29 May 2017

The South African Revenue Service
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BY EMAIL: policycomments@sars.gov.za

RE: Draft interpretation note on the VAT treatment of supplies of international and ancillary transport services

We write to comment on the draft interpretation note on the Value-Added Tax (VAT) treatment of supplies of international and ancillary transport services.

A. Background

The draft interpretation note sets out the VAT treatment of the international transportation of passengers and/or goods and ancillary transport services. Practice Note 10, which was issued on 1 October 1991, and has since been withdrawn, dealt with the international transportation of goods and related activities. It did not deal with the international transportation of passengers.

B. International transport of passengers

The international transport of passengers is a complex area which is governed by various rules. We recommend that the interpretation note should deal with the international transport of passengers in more detail and provide our comments below. The interpretation followed by the airlines, which is embedded in their systems, should be adequately taken into consideration.

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In considering the VAT treatment of international transport of passengers, cognisance should be taken of the differences between the rules governing the transport of passengers and the rules governing the transport of goods. The VAT legislation also makes certain distinctions. The ruling errs by applying the standard rules for zero-rated exports to this specialised area. In terms of determining whether something is "exported" under **section 11(1)(a),** one needs to follow the OECD VAT/GST Guidelines. In this case, a step-by-step approach is taken as performed in the interpretation note. Hence, the domestic leg would not be viewed as an export under this analysis. The problem here is that this step-by-step analysis does not apply because we are talking about "international carriage", which is an entirely different concept than "exports" (which focuses on the location of the immediate buyer). In the case of international carriage, one must look to the trip as a whole as indicated below. In this regard, it is often helpful to look at the transport arrangement from the point of view of the passenger, rather than the various parties involved in rendering the transport service.

a. Airline industry context

The **Convention for the Unification of certain rules relating to international carriage by air**[1], commonly known as the **Warsaw Convention**, is an international convention which regulates liability for international carriage of persons, luggage, or goods performed by aircraft for reward. The convention provides for the unification of certain rules relating to international carriage by air and the Republic of South Africa is one of the signatories to this convention. The unification of the rules under the convention is applied to all the countries who are signatories to this convention and the airlines operating within these countries.

Given the importance of the unification rules in the global airline industry, it is very important that adequate consideration should be taken of the Convention and international authority thereon. The interpretation of the term "international carriage" as defined in the Convention is key to the interpretation of the sections that deal with the international transport of passengers.

[1] Wikipedia accessed 28 May 2017

In terms of Article 1 of the Convention[2]:

(1) This Convention applies to all international carriage of persons, baggage or cargo performed by aircraft for reward. It applies equally to gratuitous carriage by aircraft performed by an air transport undertaking.

(2) For the purposes of this Convention, the expression "international carriage" means any carriage in which, according to the agreement between the parties, the place of departure and the place of destination, whether or not there be a break in the carriage or a transhipment, are situated either within the territories of two States Parties, or within the territory of a single State Party if there is an agreed stopping place within the territory of another State, even if that State is not a State Party. Carriage between two points within the territory of a single State Party without an agreed stopping place within the territory of another State is not international carriage for the purposes of this Convention.

(3) Carriage to be performed by several successive carriers is deemed, for the purposes of this Convention, to be one undivided carriage if it has been regarded by the parties as a single operation, whether it had been agreed upon under the form of a single contract or of a series of contracts, and it does not lose its international character merely because one contract or a series of contracts is to be performed entirely within the territory of the same State.

To understand the principle of international carriage, it is important to take into consideration that various airlines across the world enter into **code-sharing agreements** and **interline agreements** to make it possible for the passengers from different territories within a country to fly to different countries and to the different territories within those countries. The Convention facilitates the smooth flow of international travelling and removes the possible complexities that may arise in different ways and in different countries. The **Global Distribution Systems (GDS)** worldwide are developed based on the principles of the Convention and the unification rules to cater for the international travelling by all the airlines globally.

[2] Convention for the Unification of certain rules relating to international carriage by air accessed 14 May 2017

A **codeshare agreement**[3], also known as **codeshare**, is an aviation business arrangement where two or more airlines share the same flight. Sharing, in this sense, means that each airline publishes and markets the flight under its own airline designator and flight number as part of its published timetable or schedule. A seat can be purchased on each airline's designator and flight number, but is operated by only one of these cooperating airlines, commonly called the operating carrier… Under a code sharing agreement, the airline that administrates the flight (the one holding the operational permissions, airport slots and planning/controlling the flight and responsible for the ground handling services) is commonly called the *operating carrier*, …The reason for this is that a third carrier is involved, typically in the case that the airline originally planning to operate the flight needs to hire a subcontractor to operate the flight on their behalf (typically a wet lease, meaning an aircraft is leased with crew and all facilities to fly, commonly due to capacity limitations, technical problems etc.) In this case, the airline carrying the passenger should be designated the operating carrier, since it is the one carrying the passengers/cargo.

Interlining[4], also known as **interline ticketing** and **interline booking**, is a voluntary commercial agreement between individual airlines to handle passengers traveling on itineraries that require multiple flights on multiple airlines. Such agreements allow passengers to change from one flight on one airline to another flight on another airline without having to gather their bags or check-in again.

A **global distribution system (GDS)**[5] is a network operated by a company that enables automated transactions between travel service providers (mainly airlines, hotels and car rental companies) and travel agencies. Travel agencies traditionally relied on GDS for services, products & rates in order to provision travel-related services to the end consumers. A GDS can link services, rates and bookings consolidating products and services across all three travel sectors: i.e., airline reservations, hotel reservations, car rentals.

[3] Wikipedia accessed 28 May 2017
[4] Wikipedia accessed 28 May 2017
[5] Wikipedia accessed 28 May 2017

b. Relevant VAT legislation and SARS interpretation

The VAT treatment of the supply of international passenger transport services is dealt with in sections 11(2)(a) and (b) as follows:

- **Section 11(2)(a)** zero-rates the international transport services of passengers;
- **Section 11(2)(b)** zero-rates the domestic transport services of passengers to the extent that the transport is by aircraft and constitutes "international carriage" as defined in Article 1 of the Convention.

According to the preamble to the draft interpretation note, unless the context indicates otherwise-

"International transport services" comprises the transportation of passengers … from a place–

- *Outside the RSA to another place outside the RSA; or*
- *In the RSA to a place in an export country; or*
- *In an export country to a place in the RSA*

"Domestic transport services" relates to the supply of transport services from a place in the RSA to another place in the RSA

Paragraph 3.2.1. of the draft interpretation note states that:

The supply of international transport services of passengers…by any mode of transport is zero-rated under section 11(2)(a).

Paragraph 3.2.2 states that:

The domestic leg of an international passenger flight must be zero-rated under section 11(2)(b), to the extent that the supply constitutes "international carriage" as defined in the Convention. This is for example where an international flight includes a domestic flight. That is the supplier of the international passenger flight also supplies the customer with a domestic passenger flight.

According to example 1 – domestic carriage:

Facts:
Passenger X is flying to London (England) and purchases an air ticket from Airline C (vendor) for the flight from Cape Town to Johannesburg, and an air ticket from Airline A (vendor) for a flight from Johannesburg to London.

The result given is that:
Airline C is supplying a domestic passenger flight to Passenger X and VAT at the standard rate must be levied. The zero rate is not applicable as Airline C is not contractually supplying the domestic leg of an international passenger flight.
Airline A is supplying an international transport service from Johannesburg to London to Passenger X and VAT at the zero rate must be levied under section 11(2)(a)(ii).

According to example 2 – international carriage:

Facts:
Passenger X is flying to London (England) and purchases an air-ticket from Airline A (vendor) for the flight from Cape Town to London. Airline A contracts with Airline C (vendor) to fly Passenger X from Cape Town to Johannesburg, from where Airline A flies Passenger X to London. What is the VAT treatment of the passenger flights?

The result given is that:

Airline C is supplying a domestic passenger flight to Airline A and VAT at the standard rate must be levied. The zero rate is not applicable as Airline C is not contractually supplying the domestic leg of an international passenger flight. Airline A is supplying an international transport service, which incorporates a domestic leg, to Passenger X, originating at a place in the RSA (Cape Town) and ending in an export country (London). Airline A must charge VAT at the zero rate under section 11(2)(a)(ii) and section 11(2)(b) respectively.

The following interpretations appear to be applied in the examples:

- Where an airline is supplying a domestic flight to a passenger (rather than contractually supplying the domestic leg of an international flight to a passenger) the supply must be **standard rated**, even if the passenger has booked an onward international flight with another airline.

- Where an airline is supplying a direct international flight to a passenger, the supply must be zero rated under **section 11(2)(a).**

- Where an airline is supplying an indirect international flight to a passenger, the supply must be zero-rated under **section 11(2)(a)** for the international leg and under **section 11(2)(b)** in respect of the domestic leg (even if the airline has contracted with another airline to fly the passenger on the domestic leg).

- Where an airline is supplying a domestic passenger flight to another airline to fly the passenger on behalf of such other airline as part of the indirect international flight, the **zero rate is not applicable** as the airline is not contractually supplying the domestic leg of an international passenger flight.

We agree with some but not all these interpretations and expand on this comment below.

c. Questions for further consideration and clarification

Sub-contracting:

Section 11(2)(a) zero-rates the supply of a service that comprises the transport of passengers from:

(i) A place outside the Republic to another place outside the Republic; or

(ii) A place inside the Republic to a place in an export country; or

(iii) A place in an export country to a place in the Republic;

It is clear that if Planet Air sells a ticket to a passenger and flies the passenger directly from South Africa (say ORTIA) to an international destination (say Dubai UAE) that the section 11(2)(a) zero-rating would apply to the supply to the passenger. What is not clear is whether section 11(2)(a) would also apply if Planet Air sells a ticket to a passenger and subcontracts Moon Air to fly the passenger directly from ORTIA to Dubai.

The one question is whether **section 11(2)(a)** would apply to the supply by Planet Air to the passenger. We think that the supply by Planet Air to the passenger should be zero-rated under **section 11(2)(a)** as the service by Planet Air to the passenger is an international transport service of a passenger, even though Planet Air sub-contracts with Moon Air to fly the passenger. This would be in line with the interpretation followed in relation to goods under point 3.2.3(a).

The other question is whether **section 11(2)(a)** would apply to the supply by Moon Air to Planet Air. We think that the supply by Moon Air to Planet Air should be zero-rated under **section 11(2)(a)** as the service by Moon Air to Planet Air is an international transport service of a passenger, even though Moon Air did not contract with the passenger. In other words, the service comprises the international transport of a passenger, as required.

Focus on service rather than contracting party:

Based on example 2, where an airline is supplying a domestic passenger flight to another airline to fly the passenger on behalf of such other airline as part of the indirect international flight, the **zero rate is not applicable** as the airline is not contractually supplying the domestic leg of an international passenger flight. We are not convinced of this interpretation. It is not clear to us why it is important that the airline must contractually supply the flight to the passenger. By way of example, Planet Air issues an international ticket under its airline code to a passenger to fly from Cape Town to Dubai, and Planet Air requests that Comet Air flies the passenger from Cape Town to Johannesburg and that Moon Air flies the passenger from Johannesburg to Dubai. In our view, the service rendered by Comet Air to Planet Air, comprises the domestic transport of a passenger, even though Comet Air did not contract with the passenger. Furthermore, it forms part of the "international carriage" of the passenger. In our view, since the ticket is issued to the passenger to fly an international air journey, Comet Air should issue an interline billing to Planet Air with VAT at the zero rate under **section 11(2)(b).**

Direct versus indirect flight:

Based on example 2, where an airline is supplying an indirect international flight to a passenger, the supply must be zero-rated under **section 11(2)(a)** for the international leg (Johannesburg to Dubai) and under **section 11(2)(b)** in respect of the domestic leg (Cape Town to Johannesburg). We are not convinced of this interpretation. We do not think that an indirect international flight should be broken up into a domestic flight and an international flight. International Carriage is effectively carriage based on an agreement between two or more parties which determines the place of departure (in one territory) and the place of destination (in another territory), whether or not there is a break in the carriage or a transhipment. "Carriage to be performed by several successive carriers is deemed, for the purposes of this Convention, to be one undivided carriage…and it does not lose its international character merely because one contract or a series of contracts is to be performed entirely within the territory of the same State." In our view, Planet Air should zero-rate the entire ticket to the passenger under **section 11(2)(a).**

Closeness of link required:

In example 1, it was indicated that where an airline is supplying a domestic flight to a passenger (rather than contractually supplying the domestic leg of an international flight to a passenger) the supply must be **standard rated**, even if the passenger has booked an onward international flight with another airline. Questions not considered are whether the result would have been different if the ticket was part of an itinerary or arrangement leading to international air transport or formed part of, or was cross-referenced to, a ticket for international air transport when the arrangement was made. In this regard, the impact of the sophisticated GDS systems should be considered.

Conclusion:

We are of the view that in determining whether air transport of passengers is "international carriage" the contractual arrangements between all the parties read together are relevant to determine whether the service meets the requirements. Once it has been established that the transport of the passengers is "international carriage" we do not think it should make a difference which airline sold the ticket. Each service of flying the passenger should be zero rated, even if the service is rendered by one airline to another. Given the very complex arrangements and systems in the airline industry and the fact that they are governed by the Convention and unification rules, we recommend that due cognisance should be taken of the interpretation currently followed by the airlines before the interpretation note is finalised.

C. Services of insuring, arranging insurance or arranging international transport of passengers

Section 11(2)(d) zero-rates, inter alia, the insuring or the arranging of the insurance or the arranging of the transport of passengers to which **section 11(2)(a) or (b)** applies.

Paragraph 3.2.4 states that:

A vendor who is contracted to arrange the international transportation of passengers…may zero-rate the supply under section 11(2)(d). The zero-rating of the arranging service in section 11(2)(d) will only apply if the international transport services being arranged are transport services to which any of the provisions of section 11(2)(a), (b)…apply.

Examples 11 and 12 relate to the arranging of international transport services of goods. We recommend that examples should also be included which relates to the arranging of international transport services of passengers. Examples that are based on the experiences of insurers, insurance brokers and travel agents should be helpful to provide certainty to the industry.

D. Directly in connection with

This phrase is used in a number of the section 11(2) provisions, including in section 11(2)(e) where it is a requirement that "the service comprise the transport of goods or any ancillary transport services supplied directly in connection with the exportation from or the importation into the Republic of goods or the movement of goods through the Republic…"

"Directly in connection with" is not defined. Determining the precise meaning and ambit of the phrase has caused considerable difficulty in a number of jurisdictions where it has been the subject of much litigation and statements issued by fiscal authorities (See ATO GSTR 2003/7 and NZ Rulings). This would be a good opportunity for to provide a more detailed interpretation of the phrase and to consider more contentious examples.

We welcome the opportunity to comment on the draft interpretation note and look forward to future engagements.

Yours sincerely

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