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ALERT

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Securities lending arrangements: The VAT implications

The South African Revenue Service (SARS) published Binding General Ruling 62 (BGR 62) on 12 December 2022, in which it sets out its interpretation and application of the Value-Added Tax Act 89 of 1991 (VAT Act) for the lender in terms of a securities lending arrangement. BGR 62 comes into effect on 1 April 2023. The value added tax (VAT) implications of a securities lending fee as set out in BGR 62 are contrary to the VAT implications as previously set out in Practice Note 5/1999, which will be withdrawn from 1 April 2023. It is, however, arguable as to whether the interpretation and application of the VAT Act as set out in BGR 62 are correct.

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Under a securities lending arrangement, securities are transferred temporarily from the lender to the borrower. The borrower is obliged to return the same kind and number of securities at the end of the agreed term. Title to the securities is transferred to the borrower (as in a sale) during the lending period. The reference to it being a "*lending*" transaction is therefore somewhat misleading. The borrower is required to place either cash or other securities with the lender as collateral to cover the risk of default by the borrower. The borrower undertakes to pay to the lender an amount equal to the dividend or interest it receives on the securities during the loan term (manufactured dividends or manufactured interest) and a lending fee.

Practice Note 5

Practice Note 5/1999 implies that a securities lending arrangement comprises the transfer of a debt security, an equity security or the provision of credit as envisaged by section 2(1)(c), (d) or (f) of the VAT Act and is exempt from VAT under section 12(a). It stipulates that the fee payable by the borrower to the lender falls within the ambit of the proviso to section 2(1), and as such the fee is subject to VAT. It stipulates further that a "*manufactured dividend*" or "*manufactured interest*" constitutes consideration for the supply of a financial service, and does not constitute a fee, commission or similar charge as contemplated in the proviso. As such, these payments are exempt from VAT.

BGR 62

BGR 62 stipulates that securities lending arrangements constitute the provision of credit as envisaged in section 2(1)(f), the supply of which is exempt under section 12(a). In substantiation for this view, BGR 62 states that the transfer of ownership of the security is necessary to give effect to the provision of money's worth as contemplated by section 2(1)(f). The transfer of

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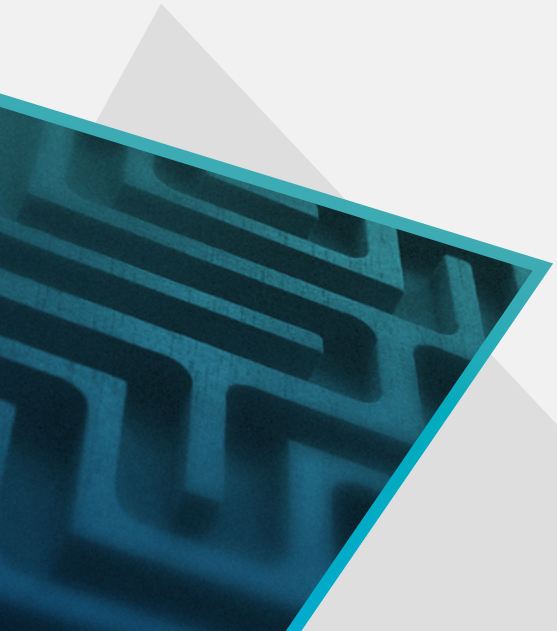

ownership of the securities are on this basis considered to be part of the activity envisaged under section 2(1)(f) and is not an independent cognisable supply of goods in the form of the security. This also applies to the return of the security or instrument at the end of the lending period.

It seems therefore that SARS is of the view that the transfer of the securities between the lender and borrower are exempt from VAT under section 2(1)(f), being the provision of credit, as opposed to section 2(1)(c) (transfer of a debt security) or section 2(1)(d) (transfer of an equity security).

Regarding the securities lending fee, BGR 62 states that this fee does not relate to any other service forming part of the activity of the securities lending arrangement, but only for the use of the security during the period. It concludes on this basis that the proviso to section 2(1) does not apply to the securities lending fee and such fee is consequently consideration for an exempt supply.

The legal position

Section 2(1)(f) applies to the provision of credit under an agreement by which money or money's worth is provided by a person to another person, and the latter agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth. Such activity is deemed to be a financial service, the supply of which is exempt under section 12(a).

Although one can consider the transfer of the security to the borrower as comprising the provision thereof, and it has a monetary value on the date of transfer, it does not mean that credit in the form of money's worth has been provided. The monetary value of the securities is not stated in the lending agreement, the lender is not required to provide securities of a specified monetary value, and the borrower is under no obligation to return securities of a specified value. The value of the securities fluctuates throughout the term of the agreement, and the borrower is only obliged to return a stated number of securities.

It is arguable as to whether the undertaking to return a specified number of securities comprise an agreement to *"pay"* a *"sum"* as envisaged by section 2(1)(f). In any event, there is no obligation that such *"sum"* must exceed the value of the securities transferred by the lender. The transfer of the securities to the borrower is exempt from VAT under section 2(1)(c) (debt securities) or 2(1)(d) (equity securities). However, it is somewhat academic as to whether the transfer falls under section 2(1)(f) or sections 2(1)(c) or (d), because it is exempt from VAT under all these provisions.

The proviso to section 2(1) provides that the activities contemplated in, amongst others, section 2(1)(c), (d) and (f) are deemed not to be financial services to the extent that the consideration payable in respect thereof is any fee, commission or a similar charge.

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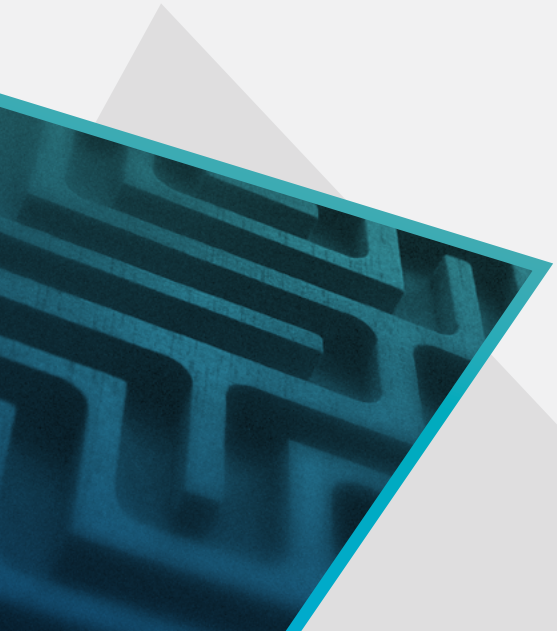

The question that arises, is whether the ruling in BGR 62 that the securities lending fee is consideration for an exempt supply, and that it falls outside the scope of the proviso to section 2(1), is correct.

The intention of the proviso to section 2(1), which was introduced following the recommendations of the Katz Commission, is to tax fees and commissions for providing the services as specified in section 2(1)(c), (d) and (f). The securities lending agreement specifically refers to the amount payable by the borrower as being a "*fee*". This fee is charged for providing the securities under the securities lending agreement and would thus fall within the ambit of the proviso to section 2(1).

The Supreme Court of Appeal held in the case of *Commissioner for the South African Revenue Service v Tourvest Financial Services (Pty) Ltd* (435/2020) [2021] ZASCA 61 (Tourvest) that the proviso creates a mixed supply out of the identified activity, and the effect of the proviso is to add a taxable element to what is, and at its core remains, an exempt financial service. It therefore turns the activity into a partly exempt and a partly taxable supply. The ruling in BGR 62 that the securities lending fee does not fall within the proviso to section 2(1) seems to be contrary to the principles laid down in the Tourvest judgment.

BGR 62 stipulates that a manufactured dividend or manufactured interest comprises consideration for a VAT exempt supply, which is exempt from VAT.

Status of BGR 62

Binding general rulings are issued by SARS on matters of general interest or importance and clarifies the Commissioner's application or interpretation of the relevant tax law relating to these matters. They are binding on SARS but not on the taxpayer. A binding general ruling is an "*official publication*" as defined in the Tax Administration Act, 28 of 2011 (TAA), and the application of the tax act as stated therein comprises a "*practice generally prevailing*" as envisaged by section 5(1) of the TAA. SARS is, therefore, in terms of section 99(1)(d) of the TAA precluded from raising an additional assessment if the original return was submitted in accordance with the practice generally prevailing.

Conclusion

The transfer of the underlying securities under a securities lending transaction, is exempt from VAT. There may be a debate as to under which section of the VAT Act the exemption applies. There is no dispute that the payment of manufactured dividends or manufactured interest is exempt from VAT, being consideration for the supply of an exempt financial service. However, it is arguable that the securities lending fee is subject to VAT, which is contrary to what is stated in BGR 62.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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