
- "notional input tax", which is the tax fraction of the lesser of the consideration in money paid or the open market value of second-hand goods acquired from a person who is a resident of the Republic under a non-taxable supply.

However, certain conditions apply, for example –

- input tax may only be deducted by the recipient vendor if the goods or services are acquired for making taxable supplies;
- where goods or services are acquired only partly for the purpose of making taxable supplies, an apportionment of input tax must be made;
- no input tax may be deducted where the goods or services are acquired for making exempt supplies, or other non-taxable activities; and
- where the goods constitute second-hand goods (including fixed property) acquired under a non-taxable supply, special rules apply, for example –
  - the input tax is limited to the payment made; and
  - where the second-hand goods constitute fixed property, the input tax is limited to the transfer duty (or stamp duty) which was payable.

The recipient vendor must retain the relevant supporting documentation in order to deduct the input tax, for example –

- the recipient vendor must be in possession of a valid tax invoice as envisaged in section 20; and
- in the case of second-hand goods, the recipient vendor must keep a declaration by the supplier (form VAT 264) stating whether the supply is taxable or not, and must maintain sufficient records containing certain details of the transaction.

Municipal entity

Is usually formed by a municipality for the purposes of better delivery of goods or services to the community and constitutes a separate legal entity to the municipality which created the municipal entity.

The term "*municipal entity*" as defined in section 1 of the Local Government: Municipal Systems Act 32 of 2000, provides that a municipality may establish the following entities:

- A private company in which a municipality, or two or more municipalities collectively, have effective control.
- A service utility which is a juristic person under the sole control of the municipality which established it.
- A multi-jurisdictional service utility which is a juristic person under the shared control of the parent municipalities (the two or more municipalities who established the service utility by written agreement).

Municipality

As defined in the VAT Act, refers to municipalities falling into the categories listed in section 155(1) of the Constitution, and which is an organ of state within the local sphere of government exercising legislative and executive authority within an area determined in terms of the Local Government: Municipal Demarcation Act 27 of 1998.

The categories are –

- Category A: A municipality that has exclusive municipal executive and legislative authority in its area (that is, a metropolitan municipality);
- Category B: A municipality that shares municipal executive and legislative authority in its area with a Category C municipality within whose area it falls (that is, a local municipality); and
- Category C: A municipality that has municipal executive and legislative authority in an area that includes more than one municipality (that is, a district municipality).

Tribal authorities, water boards, and other associations of persons which previously qualified as local authorities are therefore not included in the term municipality.

Municipal rate

Refers to a rate levied by a municipality in terms of section 2 of the Local Government: Municipal Property Rates Act 6 of 2004 (the Rates Act), on "rateable property" of an "owner" in the municipal area.

Section 2 of the Rates Act provides that metropolitan and local municipalities may levy a rate on properties in its areas. A district municipality may only levy a rate on property in its district management [that is, part of a district municipality which in terms of section 6 of the Municipal Structures Act 117 of 1998 has no local municipality and is governed by that municipality alone] area within the municipality.

A municipality must exercise its powers to levy a rate on property subject to section 229 of the Constitution and any other applicable provisions of the Constitution. Section 229 of the Constitution provides, amongst others, that the municipality may not exercise its power in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour.

Rateable property as defined in the Rates Act means property on which a municipality may levy a rate in terms of section 2 of the Rates Act, excluding property fully excluded from the levying of rates in terms of section 17 of the Rates Act.

The term "*municipal rate*" as defined in the VAT Act excludes a single charge (a "flat rate" or an all-inclusive rate) levied by the municipality for rates **and** other supplies of goods or services such as electricity, gas, water, drainage or the removal or disposal of sewage. Also excluded is a situation where a so-called "rate" is levied in respect of supplies of electricity, gas, water, drainage or the removal or disposal of sewage.

Output tax

Refers to the tax (VAT) which is charged in terms of section 7(1)(a) by a vendor on a taxable supply and is declared in the Part A of VAT 201 return. Input tax is deducted from output tax to arrive at the net VAT payable (or refundable) for any particular tax period.

Person

Refers to the entity which is liable for VAT registration and includes –

- sole proprietors, that is, natural persons;
- companies and close corporations;
- partnerships and joint ventures;
- deceased and insolvent estates;
- municipalities;
- municipal entities;
- public authorities; and
- foreign donor funded projects.

Recipient

Refers to the person to whom a supply of goods or services is made.

SARS

The acronym for "The South African Revenue Service".

Services

Is broadly defined and includes –

- the granting, assignment, cession, and surrender of any right;
- the making available of any facility or advantage; and
- certain acts which are deemed to be services in terms of section 8.

The definition of "*services*" excludes –

- a supply of "*goods*";
- money; and
- any stamp, form or card which falls into the definition of "*goods*".

Some examples of services are –

- commercial services such as services provided by electricians, plumbers, builders etc;
- professional services such as services provided by lawyers; accountants and auditors; and
- advertising services provided by advertising agencies.

Supply

Is defined very broadly and includes all forms of supply, and any derivative of the term, irrespective of where the supply is effected. The term includes performance in terms of a sale, rental agreement and an instalment agreement, and may be voluntary, compulsory or by operation of law.

Some examples are –

- the expropriation of fixed property;
- the letting of office buildings; and
- the provision of a motor vehicle in terms of an instalment sale agreement.

Taxable supplies

Includes all supplies which are chargeable with tax under the VAT Act. There are two types of taxable supplies, namely :

- Supplies which attract VAT at the zero rate (listed in section 11).
- Supplies which attract VAT at the standard rate (that is, VAT must be charged at the rate of 14%).

A taxable supply does not include any exempt supply listed in section 12, even if supplied by a registered vendor. Supplies made by persons who are not vendors (that is, not registered and not required to be registered for VAT) are also not taxable supplies.

Tax invoice

A document which must be issued by the supplier in respect of taxable supplies made exceeding R50, and must be held by the recipient vendor in order to deduct input tax. Section 20 sets out the following information which is required to be reflected on the tax invoice:

Where the consideration exceeds R3 000, a full tax invoice in terms of section 20(4) consisting of the following details is required:

- The words "tax invoice" in a prominent place.
- The name, address and VAT registration number of the supplier.
- The name, address and where the recipient is registered, the VAT registration number of the recipient.
- The individual serialised number and the date of issue.
- An accurate description of the goods and/or services supplied.
- The quantity or volume of the goods or services supplied.
- The full consideration charged, and either–
  - the VAT amount shown separately; or
  - a statement that VAT is included, and the rate of VAT charged.

Where the consideration does not exceed R3 000, an abridged tax invoice in terms of section 20(5) with the requirements being the same as above with the exception of the following particulars which may be omitted:

- The name, address and the VAT registration number of the recipient.
- The quantity or volume of the goods or services supplied.

Note that –

- it is not required to issue a tax invoice where the consideration in money does not exceed R50; and
- a full tax invoice is required in respect of zero-rated supplies, and not an abridged tax invoice.

Tax period

A vendor must submit a VAT 201 return to SARS in respect of the tax period contemplated in section 27, in terms of which the vendor is registered.

A vendor may be required to account for VAT in terms of one of the following six categories of tax periods :

- Category A – two-monthly (ending at the end of every odd month, for example, January, March, May, July etc).
- Category B – two-monthly (ending at the end of every even month, for example, February, April, June etc).
- Category C – monthly (taxable supplies greater than R30 million per year).
- Category D – six-monthly (only certain farmers whose taxable supplies are less than R1.5 million** per year).
- Category E – annually (only in exceptional circumstances where supplies are made to connected persons and payment of consideration only becomes due once a year).
- Category F – every four months (only for small businesses whose taxable supplies are less than R1.5 million** per year).

** ***Note:*** *The tax period threshold of R1.5 million for vendors who are registered on Category D and Category F applies with effect from 1 March 2008. Previously, the threshold was R1.2 million.*

Time of supply	As a general rule, a supply is deemed to take place at the earlier of the time an invoice is issued, or the time any payment of consideration is received by the supplier. However, section 9 also provides for specific time of supply rules (for example, in respect of connected persons, periodic or progressive supplies, fixed property etc).
Value of supply	Normally means the price charged, excluding the VAT component. Section 10 also makes provision for specific valuation rules in certain cases (for example, certain supplies made between connected persons, or supplies made under instalment credit agreements, or where supplies are made which involve the issuing of tokens, vouchers or stamps).
VAT	The acronym for “Value-Added Tax”.
Vendor	Refers to any person that is registered, or required to be registered for VAT. Therefore any person making taxable supplies in excess of the threshold for compulsory registration prescribed in section 23, is a vendor regardless of whether or not the person is registered as such. The VAT registration threshold is currently R1 million in any 12-month consecutive period. Before 1 March 2009, the threshold was R300 000.

ANNEXURE A

REGULATION 2570

(OBSOLETE FROM 1 JULY 2006)

I, Dawid Jacobus de Villiers, Acting Minister of Finance, hereby determine under item (*cc*)(A) of paragraph (*c*)(*iv*) of the definition of "*enterprise*" in section 1 of the Value-Added Tax Act, 1991 (Act No. 89 of 1991) for the purposes of the said item, the following categories of businesses to be categories of businesses in respect of which the provisions of the said paragraph shall be deemed to apply:

Abattoirs.
Farming.
Parking grounds and garages.
Produce markets.
Township development.
Letting of commercial and industrial buildings.
Airports.
Quarries and sale of sand.
Cement-making.
Caravan parks, pleasure and holiday resorts.
Nurseries.
Hiking trails.
Brickyards.
Liquor sales.
Provision of computer services.
Game farms.
Cattle pens and auction facilities.

DJ DE VILLIERS,

Acting Minister of Finance.

ANNEXURE B

EXAMPLES OF "ENTERPRISE" ACTIVITIES

The following is a comprehensive list of supplies made by municipalities which will be subject to VAT at the standard-rated with effect from 1 July 2006 (the list is not exhaustive):

- The supply of electricity, gas or water.
- The drainage, removal or disposal of sewage or garbage.
- Upgrading/building of roads.
- Operating hospitals as principal.
- Abattoirs.
- Farming and forestry, for example the sale of trees or wood derived from trees removed from municipal owned forests.
- Parking grounds and garages.
- Produce markets.
- Township development.
- Escorting of abnormal vehicles by Metro Police.
- Airports.
- Quarries and the sale of sand.
- Cement-making.
- Caravan parks, pleasure and holiday resorts.
- Nurseries/ hiking trails.
- Brickyards.
- Liquor sales.
- Provision of computer services.
- Game farms.
- Dog tax (fees).
- Cattle pens and auction facilities.
- Fee/refunds/commission received.
- Royalties.
- Library services.
- Museums & heritage buildings.
- Fire brigade services (fees).
- Provision of bus/taxi shelters and advertising services supplied in this regard.
- Issuing of licenses or permits as principal.
- Entrance fee to recreational facilities.
- Letting of a bus, without a bus operator.
- Parks and recreational services.
- Connection and reconnection on electricity, water or gas (fees).
- By-products sales.
- Fees for making photostat copies of documents.

- Inspection/re-inspection (fees).
- Meter reading services.
- Signage and advertising.
- Trading (fees).
- Weighbridge.
- Industrial effluent/treatment effluent – sales.
- Subdivisions/zoning/re-zoning (fees).
- Recoveries of infrastructure maintenance.
- Removal of restrictions (for example, in a title deed in respect of a building site).
- Encroachment (fees) (for example, on the purchase or letting of a roadway/path which cuts through an erf).
- Burial fees/grave sales/cremation fees/cemetery fees.
- Filming (fees).
- Informal trading levy/trade licence.
- Recoupment: telephone/parking from staff.
- Banana ripening.
- Salvage items.
- Advertising.
- Roadworthy application/certificate.
- Fishing permit.
- Boat registration.
- Licensing and regulation: trading.
- Duplicate certificates.
- Selling of animals, birds, fish, trees or plants.
- Street frontage administration fee.
- Towing fees.
- Letting of commercial buildings, for example, offices, halls or shops.
- The supply of accommodation in a hostel or boarding establishment (commercial accommodation).
- Services rendered by one municipality to another municipality.
- Services rendered to a municipal entity.
- Intra-municipality service charges (only where the division of the municipality is registered separately for VAT purposes)
- Agency fees for acting as collecting and issuing agents for Province (for example, motor licences).

ANNEXURE C

REGULATION 270

Published as Regulation No. 270 in the Government Gazette No. 29741 on 28 March 2007

TRANSITIONAL ARRANGEMENTS FOR MUNICIPALITIES FOLLOWING THE DELETION OF PARAGRAPH *(c)* OF THE DEFINITION OF "ENTERPRISE" IN SECTION 1 OF THE VALUE-ADDED TAX ACT, 1991 (ACT NO. 89 OF 1991), THE ZERO-RATING OF MUNICIPAL RATES AND OTHER CONSEQUENTIAL AMENDMENTS

By virtue of the power vested in me by section 74(1) of the Value-Added Tax Act, 1991 (Act No. 89 of 1991), I, Trevor Andrew Manuel, Minister of Finance hereby make the following regulation, as set out in the Schedule hereto, prescribing the transitional arrangements which apply to municipalities following the deletion of paragraph *(c)* of the definition of "enterprise" in section 1 of the Act, the zero-rating of municipal rates in terms of section 11(2) and other amendments to the Act affecting the taxation of municipalities which were introduced by the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006 (Act No. 9 of 2006).

TA MANUEL
Minister of Finance

Schedule

PREAMBLE

On 15 February 2006 it was announced that the regional service and joint service council levies will fall away in July 2006, and that municipalities would receive compensating income through an increase in their equitable share grants allocated from nationally collected revenue. In addition, it was announced that municipal property rates would be zero-rated for VAT purposes with effect from 1 July 2006. Part of the object of these changes was to unlock the input tax, which previously could not be claimed due to the non-taxable nature of many of the supplies made by municipalities. In so doing, revenue is shifted to municipalities by allowing them to claim more input tax, but at the same time, goods and services previously not subject to VAT are now drawn into the tax net.

The amendments contained in the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006, are also aimed at assisting municipalities to simplify their accounting and tax records. However, many legislative changes were necessary to achieve these objects and in view of the submissions received from municipalities stating that they lack administrative capacity, it appears that municipalities may experience difficulties in complying fully with the law in the short term. It was, therefore, necessary to consider an arrangement whereby municipalities are afforded an opportunity to put the necessary administrative and accounting mechanisms in place to become fully compliant. It is within this context that the regulation setting out the transitional arrangements is made.

1. Definitions

For purposes of the regulation, unless the context otherwise indicates, any word or expression to which a meaning has been assigned in the Act, 1991, bears the meaning assigned thereto, and for the purposes of this regulation —

"the Act" means the Value-Added Tax Act, 1991 (Act No. 89 of 1991);
"municipality" includes any person which complied with the definition of "local authority" in section 1 of the VAT Act prior to the deletion of that definition on 1 July 2006; and
"transition period" means the period commencing on 1 July 2006 and ending on 30 June 2007.

2. Output tax on supplies which became taxable for the first time during the transition period

2.1 Where any output tax due by a municipality on supplies which became taxable for the first time during the transition period has been omitted in error from any return for a prior tax period which was required to be submitted within the transition period, that output tax may be accounted for by the municipality in a later return which is due for payment on or before 25 July 2007.

2.2 No additional tax, penalty or interest will be imposed on any late payment of output tax referred to in paragraph 2.1.

3. Apportionment of input tax

3.1 With effect from 1 July 2006 a municipality must calculate input tax by using the turnover based method of apportionment on any goods and services acquired by it which are partly for consumption, use or supply in the course of making taxable supplies and partly for another intended use.

3.2 In order to determine the amount of input tax as contemplated in paragraph 3.1 during the transition period, a municipality must use the information pertaining to the value of the supply of goods and services made during the previous 12 months as per its financial statements as at 30 June 2006, and apply the following the formula:

$$Y = \frac{A}{B} \times \frac{100}{1}$$

where—

"Y" = the percentage of input tax which may be claimed on supplies of goods and services acquired on or after 1 July 2006 which are partly attributable to making taxable supplies.

"A" = the aggregate value of all taxable supplies made during the previous 12 month period.

"B" = the aggregate value of all supplies made during the previous 12 month period (including the value of any other amounts received during that period which are not in respect of any supply).

3.3 The following adjustments must be made to the financial statements for the purposes of applying the formula referred to in paragraph 3.2 during the transition period:

3.3.1 The value of supplies of goods and services which were not taxable prior to 1 July 2006, but which become taxable on that date must be included in the value of taxable supplies for purposes of A and B of the formula.

3.3.2 The amounts received in respect of punitive statutory fines and penalties levied by the municipality must only be included in the value of supplies for purposes of B of the formula.

3.3.3 Grants (including capital grants) made to a municipality for purposes of financing the taxable supplies of goods or services made by that municipality must be included in the value of supplies for purposes of A and B of the formula.

3.3.4 Grants (including capital grants) made to a municipality for the purposes of financing supplies of goods or services made by that municipality which are exempt in terms of section 12 of the Act, or which are out-of-scope for VAT purposes, must be included in the value of supplies for purposes of B of the formula.

3.4 Where a municipality is unable to apply the turnover based method of apportionment specified in this regulation, the Commissioner may, in terms of section 17(1) of the Act, approve another method of apportionment which is equitable in the circumstances and which may be used during the transition period, or for any period thereafter.

3.5 An application to apply another method of apportionment as contemplated in paragraph 3.4 will only be considered upon receipt of full reasons in writing, together with supporting evidence, as to why the prescribed method of apportionment cannot be applied.

3.6 At the end of the transition period, a revised apportionment percentage must be calculated with reference to the actual value of supplies of goods and services made during the transition period according to the financial statements for the financial year ending on 30 June 2007. Any difference in input tax for the transition period between the revised apportionment percentage and the percentage determined in paragraph 3.2 must be accounted for in the September 2007 return, which is due on 25 October 2007.

3.7 No additional tax, penalty or interest will be levied on any tax which may be payable as a result of the adjustment in paragraph 3.6, provided that the amount is paid on or before 25 October 2007 or any further period that the Commissioner may allow.

4. Payments basis of accounting

Where a municipality accounts for VAT on the payments basis as contemplated in section 15(2) of the Act, it must treat payments received by it on or after 1 July 2006 in respect of the supply of goods or services made by that municipality before that date as if that payment had been received before that date.

Where a municipality accounts for VAT on the payments basis as contemplated in section 15(2) of the Act, it must treat payments made by it on or after 1 July 2006 in respect of the supply of goods or services acquired by that municipality before that date as if that payment had been made before that date.

ANNEXURE D

EXPLANATORY NOTE TO REGULATION 270

TRANSITIONAL ARRANGEMENTS FOR MUNICIPALITIES FOLLOWING THE ZERO-RATING OF MUNICIPAL RATES AND OTHER CONSEQUENTIAL AMENDMENTS

INTRODUCTION AND PURPOSE

- The Minister of Finance, in his budget speech on 15 February 2006, announced that the regional service and joint service council levies would fall away as from 1 July 2006, and that municipalities would receive compensating income through an increase in their equitable share grants from nationally collected revenue.

- It was also announced in the budget speech that municipal property rates, would be brought into the VAT net and zero-rated for VAT purposes with effect from 1 July 2006.

- Furthermore, a number of VAT amendments were proposed, which make the majority of the supplies by a municipality taxable at the standard rate.

- The main objective of these amendments was to unlock the input tax which municipalities could previously not claim, because of the non-taxable nature of many of the supplies made by municipalities. The amendments are also aimed at assisting municipalities to simplify their accounting and tax records.

Many legislative changes were necessary to achieve these objects. Many municipalities submitted that they lacked administrative capacity and experienced difficulties in fully complying with the law in the short term. It was therefore necessary to consider an arrangement whereby municipalities are afforded an opportunity to put in place the necessary administrative and accounting mechanisms to become fully compliant. It is within this context that the transitional arrangements as set out in the Regulation are made.

The purpose of this explanatory note is to provide clarity in the application of the Regulation and applies to "municipalities" as defined in section 1 of the VAT Act, as well as any person which complied with the definition of "local authority" in section 1 of the VAT Act prior to the deletion of that definition on 1 July 2006, e.g. tribal authorities, certain municipal entities, water boards, etc (which entities are collectively referred to herein as a "municipality").

[An asterisk (*) denotes a proposed amendment contained in the Revenue Laws Amendment Bill, 2006, which was published on the SARS website for public comment and now awaits the President's assent.]

TRANSITIONAL ARRANGEMENT

1. Scope and application

A period of 1 year is granted to a municipality to put in place the necessary administrative and accounting mechanisms so that it will be able to fully comply with the VAT law in consequence of the deletion of paragraph (c) of the definition of "enterprise" defined in section 1 of the VAT Act as amended by the Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006.

1.1 The period of 1 year will commence on 1 July 2006 and end on 30 June 2007, and is referred to as "the transition period".

1.2 The arrangement applies to any municipality, which includes those persons which complied with the definition of "local authority" in section 1 of the VAT Act prior to the deletion of that definition on 1 July 2006.

1.3 The transitional arrangement only applies in respect of supplies, which became taxable for the first time for the municipality concerned on or after 1 July 2006.

2. Output tax on supplies which became taxable for the first time on or after 1 July 2006

Where a municipality omits in error any output tax that is due in respect of supplies which became taxable for the first time on or after 1 July 2006, no additional tax, penalty or interest will be imposed. This will only apply where the output tax is accounted for by the municipality in a later VAT return which is due for payment on or before 25 July 2007

See Examples 1, 2 and 3.

3. Apportionment of input tax

3.1 All VAT rulings issued to municipalities prior to 1 July 2006 in terms of which municipalities were allowed to apply a special method of apportionment to calculate input tax on expenses partially attributable to making taxable supplies are withdrawn with effect from 1 July 2006.

3.2 With effect from 1 July 2006, where municipalities acquire goods and services partially for making taxable supplies, input tax on these goods and services must be calculated using the turnover basis of apportionment.

3.3 For the purposes of calculating the apportionment percentage contemplated in paragraph 3.2 above, a municipality must use the information on the value of the supply of goods and services ("income streams") during the previous 12 months as per the financial statements at 30 June 2006, and apply the following formula:

$$Y = \frac{A}{B} \times \frac{100}{1}$$

where—

"Y" = the percentage of input tax which may be claimed on goods and services acquired on or after 1 July 2006 that are partly attributable to making taxable supplies.

"A" = the aggregate value of all taxable supplies made during the previous 12 month period.

"B" = the aggregate value of all supplies made during the previous 12 month period (including the value of any other amounts received (e.g. statutory fines and penalties) during that period which are not in respect of any supply.

3.4 The following **adjustments must be made** to the financial statements for the purposes of applying the apportionment formula, **during the transition period**:

3.4.1 Income streams from activities which were not taxable prior to 1 July 2006, but which become taxable on that date must be included for purposes of A and B of the formula.

3.4.2 Income from punitive statutory fines and penalties such as those levied for the infringement of municipal by-laws, or traffic offences, must be included for purposes of B of the formula. See paragraph 3.4.3.

3.4.3 Where a municipality acts as agent on behalf of another person, for example, where motor vehicle licence fees are collected on behalf of the Provincial Government (the principal), any amounts collected on behalf of that principal must not be included for purposes of A and B of the formula. However, any fees or commissions charged or retained or refunds received in lieu of, in respect of, or for the performance of the collection or agency service, or which otherwise constitutes consideration received in exchange for the supply of goods or services by the municipality, must be included for purposes of A and B of the formula.

3.4.4 Grants (including capital grants) made to a municipality for the purposes of financing taxable supplies of goods or services, e.g. township development, must be included for purposes of A and B of the formula.

3.4.5 Grants (including grants for capital projects) made to a municipality which are for the purpose of making exempt supplies in terms of section 12 of the Act, such as, the supply of passenger transport or accommodation in a dwelling, must be included for purposes of B of the formula.

3.5 "A" and "B" are therefore calculated **for the transition period** as follows:

3.5.1 "A" is the aggregate of the following items:

i. All supplies made at the standard rate during the past 12 month period including those supplies which became taxable at the standard rate on 1 July 2006;

ii. All supplies made at the zero rate during the past 12 month period including those supplies which became taxable at the zero rate on 1 July 2006;

iii. All deemed supplies which are taxable at the zero rate or standard rate during the past 12 month period;

iv. All grants (including capital grants) received during the past 12 month period prior to 30 June 2006 in respect of making taxable supplies which are taxable at the zero rate during the past 12 month period; and

v. All non-taxable supplies made during the past 12 month period prior to 30 June 2006 of the type which became taxable on or after 1 July 2006, including any commission, fees, any amounts withheld as agent or received as consideration for collecting services, e.g. motor vehicle licence fees collected on behalf of the Province.

3.5.2 "B" is the aggregate of the following income items:

i. All the taxable supplies included in "A" (see paragraph 3.5.1 above);

ii. All exempt and non-taxable supplies made during the past 12 month period which do not become taxable on or after 1 July 2006;

iii. All grants (including capital grants) received during the past 12 month period prior to 30 June 2006 whether it is for making taxable or exempt or out-of-scope supplies;

iv. All exempt supplies made in terms of section 12 of the Act.

v. Amounts accruing to the municipality that are not in respect of a supply of goods or services, e.g. traffic fines.

3.6 Where the application of the formula in paragraph 3.3 above results in an apportionment percentage of more than 95%, the municipality is entitled to claim the full amount of input tax on the expenses which are incurred partly for making taxable supplies up to the end of the transition period.

3.7 At the end of the transition period, an annual adjustment to the apportionment percentage must be calculated with reference to the actual income streams for the total value of goods and services supplied during the transition period i.e. for the financial year ending 30 June 2007. The actual apportionment percentage must be compared to the estimated percentage used during the transition period (as prescribed by the Regulation), and an adjustment must be made for any difference in output tax or input tax which has been accounted for during the transition period. The adjustment must be accounted for in the September 2007 VAT return, which is due on or before 25 October 2007.

See Example 4.

3.8 No additional tax, penalty or interest will be levied on output tax which may be payable as a result of the adjustment, provided that the amount is paid on or before 25 October 2007, or any further period that the Commissioner may allow.

3.9 The revised apportionment percentage that has been calculated in terms of paragraph 3.7 above must be used to claim input tax on expenses partially attributable to taxable supplies for the period 1 July 2007 to 30 June 2008. Thereafter, the municipality must continue to apply the turnover based method of apportionment.

3.10 The municipality will be required to make an adjustment in respect of input tax or output tax as a result of the recalculation of the apportionment percentage, and make its annual adjustment to the apportionment percentage.

3.11 Where a municipality is unable to apply the turnover based method of apportionment, the Commissioner may, in terms of section 17(1) of the Act, approve another method of apportionment which is equitable in the circumstances and which may be used during the transition period, or for any period thereafter.

3.12 An annual adjustment in respect of the use or application of capital goods or services must be effected in the following instances:

- Adjustments to **output tax** are required in those situations where there is a decrease in the extent of taxable use or application of capital goods and/or services by a vendor (see section 18(2));
- Adjustments to **input tax** are required in those situations where there is an increase in the extent of taxable use or application of capital goods and/or services by a vendor (see section 18(5)).

The provisions are aimed at ensuring that, where capital goods and services are used for mixed purposes, the input tax which may be claimed must be in proportion to the extent to which those assets are applied for taxable use in the municipality's enterprise over the lifetime of the assets. The adjustments are required where the input tax apportionment percentage applied by the municipality during the year varies by more than 10% from the percentage applied in the previous year.

The amendments provide that the adjustments under sections 18(2) and 18(5) of the VAT Act will not apply in the case of a municipality where the capital goods or services were acquired prior to 1 July 2006.

3.13 All applications to apply a different method of apportionment as contemplated in paragraph 3.10 above must be made to SARS Head Office, and will only be considered upon receipt of full reasons, in writing, together with supporting evidence, as to why the turnover based method of apportionment cannot be applied. Applications may be submitted to:

policycomments@sars.gov.za or the following fax number (012) 422 5043.

4. Payments basis of accounting

4.1 The time of supply of goods and services is, in terms of section 9 of the Act, deemed to take place at the time any invoice is issued or the time any payment of consideration is received by the supplier in respect of that supply, whichever time is earlier. The fact that a municipality may account for VAT on the payments basis will not alter the time of supply rule.

4.2 Where *payment is received by a municipality* on or after 1 July 2006 for a supply of a type which, at the time of supply was not a taxable supply by that municipality under paragraph (*c*) of the definition of "enterprise", no output tax will be payable on the receipt of that amount.

However, where the time of supply occurred on or after 1 July 2006, and in consequence of the deletion of paragraph (c) of the definition of "enterprise", that supply becomes taxable, the consideration received will include an amount of VAT at the standard rate, which must be declared as output tax in the tax period concerned. If the output tax is omitted in error from the VAT return in respect of the tax period in which the payment was received, the output tax may be accounted for in a later tax period as provided in paragraph 2 above.

4.3 Where *payment is received by a municipality* on or after 1 July 2006 in respect of a taxable supply made before 1 July 2006, the accrued output tax must be accounted for in the tax period in which the payment is received (see paragraph 4.1 above for the time of supply rule).

If the output tax is omitted in error from the tax period in which the payment was received, such omission will be subject to penalty and interest and cannot qualify for the relief provided in paragraph 2 above. However, the municipality may, in accordance with the provisions of section 39(7) of the Act, apply to the Commissioner to consider remitting the penalty and/or interest, based on the merits of that particular case.

4.4 Where *payment is made by a municipality* on or after 1 July 2006 in respect of the accrued expense (on which input tax will be allowed) (see paragraph 4.1 above for the time of supply), the following will apply:

4.4.1 to the extent that the expense as at the time of the supply was wholly and directly attributable to the making of taxable supplies contemplated under the Act as the Act read prior to 1 July 2006, the full amount of input tax may be claimed; and

4.4.2 to the extent that the expense was partly attributable to the making of taxable supplies and partly for other non-taxable purposes, a portion of the input tax may be claimed according to the apportionment percentage which was applied by that municipality prior to 30 June 2006, i.e. the apportionment percentage for the financial year 2004/2005. Where the application of the apportionment percentage for the financial year 2004/2005 results in an apportionment percentage of more than 95%, the municipality is entitled to claim the full amount of input tax concerned; and

4.4.3 to the extent that the expense as at the time of the supply was wholly and directly attributable to the making of exempt or other non-taxable or non-supplies, as the Act read prior to 1 July 2006, no input tax may be claimed.

4.5 Accounting for output tax on contracts spanning the imposition of VAT on supplies made by the municipality which become taxable for the first time on 1 July 2006

4.5.1 Municipalities that have concluded long term contracts for successive or progressive supplies of a kind which became taxable during the transition period as a result of the deletion of paragraph (c) of the definition of “enterprise”, may increase their prices in terms of section 67(1) of the Act to include the VAT which must be charged with effect from 1 July 2006 (unless there is a written agreement to the contrary between the contracting parties).

4.5.2 Whether or not a municipality alters the price charged for the supplies mentioned in paragraph 4.5.1 above, the consideration charged will include VAT at the standard rate with effect from 1 July 2006.

4.5.3 The supplies to which paragraph 4.5 applies includes:

i. **goods** supplied before 1 July 2006;

ii. goods supplied **under a rental agreement** (e.g. office rent) during a period beginning before and ending on or after 1 July 2006;

iii. goods supplied under any agreement or law which provides for the **consideration to be paid in instalments or periodically** and in relation to the progressive or periodic supply of the goods (e.g. royalties) during a period beginning before and ending on or after 1 July 2006. Where a payment is received on or after 1 July 2006 in respect of the price charged for successive or progressive supplies for any period before 1 July 2006 in terms of the contract mentioned in paragraph 4.5.1 above, that payment will not include any VAT.

iv. **services** supplied during a period beginning before and ending on or after 1 July 2006 (e.g. management fees/agency fees for collecting licence fees or issuing licenses).

v. The supply of **fixed property.**

The time of supply in terms of section 9(3)(d) of the VAT Act is the earlier of the date of registration of transfer, or the date any payment of the consideration is made. Therefore if the time of supply in respect of a sale by the municipality of fixed property, which prior to 1 July 2006 was not used in the course or furtherance of the municipality's enterprise falls on or after 1 July 2006, VAT is payable at the standard rate even though the agreement of sale might have been entered into prior to 1 July 2006. The supply of fixed property which was used to make exempt supplies, e.g. residential accommodation, will however not be subject to VAT, as the supply is exempt.

Example A:

From 1 July 2006 royalties received by the municipality are subject to VAT at the standard rate. Where an agreement was concluded on 15 April 2006 and payment of the royalties is due to the municipality on the 15th of each month, the municipality will only be liable to account for VAT in respect of the royalties received on or after 1 July 2006. The municipality will therefore have to apportion the payment for royalties it received on the 15th of July 2006, as only a portion thereof will be taxable at the standard rate.

Example B:

From 1 July 2006, the fire brigade services provided by municipalities are subject to VAT at the standard rate. If the fire brigade had in fact rendered services prior to 1 July 2006, but invoiced the customer only after 1 July 2006 (and received no consideration in respect of such services before that date), the municipality will be liable to charge VAT in respect of those services, as the time of supply occurred after 1 July 2006.

4.5.4 The municipality must account for output tax at the standard rate in respect of the regional service council levies received, notwithstanding the fact that as from 1 July 2006 the Regional Service Board ("RSC") and Joint Service Board ("JSB") levies are no longer raised. Therefore, where the final returns in respect of the RSC or JSB levies (the levies), for the month of June 2006 or any other outstanding return or outstanding payment for periods before June 2006 are submitted in July 2006, and only paid in July 2006 or at any time thereafter (e.g. 3 years to collect outstanding levies), output tax at the standard rate must be accounted for by the municipality.

5. Examples

Example 1: *Omission of output tax during the transition period on supplies which are taxable for the first time on or after 1 July 2006*

XYZ Municipality often lets out one of its community halls to members of the community for use as a venue for wedding receptions and other social events. The Municipality charges a fee of R1 000 per day for hiring the hall and decides not to increase this charge on 1 July 2006, as it was felt that the input tax unlocked by the amendments to the VAT Act, more than covered the maintenance and other incidental costs of making the hall available for hire. The Municipality therefore continued to charge R1 000 per day (now inclusive of 14% VAT) after 1 July 2006.

On 15 July 2006, the hall was rented out for a function, which amount was paid by the customer on the same day. Due to an administrative error, the Municipality's accounting system was not changed to code that supply as being inclusive of VAT at the standard rate with effect from 1 July 2006. The error was only discovered on 15 November 2006, and as a result, the output tax on that supply was omitted from the VAT 201 return for the period ending July 2006.

Question: Can XYZ Municipality account for the output tax in the November 2006 tax period, and will it be liable for any interest and penalties for the omission of such output tax?

Answer: XYZ Municipality may account for the output tax of R 122.81 (R1 000 X 14/114) in the November 2006 VAT 201 return, and pay the amount on the due date for that tax period without incurring any additional tax, penalty or interest on the late payment. This is due to the fact that the output tax was omitted in error from a return which falls within the "transition period", and the supply concerned was not a taxable supply by the Municipality prior to 1 July 2006. Penalty and interest will be applicable where the output tax is only been declared after the June 2007 return.

Example 2: *Omission of output tax during the transition period on supplies which were always taxable*

DEF Municipality supplies water and electricity to customers in its demarcated area. On 15 September 2006, a customer pays DEF Municipality R1 000 in partial settlement of the R3 000 outstanding bill, which had accumulated on the account over the period April 2006 to August 2006. Due to an error in the accounting system, the output tax was not posted to the VAT control account, and was omitted from the VAT 201 return for the period ending September 2006.

The error was only discovered by the internal auditors on 15 December 2006, and output tax was subsequently included in the December 2006 return and paid on 25 January 2007.

Question: Can DEF Municipality account for the output tax in the December 2006 tax period, and will it be liable for any additional tax, interest and penalties for the omission of such output tax?

Answer: The late payment in this example relates to the supply of water and electricity, which was a taxable supply before 1 July 2006 and continues to be taxable at the standard rate on or after 1 July 2006. Therefore, the late payment of output tax is not covered by the transitional arrangement. A 10% penalty, as well as interest for every month or part thereof calculated from 1 November 2006 until the date of payment (i.e. 3 months in this instance – November 2006 to January 2007) will be levied. The Municipality is required to inform SARS of the under-declaration.

Example 3: *Omission of output tax during the transition period on supplies which are taxable for the first time on or after 1 July 2006*

On 1 September 2006, GHI Municipality opened its new caravan park and hiking trail facility to the public. GHI earned R200 000 from conducting this activity during each month from September 2006 to December 2006. However, the manager of the facility only reported that the supplies were taxable from November 2006, which was captured on the municipality's accounting system accordingly. The supplies for September 2006 and October 2006 were therefore reported on the respective VAT 201 returns as exempt supplies. This error was picked up and corrected in the November 2006 VAT 201 return, which was paid on 22 December 2006.

Question: Can GHI Municipality account for the output tax in the November 2006 tax period and will it be liable for any additional tax, interest and penalties for the omission of such output tax?

Answer: As in example 1, the omission of output tax on the supplies made for September and October 2006 may be declared in the November 2006 return and paid on 22 December 2006 without incurring any additional tax, penalty or interest thereon as this is in accordance with the transitional arrangement (see paragraph 2).

Example 4: *Apportionment of input tax during the transition period according to the annual turnover based method and using the final trial balances as at 30 June 2006*

KLM Municipality buys office furniture costing R1 140 000 (including VAT) and a new bus costing R570 000 (including VAT) during the November 2006 tax period. Prior to 1 July 2006, the Municipality was using a pre-approved method of apportionment, commonly known as the varied input-based method.

On 1 July 2006, the municipality was compelled to utilise the turnover-based method of apportionment. The following income streams were reflected on the Municipality's final trial balance for the year ended 30 June 2006:

Trial balance for the year ended 30 June 2006 ***Note:*** ** Income values exclude VAT*

No	Description	Tax Status Prior 1/07/06	Tax Status Post 1/07/06	Value * (R)
1	Assessment rates	non-taxable	0%	1 000 000
2	Sale of electricity	14%	14%	2 500 000
3	Sale of water	14%	14%	2 000 000
4	Water & Electricity Meter reading fees	14%	14%	200 000
5	Community Hall Rental Income	non-taxable	14%	50 000
6	Speeding and Parking fines	non-taxable	Non-taxable	500 000
7	Collection fee from Transport Department	Non-taxable	14%	50 000
8	Passenger transport (Bus service)	exempt	exempt	500 000
9	Grants for taxable activities	0%	0%	1 000 000
10	Grants for non-taxable activities	non-taxable	Non-taxable	1 500 000
	Total Income			**9 300 000**

Question: How does KLM Municipality determine the apportionment percentage by applying the formula in paragraph 3.3 above for the period after 1 July 2006 using the turnover based method of apportionment to calculate the input tax it may claim?

Answer: In determining the total value of taxable supplies and of all supplies, the following income streams must be taken into account:

Value of taxable supplies and value of all supplies

No	Description	Value (R)
1	Assessment rates	1 000 000
2	Sale of electricity	2 500 000
3	Sale of water	2 000 000
4	Water & Electricity Meter reading fees	200 000
5	Community Hall Rental Income	50 000
6	Speeding and Parking fines	500 000
7	Collection fee from Transport Department	50 000
8	Passenger transport (Bus service)	500 000
9	Grants for taxable activities (2005/6)	1 000 000
10	Grants for non-taxable activities	1 500 000
	Total Income from taxable supplies (exclude items 6, 8 , and 10)	**6 800 000**
	Total Income from all supplies	**9 300 000**

$$\mathbf{Y = \frac{A}{B} \times \frac{100}{1}} = \frac{\text{Total value of taxable supplies}}{\text{Total value of all supplies}} \times \frac{100}{1}$$

Therefore: **Y** (apportionment %) = $\frac{6\,800\,000}{9\,300\,000} \times \frac{100}{1} =$ **73.12%**

KLM Municipality may therefore claim 73.12% of the R 140 000 VAT paid on the purchase of office furniture as input tax, as the expense is incurred partly for making taxable supplies, and partly for making exempt supplies. No input tax may be claimed on the purchase of the new bus, as the expense is wholly attributable to the making of exempt supplies (passenger transport).

Example 5: *Payments basis of accounting – Income and expenses accrued prior to 1 July 2006*

QRS Municipality accounts for VAT on the payments basis of accounting as contemplated in section 15(2)(a) of the Act. The balance of accrued income and expense items (i.e. invoices issued or received but not yet paid) as at 30 June 2006, is as follows:

Accrued income and expenses as at 30 June 2006

No	Description	Invoice Date	Payment Date	Tax Status Prior 1/07/06	Tax Status Post 1/07/06	Amount (incl. VAT) (R)
	Income					
1	Rates	30/06/2006	31/07/2006	non-taxable	0%	1 500
2	Electricity sales	30/06/2006	31/07/2006	14%	14%	22 800
3	Water sales	30/06/2006	31/07/2006	14%	14%	11 400
4	Community Hall hire	30/06/2006	15/07/2006	non-taxable	14%	1 000
5	Housing Rental	Arrears accrued to the end of June 2006	15/07/2006	exempt	exempt	5 400 (no VAT)
	Expenses					
6	Water	01/06/2006	15/07/2006	14%	taxable	7 980
7	Electricity	01/06/2006	Not yet paid	14%	taxable	17 100
8	Roads and street lighting	15/06/2006	15/07/2006	non-taxable	taxable	5 700
9	Administration	25/06/2006	25/07/2006	mixed	taxable	11 400
10	Housing maintenance	1/04/2006	29/07/2006	exempt	exempt	1 140

QRS Municipality's apportionment percentage prior to 1 July 2006 was 50% as determined in accordance with the varied input-based method, which it used up to 30 June 2006.

Question: On what amounts must QRS Municipality declare output tax and claim input tax as from 1 July 2006?

Answer: QRS Municipality must declare output tax and claim input tax as follows:

No	Description	Declare output tax	Claim input tax	Calculation / reason	VAT Amount (R)
	Output tax				
1	Rates	No	-	Not taxable before 1/7/06	nil
2	Electricity sales	Yes	-	Taxable before 1/7/06	2 800
3	Water sales	Yes	-	Taxable before 1/7/06	1 400
4	Community Hall hire	No	-	Not taxable before 1/7/06	nil
5	Rental of dwellings	No	-	Exempt supply	nil
	Input tax				
6	Water	-	Yes	Wholly for taxable supplies before 1/7/06	980
7	Electricity	-	Yes, but only when paid	Wholly for taxable supplies before 1/7/06	Nil (claim 2 100 when paid)
8	Roads and street lighting	-	No	Wholly for non-taxable supplies before 1/7/06	0
9	General administration	-	Yes	Partly for taxable before 1/7/06 Claim per apportionment method used prior to 1/7/06 (11 400 X 14/114) X 50%	700
10	Housing maintenance	-	No	Wholly for exempt supplies	nil

<u>Example 6</u>: *Contracts commencing before, and ending after 1 July 2006 - Expenses incurred wholly for making non-taxable supplies, which supplies became taxable on or after 1 July 2006*

TUV Municipality accounts for VAT on the payment basis of accounting as contemplated in section 15(2)(a) of the Act and is required to submit a VAT return every month. A street lighting project was undertaken where a private electrical contractor (vendor) was engaged to replace old and broken street lights in various districts in the Municipality's demarcated area. The invoices and progress payments for the various phases are as follows:

Street lighting project: invoices and progress payments

No	Description	Invoice Date (Time of supply)	Payment Date	Amount (incl. VAT) (R)
1	Phase 1 – District 1	30/05/2006	1/07/2006	28 500
2	Phase 2 – District 2	30/06/2006	31/07/2006	22 800
3	Phase 3 – District 3	30/06/2006	31/07/2006	114 000
4	Phase 4 – District 4	31/07/2006	15/08/2006	114 000
5	Phase 5 – District 5	31/08/2006	15/09/2006	171 000
6	Phase 6 – District 6	31/08/2006	15/09/2006	57 000
7	Phase 7 – District 7	15/09/2006	15/10/2006	57 000
8	Phase 8 – District 8	25/09/2006	15/10/2006	34 200

Question: On what amounts can TUV Municipality claim input tax, and in which tax periods can the deductions be made?

Answer: TUV Municipality can claim input tax as follows:

No	Description	Claim input tax	Reason	Tax Period deductible	Input tax claim (R)
1	Phase 1 – District 1	No	Time of supply before 1/7/06	n/a	nil
2	Phase 2 – District 2	No	Time of supply before 1/7/06	n/a	nil
3	Phase 3 – District 3	No	Time of supply before 1/7/06	n/a	nil
4	Phase 4 – District 4	Yes	Time of supply after 1/7/06	Aug 06	14 000
5	Phase 5 – District 5	Yes	Time of supply after 1/7/06	Sept 06	21 000
6	Phase 6 – District 6	Yes	Time of supply after 1/7/06	Sept 06	7 000
7	Phase 7 – District 7	Yes	Time of supply after 1/7/06	Oct 06	7 000
8	Phase 8 – District 8	Yes	Time of supply after 1/7/06	Oct 06	4 200

Example 7: *Contracts commencing before, and ending after 1 July 2006 - Expenses incurred partly for making taxable supplies before and after 1 July 2006*

Assume the same invoice and payment dates for the progress payments in example 6 above for the TUV Municipality, except that:

- the contractor was engaged to build a new administration building (for mixed use);
- prior to 1 July 2006, the Municipality had permission to use the varied input-based method of apportionment, which yielded a 75% apportionment percentage; and
- after converting to the turnover based method of apportionment on 1 July 2006, the apportionment percentage increased to 90%.

In this case, the TUV Municipality would claim a portion of the VAT incurred as input tax in the respective tax periods as follows:

- 75% of the VAT incurred on payments numbered 1 to 3, according to the method which it applied up to 30 June 2006; and
- 90% of the VAT incurred on payments numbered 4 to 8, according to the turnover based method of apportionment, as set out in paragraph 3.2 above.

ANNEXURE E

BINDING GENERAL RULING (VAT) NO: 3 - 4 DECEMBER 2007

ACT : VALUE-ADDED TAX ACT, NO. 89 OF 1991 (the VAT Act)
SECTION : SECTIONS 28 AND 72
SUBJECT : TRANSITIONAL ARRANGEMENTS FOR MUNICIPALITIES: RETURNS AND PAYMENT OF TAX IN RESPECT OF SUPPLIES WHICH BECAME TAXABLE FOR THE FIRST TIIME DURING THE TRANSITION PERIOD

1. Purpose

The purpose of this binding general ruling is to —

1.1 provide approval to municipalities regarding the accounting of output tax on supplies which became taxable for the first time during the transition period; and

1.2 make an arrangement in terms of section 72 of the VAT Act for municipalities —
a. registered on Category A in terms of section 27(1) of the VAT Act;
b. registered as e-filers; or
c. who make payment by debit orders,
to account for output tax as contemplated in paragraph 1.1, in a later return which is due for payment on a date later than on or before 25 July 2007 (as set out in paragraph 3. below).

2. Background

The Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006 (Act No. 9 of 2006), effected certain amendments to the VAT Act with the purpose of simplifying municipalities' accounting and tax records. As a result, certain supplies previously made by municipalities which were exempt or non-taxable for VAT purposes became taxable at the standard rate after 1 July 2006.

Due to the change in the taxable nature of certain supplies and in order to assist municipalities to fully comply with these amendments, transitional arrangements were introduced in order to afford municipalities an opportunity to put in place the necessary administrative and accounting mechanisms. These transitional arrangements are set out in Regulation No. 270 in Government Gazette No. 29741, dated 28 March 2007 (the Regulation).

The Regulation makes provision for the output tax due on supplies which became taxable for the first time during the transition period to be accounted for in a later tax period which is due and payable on or before 25 July 2007.

This provision in the Regulation, however, omitted to include municipalities —
- registered on Category A in terms of section 27(1) of the VAT Act;
- registered as e-filers; or
- who make payment by debit orders.

As a result of the aforementioned, discussions were held with relevant stakeholders and it was agreed that a binding general ruling be issued in order to formalise the arrangement in respect of the submission of returns and payment of tax relating *inter alia* to supplies which became taxable for the first time during the transition period.

3. Ruling

3.1 Where any amount of output tax is due by a municipality on supplies which became taxable for the first time during the transition period and has been omitted in error from any return for a prior tax period which was required to be submitted within the transition period, that output tax may be accounted for by the municipality no later than the payment due dates set out below:

	Category A		Category B		Category C	
Tax period	June/July 2007		May/June 2007		June 2007	
	VAT201 submission date	**Payment due date**	**VAT201 submission date**	**Payment due date**	**VAT201 submission date**	**Payment due date**
All vendors except e-filers and vendors making payment by debit orders	24 August 2007	24 August 2007	25 July 2007	25 July 2007	25 July 2007	25 July 2007
E-filers	31 August 2007	31 August 2007	31 July 2007	31 July 2007	31 July 2007	31 July 2007
Vendors making payment by debit orders	24 August 2007	31 August 2007	25 July 2007	31 July 2007	25 July 2007	31 July 2007

3.2 Penalty and interest will be levied in terms of section 39(1) of the VAT Act where the payment as set out in the aforementioned table is effected on a date which is later than the dates set out in the table.

3.3 Furthermore, no additional tax, penalty or interest will be imposed on the late payment of output tax which became payable on supplies which became taxable for the first time during the transition period and which is accounted for and paid in terms of paragraph 3.1.

3.4 The aforementioned ruling is issued in terms of section 72 of the VAT Act in order to overcome the anomaly experienced by enforcing the due date of 25 July 2007 as set out in the Regulation. In this regard, it must be noted that this ruling is only applicable to output tax on supplies that became taxable for the first time and such output tax has been omitted in error from any return for a prior tax period which was required to be submitted within the transition period.

3.5 This ruling is a binding general ruling issued in accordance with section 76P of the Income Tax Act, 1962 (Act No. 58 of 1962) as made applicable to the VAT Act by section 41A of the VAT Act. This binding general ruling is valid until 31 August 2007.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

ANNEXURE F

Extracts from the Constitution

(The Constitution of the Republic of South Africa, Act 108 of 1996)

The relevant sections of the Constitution, are quoted below:

1. Sections 155(2), (3), (6) and (7): Establishment of municipalities.

…

(2) National legislation must define the different types of municipality that may be established within each category.

(3) National legislation must—

(a) establish the criteria for determining when an area should have a single category A municipality or when it should have municipalities of both category B and category C;

(b) establish criteria and procedures for the determination of municipal boundaries by an independent authority; and

(c) subject to section 229, make provision for an appropriate division of powers and functions between municipalities when an area has municipalities of both category B and category C. A division of powers and functions between a category B municipality and a category C municipality may differ from the division of powers and functions between another category B municipality and that category C municipality.

…

(6) Each provincial government must establish municipalities in its province in a manner consistent with the legislation enacted in terms of subsections (2) and (3) and, by legislative or other measures, must—

(a) provide for the monitoring and support of local government in the province; and

(7) The national government, subject to section 44, and the provincial governments have the legislative and executive authority to see to the effective performance by municipalities of their functions in respect of matters listed in Schedules 4 and 5, by regulating the exercise by municipalities of their executive authority referred to in section 156(1).

2. Section 156(1): Powers and functions of municipalities.

(1) A municipality has executive authority in respect of, and has the right to administer—

(a) the local government matters listed in Part B of Schedule 4 and Part B of Schedule 5; and

(b) any other matter assigned to it by national or provincial legislation.

3. Section 229(1), (2) and (3): Municipal fiscal powers and functions.

(1) Subject to subsections (2), (3) and (4), a municipality may impose—

(a) rates on property and surcharges on fees for services provided by or on behalf of the municipality; and

(b) if authorised by national legislation, other taxes, levies and duties appropriate to local government or to the category of local government into which that municipality falls, but no municipality may impose income tax, value-added tax, general sales tax or customs duty.

(2) The power of a municipality to impose rates on property, surcharges on fees for services provided by or on behalf of the municipality, or other taxes, levies or duties—

(a) may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour; and

(b) may be regulated by national legislation.

(3) When two municipalities have the same fiscal powers and functions with regard to the same area, an appropriate division of those powers and functions must be made in terms of national legislation. The division may be made only after taking into account at least the following criteria:—

(a) The need to comply with sound principles of taxation.

(b) The powers and functions performed by each municipality.

(c) The fiscal capacity of each municipality.

(d) The effectiveness and efficiency of raising taxes, levies and duties.

(e) Equity.

…

4. Part A of Schedule 4: Functional Areas Of Concurrent National And Provincial Legislative Competence

PART A

Administration of indigenous forests
Agriculture
Airports other than international and national airports
Animal control and diseases
Casinos, racing, gambling and wagering, excluding lotteries and sports pools
Consumer protection
Cultural matters
Disaster management
Education at all levels, excluding tertiary education
Environment
Health services
Housing
Indigenous law and customary law, subject to Chapter 12 of the Constitution
Industrial promotion
Language policy and the regulation of official languages to the extent that the provisions of section 6 of the Constitution expressly confer upon the provincial legislatures legislative competence
Media services directly controlled or provided by the provincial government, subject to section 192
Nature conservation, excluding national parks, national botanical gardens and marine resources
Police to the extent that the provisions of Chapter 11 of the Constitution confer upon the provincial legislatures legislative competence
Pollution control
Population development
Property transfer fees
Provincial public enterprises in respect of the functional areas in this Schedule and Schedule 5
Public transport
Public works only in respect of the needs of provincial government departments in the discharge of their responsibilities to administer functions specifically assigned to them in terms of the Constitution or any other law
Regional planning and development
Road traffic regulation
Soil conservation
Tourism
Trade
Traditional leadership, subject to Chapter 12 of the Constitution
Urban and rural development
Vehicle licensing
Welfare services

6. Part B of Schedule 4: Functional Areas Of Concurrent National And Provincial Legislative Competence

PART B

The following local government matters to the extent set out in section 155(6)(a) and (7):

Air pollution	*Building regulations*	*Child care facilities*
Electricity and gas reticulation	*Fire-fighting services*	*Local tourism*
Municipal airports	*Municipal planning*	*Municipal health services*

Municipal public transport
Municipal public works only in respect of the needs of municipalities in the discharge of their responsibilities to administer functions specifically assigned to them under this Constitution or any other law
Pontoons, ferries, jetties, piers and harbours, excluding the regulation of international and national shipping and matters related thereto
Stormwater management systems in built-up areas
Trading regulations
Water and sanitation services limited to potable water supply systems and domestic waste-water and sewage disposal systems

7. Part A of Schedule 5: Functional Areas of Exclusive Provincial Legislative Competence

PART A

Abattoirs
Ambulance services
Archives other than national archives
Libraries other than national libraries
Liquor licences
Museums other than national museums
Provincial planning
Provincial cultural matters
Provincial recreation and amenities
Provincial sport
Provincial roads and traffic
Veterinary services, excluding regulation of the profession

8. Part B of Schedule 4: Functional Areas of Exclusive Provincial Legislative Competence

PART B

The following local government matters to the extent set out for provinces in section 155(6)(a) and (7):

Beaches and amusement facilities
Billboards and the display of advertisements in public places
Cemeteries, funeral parlours and crematoria
Cleansing
Control of public nuisances
Control of undertakings that sell liquor to the public
Facilities for the accommodation, care and burial of animals
Fencing and fences
Licensing of dogs
Licensing and control of undertakings that sell food to the public
Local amenities
Local sport facilities
Markets
Municipal abattoirs
Municipal parks and recreation
Municipal roads
Noise pollution
Pounds
Public places
Refuse removal, refuse dumps and solid waste disposal
Street trading
Street lighting
Traffic and parking

ANNEXURE G

BINDING GENERAL RULING (VAT) NO: 4

DATE: 21 January 2010
ACT : VALUE-ADDED TAX ACT, NO. 89 OF 1991 (the VAT Act)
SECTION : SECTION 1 – DEFINITION OF "INPUT TAX" AND SECTION 17(1)
SUBJECT : APPORTIONMENT METHODOLOGY TO BE APPLIED BY CATEGORY A MUNICIPALITIES

1. Purpose

The purpose of this binding general ruling is to prescribe the apportionment method, as contemplated in section 17(1), that Category A[7] municipalities must use to calculate the amount of value-added tax (VAT) to be allowed as input tax in respect of the acquisition of goods or services for a mixed purpose.[8]

2. Background

The Small Business Tax Amnesty and Amendment of Taxation Laws Act, No. 9 of 2006, effected certain amendments to the VAT Act with the purpose of simplifying municipalities' accounting and tax records. As a result, certain supplies previously made by municipalities which were exempt or non-taxable for VAT purposes became taxable at the standard or zero rate after 1 July 2006.

The effect of the amendments is that the activities of a municipality fall within the scope of paragraph (*a*) of the definition of "enterprise" in section 1. The amendments therefore fundamentally broadened the scope of taxable supplies made by a municipality. A municipality is now treated for VAT purposes in more or less the same manner as any other vendor.

3. The law and its application

The statutory framework [i.e. the definition of "input tax" in section 1] requires the principle of "direct attribution" to be applied, in that VAT must be attributed in the first instance according to whether it is wholly related to the making of taxable supplies or wholly to the making of exempt or out of scope supplies. VAT that cannot be attributed must be allocated to a mixed purpose.

A municipality, being a vendor, may deduct the full amount of the VAT incurred on the acquisition of goods or services, as input tax, where the acquisition is wholly for the purpose of consumption, use or supply in the course of making taxable supplies and may not deduct the VAT incurred on the acquisition of goods or services, as input tax, where the acquisition is for the purpose of consumption, use or supply in the course of making wholly exempt or wholly out of scope supplies[9]. The VAT incurred on the acquisition of goods or services where the acquisition is for a mixed purpose may also be deducted as input tax to the extent determined in accordance with an approved apportionment method as contemplated in section 17(1).

4. Ruling

4.1 Category A municipalities must use the turnover-based method of apportionment to calculate the amount of VAT to be deducted as input tax in respect of the acquisition of goods or services for a mixed purpose.

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[7] A "Category A Municipality" is a municipality that has the exclusive authority to administer and make rules in its area being the "metropolitan area".

[8] For purposes of this document the acquisition of goods or services partly for the purpose of consumption, use or supply in the course of making taxable supplies and partly for another intended use will be referred to as a "mixed purpose".

[9] An out-of-scope supply refers to a supply that is made by a municipality that is neither in the course or furtherance of that municipality's enterprise nor is it an exempt supply. This term is also synonymous with the term "non-supply", for example dividends and statutory fines.

4.2 The apportionment formula (the Formula) to be applied to determine the amount of input tax contemplated in **4.1** is as follows:

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

Where:
"y" = the apportionment 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, for example, income received in respect of out of scope supplies).

Notes:
1. The term "value" excludes any VAT component.
2. "c" in the Formula will typically include, but not limited to, items such as dividends and statutory fines (if any).
3. Exclude from the calculation the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease[10] or instalment sale agreement).
4. Exclude from the calculation the value of any goods or services supplied where input tax on those goods or services was specifically denied.
5. The apportionment percentage should be rounded off to 2 decimal places.
6. Where the Formula yields a result equal to 95% or more, the full amount of VAT incurred for a mixed purpose may be claimed (the *de minimis* rule).

4.3 Category A municipalities, for purposes of determining the amounts to be included in the Formula, are required to comply with the following arrangements:

4.3.1 A grant that is received for purposes of making mixed supplies must be attributed accordingly. For example, if 30% of a grant is for subsidising the municipality's public transport business, which is an exempt supply, and 70% is for subsidising the supply of water and electricity to customers, which is a taxable supply, the grant will have to be split under section 10(22). Therefore, 30% of the grant will be applied for exempt supplies and will therefore be included in "*b*" in the Formula, and the remaining 70% will be subject to VAT at the zero rate and will therefore be included in "*a*" in the Formula.

4.3.2 Category A municipalities are required to re-calculate the apportionment percentage based on the actual attribution of all grants, within three months after their financial year end, which may result in an increase or decrease to input tax. A Category A municipality that is unable to perform the re-calculation within the stipulated timeframe must approach the South African Revenue Service (SARS) to request an extension.

4.3.3 The assignment of functions by national or provincial government falls within the ambit of the "enterprise" activities carried on by that municipality, provided that the activity does not fall within the ambit of section 12. Any consideration charged, must be included in "*a*" in the Formula. Any payment received as a result of the national or provincial government providing financial assistance to enable the Category A municipality to carry out the assigned activity is regarded as a "grant" as defined and must be included in "*a*" in the Formula.

4.3.4 The activities in respect of which Category A municipalities are appointed as agent by provincial government do not fall within the ambit of the enterprise carried on by Category A municipalities. Only the amount charged in respect of the taxable supply of such agency service to provincial government must be included in "*a*" in the Formula.

[10] Means paragraph (*b*) of the definition of "*instalment credit agreement*" in section 1.

4.3.5 Interest earned on, for example, investing surplus funds or overdue accounts, must be included in "*b*" the Formula.

4.4 The VAT incurred and paid for directly on the supply of goods or services associated with provincial government mandates, referred to as "unfunded mandates", is regarded as being incurred in the course or furtherance of that municipality's enterprise, provided that the provincial government mandate activity is not exempt in terms of section 12. The VAT may be deducted in full where incurred wholly for purposes of use, consumption or supply in the course of making taxable supplies or deducted in accordance with the formula if incurred for mixed purposes, subject to sections 16(2), 16(3), 17 and 20.

4.5 Category A municipalities are required to exclude the value of the supply of capital goods or services (unless supplied under a rental agreement/operating lease) and the value of the supply of goods or services where input tax was specifically denied. The value of all other taxable supplies, exempt supplies and non-supplies must be included in the Formula.

5. Period for which this ruling is valid

This ruling is a binding general ruling issued in accordance with section 76P of the Income Tax Act, No. 58 of 1962, as made applicable to the VAT Act by section 41A. This binding general ruling is valid until 31 June 2014.

Any ruling issued to Category A municipalities approving a method of apportionment other than that which is confirmed in this ruling, is hereby withdrawn. The effective date of withdrawal is 1 July 2010.

Legal and Policy Division
SOUTH AFRICAN REVENUE SERVICE

ANNEXURE H

APPLICATION OF SECTION 40B

As a result of uncertainty in the past as to what constitutes a "*transfer payment*", some municipalities applied the zero rate of tax to the deemed supply which arose in terms of section 8(5) upon receipt of certain payments. In some of these cases, the incorrect application of the law (for example, by zero-rating supplies of actual goods and services) has been corrected by the Commissioner by the issuing of assessments and the amounts due on these assessments are wholly or partly outstanding. If the municipality approached the relevant government department which paid the "*transfer payment*" to obtain additional funds to pay the tax, it would result in a circular flow of funds in the government sphere.

The introduction of **section 40B(1)** was necessary so that the VAT consequences of the incorrect treatment of certain payments for supplies made before 1 April 2005 could be dealt with and furthermore, the provision is to reduce the circular flow of funds within government departments and various government agencies.

To qualify for the relief provided in section 40B, where goods or services were supplied on or before 31 March 2005, the supplier must at that time have qualified as a "*local authority*" as defined in section 1 prior to the deletion of that definition by the Small Business Amnesty and Amendment of Taxation Laws Act, 2006. The entity must have an existing or potential liability for VAT in accordance with the specific conditions contained in sub-paragraphs 40B(2) or (3), which are discussed below.

The first part of **section 40B(2)** deals with the situation where, on or before 31 March 2005, the Commissioner raised an assessment for the VAT which should have been charged by that local authority at the standard rate in terms of section 7(1)(*a*) on a payment for a taxable supply, but instead, that local authority incorrectly applied the zero rate in terms of sections 8(5) and 11(2)(*p*). This is where the local authority acted on the assumption that the payment was a "*transfer payment*" as defined in section 1 prior to the deletion of that definition by the Small Business Amnesty and Amendment of Taxation Laws Act.

Any local authority/municipality which has had an assessment raised against them, may apply in writing to the Commissioner to reduce the assessment for the tax period concerned. If all the conditions in the section are met, the Commissioner **must** reduce the assessment accordingly.

The specific liability which may be reduced, is the total amount of tax, additional tax, penalty or interest which has arisen directly as a result of any assessment which was issued by the Commissioner in respect of the supplies referred to in sections 40B(1) and (2), which were incorrectly regarded as being in respect of a zero-rated "transfer payment".

For example, the reduced assessment will not apply where –

- the VAT declared on the VAT 201 return was merely not paid, or was paid late; or
- there was a failure to submit a VAT 201 return and as a result, an estimated assessment was issued in respect of that tax period; or
- an assessment was issued because output tax was under-declared for any reason other than the one mentioned in section 40B(2), or if the input tax was overstated in respect of any tax period.

The provision applies only to the net balance of any tax, additional tax, penalty or interest on 31 March 2005 which remains payable in respect of the incorrectly-treated payments referred to in sections 40B(1) and (2). It does not apply to any amount assessed in this regard which has already been paid or otherwise recovered by the Commissioner. This includes debt which was set off (or which could have been set off) against refund credits, arising in another tax period.

The application of the reduced assessment may not have the effect that the local authority or municipality obtains a refund of any tax (including additional tax, or any amount allocated to penalty or interest) for any period prior to 1 April 2005 to which the assessment relates.

Where a part of, or the entire debt, has been paid or otherwise recovered by the Commissioner, that amount will not be added back before calculating the amount of the reduced assessment. This is because the proviso to this section clearly states that the application of this provision may not result in a refund to that local authority or municipality. This means that the balance of existing credits in any other tax period must first be transferred to the tax period in which the debt exists so that it reduces the outstanding debt, before applying the provisions of section 40B(2).

However, where the Commissioner has not issued an assessment for the tax liability concerned, which would otherwise be recoverable from the local authority, **section 40B(3)** ensures that the Commissioner may no longer raise an assessment in respect of the tax liability pertaining to those incorrectly treated payments with effect from 1 April 2005.

This means that an assessment may only be raised by the Commissioner on or after 1 April 2005 to recover the VAT payable on taxable supplies prior to 1 April 2005 in circumstances **other than** those covered by this provision.

For example, an assessment may still be raised by the Commissioner where–

- there was a failure to submit a VAT 201 return and as a result, an estimated assessment was issued in respect of that tax period; or
- an assessment was issued in respect of any tax period where the output tax was under-declared (other than in the specific circumstances provided for in section 40A(1)), or the input tax was overstated.

Section 40B(4) deals with the situation where the local authority has incorrectly treated a "*transfer payment*" as consideration for a taxable supply and has paid output tax to the Commissioner at the standard rate in terms of section 7(1)(*a*) instead of the zero rate in terms of sections 8(5) and 11(2)(*p*). In such cases, section 40B(4) will override the rules regarding refunds in sections 44(2) and (3), so that the local authority or municipality may not claim a refund of the output tax which it may consider as having been overpaid.

Example 1

A local authority (vendor) supplies management services to the Department of Tourism. VAT should have been charged at 14% in respect of the actual services supplied in terms of section 7(1)(*a)*, but both parties were under the mistaken impression that the payment received by the local authority was a zero-rated "*transfer payment*". The Commissioner raised an assessment against the local authority in the amount of R50 000 in March 2003. Since that date, the Commissioner has recovered R35 000 of that amount by offsetting VAT refunds due to that local authority. The local authority still has a VAT liability of R15 000 plus penalty and interest thereon as at 31 March 2005.

In terms of section 40B(2), the remaining tax liability of R15 000, plus the penalty and interest thereon must be reduced to nil by the issuing of a reduced assessment by the Commissioner, if written application is made by the local authority in this regard. This is because the entire tax liability relates to the incorrect application of the law referred to in that section.

Example 2

If in **Example 1**, the Commissioner had not raised an assessment by 31 March 2005 in respect of the VAT which should have been levied on the consideration paid for the management services supplied in terms of section 7(1)(*a*), the Commissioner may not make any assessment to correct the previously incorrect application of the zero rate after that date (section 40B(3)).

Example 3

A local authority receives an equitable share payment from the government (public authority), which was used in the course of making taxable supplies (free basic services (water and electricity)). Both parties were under the mistaken impression that the payment received by the local authority was a "*transfer payment*" and zero-rated the receipt of that payment in terms of section 11(2)(*p*), read with section 8(5). The Commissioner raised an assessment against the local authority at the standard rate of 14% in the May 2004 tax period. The Commissioner has not yet recovered any of the outstanding amount and the local authority still has an existing VAT liability of R258 000 plus penalty and interest thereon as at 31 March 2005.

In terms of section 40B(2), the full tax liability of R258 000, plus the penalty and interest thereon must be reduced to nil by the issuing of a reduced assessment by the Commissioner, if written application is made by the local authority in this regard. This is because the entire tax liability relates to the incorrect application of the law referred to in section 40B(2).

Example 4

If the local authority in **Example 3** above had correctly declared VAT at the standard rate of 14% on the receipt in terms of section 7(1)(*a*), it will not be entitled to claim back the VAT paid to the Commissioner (section 40B(4)).

CONTACT DETAILS

The SARS website contains contact details of all SARS branch offices and border posts.

Contact details appearing on the website under “Contact Us” (other than branch offices and border posts) are reproduced below for your convenience.

SARS Head Office

Physical Address
South African Revenue Service
Lehae La SARS
299 Bronkhorst Street
Nieuw Muckleneuk
0181
Pretoria

Postal Address
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Pretoria
0001
South Africa

SARS website
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Telephone
(012) 422 4000

SARS Fraud and Anti-Corruption hotline
0800 00 28 70

SARS Large Business Centre (LBC) Head Office

Physical Address
Megawatt Park
Maxwell Drive
Sunninghill
Johannesburg

Postal Address
Private Bag X170
Rivonia
2128
South Africa

Telephone
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email
LBC@sars.gov.za

For the contact details of each LBC sector go to “Contact Us” on SARS’ website the go to “SARS Large Business Centre”.

SARS Service Monitoring Office

Telephone
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National Call Centre

Please note:

- All the e-mail addresses and fax numbers displayed below **are** routed to the central SARS National Call Centre.
- If you are **not** a tax practitioner, and you have eFiling queries, you can contact the channel for the specific tax type you are dealing with (for example, VAT, PAYE, Income Tax etc) for assistance.

Query Type	Telephone	Fax	email
Income Tax	0800 00 7277	031 328 6011 021 413 8901	*it.cc@sars.gov.za* *it.wc@sars.gov.za*
Value-Added Tax (VAT)	0800 00 7277	021 413 8902	*vat.wc@sars.gov.za*
Pay As You Earn (PAYE)	0800 00 7277	031 328 6013	*paye.cc@sars.gov.za*
Tax Clearance Certificates	0800 00 7277	031 328 6048 021 413 8928	*tcc.kzn@sars.gov.za* *tcc.wc@sars.gov.za*
Customs: General	0800 00 7277	031 328 6017 021 413 8909	*customs.qry@sars.gov.za cqry.wc@sars.gov.za*
Tax Practitioners	0860 12 12 19	011 602 5049	*pcc@sars.gov.za*
Tax Practitioners: eFiling	0860 12 12 19	011 602 5312	*pccefiling@sars.gov.za*