FINAL REPORT ON

VAT

FOR THE MINISTER OF FINANCE

Intended use of this document:

This report replaces the first report on VAT.

The Davis Tax Committee is advisory in nature and makes recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.

THE DAVIS TAX COMMITTEE

March 2018

Dear Minister

We, as the Members of the Davis Tax Committee, have the honour and privilege to provide you with this report which has been:

Prepared by:

Judge Dennis Davis (Chairperson)		12/3/2018
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Reviewed and supported by:

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And the following ad hoc Members:

Aleweyah Price (Old Mutual)

Anne Bardopoulos (Deloitte)

Gerhard Badenhorst (ENS)

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And the Secretariat for the Davis Tax Committee

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1. Terms of reference

The terms of reference of the Davis Tax Committee (DTC), as announced by the Ministry of Finance in July 2013, in general require the Committee "*to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability*", and in particular as it relates to value-added tax ("VAT"), to give specific attention to:

> "*5. …efficiency and equity. In this examination, the advisability and effectiveness of dual rates, zero rating and exemptions must be considered*".

2. VAT Sub- Committee

The Committee appointed a sub-committee of its members and ad hoc members to consider the terms of reference referred to above.

The VAT Sub-Committee comprised Judge Dennis Davis (Chair of the Committee), Professor Ingrid Woolard (Member), Mr Cecil Morden (Ex-officio Member and the following Ad Hoc Members:

- Des Kruger
- Gerhard Badenhorst
- Lesley O'Connell
- Mpho Legote
- Aleweyah Price
- Anne Bardopoulos

3. **Submissions and comments on first report**

In compiling its First Interim Report on VAT, the DTC requested written submissions relating to VAT by way of a media statement dated 3 June 2014. and the DTC received 29 submissions from the individuals and organisations as listed in Annexure A. Should the public require access to the submissions, the relevant party should be approached directly for a copy thereof.

The DTC's First Interim Report on VAT was submitted to the Minister of Finance on 30 December 2014 and subsequently published on the DTC's website for public comment on 7 July 2015. The Committee received 13 sets of comments from interested parties (Annexure A).

The Committee thanks all parties who provided submissions and comments and appreciates the effort and time taken by these parties in putting forward their issues and proposing recommendations. The submissions and comments have been taken into account in this final report which replaces the first report on VAT.

4. Executive Summary

4.1 Taxpayer compliance: The VAT gap

It has been noted[1] that tax gaps exist in all economies, and South Africa is no exception. Essentially the tax gap in the VAT environment is the difference between the tax that is due under the VAT law, and the amount of actual tax collected. The magnitude of the gap "*can be seen as an indicator of the effectiveness of VAT enforcement and compliance measures, as it arises as a consequence of revenue loss through cases of fraud and evasion, tax avoidance, bankruptcies, financial insolvencies as well as miscalculations*".[2]

The IMF report on the VAT gap in South Africa for the period 2007 to 2012[3] identifies four important related gap indicators, namely the compliance gap, assessment and collection gap, VAT policy gap and the c-efficiency ratio. The findings of the report are as follows.

The estimated **compliance gap** for VAT in South Africa between 2007 and 2012 is hump-shaped. The compliance gap is estimated to be between 5 percent and 10 percent of potential VAT revenues during the period 2007-12, and peaking in 2008 and 2009. The compliance gap increased to 10 percent of potential revenue in 2009, when the global financial crisis severely hit the South African economy but has since gradually decreased to the same level as 2007, namely 6%. The level of calculated gaps is generally consistent with internal estimates by SARS using a demand approach between 2007 and 2012.

The **policy gap** shows the efficiency of VAT policy structure by calculating the difference between theoretical revenue given a hypothetical, 'ideal' policy framework and potential revenue given the current policy framework. The policy gap is calculated to be between 27 percent and 33 percent during the period of 2007 to 2012, while the average of European countries is 41 percent. The level of the VAT policy gap in South Africa is low by international standards, owing to its simple VAT policy structure.

The **collections gap** is the difference between actual VAT collections and the total amount of VAT declared or assessed as due from taxpayers, while the **assessment gap** is the difference between the amount of VAT declared or assessed and potential VAT. These two gaps correspond to the identified portion of the compliance gap (the collections gap) and the unidentified portion (the assessment gap). For the period from 2007 to 2012, the

[1] In the shade: Research on the UK's missing Economy, Tax Research UK, May 2014.

[2] *2012 Update Report to the Study to Quantify and Analyse the VAT Gap in the EU-27 Member States*, Centre for Social and Economic Research on behalf of European Commission, September 2014

[3] South Africa: Revenue Administration Gap Analysis Program - The Value-Added Tax Gap, International Monetary Fund, Fiscal Affairs Department, January 2015.

collections gap gradually grew, while the assessment gap first increased sharply and then fell back to less than its former level. The increase of the collections gap means that the differences between declared and assessed VAT and collected VAT have become wider year by year. It would naturally reflect a first-in-first-out procedure for late payments that prioritizes older tax liabilities, but there is a risk of increasing future uncollectible tax liabilities to the extent that it reflects a growing stock of outstanding taxpayers' arrears.

The **c-efficiency ratio** is an indicator that can be simply calculated from VAT revenues, the VAT standard rate and GDP final consumption aggregates to indicate the overall efficiency of VAT revenue collections. It presents the ratio of actual VAT collections to the amount that would be collected under a perfectly enforced tax levied at the standard rate on overall final consumption. The average of c-efficiency ratios in South Africa between 2007 and 2013 is 63.6 percent, which is relatively high. This result is among the highest in Sub-Saharan African counties over the same period. The high c-efficiency ratio will be at least partly a result of South Africa's simple VAT legislation which has limited exempted and zero-rated goods and services. It may also suggest that the revenue administration in South Africa is relatively effective compared to its peer countries, and that the room for additional revenues mobilization by improvement of tax compliance and expanding tax base of VAT would be limited compared with other countries in the region.

The IMF report makes the following observations and suggests the following possible actions by SARS:

- SARS should continue to monitor the VAT compliance gap as a means of evaluating its performance, and to inform strategic decisions about tax;
- SARS should take the opportunity of the release of the supply-use tables in February 2015 to update its estimate of the VAT gap, and its sectoral composition;
- SARS could consider broadening its tax gap analysis to include other major taxes; and
- SARS should further integrate its revenue and national compliance analyses, to support systemic compliance risk management. There is more scope for more detailed revenue analysis of revenues from individual industry sectors and taxpayer segments to support strategic risk analysis.

The Committee **notes** the findings of the IMF Report and **encourages SARS** to adopt the recommendations of the IMF Report noted above.

4.2 Structural features: Zero-rating

In line with most VAT jurisdictions worldwide, certain so-called basic foodstuffs are zero rated in South Africa. It is clear that the zero rating of such basic foodstuffs, taken in isolation, addresses to some extent the regressivity of the VAT. However, there is clear evidence that this approach is not optimal from an economic efficiency perspective given that, in absolute terms, the concession is of significantly greater benefit to the more affluent households. Theoretically, it must always be better to rather collect the tax revenue and redistribute the additional income through a targeted transfer to the poor.

However, while the DTC is of the view that zero-rating is an extremely blunt and second-best instrument for addressing equity considerations, the DTC takes the view that it would be very difficult to eliminate the current zero-ratings. At best, it may be appropriate to consider only retaining those items that more clearly benefit the poor households, such as maize meal, brown bread, rice and vegetables, while withdrawing those items more clearly consumed by the more affluent households, such as fruit and milk.

The **strong recommendation** of the Committee is, however, that no further zero-rated food items should be considered.

4.3 Structural features: Dual (multiple) rates

The question of whether multiple rates would be appropriate for South Africa is also founded on equity considerations. There is a view that the goods and services consumed by the more affluent households should bear a higher VAT burden. There is no empirical evidence that suggests that higher rates on so-called luxury goods addresses in any meaningful way equity in the VAT system. There is instead clear evidence that multiple rates add significantly to the complexity and administrative burden of the tax. Importantly, high rates generally (except possibly in the case of motor vehicles) apply to goods that account for a relatively small proportion of total consumption.

In addition, the question of multiple rates cannot be divorced from the issue of excise duties. The fact of the matter is that a number of ‘so-called’ luxury goods (including passenger motor vehicles, cell phones, perfume, photographic equipment, etc.) presently bear an *ad valorem* excise charge, upon which VAT is once again levied. In essence, the imposition of *ad valorem* excise duties on a number of so-called luxury items addresses to some degree the equity concerns.

The Committee **recommends** that multiple rates not be adopted.

4.4 Exemptions

The taxation of financial services continues to challenge VAT design. While there does not seem to be any disagreement that the supply of financial services should be subject to tax when supplied to a final consumer, determining the consideration for that supply has proved to be elusive. The issue seems to be that in many instances no explicit charge is made for the supply of the financial service. While a very limited number of countries impose a type of proxy VAT, and a form of cash-flow VAT has been proposed, in most instances VAT jurisdictions exempt financial transactions. South Africa is no exception, albeit that it imposes VAT on most explicit charges made by financial institutions. The most important area identified for consideration is VAT cascading.

VAT cascading arises in consequence of the fact that a financial institution making exempt financial services is denied input tax relief in respect of VAT borne by it on the acquisition of goods and services from third parties. To the extent that the relevant financial services are supplied to businesses that themselves would have been entitled to input tax relief had the financial institution in effect on-charged the VAT paid by the financial institution, the VAT paid by the financial institution in effect becomes a cost.

In order to eliminate the incentive for financial institutions for vertical integration, and to eliminate or reduce the cascading effect of VAT under the current VAT exemption provisions, the following options have been considered in the South African context:

- The introduction of a self-supply taxing mechanism in terms of which the self-supply of goods or support services is subjected to VAT, by placing a specific value on these goods or services and requiring the financial institution to account for output tax on the value of the self-supply;
- Apply VAT at the rate of zero per cent to the supply of financial services in line with the options followed by New Zealand and Singapore, and which was followed by the province of Quebec in Canada;
- Allowing the financial institution to claim an input tax deduction or reduced input tax deduction on the goods or services it acquires from suppliers to supply financial services, i.e. similar to the Reduced Input Tax Credit (RITC) model followed in Australia;
- Providing financial institutions with the option to tax financial services supplies to taxable persons (i.e. vendors) who may claim the VAT as input tax;
- The introduction of VAT group registration; and

- The reinstatement of the exemption of intermediary services supplied to financial institutions.

After consideration of the various approaches adopted to mitigate VAT cascading in the financial services sector, the Committee is of the view that **the various approaches adopted in other jurisdictions should receive further urgent consideration by National Treasury and SARS.**

4.5 Place of Supply Rules

Explicit place of supply rules have been adopted in most jurisdictions so as to fix the place in which supplies are to be taxed and accounted for. Given the magnitude of cross-border trade, in particular cross-border services, generally accepted place of supply rules are necessary to prevent double taxation and non-taxation. The OECD has issued the *International VAT/GST Guidelines*[4] that seek to promote common place of supply rules.

While the South African VAT Act includes what may be referred to as, 'implicit rules', it does not contain the explicit general place of supply rules advocated in the OECD Guidelines. The adoption of internationally accepted explicit place of supply rules that are understood by both South African and foreign suppliers will enhance understanding of where VAT must be accounted for on cross-border supplies.

The Committee **recommends** that the VAT Act be amended to ensure the inclusion of clearly stated 'place of supply rules', specifically rules that are in harmony with the OECD Guidelines and which are supported and adhered to by other VAT jurisdictions.

4.6 E-Commerce

The new frontier for VAT is its application in an electronic commerce **("e-commerce")** environment, where the supply of electronic services across jurisdictional boundaries has given rise to many compliance challenges for governments. A significant number of foreign jurisdictions have sought to address this conundrum by adopting place of supply rules that apply specifically to e-commerce.

South Africa adopted its own rules, effective 1 June 2014 as regards the taxation of the supply of "*electronic services*" as defined from outside South Africa. These new rules have in the main been well received by commerce. Importantly, unlike the initial position adopted in

[4] International VAT/GST Guidelines, OECD, 2017

the OECD report, the South African rules do not presently explicitly provide for a distinction between supplies made between businesses, so-called business-to-business (B2B), and business-to-consumer (B2C), supplies.

The Committee **recommends** that a number of technical amendments be made as regards the definition of “electronic services”, while the Committee also **recommends** that a distinction be drawn between B2B and B2C supplies for the reasons advanced in Annexure D.

4.7 Macroeconomic impact of raising VAT

It is evident that an increase in the present standard rate of VAT (14%[5]) would be somewhat inflationary in the short-run. This is to be expected given that prices of standard-rated consumer items would rise overnight. In contrast, an increase in personal or corporate tax rates would be much less inflationary. While there would be a negative impact on real gross domestic product (GDP) and employment – particularly in the short-run – the impact of a VAT increase on these two variables would be far less severe than that of a rise in personal income tax (PIT) or corporate income tax (CIT). It is thus clear that from a purely macroeconomic standpoint, an increase in VAT is less distortionary than an increase in direct taxes.

However, an increase in VAT would have a greater negative impact on inequality than an increase in PIT or CIT. Should it be necessary to increase the standard rate of VAT, it will be important for the fiscus to think carefully about compensatory mechanisms for the poor who will be adversely affected by the increase. A range of measures should be considered, such as increases in social grants or the strengthening of the school nutrition programme.

4.8 Traditional Communities

Representations were received from the Royal Bafokeng Nation Development Trust ("**RBNDT**") regarding the VAT status of traditional communities such as the Royal Bafokeng Nation ("**RBN**"). In essence traditional communities such as the RBN previously accounted for VAT on the basis that they were "local authorities" as then defined in the VAT Act. The definition also included municipalities. The then definition of "transfer payment" did not include "grants" made to local authorities by government, and as such the grants did not qualify for zero-rating under the VAT Act.

[5] Since compiling this report, the Minister of Finance announced in his 2018 Budget Speech that the VAT rate will increase to 15% from 1 April 2018.

The VAT Act was amended with effect from 1 July 2016 so as to simplify the treatment of various payments made to and from local authorities. The definition of local authority was replaced by "municipality" and the VAT Act further amended to zero rate "grants" made by, *inter alia*, municipalities in the course or furtherance of their enterprise activities and any "municipal rate" imposed by a municipality. In consequence of the amendment to the definition of "municipality", traditional communities were no longer treated on the same favorable basis as municipalities

RBNDT makes a compelling argument that traditional communities that operate on the same basis as municipalities should be treated on the same basis as municipalities, and the Committee **recommends** that the VAT Act be amended to place traditional communities who operate similarly to a municipality on the same footing as municipalities.

5. Introduction

The VAT is a modern tax with the first VAT being introduced in France in 1948. VAT is a tax that has found world-wide acceptance and respectability and accounts for more than one-quarter of tax revenue in most jurisdictions[6]. Despite its name, VAT is not intended to be a tax on value-added as such; rather, it can be viewed as a consumption tax as the final consumer ultimately bears the burden. In essence VAT is charged at all stages of production, but firms are able to offset the tax they have paid on their own purchases of goods and services against the tax they charge on their sales of goods and services. Since the burden of VAT is ultimately borne by consumers and not on intermediate transactions between firms (since tax on such purchases is refunded) a VAT does not distort the prices that producers face in buying and selling from one another. Hence, unlike other indirect taxes which drive a wedge between the buying and selling prices of producers, VAT does not violate production efficiency.[7] VAT also eliminates the cascading effects of taxes on intermediate inputs. When tax is charged on both inputs and outputs, there is essentially a 'tax on tax'[8] and the tax embodied in any given item will depend on the number of production stages that are subject to tax. The elimination of this cascading makes VAT a much more efficient tax than its predecessor, the sales tax.

Transparency and certainty

VAT is a transparent tax. Under an invoice method VAT system all invoices must show the amount of VAT included in the sale price. The VAT system entails a trail of invoices that helps improve tax compliance and enforcement. The VAT is, in principle, described as "self-enforcing" as a taxable business can claim for the refund of the input VAT only if the claim is supported by purchase invoices.

A major benefit of VAT over a retail sales tax (or general sales tax as it was known in South Africa) is it's professed self-enforcement mechanism – the notion that registered vendors will ensure that suppliers will issue valid tax invoices so as to enable them to claim input tax credits. This mechanism provides strong incentives for firms to keep invoices of their transactions. However, it is apparent that this claimed benefit is not necessarily true in

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[6] While the Mirrlees Review in the United Kingdom (*Tax by Design*, Chapter 6, Oxford University Press, September 2011) notes that some 150 countries have now adopted VAT, including all the OECD countries, a number of other countries have since the release of the Mirrlees Review also adopted VAT - the United States of America being the only significant jurisdiction that has not done so. It is noted that more than 70% of the world's population now live in a country with a VAT (*The Modern VAT*, International Monetary Fund, 2001).

[7] Diamond and Mirrlees (1971) show that in order to ensure that production efficiency is attained, inputs should not be taxed so that all taxes should fall in final consumption goods.

[8] Ebrill (2001)

practice[9]. Allied to this benefit is the ability of the revenue authorities to cross-check invoices so as to ensure that supplies are properly reported, that is, it is an efficient means for tax authorities to check and cross-check for enforcement enhancement. However, this potential benefit is also seemingly more theoretical than real. Graham Harrison[10] notes that *"(t)he net benefits of large-scale cross-checking systems are yet to be proven, with associated costs to business and tax administrations continuing to be unacceptably high*".

Efficiency

Another benefit expounded by the proponents of VAT is that as VAT is collected at various stages in the production/distribution chain (rather than at only one stage, as is the case with retail sales tax), VAT is thus less vulnerable to evasion in that VAT is collected from various vendors, many of which operate in the formal/regulated environment. By contrast, in the case of retail sales tax most of the revenue is collected at the final point of sale to final consumers, putting all the tax revenue at risk. It is important to note that firms that do not register as VAT vendors (either because they are evading tax or because they fall below the threshold for registration) nevertheless pay VAT. While these traders will not pay over VAT on their sales, they will pay VAT on both their imports and their purchases from VAT-compliant firms. The VAT payable in such cases is in the form of unrecovered input tax.

It is now generally accepted that VAT, provided its base is kept as broad as possible, is an efficient means of raising tax revenue with very little distortion to an economy. While conceding that *"(i)t is hard to gauge the extent to which the spread of VAT has increased the efficiency with which productive resources are allocated*", the authors of *The Modern VAT*[11] conclude that *"(t)here is…an important, albeit limited, sense in which the supposed ability of the VAT to bolster revenues in an efficient manner is borne out by the data,…(t)he extent of the effect, however, cannot be estimated with precision*". The Mirrlees Review[12], perhaps the most far reaching study of taxation in the United Kingdom, arrives at a similar conclusion. It argues that as taxes on inputs "*would distort the input choices of firms and result in a loss of production efficiency…the requirement for production efficiency is powerful and a key reason for the use of VAT in preference to taxes that burden intermediate transactions*[13]".

The efficiency cost of taxes arises from their effect on relative prices, and the size of this effect is directly related to the tax rate. The distortionary effect of taxes generally increases

[9] *The Modern VAT*, *supra*, at page 23.
[10] Harrison G "*VAT Refunds*" in Richard Krever (ed), *VAT in Africa* (Pretoria University Press, 2008) at page 149.
[11] Ebril, L, Keen M, Jean-Paul Bodin and Summers, V, *The Modern VAT*, 2001, International Monetary Fund, at page 37.
[12] *Dimensions of Tax Design: The Mirrlees Review*, 2010, Oxford University Press.
[13] Mirrlees Review (*Tax by Design*, *supra* at page 150).

proportionally to the square of the tax rate[14]. From an efficiency perspective, it is therefore better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. This implies that consumer choices are not influenced by differential tax rates, thereby enhancing efficiency and neutrality. Having one uniform rate also reduces the administrative and compliance costs of the tax system and avoids legal wrangling over the classification of goods.

The South African VAT system follows the destination principle, i.e. exports are zero-rated and imports are subject to VAT. Accordingly, the total tax paid in relation to a supply is determined by the rules applicable in the jurisdiction of its consumption and therefore all revenue accrues to the jurisdiction where the supply to the final consumer occurs. The destination principle has the advantage that it does not affect the competitiveness of exports. There is widespread consensus that the destination principle, with revenue accruing to the country of import where final consumption occurs, is preferable to the origin principle from both a theoretical and practical standpoint.

It has been suggested in a submission from the South African Constitutional Property Rights Foundation that a national property tax would be more efficient than VAT (and income tax combined) and that it should in fact replace VAT and income tax. Such a radical departure from a tried and tested revenue source would require a far more detailed study and is beyond the scope of this Committee's terms of reference.

6. The South African experience

Adoption of VAT in SA

VAT was introduced in South Africa on 30 September 1991. It replaced the local retail sales tax (colloquially referred to as the general sales tax or GST[15]) which was imposed at the final point of sale on the sale of goods and the rendering of a limited number of services to final consumers and on capital and intermediate goods acquired by businesses. The South African VAT system is a good example of a 'modern' VAT (in the tradition of countries such as New Zealand) with relatively few exemptions, zero-ratings and exclusions.

[14] Bird, G. and Zolt, E. *Introduction to Tax Policy Design and Development*, 2003, World Bank Institute, at page 15.

[15] Not to be confused with the Goods and Services Tax – GST - adopted in a number of countries. In essence the GST adopted in such countries as New Zealand and Australia (and a host of other countries) is in essence a credit-invoice form of VAT.

Whilst one of the major recommendations of the Margo Commission[16] was the adoption of a so-called "comprehensive business tax" (CBT), in essence an origin-based additive VAT, Government decided in 1988 to adopt the more mainstream destination-based invoice/credit method VAT. The Value-Added Tax Act[17] introduced such a VAT at a rate of 10% with effect from 30 September 1991. The rate increased to 14% in 1993 (following the inclusion of additional zero-rated foodstuffs).

Previous reviews/studies

The subsequent Katz Commission mainly considered the vexed questions of the taxation of basic foodstuffs, the possibility of differential rates[18] and the taxation of financial services[19]. The Commission nevertheless also dealt with certain related aspects, including *ad valorem* excise duties and the role of non-tax poverty relief measures. The major conclusions of the Katz Commission in its *Interim Report* as regards VAT and *ad valorem* excise duties were that:

- the further erosion of the VAT base through zero rating or exemptions should not be considered in view of the limited contributions which such measures make to the relief of poverty;
- a higher tax on luxury goods or a multiple VAT rate system should not be adopted, in view of the limited contribution of such measures to reducing the regressivity of the VAT, the administration and compliance costs involved, and the limited potential for raising additional revenue thereby;
- the present *ad valorem* excise duties should be retained at present rates for the time being, but that the possibility of introducing a progressive *ad valorem* duty on luxury motor vehicles be investigated[20];
- the scope of the exemptions should be narrowed thereby bringing into the VAT net all fee based financial services[21]; and
- a definition of a basis of apportionment should receive urgent attention.

The Katz Commission then concluded[22]:

"*The Commission makes the above recommendations (*which included a number relating to no-tax related poverty relief measures*) in the confidence that the Government will*

[16] Margo, C. S. *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa* (Government Printer, 1986).
[17] No. 89 of 1991.
[18] *Interim Report, supra*.
[19] Katz, M. *Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. 1995. Government Printer.
[20] This proposal has been implemented.
[21] This proposal has been implemented.
[22] *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*, 1994, at page 133.

proceed, expeditiously, with the implementation of adequate and effective poverty relief measures to address the hardships suffered by the poor. Success in this regard, in the Commission's view, should in due course permit Government to consider the reintroduction of the presently zero rated foodstuffs into the VAT base".

VAT as income generator

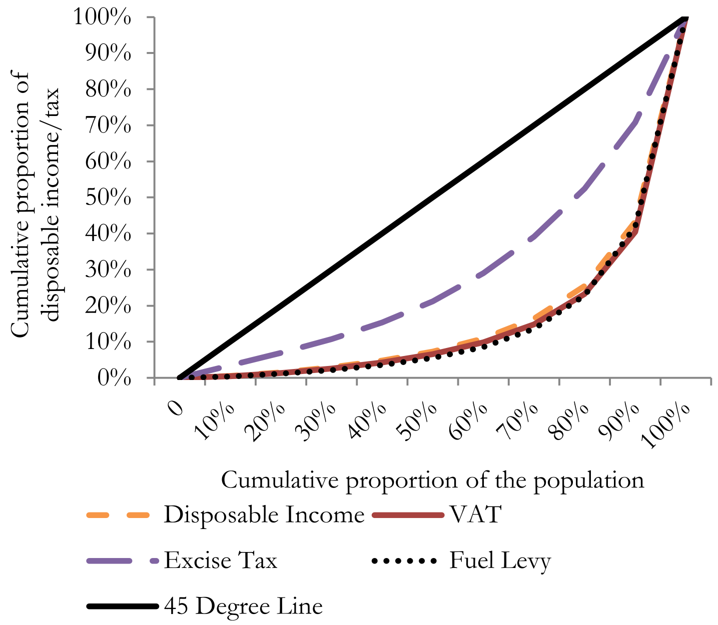
VAT in South Africa yielded R281 billion in 2015/16, R289 billion in 2016/17[23] and is estimated to yield R299 billion[24] in 2017/18, an increase in nominal terms of 3.30 %. As a source of revenue, VAT has accounted for just slightly more or less than a quarter of Total Main Budget tax revenue over the last number of years, namely 27.3% in 2010/11; 25.6% in 2011/12; 26.9% in 2012/13; 26.8 % in 2013/14, 27.8 % in 2014/15, 26.3% in 2105/16, 25.27% in 2016/17 and 25.4 % in 2107/18. VAT continues to be the second most important source of revenue in South Africa. The most important source of tax revenue remains the personal income tax (PIT).

7. **Equity considerations**

A recent study[25] shows that VAT in South Africa would be regressive in the absence of the zero-rated food items. When the zero-ratings are taken into consideration, however, VAT is broadly neutral – i.e. households across the income distribution pay roughly the same proportion of their income as VAT. This can be seen in the figure below: the concentration curve for VAT lies almost exactly on top of the Lorenz curve for disposable income. (By contrast, excise duties are regressive as the concentration curve for excise duties lies above the Lorenz curve.) As such, VAT does not make inequality better or worse since everyone shoulders the burden of VAT roughly proportionally with their income.

[23] Budget Review 2018, National Treasury, Republic of South Africa, 21 February 2018.
[24] Budget Review 2018, National Treasury, Republic of South Africa, 21 February 2018.
[25] Inchauste, G., Lustig, N., Maboshe, M., Purfield, C., & Woolard, I. (forthcoming). *The distributional impact of fiscal policy in South Africa.* Washington DC: World Bank.

Figure 1 Concentration Curves of Indirect Taxes (share paid by disposable income deciles)



However, since VAT is paid by everyone, including the poor, poverty is higher in the presence of the VAT system than it would be in the absence of such a tax. The same study[26] finds that poverty (as measured by Stats SA's 'lower bound poverty line'[27]) increases by about 5 percentage points as a result of indirect taxes (of which VAT is by far the biggest

8. **Analysis**

As so succinctly noted by the Organisation for Economic Cooperation and Development ("OECD"):

"*Overall the performance of VAT systems depends on three main factors:*

- *the degree of compliance by taxpayers;*
- *the structural features of the tax: rates, exemptions, thresholds, and*
- *the capacity of the tax administration to manage the system in an efficient way*."[28]

The first two factors are considered below. The capacity of the South African Revenue Service to adequately administer VAT is beyond the scope of this report, suffice it to say that the Ad-Hoc Committee has not been provided with indication that this is not the case.

[26] Inchauste, G., Lustig, N., Maboshe, M., Purfield, C., & Woolard, I. (2016). *The distributional impact of fiscal policy in South Africa.* Washington DC: World Bank.
[27] This poverty line was R443 per month per month in 2010 prices.
[28] OECD, *Consumption tax trends, VAT/GST and excises, trends and administration issues* (2006) at page 42).

8.1 Taxpayer compliance: The tax gap

"*The VAT Gap can be seen as an indicator of the effectiveness of VAT enforcement and compliance measures, as it arises as a consequence of revenue loss through cases of fraud and evasion, tax avoidance, bankruptcies, financial insolvencies as well as miscalculations*".[29]

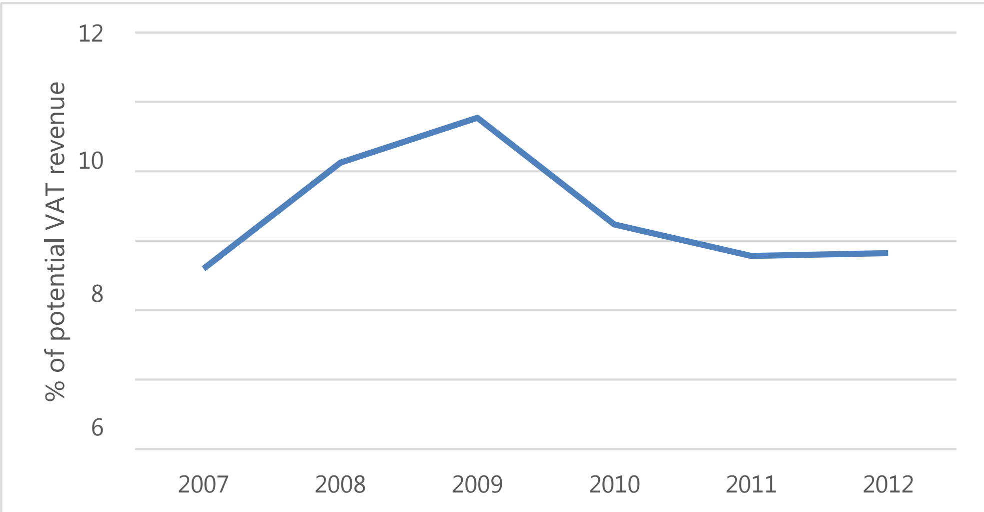
VAT Compliance Gap

The methodology employed by the IMF Report on the VAT gap in South Africa[30] is a top-down approach for estimating the potential VAT base, using statistical data on value-added generated in each sector. There are two main components to this methodology for estimating the VAT compliance gap: 1) estimate the potential net VAT collections for a given period, and 2) determine the accrued net VAT collections for that period. The difference between the two values is the compliance gap.

The compliance gap grew significantly in South Africa from 2007 to 2009, but has since reverted to the same level as 2007.

The compliance gap increased to 10 percent of potential revenue in 2009, when the global financial crisis severely hit the South African economy. The gap has since gradually decreased to 6 percent of potential revenue, which is around the same level as 2007.

VAT compliance gap in South Africa, 2007-2012



While a method to estimate tax gaps for VAT has been studied and explored internally in SARS, the results at times differ significantly with that obtained by the IMF. Thus, according

[29] 2012 Update Report to the Study to Quantify and Analyse the VAT Gap in the EU-27 Member States, Centre for Social and Economic Research on behalf of European Commission, September 2014.

[30] South Africa: Revenue Administration Gap Analysis Program - The Value-Added Tax Gap, International Monetary Fund, Fiscal Affairs Department, January 2015.

to the SARS analysis, the calculated gap fell significantly from nearly 30 percent in 2002 to 10 percent in 2005, and then fluctuated in the range between 5 percent and 17 percent of potential VAT revenues Because the estimates by SARS use net cash collection data in the calculation, their gap numbers are more volatile, especially in 2009 and 2011, while the gap numbers from the IMF approach are based on accrued collections and remain relatively stable. Although the original estimates by SARS need some adjustments to maintain consistency in the assumptions used, the combined estimates by SARS and the IMF gap methodology show a declining trend of compliance gaps in the years after 2002.

Assessment and collection gaps

The collections gap is the difference between actual VAT collections and the total amount of VAT declared or assessed as due from taxpayers, while the assessment gap is the difference between the amount of VAT declared or assessed and potential VAT. These two gaps correspond to the identified portion of the compliance gap (the collections gap) and the unidentified portion (the assessment gap).

Over the period from 2007 to 2012, the collection gap gradually grew, while the assessment gap first increased sharply and then fell back to less than its former level

The increase of the collections gap means that the differences between declared and assessed VAT and collected VAT have become wider year by year. It would naturally reflect a first-in-first-out procedure for late payments that prioritizes older tax liabilities, but there is a risk of increasing future uncollectible tax liabilities to the extent that it reflects a growing stock of outstanding taxpayers' arrears.

VAT policy gap

The level of the VAT policy gap in South Africa is low by international standards, owing to its simple VAT policy structure. The policy gap shows the efficiency of VAT policy structure by calculating the difference between theoretical revenue given a hypothetical, 'ideal' policy framework and potential revenue given the current policy framework. The policy gap is calculated to be between 27 percent and 33 percent during the period of 2007 to 2012, while the average of European countries is 41 percent.

Although the level of policy gaps is higher than the level of compliance gaps, the room for additional revenue by changing VAT policy structure looks limited.

Changes in Potential VAT Revenues

Potential VAT revenues in South Africa have been declining since 2008 compared with GDP. Potential VAT revenues as a percent of GDP, calculated from national accounts data, have been declining since at least 2008. Because there have been no significant policy changes in VAT legislation over this period, this decline is attributable to changes in the tax base.

The decline in potential VAT relative to GDP is attributable to increased non-taxable GDP components, including government final consumption and an increase in consumption of petroleum products. The increase in government final consumption, which is out of scope of VAT (for central and state government) and zero-rated (for local government), was the main contributor to the recent declining trend in potential VAT revenues relative to GDP.

C-Efficiency ratio in South Africa

The c-efficiency measure was used to analyse the overall efficiency of the South African VAT. The c-efficiency ratio is an indicator that can be simply calculated from VAT revenues, the VAT standard rate and GDP final consumption aggregates to indicate the overall efficiency of VAT revenue collections. It presents the ratio of actual VAT collections to the amount that would be collected under a perfectly enforced tax levied at the standard rate on overall final consumption.

The average of c-efficiency ratios in South Africa between 2007 and 2013 is 63.6 percent, which is relatively high. This result is among the highest in Sub-Saharan African counties over the same period. The high c-efficiency ratio will be at least partly a result of South Africa's simple VAT legislation which has limited exempted and zero-rated goods and services. It may also suggest that the revenue administration in South Africa is relatively effective compared to its peer countries, and that the room for additional revenues mobilization by improvement of tax compliance and expanding tax base of VAT would be limited compared with other countries in the region.

Observations and possible follow-up action

- SARS should continue to monitor the VAT compliance gap as a means of evaluating its performance, and to inform strategic decisions about tax.
- SARS could consider broadening its tax gap analysis to include other major taxes.

- SARS should further integrate its revenue and national compliance analyses, to support systemic compliance risk management. There is more scope for more detailed revenue analysis of revenues from individual industry sectors and taxpayer segments to support strategic risk analysis.

The Committee **notes** the findings and recommendations of the IMF Report and **endorses** its recommendations.

8.2 Structural features: Zero-rating

While having one uniform rate which applies to all consumption is optimal from an efficiency point of view, no country in the world has such a system. Nearly all jurisdictions provide relief of one sort or another in relation to so-called basic foodstuffs in order to advance equity considerations, either by way of zero rating, exemption or by applying a reduced rateto certain foodstuffs.

Other goods such as diesel and petrol are sometimes zero-rated as they are subject to excise duties (as is the case in South Africa). While some would argue that to impose VAT as well would amount to double taxation, this is not the case. Excise duties and import duties form an integral part of the basic price, in the case of excise duties to partly account for certain externalities and in the case of import duties as a means of protection for local industry – i.e. the so-called infant industry argument. Thus, in both instances the duties constitute part of the price (consideration) paid for the goods acquired by end consumers, and as such generally form part of the value upon which VAT is imposed.

Zero-ratings and VAT exemptions shrink the tax base and necessitate a higher standard rate in order to compensate for the revenue loss. Thus, for example, in South Africa, R55.013 billion in revenue was forgone in the 2015/16 fiscal year as a result of zero rating certain supplies (R22.794 billion in relation to basic foodstuffs), while revenue was reduced by a further R1.332 billion as a result of the exemption of other supplies.[31]

The OECD has taken the view since the 1980s that a broad-based, single-rate VAT is ideal.[32] This view has been endorsed by more recent studies such as the Mirrlees Review[33]

[31] Annexure B: 2018 Budget Review.

[32] Robert P. Hagemann, Brian R. Jones, and Robert Bruce Montador. (1987). ''*Tax Reform in OECD Countries: Economics Rationale and Consequences*,'' OECD Economics Department Working Paper No. 40 OECD Publishing, pp. 34-37.

[33] Crawford Ian, Michael Keen, and Stephen Smith, 2010,"*VAT and Excises*," in (*eds.*) James

which argues that a broad base with a single standard rate would enable significant revenues to be raised while decreasing tax administration costs for the revenue collection agency and compliance costs for businesses. There is broad support in the literature for the view that VAT is not an appropriate tool for manipulating social behaviours or advancing equity considerations.

For all its tried and tested benefits, however, VAT's Achilles heel is its perceived regressive effect. While having a single uniform rate enhances horizontal equity - since individuals with similar expenditure levels will pay the same amount of tax, regardless of their tastes (i.e. how much they spend on particular items) - VAT is not vertically equitable. It is widely acknowledged that the poor have a higher marginal propensity to consume than the rich; i.e. the poor tend to consume almost everything that they earn while the rich are able to save a larger portion of their income. Consequently, a broad-based VAT system with a single rate will tend to be regressive (when regressivity/progressivity is measured relative to income at a point in time). However in terms of the lifetime income hypothesis, where accumulated savings are used to fund consumption expenditure during retirement the extent of this regressivity might be overstated.

The Katz Commission in its *Interim Report* dealt extensively with the question of the incidence and benefits of zero-rating basic foodstuffs and found[34] that:

- Zero rating benefits the poor modestly in absolute rand terms and benefits the non-poor by substantially greater amounts;
- Of the total estimated revenue loss due to zero rating of about R2,6 billion (at that time), little more than a third of the benefits went to households in the bottom half of the income distribution. In other words, of the tax revenue forgone of R2,6 billion as a result of the zero rating of basic foodstuffs, only R866 million benefited the poorest 50 percent of households.

In a subsequent paper prepared by the then Tax Policy Chief Directorate of the National Treasury in 1999[35], it was pointed out that these results ignore the "*fact that the revenue loss through zero-rating is compensated by a higher standard rate*", and that a "*more realistic basis for judging the benefits of VAT relief is an examination of revenue-neutral VAT*

Mirrlees and others, *Dimensions of Tax Design: The Mirrlees Review*. Oxford: Oxford University Press for Institute for Fiscal Studies; 275-362.

[26] *Interim Report*, *supra* at pages 113 to 120.

[35] Discussion Paper prepared for the Tax Symposium, 19 to 23 July 1999.

systems, with and without zero-rating[36]". At that time, it was estimated that the VAT rate could be reduced by 1.25% if the zero-rating of basic foodstuffs was withdrawn.

The vexed issue of the taxation of basic foodstuffs and other so-called merit goods was the subject of a further study by National Treasury in 2006[37]. The report finds that the zero-rating of specific foodstuffs provides a larger *proportional* benefit to the poor (i.e. progressivity is enhanced), but provides a larger *absolute* benefit to the rich (who consume larger quantities). It goes on to argue that the poor would be better served by the elimination of zero-ratings if the additional revenue that were realized were used to increase pro-poor spending on the expenditure side of the budget.

Woolard *et al*[38] and Inchauste *et al*[39] find that the provision of zero-rated foodstuffs results in the South African VAT system being essentially neutral or even slightly progressive. Inchauste *et al*[40] find that in the absence of the zero-ratings the VAT system would be regressive. In the current system, the bottom decile allocate 9.9% of their consumption to the payment of VAT whereas the top decile allocate 11.1%. In the absence of zero-ratings (and with no adjustment to the standard rate) the allocation to VAT would go up to 13.0% for the bottom decile and to 12.2% for the top decile.

Thus, while there is some empirical local and international evidence that suggests that a VAT system with targeted exemptions and zero-ratings may make the VAT somewhat progressive[41], the Katz Commission noted that "*zero rating (of foodstuffs) may be considerably less beneficial to consumers than is commonly assumed*"[42]. There is broad consensus that targeted poverty relief measures are better suited to address the possible regressive effects of VAT than exemptions/zero rating. However, as noted by the authors of *The Modern VAT*[43], whatever real or perceived benefits to the poor that may be achieved by zero rating basic foodstuffs, such an approach gives rise to administrative and compliance costs.

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[36] At page 4.
[37] *The VAT Treatment of Merit Goods and Services*, National Treasury T16/05.
[38] Woolard I, *Final Report: Tax Incidence Analysis for the Fiscal Incidence Study being conducted for National Treasury, supra*.
[39] Inchauste, G., Lustig, N., Maboshe, M., Purfield, C., & Woolard, I. (2016). *The distributional impact of fiscal policy in South Africa.* Washington DC: World Bank.
[40] Inchauste, G., Lustig, N., Maboshe, M., Purfield, C., & Woolard, I. (2016). *The distributional impact of fiscal policy in South Africa.* Washington DC: World Bank.
[41] See *The Modern VAT*, *supra* at pages 106 to 112, and the authorities cited therein.
[42] Katz, M. *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa,* (Government Printer, 1994), at page 118.
[43] *Supra* at page 78.

In spite of this, many countries, including South Africa, have implemented a reduced rate with the justification that the poorest households spend a high proportion of their income on essentials and need tax relief in order to help them afford basic goods.

An analysis for the Committee[44] (see Table 2 below) shows that the poorest 40 percent of South African households spend roughly one-third of their income on food, whereas the richest 10 percent of households spend only 5 percent.

Table 1: Spending by expenditure categories as a proportion of total consumption, by consumption decile

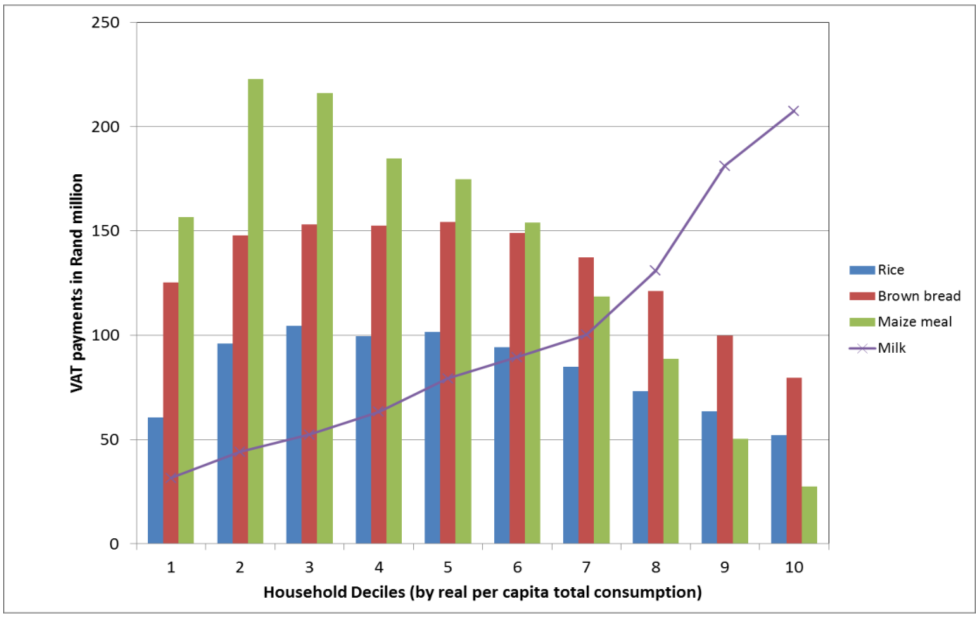
Decile	Food and non-alcoholic beverages	Alcoholic beverages, tobacco and narcotics	Clothing and footwear	Housing, water, electricity, gas and other fuels	Furnishings, household equipment and maintenance of house	Health	Transport	Communication	Recreation and Culture
1	37.4	1.3	10.6	21.6	5.5	1.7	7.5	2.9	1.4
2	36.1	1.4	9.6	21.9	6.4	1.5	8.6	2.8	1.6
3	33.0	1.3	9.0	22.4	5.8	1.5	10.4	2.9	1.7
4	29.4	1.8	8.5	23.4	5.7	1.4	11.6	3.1	1.9
5	26.2	2.0	8.1	24.0	5.6	1.3	13.3	3.0	2.1
6	22.8	1.9	7.1	26.7	5.3	1.2	14.3	3.2	2.2
7	17.7	1.6	6.6	29.1	5.1	1.4	15.2	3.3	2.4
8	13.3	1.4	5.4	31.4	5.0	1.3	15.2	3.3	3.2
9	9.1	1.2	3.9	33.3	5.1	1.5	15.6	3.1	3.3
10	5.3	0.6	2.2	36.2	4.9	1.5	21.4	2.4	3.6

Source: 2010/11 Income and Expenditure Survey, Stats SA

Given these differential expenditure patterns, the zero-rating of some basic foodstuffs reduces the regressivity of VAT and mitigates the impact of VAT on the poor to some extent. Indeed, Figure 2 below shows that the poor benefit more than the non-poor from the zero-ratings on maize meal and brown bread but less than the non-poor from the zero-rating of milk.

[44] Jansen, A. and Calitz, E. 2014. *Zero Rating of Value-Added Tax: Report to the Davis Tax Committee*. University of Stellenbosch.

Figure 2: VAT revenue foregone on selected zero-rated goods, in Rand million



Source: Jansen, A. and Calitz, E. 2014. *Zero Rating of Value-Added Tax: Report to the Davis Tax Committee*. University of Stellenbosch.

It is clear from Figure 2 that the wealthiest not only benefit from the zero-ratings of food but for some items benefit significantly more than the poor. This underscores Keen's[45] reminder that "most of the benefit of reduced indirect tax rates actually accrues to the better-off, making this a very poorly targeted way of pursuing equity objectives."

Table 1 shows that the richest decile benefits 46% more from the zero-rating of basic foodstuffs than poorest decile. Table 2 shows that benefit of the zero-rating of milk, fruit and vegetables is particularly skewed towards the rich.

[45] Keen, M. 2012. "Targeting, Cascading, and Indirect Tax Design". Paper delivered as the third Dr. Raja J. Chelliah Memorial Lecture. New Delhi: National Institute of Public Finance and Policy. 9 February 2012.

Table 2: Revenue foregone (in Rand million, 2012 prices) on zero-rated goods, by consumption decile

Decile	Rice	Brown bread	Maize meal	Mealie Rice	Samp	Dried Beans	Dried Lentils	Canned Pilchards	Milk
1	61	125	157	0	12	19	0	17	32
2	96	148	223	0	17	22	0	25	44
3	105	153	216	1	15	22	0	27	52
4	100	152	185	1	12	18	0	27	63
5	102	154	175	0	13	16	1	26	79
6	94	149	154	0	10	11	1	31	90
7	85	137	119	0	8	8	0	28	100
8	73	121	89	0	5	6	1	24	131
9	64	100	50	1	3	5	1	16	181
10	52	80	27	0	2	3	1	10	208

Decile	Cooking fat (Vegetable)	Edible Oils	Eggs	Fruit	Vegetables	Paraffin
1	0	48	20	14	115	26
2	0	69	37	21	147	30
3	1	72	39	24	155	33
4	1	68	46	27	158	32
5	1	66	51	31	165	29
6	1	60	55	36	170	24
7	1	57	61	43	167	19
8	0	49	58	60	177	13
9	1	38	63	101	215	4
10	0	32	60	167	297	2

Source: Jansen, A. and Calitz, E. 2014. *Zero Rating of Value-Added Tax: Report to the Davis Tax Committee*. University of Stellenbosch.

The DTC's analysis accords with the findings from a report by the OECD[46]. The OECD report notes that its study –

[46] OECD, Centre for Tax Policy and Administration, "*The Distributional Effects of Consumption in OECD Countries Progress Report*", April 2014

> "…*has clearly illustrated that, despite (the) progressive effect (of reduced rates on food and energy products), reduced VAT rates are a very poor tool for targeting support to poor households. At best, rich households receive as much benefit from the reduced rate as do poor households. At worst, rich households benefit vastly more than poor households…(The study) has shown that in some case, the benefit to rich households is so large that the reduced VAT rate actually has a regressive effect – benefiting the rich much more in absolute terms , and as a proportion of expenditure*".

In effect, the current zero-rating is equivalent to a generalized subsidy which mostly favours the richest sectors of the population at a high cost for public finances. As such, zero rating is a very blunt instrument for the pursuit of equity objectives. In trying to assist the poor, more of the benefit flows to the non-poor than the poor. Theoretically, as noted by the Katz Commission, it must always be better to rather collect the tax revenue and redistribute the additional income through a targeted transfer to the poor. The key question then becomes whether the government has the ability to pursue its distributional objectives by other means. The DTC turns now to this vexed question.

Certainly, the post-apartheid government has made great strides in expanding the social safety net to deliver cash transfers to poor households. Cash transfers now go to 17 million individuals in almost 7 million households. More than three-quarters of households in the poorest four deciles already receive cash transfers. Nevertheless, the DTC also recognizes that there are poor households that fall outside of the social assistance net because they do not contain children, elderly or disabled persons. If the zero-ratings were eliminated, compensatory mechanisms would need to be found to reach those households with, for example, only unemployed or working-poor adults that do not receive cash transfers.

Thus, while the Committee is of the view that zero-rating is an extremely blunt instrument for addressing equity considerations, the DTC takes the view that it would be very difficult to eliminate the current zero-ratings at this time because no perfect compensatory mechanism has yet been identified. The Committee therefore **recommends** that no further zero-rated food items should be considered. Not only is the DTC of the view that to do so would not provide any tangible benefit to poorer households, but there is clear evidence from the fairly recent experience in Europe where a decision was made to apply reduced VAT rates on labour-intensive services that reducing rates of VAT will "*only partially (be) reflected in consumer prices, or not at all and that at least part of the VAT reduction (will be) used to* *increase margins of service providers*".[47] This experience is in fact supported by the experience in South Africa. It has, for example, been noted[48] that in relation to the introduction of zero-rating on illuminating paraffin that –

> "*The expectation that the zero-rating of illuminating paraffin for VAT purposes would provide a significant distributive gain to the poor was, however, not fully realised. It would appear that most of the benefits of VAT zero-rating was captured by retailers in the form of higher profit margins*".

8.3 Structural features: Dual (multiple) rates

The issue of whether the use of multiple rates of VAT will enhance the efficiency and equity of a VAT system has received consideration in the public finance arena, and more recently in the European Community where there has been considerable debate regarding the widespread use of multiple rates. The main objective with multiple rates would seem to be to enhance equity in the VAT system, with so-called luxury goods being more heavily taxed than essential goods and services.

A perusal of the literature and studies undertaken in regard to the efficacy of dual (multiple) rates indicate a surprising consensus, namely that multiple rates are inefficient, both economically and administratively. As argued by Alan Tait[49] a number of years ago –

> "*It cannot be emphasised too strongly that both official administrative costs and traders' compliance costs rise dramatically as the number of rates multiply and nothing much is gained in terms of revenue*".

The author went on to conclude that multiple rates are undesirable for the following reasons:

- Rate differentiation gives raise to significant administrative and compliance costs.
- Multiple rates distort both consumer and producer choices.
- Low rates of tax do not necessarily benefit the final consumer.
- Differential rates are very blunt instruments for favouring particular households.
- Favourable treatment creates dissatisfied consumers and traders, who argue that their products are at the chosen dividing line.
- The legislation necessary to delineate the various products or services that fall within and outside the relevant VAT rate creates significant complexity.

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47 Rita de la Freia, *Blueprint for Reform of VAT rates in Europe*, Oxford University Centre for Business Taxation, WP 14/13.
48 Cecil Morden, *Fifteen Years of Value-Added Tax in South Africa*, at page 468.
49 Alan A Tait, *Value-Added Tax: International Practice and Problems*, International Monetary Fund, 1088.

- High rates generally (except for motor vehicles) apply to goods that account for a relatively small proportion of total consumption.
- Finally, using a general equilibrium model, it has been shown that rate differentiation leads to significant reductions (about 60%) in the welfare gains of adopting equalised tax rates.

More recently, Ebrill *et al* in their seminal work, *The Modern VAT*[50], have noted that while there are numerous problems associated with multiple rates (mainly those identified by Alan Tait above), there are some benefits. It is argued that the following benefits may arise in consequence of the adoption of multiple rates:

- Efficiency may be enhanced by taxing more heavily those goods whose consumption is associated with enjoyment of leisure as this will mitigate the distortion of decisions away from paid work.
- As opposed to the view held by Alan Tait, the learned authors argue that there may be some efficiency gains from the perspective of raising revenue from rate differentiation.
- In terms of equity considerations, it is argued that "*it will be desirable, all else equal, to tax most heavily those goods that account for a greater share of the expenditure of the better off*". However, it is accepted that multiple rates are not the best instrument to achieve equity between households. It is stated that:

  "*The presence of other instruments, however, makes it less likely that social gains will be had from setting more than one rate of VAT. Most obviously, the presence of an income tax provides a more effective means of pursuing distributional objectives, and differentiation is consequently less likely to be needed…It has also been argued that expenditure policies, in areas such as education and health, may be more effective tools for pursuing equity objectives rather than the use of differential rates…The availability of other instruments thus weakens the case for rate differentiation*".[51]

  Furthermore, having identified certain inherent limitations that apply (the small benefit to the poor relative to the rich in absolute terms), the following conclusion is arrived at -

  "*These inherent limitations…mean that even the best-informed government will be severely constrained in the redistribution it can achieve by rate differentiation*".

[50] Ebrill L (ed), *The Modern VAT*, *supra* at pages 68 to 82.
[51] Ebrill L (ed), *The Modern VAT*, *supra* at page 74.

The following conclusions are arrived at by Ebrill *et al*[52]:

- "*Support for setting only a single rate is based both on experience with the administrative and compliance difficulties associated with multiple rates and on the realisation that the amount of redistribution that can be achieved through indirect taxation is inherently limited…*
- *The extent to which equity gains can be achieved by differential rates of VAT depends on the range of other instruments available. A few excises on goods in inelastic demand may be able to reap the main efficiency gains from differentiation…*
- *The equity case for differential VAT rates will be stronger the more restricted is the set of other tax-spending instruments is available to government…*".

The Mirrlees Review came to a similar conclusion:[53]

> *"(I)n the absence of strong evidence to the contrary, our view is that the advantages in terms of simplicity of a single rate are likely to outweigh any possible advantage from differentiating tax rates for this or any other reason*".

The question of multiple rates cannot be divorced from the issue of excise duties. The fact of the matter is that a number of luxury goods presently bear an *ad valorem* excise charge, upon which VAT is once again levied. Thus, for example, *ad valorem* excise duties are levied on essential oils, perfumes, photographic equipment, etc. The benefit of *ad valorem* taxes over VAT is that the tax is collected at the stage of production and the number of traders who will need to be able to administer the system is limited, as opposed a VAT differentiation that needs to be complied with by all traders in the production/distribution chain. While the definitional problems persist under an *ad valorem* tax system, it is apparent that the administrative and compliance costs are significantly reduced. On balance, it would seem to the DTC that should it be deemed necessary to impose a higher tax burden on so-called luxury, the issue would be better dealt with through an *ad valorem* tax.

In conclusion, the view that VAT should be levied at a single, uniform rate has gained increasing traction. As shown in Table 3, the proportion of new VAT systems which were introduced with a single rate had increased markedly over time, to a point at which uniformity, on introduction, has become the norm.

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[52] Ebrill L (ed), *The Modern VAT*, *supra* at page 82.
[53] *Supra* at page 166.

Table 3. VAT systems with a single rate at time of introduction

	Number of countries introducing VAT for the first time	Percentage with a single rate at introduction
Before 1990	48	25%
1990-1999	75	71%
1999-2011	31	81%

Source: Keen, 2012. *Targeting, Cascading and Indirect Tax Design*. Third Dr. Raja J. Chelliah Memorial Lecture at the National Institute of Public Finance and Policy, New Delhi, 9th February, 2012

More recently, Ebrill *et al*[54] note that more than 53% of countries that presently have a VAT system use a single rate (excluding, one assumes a zero rate that is standard in all countries). These countries are predominately those countries that have introduced VAT in the last decade or so.

8.4 Structural features: Exemptions

VAT exemptions are considered to be an '*aberration in terms of the basic logic of VAT*'[55]. Exemptions go against the core principle of VAT as a tax on all consumption, and also undermine the efficiency and neutrality of the tax[56]. In European countries, where VAT was first introduced, exemptions constitute a very sizeable portion of the potential tax base. By comparison, South Africa compares very favourably with a very limited number of exemptions, notably certain forms of passenger transport, educational services[57] and non-fee based financial services.

Most exemptions are justified on the basis that they are so-called merit goods, such as education. However, some goods are exempt because they are perceived to be hard to tax, e.g. financial services. In the case of public transport in South Africa, exemption was justified on the basis that compliance would be a major challenge, given the significant number of small informal taxi operators[58].

The taxation of financial services continues to challenge VAT design. While there does not seem to be any disagreement that the supply of financial services should be subject to tax

[54] Ebrill L (ed), *The Modern VAT*, *supra* at page 68.
[55] Ebrill L (ed), *The Modern VAT*, *supra*.
[56] Bird (2007).
[57] The VAT treatment of both these services is under review by National Treasury.
[58] *Report of the Value-Added Tax Committee (VATCOM)* (Government Printer, Pretoria 1991) par 3.42.

when supplied to a final consumer, determining the consideration (taxable value) for that supply has proved to be elusive. The issue seems to be that in many instances no explicit charge is made for the supply of the financial service. While a very limited number of countries impose a type of proxy VAT[59], and a form of cash-flow VAT has been proposed[60], in most instances VAT jurisdictions exempt financial transactions. South Africa is no exception, albeit that it imposes VAT on most explicit charges made by financial institutions.

A detailed analysis of the present state of affairs as regards the taxation of financial services, both locally and internationally, is provided in the attached Annexure B. The most important area identified for consideration is VAT cascading.

VAT cascading arises in consequence of the fact that a financial institution making exempt financial services is denied input tax relief in respect of VAT borne by it on the acquisition of goods and services from third parties. To the extent that the relevant financial services are supplied to businesses that themselves would have been entitled to input tax relief had the financial institution on-charged the VAT paid by the financial institution, the VAT paid by the financial institution in effect becomes a cost.

The non-recoverable VAT cost incurred by the financial services organisation has the following effects:

- It has a cascading effect in respect of financial services supplied to taxable businesses that are entitled to recover VAT. Cascading occurs where the financial supply is an intermediate supply in relation to a taxable supply, and the VAT levied by a supplier to the financial institution becomes a hidden cost as it cannot be deducted by the financial institution. The cascading effect of VAT is more prevalent in the Banking Industry than in the Life Insurance Industry. The economic impact is, however, difficult to determine and quantify; and
- There is a significant incentive for the financial services organisation to self-supply the services or infrastructure (“**vertical integration**”) to avoid the additional VAT cost resulting from outsourced services.

Vertical integration in turn creates certain problems, including:

- Discrimination against third party suppliers;

[59] A Schenk and HH Zee, “*Financial Services and Value-Added Tax*” in Zee (ed), *Taxing the Financial Sector – Concepts, Issues, and Practices* (IMF, 2004).
[60] See paragraph 8.1 of *Tax by Design*, the Mirrlees Review, at page 197 and authorities cited therein.

- Discrimination against smaller financial institutions that are not in a position to vertically integrate[61]; and
- It frustrates the natural development of specialisation and creates inefficiencies in the production and delivery of financial services[62].

Foreign jurisdictions' methods of addressing VAT cascading and vertical integration in financial services, and the various approaches adopted are canvassed in Annexure B. In summary –

- In order to eliminate the cascading effect of VAT in respect of non-recoverable VAT on financial services, New Zealand has with effect from 1 January 2005 introduced the zero rating of the supply of financial services to certain customers;
- Singapore treats exempt supplies made to taxable persons as taxable supplies, thereby effectively zero rating these supplies and allowing the financial institution to claim input tax in relation to the supplies[63]. Alternatively, a financial institution can claim input tax for a fixed percentage of total input tax in terms of a special apportionment method allowed for specific type of financial institutions;
- Australia introduced a Reduced Input Tax Credit ("**RITC**") scheme, which is a unique feature of the Australian GST Act[64]. The object of the RITC scheme is to eliminate the bias to vertical integration and to facilitate outsourcing from a cost efficiency perspective. The RITC scheme allows suppliers of financial services to claim 75% of the GST paid on specified inputs as listed in the GST regulation;
- The European Union VAT law allows for companies which form part of the same group to register for VAT purposes as a single person. The effect of a VAT group registration is that supplies of goods or services between members of the group are ignored for VAT purposes and do not attract any VAT, thereby eliminating any non-recoverable VAT cost on centralized functions and allowing for the more effective and cost efficient service delivery to consumers, and eliminating the cascading effect of any non-recoverable

[61] Schenk A & Oldman O. (2007). *Value Added Tax: A Comparative Approach* Cambridge: Cambridge University Press p317; Schenk A., (2008) '*Financial Services'* in R Krever (ed), *VAT in Africa* Pretoria: Pretoria University Press 31 – 46, 40.
[62] *Report of the VAT Sub-Committee into the Taxation of Financial Services* (Government Printer, Pretoria, 1995) par 4.2.3, at 16.
[63] Goods and Services Tax (General) Regulations, (Rg 1) Part V, Reg 30(2) (Singapore Regulations).
[64] GSTA, Div 70 and GSTR Pt 4-2.

VAT cost on inter-company supplies where financial services are supplied to taxable consumers.

In order to eliminate the incentive for financial institutions for vertical integration, and to eliminate or reduce the cascading effect of VAT under the current VAT exemption provisions, the following options have been considered in the South African context:

- The introduction of a self-supply taxing mechanism in terms of which the self-supply of goods or support services is subjected to VAT, by placing a specific value on these goods or services and requiring the financial institution to account for output tax on the value of the self-supply[65];
- Apply VAT at the rate of zero per cent to the supply of financial services in line with the options followed by New Zealand and Singapore, and which was followed by the province of Quebec in Canada;
- Allowing the financial institution to claim an input tax deduction or reduced input tax deduction on the goods or services it acquires from suppliers to supply financial services, i.e. the RITC model followed in Australia;
- Providing financial institutions with the option to tax financial services supplies to taxable persons who may claim the VAT as input tax;
- The introduction of VAT group registration; and
- The reinstatement of the exemption of intermediary services supplied to financial institutions.

After consideration of the various approaches adopted to mitigate VAT cascading in the financial services sector, the Committee is of the view that **various approaches adopted by other jurisdictions should receive urgent consideration by National Treasury and SARS.**

8.5 Structural features: Place of Supply Rules

An issue that continues to receive significant interest is the question as to the place (jurisdiction) where VAT should be imposed and accounted for.

Clear and decisive "place of supply rules" have become increasingly important due to globalization which may be directly attributed to the proliferation of cross-border transactions. "Place of supply rules" provide assistance in determining whether a supply is regarded as being made within a jurisdiction.

[65] Schenk & Oldman 317 - 318.

The OECD, to this extent, endorses place of supply / taxation rules and guidelines and, furthermore, recommends "*that jurisdictions take these guidelines into account the application of… [the main rule being] in a way that is consistent with the…[guidelines and commentary on how to apply the main rule]. Wherever possible, tax administrations are encouraged to communicate these approaches and relevant national laws as clearly and as widely as possible.*"[66]

Given the escalation of cross-border transactions, particularly cross-border services, it is becoming increasingly important to not only harmonize VAT principles internationally, but also to ensure clear and unambiguous place of taxation / supply rules, which are not in contravention of each other, are introduced in VAT jurisdictions. Place of supply rules assist in determining where a supply should be subject to tax in terms of the OECD endorsed destination principle.

Furthermore, reference to New Zealand's recent GST amendments, to allow non-resident businesses who do not qualify to register for VAT in New Zealand, to claim input tax deductions in respect of taxable goods and services acquired in New Zealand, are in keeping with both the destination principle[67] and the input-credit method of VAT. In addition, introduction of such provisions is in keeping with the OECD principles of neutrality and will assist in ensuring the prevention of double taxation which is a point at issue where input tax deductions are not allowed in a particular jurisdiction. . It will also prevent cross-border transactions from not being taxed in either country.

While the SA VAT Act includes, what may be referred to as, 'implicit rules', the Committee **recommends** that the SA VAT Act be amended as a matter of urgency to ensure the inclusion of clearly stated 'place of supply rules', specifically rules that are in harmony with the OECD Guidelines and which are, as previously discussed, supported and adhered to by other VAT jurisdictions.

The Committee **further recommends** that consideration be given to evaluating the implementation of an effective refund mechanism in respect of non-resident suppliers and the right to claim input tax deductions in respect of taxable goods and services acquired (e.g.

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[66] *supra*

[67] The destination principle in turn "*facilitates the ultimate goal of ensuring that tax is paid and revenue accrues to the jurisdiction where the supply to the final consumer occurs. This ensures that services and intangibles supplied across borders are taxed according to the rules of the customer's jurisdiction irrespective of the jurisdiction from where they are supplied. It also ensures a level playing field for suppliers so that businesses acquiring such services are driven by economic, rather than tax considerations*" Ibid *OECD International VAT Guidelines* (2017)

similar to the provisions implemented in New Zealand's recent GST amendments) to ensure that the principle of neutrality is achieved.

Full discussion and analysis of the matter is attached herewith as Annexure B.

8.6 Structural features: E-Commerce

The new frontier for VAT is its application in an electronic commerce **("e-commerce")** environment, where the supply of electronic services across jurisdictional boundaries has given rise to many compliance challenges for governments.

The OECD has been at the forefront of researching e-commerce. At the OECD Global Forum on VAT held on 17-18 April 2014 in Tokyo, the governments of some 86 countries endorsed a new set of guidelines for the application of VAT on international trade[68].

South Africa adopted its own rules as regards the taxation of the supply of "electronic services" as defined[69] from outside South Africa in 2014. Essentially, the rules impose a liability on the supply by a supplier in a foreign jurisdiction of electronic services to a recipient in South Africa, The new rules apply from 1 June 2014. Foreign businesses that supply "electronic services" are required to register and account for VAT in South Africa if their taxable turnover exceeds a specified registration threshold (currently R50 000).

It will be evident that the treatment of VAT in an e-commerce environment is complex and has, and continues to, enjoy a significant amount of attention.

The Regulation setting out qualifying electronically supplied services may not allow for the required 'flexibility' legislation should carry in order to effectively adapt to technological changes. As noted, Canada provides 'categories' of services and the EU has moved from an exhaustive list to 'categories' as well, which assists with addressing various types of

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[68] OECD, *International VAT/GST Guidelines* (2017)

[69] The supply of "electronic services" was added to the definition of 'enterprise', as defined in section 1 of the VAT Act and presently reads as follows:

"(a) *…;*

(b) Without limiting the applicability of paragraph (a) in respect of any activity carried on in the form of a commercial, financial, industrial, mining, farming, fishing or professional concern – …

(vi) the supply of electronic services by a person from a place in an export country where at least two of the following circumstances are present –

(aa) the recipient of those electronic services is a resident of the Republic;

(bb) any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act, 1990 (Act No. 94 of 1990);

(cc) the recipient of those electronic services has a business address, residential address or postal address in the Republic."

electronic services as they change and develop. **It is recommended that South Africa follow suit.** That is, supplies qualifying as electronically supplied services should be in terms of ‘categories’ which are then further explained in a guide or interpretation note. Alternatively, should an exhaustive list be the preferred route then the Regulations should specify that the list will be reviewed and updated on a regular basis, e.g. every 2 years.

Furthermore, as far as electronic commerce is concerned, given its cross-border nature, South Africa should avoid implementing rules and provisions which are not harmonized with international principles. The point at issue is that the OECD recommendations and guidelines should be followed where possible or necessary for purposes of determining the treatment of e-commerce and cognizance should be taken of other VAT jurisdictions’ treatment of electronic services and application of definitions. It is most imperative that the OECD principles, especially the principle of ‘neutrality’, be adhered to.

South Africa, in implementing the specific imposition of VAT on electronic services sought not to make a distinction between business-to-business (B2B) and business-to-consumer (B2C) transactions. However, given the recent international practice of making such a distinction, and the sound reasons for doing so, the Committee **recommends** that the SA VAT Act should be amended to reflect such a distinction.

However, in terms of the above analysis and discussion, the VAT provisions relating to electronic services, including the list of qualifying services should be reconsidered and re-examined in accordance with this recommendation.

A distinction should be made in respect of ‘telecommunication services’ and, in harmony with other VAT jurisdictions the Committee recommends that, South Africa incorporate provisions addressing ‘telecommunication services’. That is, a definition for “telecommunication services” in accordance with the International Telecommunication Regulations should be included, and specific place of supply rules to address the VAT treatment of such supplies should be provided for.

The specific place of supply rules should be as closely harmonized with the place of supply rules implemented by other VAT jurisdictions. Furthermore, the provisions should allow for the necessary ‘flexibility’ to cater for technological advancements and changes.

As regards the current provisions, the following is noted:

Registration

The Committee sees no justification for the very low registration threshold applicable to suppliers of electronic services and **recommends** that the current compulsory registration threshold of R1 million in any 12-month period be applicable to suppliers of electronic services.

Time of supply

As regards the issue relating to the implementation of the ***payments basis*** of accounting for VAT for electronic services suppliers, it is ***recommended*** that the default (and legally mandated approach) position should be that the vendor is required to adopt the invoice basis but retain the option to adopt the payments basis if it meets the requirements set out in the law.

Invoicing

Consideration should be given to alleviating the requirement that the electronic services supplier (i.e. vendor) is required to issue a tax invoice to all customers. In this regard, the international norm is to not require tax invoices to be issued to final consumers. The rationale being that the administrative burden for these non-resident businesses is alleviated and furthermore, most final consumers do not require the document for purposes of deducting input tax.

A full discussion and analysis is attached herewith as Annexure D.

8.7 Macroeconomic impact of raising VAT

The Committee is cognizant of the fact that the fiscus needs to generate additional tax revenue now and in the future. For example, if National Health Insurance is to become a reality, the tax to GDP ratio will need to rise quite significantly. To this end, the Committee requested the National Treasury to undertake a modelling exercise to investigate the impact of increasing the standard VAT rate from 14 to 17 percent. (It should be noted that there was no particular rationale for the choice of a three percentage point rate hike. This example is purely illustrative. The modelling was done before the PIT top marginal rate was increased to 45%) For the purposes of the exercise, the zero-ratings and exemptions remain in place and all revenue is ‘recycled’ into government expenditure in the same proportions as current government spending. As such, these simulations do not reflect increased spending on a particular item (e.g. health) but rather increased overall government spending in line with current budget expenditure. Of course, the true impact of the tax increase would depend crucially on how the money is spent.

For comparative purposes, the Committee asked the Treasury to simulate an ‘across the board’ increase in personal income tax (PIT) rates and an increase in the headline corporate income tax (CIT) rate, such that each of these taxes individually raised tax revenue by the same amount as the three percentage point increase in VAT, i.e. to generate an additional R45 billion. The increase in PIT would need to be 6.1 percentage points and the increase in CIT would need to be 5.2 percentage points in order to realize the same revenue as a 3 percentage point increase in VAT. The results are shown in Figure 3.

	Impacts by 2017		
	VAT	PIT	CIT
Fiscal Impacts			
Total Direct Tax Revenue	-0.91	8.83	8.29
Total Indirect Tax Revenue	11.56	-1.32	-1.25
Total Tax Revenue	**4.28**	**4.32**	**4.05**
Macroeconomic Impacts			
Real GDP	-0.65	-1.44	-2.64
Agriculture	-2.00	-3.21	-2.66
Mining	1.09	-1.77	-6.75
Manufacturing	-3.25	-4.15	-6.70
Other Industry*	-2.46	-4.12	-11.85
Services	0.06	-0.12	0.03
Welfare			
Household expenditure	-1.83	-5.80	-3.13
Inequality**	0.013	-0.145	-0.022

All values are per cent deviation from baseline level, unless specfied elsewhere
**Includes electricity, water and construction*
***Measured as the ratio of expenditure of the richest 10 versus the poorest 40 per cent*

An increase in VAT would be inflationary in the short-run (not shown in the table) since the prices of most consumer items would rise overnight. In contrast, an increase in personal or corporate tax rates would have a smaller impact on inflation. While there would be a negative impact on real GDP and employment – particularly in the short-run – the impact of a VAT increase on these two variables would be less severe than that of a rise in PIT or CIT. It is thus clear that from a purely macroeconomic standpoint, an increase in VAT is the least distortionary of the three taxes.

However, an increase in VAT would have a greater negative impact on inequality than an increase in PIT or CIT. According to the modelling work shown in Figure 3, inequality (as measured by the ratio of the income in the richest decile relative to the poorest 4 deciles) would rise very slightly in the VAT scenario while inequality would decline in the PIT and CIT scenarios. This is because it is primarily high income households that are affected by the increase in direct taxes.

From the above it is clear that there is a trade-off between efficiency and equity. Raising VAT will have an (albeit very small) negative impact on inequality, but will be more efficient than an increase in direct taxes. It is also important to consider the longer-run: increases in direct taxes dampen growth which in turn leads to reductions in tax revenues and may constrain the ability of the state to reduce inequality through the expenditure side of the budget.

ANNEXURE A: LISTS OF SUBMISSIONS AND COMMENTS RECEIVED

List of submissions received

	DATE	NAME
1	20131114	Ian Anderson
2	20140207	SACTWU and COSATU
3	20140421	Rolf Jonker
4	20140528	Free Market Foundation
5	20140623	BUSA
6	20140704	Banking Association of SA
7	20140708	Abigail Cohen, KPMG
8	20140709	Dani Roberts
9	20140714	National Association of Pharmaceutical Manufacturers
10	20140715	Tax Consulting SA
11	20140715	SACPRIF
12	20140715	Deloitte
13	20140715	SAICA
14	20140715	BDO
15	20140715	PWC
16	20140717	Wits University
17	20140722	Ian Anderson
18	20140805	David Levenstein
19	20140807	SAICA
20	20140813	PWC
21	20140905	ISASA
22	20140926	NALEDI (COSATU)
23	20141210	Royal Bafokeng Nation Development Trust
24	20150203	Clover
25	20150226	HESA
26	20150527	ASISA
27	20151119	E Commerce SA
28	20160520	Retina SA
29	20170505	Ian Anderson

List of comments received on first interim report

	DATE	NAME
1	20150729	Gordon Pascoe
2	20150911	Ferdie Schneider (BDO)
3	20150922	PKF
4	20150923	SACBC Justice and Peace
5	20150928	Agri SA
6	20150930	ASISA
7	20150930	SAIPA
8	20150930	Free Market Foundation
9	20151001	PWC
10	20150928	Milk SA
11	20151007	PWC
12	20151007	BASA
13	20160308	Commission for Gender Equality

ANNEXURE B: FINANCIAL SERVICES

Introduction

Set out below is the detailed history of the VAT treatment of financial services since the introduction of VAT in South Africa, and the reduction of the scope of the exemption of VAT on financial services.

The purpose of the discussion that follows is, firstly, to provide an analysis of the treatment of VAT on group and inter-group transactions in the context of financial services organisations. In this regard, it is evident that the current exemption of financial services causes a cascading effect of the tax where financial services are supplied to taxable businesses, and is an incentive for financial services organisations to self-supply goods and services, which in turn eliminates to a large extent the effect of cost and business efficiencies.

The DTC considers the measures implemented by foreign jurisdictions to eliminate or reduce the incidence of cascading and the incentive to self-supply goods and services.
An analysis of the issue of VAT apportionment within the financial services sector and the claiming of input tax is also dealt with.

The appropriateness of the current VAT exempt treatment of financial services or alternative methods of taxing financial services under a VAT system has not been considered. Although many studies have been carried out world-wide on the various methods to tax financial services under a VAT system, no appropriate alternative has as yet been identified that can be considered further in the South African context. The DTC's analysis and recommendations set out herein are therefore based on the current exemptions as provided for in the Value-Added Tax Act, No 89 of 1991 ("**the VAT Act**").

History of VAT on financial services

The Margo Commission recommended in its report that a broad based tax on sales and services should be implemented to replace the then general sales tax. The White Paper on the Margo Report which was published in 1988 noted that Government was aware that VAT would give rise to many problems for different groups of taxpayers, including specialised financial institutions such as insurers, building societies and banking institutions[70].

[70] (1988) *White Paper on the Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa (The Margo Report)* Government Printer, Pretoria. Part 1 Division 10, paragraph 10.3.3 31

The draft Value-Added Tax Bill that would give effect to the proposal to introduce an invoice/credit value-added tax system was published on 18 June 1990 ("**the Draft Bill**") and provided for the exemption of various financial services enumerated in the Draft Bill.

A Value-Added Tax Committee ("**VATCOM**") was appointed following the publication of the Draft Bill to consider the comments and representations made by interested parties on the Draft Bill[71]. VATCOM noted, *inter alia*, the following with regard to financial services[72]:

- Financial services provided by any vendor should be exempt. The institutions providing the services should in respect of their inputs be treated as "end users". This will result in double taxation on the inputs of these institutions to the extent that the services are rendered to vendors;
- In theory, there does not appear to be any reason why financial services should not be subject to VAT. Financial services are consumption expenditure just like any other services and in fact, because they form a higher proportion of budgets of higher income households, there is every reason to subject them to VAT;
- In South Africa, banks and insurance companies which provide the greatest proportion of financial services have a high profile and this makes it even more difficult to justify exemption.

VATCOM considered the consequences and practical difficulties associated with the taxing of financial services and recommended that "financial services" as defined in the Draft Bill be exempted from VAT, and that further consideration be given to subjecting the value added by financial institutions to tax. As an alternative, VATCOM recommended that other indirect taxes be imposed to ensure that tax, equivalent to what would have been collected from private investors, private policy holders etc. is collected from financial institutions[73].

The VAT Act was implemented with effect from 30 September 1991, and adopted the VATCOM recommendations to exempt the supply of financial services as defined in section 2 of the VAT Act from VAT in terms of section 12(a) of the VAT Act.

Section 12(a) of the VAT Act was amended in 1992 to exempt the supply of any other goods or services by the supplier of the financial services, which is necessary for the supply of those financial services[74]. The purpose of the amendment was to extend the scope of the exemption to include those goods or services which were necessary for the supply of the

[71] (1991) *Report of the Value-Added Tax Committee (VATCOM)*. Government Printer, Pretoria.

[73] Ibid. par 3.15 32

[74] Section 18(a) of the Taxation Laws Amendment Act, No 136 of 1992

financial services by the supplier thereof, such as valuation fees charged to value a property for purposes of granting a mortgage loan, or a cheque book issued by a bank to a current account holder[75].

Section 12(a) of the VAT Act was again amended in 1994 to include in the exemption the incidental supply of goods or services by the supplier of the financial services, where the supply of such goods or services is necessary for the supply of the financial services[76]. The reason for the amendment was that problems were experienced where the supply of goods or services which constituted a separate or main supply was claimed to be *necessary* for the supply of financial services. The amendment was aimed at clarifying that only supplies of goods or services which were incidental to the supply of financial services qualified for the exemption[77].

Section 2 of the VAT Act was amended with effect from 1 April 1995 to delete section 2(1)(m) of the VAT Act which listed as a financial service the activity comprising of the payment or collection on someone's behalf of debts in respect of a financial transaction[78]. Section 2(1)(m) had the effect that rent and debt collection services were exempt from VAT, and was deleted as they comprise either administrative or professional services and it was considered that there was no justification to treat these services different from other administrative or professional services[79].

Section 2(1)(n) which listed as a financial service the activity of agreeing to do or arranging any of the activities specified in section 2(1), was amended with effect from 1 April 1995 by the deletion of the words "or arranging" [80]. The word "arranging" covered the activities of brokers, agents and other intermediaries in providing financial services. The words "or arranging" were deleted from section 2(1)(n) because it was considered that the rationale for exempting financial services does not apply to these services and there appeared to be no reason to exempt them from VAT[81].

[75] Explanatory Memorandum to the Taxation Laws Amendment Bill, 1992
[76] Section 14(a) of the Taxation Laws Amendment Act, No 20 of 1994
[77] Explanatory Memorandum to the Taxation Laws Amendment Bill, 1994
[78] Section 10(1)(a) of the Taxation Laws Amendment Act, No 20 of 1994
[79] Explanatory Memorandum to the Taxation Laws Amendment Bill, 1994
[80] Section 10(1)(b) of the Taxation Laws Amendment Act, No 20 of 1994
[81] Explanatory Memorandum to the Taxation Laws Amendment Bill, 1994

The Katz Commission appointed a specialist Sub-Committee to investigate the inclusion of a wider range of financial services in the VAT system. The Katz Commission made the following recommendations[82]:

- The provisions of section 2(1) of the VAT Act should be narrowed to bring into the VAT net all fee based financial services, and all fee based financial services in respect of life insurance and other superannuation funds;
- The financial service levy which was implemented simultaneously with VAT to compensate for the loss of revenue arising from the exemption of financial services, be abolished;
- A specialist team at the office of the Commissioner for Inland Revenue be established to investigate the adoption of a more refined definition of financial services;
- A definition of a basis of apportionment should receive urgent attention in the office of the Commissioner for Inland Revenue;
- Self-supply rules whereby specified supplies and functions are valued at market prices and are deemed to be supplied by institutions to themselves, should not be introduced; and
- VAT grouping provisions should not be implemented mainly due to the complexity of such a system. This recommendation was contrary to the recommendation of the VAT Sub-Committee that VAT grouping should be introduced.

Following the recommendations of the Katz Commission, the VAT Act was amended with effect from 1 October 1996 as follows:

- Section 2(1)(e) of the VAT Act that included the underwriting or sub-underwriting of the issue of a debt security, equity security or participatory security as a financial service, was deleted[83]. The section was deleted as it comprises the supply of a service comprising of the acceptance of a risk for which consideration is paid, and as such should be taxable[84];
- Sections 2(1)(g) and 2(1)(h) were deleted[85]. Section 2(1)(g) included in the definition of "financial services" the renewal or variation of a debt security, equity security or participatory security or of a credit agreement. Section 2(1)(h) listed the provision, taking, variation or release of a financial

[82] (1995) *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa.* Government Printer, Pretoria. Chapter 14, paragraph 14.4
[83] Section 19(1)(a) of the Taxation Laws Amendment Act, No 37 of 1996
[84] Explanatory Memorandum to the Taxation Laws Amendment Bill, 1996
[85] Section 19(1)(c) of the Taxation Laws Amendment Act, No 37 of 1996

guarantee, indemnity, security or bond in respect of the performance of obligations under a cheque, credit agreement, debt security, equity security or participatory security as a financial service. The effect of the deletion of section 2(1)(g) was that any fee payable for these services became taxable, and that the transaction in relation to the services listed in section 2(1)(h) be treated in the same manner as taxable short-term insurance[86];

- The scope of section 2(1)(i) which provided for the supply of a long-term insurance policy to be an exempt financial service was reduced to exclude from the definition of a "financial service" the management of a superannuation scheme by long-term insurers[87];
- The scope of section 2(1)(j) which included the provision or transfer of ownership of an interest in a superannuation scheme or the management of a superannuation scheme as a financial service, was limited by the exclusion of the activity of the *management* of a superannuation scheme[88]. The service of managing a superannuation scheme by an intermediary therefore became a taxable service in line with the recommendations of the Katz Commission[89];
- Section 2(1)(n) which provided for the activity of agreeing to do any of the activities specified in section 2(1) to be a financial service was deleted[90]. This was in line with the recommendation of the Katz Commission that all fee based financial services should be subjected to VAT[91];
- A proviso was added to section 2(1) to stipulate that the activities contemplated in section 2(1)(a) to 2(1)(f) of the VAT Act shall not be considered to be a financial service to the extent that the consideration payable in respect thereof is any fee, commission or similar charge, but excluding a discounting cost[92]; and
- Section 12(a) of the VAT Act was amended to exclude from the exemption the incidental supply of goods or services by the supplier of the financial services, where the supply of such goods or services is necessary for the supply of the financial services[93]. Any incidental supplies to financial services such as the supply of a cheque book to a current account holder became subject to VAT with effect from 1 October 1996.

86 Explanatory Memorandum to the Taxation Laws Amendment Bill, 1996
87 Section 19(1)(d) of the Taxation Laws Amendment Act, No 37 of 1996
88 Section 19(1)(e) of the Taxation Laws Amendment Act, No 37 of 1996
89 Explanatory Memorandum to the Taxation Laws Amendment Bill, 1996
90 Section 19(1)(f) of the Taxation Laws Amendment Act, No 37 of 1996
91 Explanatory Memorandum to the Taxation Laws Amendment Bill, 1996
92 Section 19(1)(g) of the Taxation Laws Amendment Act, No 37 of 1996
93 Section 22(1) of the Taxation Laws Amendment Act, No 37 of 1996

The scope of financial services was further limited by the inclusion of merchant's discount in the proviso to section 2(1) with effect from 1 March 1999 which became subject to VAT from that date[94]. A "merchant's discount" is defined in section 2(2)(vA) as a charge made to merchants for accepting a credit or debit card as payment for the supply of goods or services, or a similar charge by a buying organisation.

In 2001 the definition of a 'debt security' in section 2(2) was expanded to include in the definition of an exempt supply of a financial service the transfer of an obligation or liability to pay money.

Section 2(4)*(b)* originally excluded from the ambit of financial services and therefore from the exemption from VAT the transfer of any interest in or right to be paid money owing by any person *under a rental agreement*. As a result of the abuse of section 2(4)(*b*) whereby vendors entered into bare dominium structures to disguise financial services as rental payments thereby claiming input tax, section 2(4)(*b*) was deleted with effect from 1 October 2008.[95] The transfer of a right to receive money under a rental agreement is therefore exempt from VAT with effect from that date.

VAT cascading and self-supplies

Problem statement

The supply of financial services as defined in section 2 of the VAT Act is exempt from VAT in terms of the provisions of section 12(a). The exemption from VAT implies that no VAT on expenses incurred in supplying the financial services may be claimed as input tax[96]. Consequently, where a financial services organisation acquires goods or services for the purpose of consumption, use or supply of such financial services, the VAT incurred on such goods or services is not deductible as input tax.

Fee based financial services were brought into the VAT net because it was considered unjustifiable to treat these services different from other administration or professional services. The taxation of fee based financial services also resulted in financial services organisations that supply financial services for a fee becoming entitled to claim a larger percentage of the VAT they incur on their taxable expenses as input tax. However, due to the fact that these services mainly comprise of staff cost, the taxable expenses in relation to the provision of these services, and which qualify for input tax are generally not significant. The taxable expenses incurred by a financial services organisation are generally attributable to the business as a whole, which requires the financial services organisation to apportion its

[94] Section 87(1)(a) of the Taxation Laws Amendment Act, No 30 of 1998

[95] Section 105(1) of the Taxation Laws Amendment Act, No 60 of 2008

[96] Section 1, definition of "input tax" read with section 16(3) of the VAT Act

expenses between taxable and exempt activities, with the result that the financial services organisation is not entitled to deduct the total amount of VAT incurred on the expenses as input tax.

The non-deductible VAT cost to the financial services organisation is significantly increased where any function in supplying the financial services is outsourced because these services which were previously exempt from VAT are now taxable, and the financial services organisation is only entitled to claim a portion thereof as input tax. The increase in the VAT cost is mainly due to the non-taxable personnel cost which is included in the fee that is charged for the outsourced service on which VAT is levied, for which there is no corresponding input tax deduction.

Examples of the outsourced transactions which result in a non-recoverable VAT cost to a financial services organisation include:

- The supply of support services such as human resources, information technology, treasury, finance and legal services, etc.;
- The employment of staff by one company in a group and the deployment of such staff in other companies within the group;
- Loan origination and valuation services;
- Processing and assessing claims under long-term insurance policies;
- Binder agreements and underwriting management services in relation to long-term insurance business.
- Centralised customer call and service centres;
- Management and administration services; and
- Provision of infrastructure such as buildings and equipment.

The non-deductible VAT cost also impacts on the manner in which a financial services group is structured. For example, a life insurance company may invest directly in fixed property in order to avoid any irrecoverable VAT cost on inter-company rentals. Life insurance companies who own their property investments directly also generally enjoy a higher VAT apportionment ratio compared to life insurance companies that invest via property companies. The manner of investment in fixed properties is further affected by the restrictions on borrowings by life insurance companies. Life insurance companies that do not have the financial resources to invest in fixed properties directly are forced to invest in fixed properties via property companies, where the property investments are financed by loan capital. These life insurance companies generally have a lower VAT apportionment ratio because the rental income generated by the property companies is excluded from the life insurance company's VAT apportionment formula. They also incur a non-deductible VAT cost on the rentals paid to the property owning company.

The non-recoverable VAT cost incurred by the financial services organisation has the following effects:

- It has a cascading effect in respect of financial services supplied to taxable businesses that are entitled to recover VAT. Cascading occurs where the financial supply is an intermediate supply in relation to a taxable supply, and the VAT levied by a supplier to the financial institution becomes a hidden cost as it cannot be deducted by the financial institution. It is apparent that the cascading effect of VAT is more prevalent in the Banking Industry than in the Life Insurance Industry. The economic impact is, however, difficult to determine and quantify; and
- There is a significant incentive for the financial services organisation to self-supply the services or infrastructure ("**vertical integration**") to avoid the additional VAT cost resulting from outsourced services.

Vertical integration in turns creates certain problems, including:

- Discrimination against third party suppliers;
- Discrimination against smaller financial institutions that are not in a position to vertically integrate[97]; and
- It frustrates the natural development of specialisation and creates inefficiencies in the production and delivery of financial services[98].

New Zealand – zero rating of financial services supplied to vendors[99]

In order to eliminate the cascading effect of VAT in respect of non-recoverable VAT on financial services, New Zealand has with effect from 1 January 2005 introduced the zero rating of the supply of financial services to customers who:

- are registered for GST if the level of taxable supplies made by the customer in a given 12-month period (including the taxable period in which the supply is made) is equal to or exceeds 75% of their total supplies for the period;
- may not meet the 75% threshold but are part of a group that meets the threshold in a given 12-month period (including the taxable period in which the

[97] Schenk A & Oldman O. (2007). *Value Added Tax: A Comparative Approach* Cambridge: Cambridge University Press p317; Schenk A., (2008) *'Financial Services'* in R Krever (ed), *VAT in Africa* Pretoria: Pretoria University Press 31 – 46, 40.
[98] *Report of the VAT Sub-Committee into the Taxation of Financial Services* (Government Printer, Pretoria, 1995) par 4.2.3, 16.
[99] *Tax Information Bulletin Vol 16 No 10 (November 2004).*

supply is made), for example, the treasury or finance function of a group of companies who receives financial services.

With effect from 1 January 2005 the New Zealand GST Act also provides for an additional deduction from output tax for supplies of financial services made to another financial services provider, which in turn makes supplies to businesses that would qualify to receive zero-rated financial services. The amount that can be deducted is determined by the ratio of taxable to non-taxable supplies made by the recipient financial services provider.
The current standard rate of GST in New Zealand is 15%.

Singapore – treatment of exempt supplies to taxable persons as taxable supplies[100]

VAT incurred on expenses and acquisitions which are not wholly attributable to either taxable or exempt supplies must be apportioned and can be claimed in the ratio of taxable supplies to total supplies. However, the Comptroller can approve an apportionment method that allows a supplier of financial services to claim input tax incurred in the course of the supply of certain financial services[101].

In order to reduce the cascading effect of VAT on financial services supplied to taxable businesses, Singapore treats exempt supplies made to taxable persons as taxable supplies, thereby effectively zero rating these supplies and allowing the financial institution to claim input tax in relation to the supplies[102]. Alternatively, a financial institution can claim input tax for a fixed percentage of total input tax in terms of a special apportionment method allowed for specific type of financial institutions[103].

For example, assume a bank has taxable supplies of 20 million, specified exemption financial services of 50 million, and other exempt supplies of 30 million. The input tax not directly attributable to taxable or exempt supplies is 700 000. For purposes of the ratio of taxable to total supplies (the ratio that allocates input tax not directly attributable to taxable or exempt supplies), taxable supplies are 70 million (both the 20 million of taxable supplies and 50 million of specified exempt financial services). The allowable credit is 700 000 x 70 million / 100 million, or 490 000[104]. The current standard rate of GST in Singapore is 7%.

[100] Zee, HH. (2004). *Taxing the Financial Sector: Concepts, Issues, and Practice*. Washington D.C.: International Monetary Fund.
[101] Goods and Services Tax (General) Regulations, (Rg 1) Part V, Reg 30 and 33 (Singapore Regulations) subject to Reg 34 and 35.
[102] Goods and Services Tax (General) Regulations, (Rg 1) Part V, Reg 30(2) (Singapore Regulations).
[103] Goods and Services Tax Act, section 20.
[104] Krever (note 3 above) 38 and 39.

Australia – Reduced Input Tax Credit Scheme[105]

Australia introduced a Reduced Input Tax Credit ("**RITC**") scheme, which is a unique feature of the Australian GST Act[106]. The object of the RITC scheme is to eliminate the bias to vertical integration and to facilitate outsourcing from a cost efficiency perspective[107].

The RITC scheme allows suppliers of financial services to claim 75% of the GST paid on specified inputs as listed in the GST regulation. These transactions include the following:

- transaction banking and cash management services;
- payment and fund transfer services;
- securities transactions services;
- loan services;
- debt collection services;
- fund management services;
- insurance brokerage and claims handling services;
- trustee and custodial services;
- supplies for which financial supply facilitators are paid a commission.

With effect from 1 July 2012 the RITC rate was reduced from 75% to 55% for certain services acquired by investment trusts including superannuation funds, and the RITC was expanded to apply to audit and legal expenses incurred by these entities.

The Australian GST Act also contains *de minimis* provisions, the object of which is to allow taxpayers who make financial supplies below a certain threshold to recover all of their input GST costs despite the making of financial supplies. To allow recovery of input GST costs on an acquisition under the *de minimis* rules, the following requirements need to be satisfied:

- The only reason the acquisition would (apart from the *de minimis* provisions) be treated as relating to making supplies that would be exempt is because it relates to making financial supplies.
- The taxpayer entity does not exceed the financial acquisitions threshold.

The "financial acquisitions threshold" is based on an entity's level of input tax credits. Under the *de minimis* test, a registered entity can obtain input tax credits for acquisitions that relate to making financial supplies if the total amount of credits which would otherwise be denied do not exceed either or both of the following levels:

- $50,000 or such other amount specified by the GSTR;
- 10% of the total input tax credits of the entity.

[105] McMahon O & Macintyre A, *GST and Financial Supplies*, Journal of Australian Taxation May/June 2000.
[106] GSTA, Div 70 and GSTR Pt 4-2.
[107] Senate Further Supplementary Explanatory Memorandum to the GST Bill (1998-9) at para 5.1.

If either or both of these levels are exceeded, an entity will have exceeded the financial acquisitions threshold. In that event, it is denied input tax credits to the extent its acquisitions are not acquired for a creditable purpose, and the RITC may be claimed on the expenses listed in the regulation. The current standard rate of GST in Australia is 10%.

European Union – VAT grouping

The European Union VAT law allows for companies which form part of the same group to register for VAT purposes as a single person[108].

A VAT group occurs when related companies or limited liability partnerships register as a single taxable person if certain criteria are met. A VAT group is treated in the same way as a single taxable person registered for VAT on its own. The registration is made in the name of a “representative member”. The representative member is responsible for completing and submitting a single VAT return and making VAT payments or receiving VAT refunds on behalf of the group. All the members remain jointly and severally liable for any VAT debts[109].

The effect of a VAT group registration is that supplies of goods or services between members of the group are ignored for VAT purposes and do not attract any VAT, thereby eliminating any non-recoverable VAT cost on centralized functions and allowing for the more effective and cost efficient service delivery to consumers, and eliminating the cascading effect of any non-recoverable VAT cost on inter-company supplies where financial services are supplied to taxable consumers. VAT grouping also reduces the administration cost associated with the completion and submission of VAT returns for the entities within a VAT group, and reduces the administration with regard to the invoicing and processing of VAT on inter-group transactions.

Eighteen European Union Member States have introduced VAT grouping[110]. Luxembourg has not introduced VAT grouping but introduced a VAT exemption for cost sharing associations[111].

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[108] Article 11 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value-added tax.

[109] HM Revenue & Customs. *Group, division or joint venture VAT registration*.

[110] Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Ireland, Italy, Latvia, the Netherlands, Romania, Slovakia, Spain, Sweden, and the United Kingdom.

[111] as foreseen in article 132, 1(f) of the Council Directive 2006/112/EC; article 44, 1 y – (2013) KPMG, *Luxembourg: VAT essentials*.

Certain member states only allow VAT exempt organizations to apply VAT grouping, which is specifically aimed at facilitating the outsourcing of intragroup taxable services, while other member states do not allow companies that engage in exempt activities to join a tax group[112]. In the latter case the objective is economic, i.e. the reduction of compliance costs and the set off of excess input tax of one group-company against output tax of another to minimize cash flow costs[113].

European Union – option to tax

The European Council Directive grants a right to Member States to introduce an option to tax certain financial services, but not insurance transactions[114].

Currently, only five Member States have introduced an option to tax in their national VAT legislation[115]. However, the scope of the application of the option to tax varies considerably amongst these Member States with regard to the transactions to which they apply, whether they apply to business to business transactions or also business to consumer transactions, whether the option can be exercised on a transaction by transaction basis, whether the option is revocable and whether it applies to cross-border transactions as well[116].

It was found that the option to tax is profitable only for financial institutions where a transaction comprises a sale to a taxable person who can reclaim the VAT where financial institutions do not or cannot coordinate their behavior to exercise the option to tax[117].

Canada – zero rating of financial services

Canada exempts most financial services from VAT. Specific exclusions from the exemption include management and advisory services and administrative services, as well as investment advisory services.

One Canadian state, Quebec, effectively zero rated financial services under its VAT equivalent system, QST. The initial justification for this approach was to maintain the

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[112] Denmark & Cyprus

[113] Parolini A. (2008) European VAT and Groups of Companies. In *International and EC Tax Aspects of Groups and Companies*. Maisto G (ed). Amsterdam: International Bureau of Fiscal Documentation p112-113

[114] Article 11 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

[115] Austria, Belgium, Estonia, France, Germany and Lithuania.

[116] De la Feria R & Lockwood B. (2010). Opting for Opting In? An Evaluation of the European Commission's Proposals for Reforming VAT on Financial Services. In *Warwick economics research paper series* Vol 210 No 927. Coventry: University of Warwick. Dept. of Economics. 14-15, 35-37

[117] De la Feria & Lockwood (note 48 above) 17

competitiveness of the Quebec financial institutions and to limit the incentive to imports of financial services from abroad[118].

This apparent advantage for Quebec financial institutions was mitigated by a partial restriction on input tax deductions and by a compensation tax imposed on financial institutions as a *quid pro quo* for the zero rating of financial services. For banks the tax rate was 0.25% of the Quebec paid up capital plus 2% of Quebec wages, and the tax rate for insurance companies was 0.35% of premiums payable[119].

However, Quebec changed from the zero rating to apply exemption in 2013 as part of its harmonization arrangement with the federal government[120].
The current standard rate of HST in New Brunswick, Newfoundland and Labrador is 13%. In Nova Scotia the HST rate is 15% (reduced to 14% from 1 July 2014) and in Quebec the QST rate is 9.975%. Elsewhere in Canada the standard GST rate is 5%[121].

Options for consideration

The vertical integration and cascading effect of VAT resulting from the exemption of financial services can be eliminated by taxing financial services. However, due to the difficulties in determining an appropriate basis of subjecting financial services transactions to VAT, a detailed investigation into the methods of taxing of financial services should be carried out before consideration is given to bring financial services within the VAT net. Although various studies have been carried out in this regard, no jurisdiction has to date successfully subjected financial services transactions (other than fee based financial services) to VAT. It is also not certain that the taxation of financial services will yield additional VAT revenue.

In order to eliminate the incentive for financial institutions for vertical integration, and to eliminate or reduce the cascading effect of VAT under the current VAT exemption provisions, the following options have been considered in the South African context:

- The introduction of a self-supply taxing mechanism in terms of which the self-supply of goods or support services is subjected to VAT, by placing a specific

[118] Quebec (1992) *Precisions relatives a la detaxation des services financiers dans le regime de la TVQ et a la perception de certaines taxes quebecoises aux frontiers: Bulletin d'Information no 92-1*. Quebec: Ministere des Finances at 1.

[119] Gendron PP. (2008) VAT Treatment of Financial Services: Assessment and Policy Proposal for Developing Countries. In Dickenson F (ed). *Bulleting for International Taxation November 2008*. Amsterdam: International Bureau of Fiscal Documentation

[120] Firth, M, and McKenzie, K. (2012). The GST and Financial Services: Pausing for Perspective. In Gianuzzi (ed). *The School of Public Policy SPP Research Papers*. Calgary: University of Calgary.

[121] (2013) KPMG, *Canada: VAT essentials*.

value on these goods or services and requiring the financial institution to account for output tax on the value of the self-supply[122];

- Apply VAT at the rate of zero per cent to the supply of financial services in line with the options followed by New Zealand and Singapore, and which was followed by the province of Quebec in Canada;
- Allowing the financial institution to claim an input tax deduction or reduced input tax deduction on the goods or services it acquires from suppliers to supply financial services, i.e. the RITC model followed in Australia;
- Providing financial institutions with the option to tax financial services supplies to taxable persons who may claim the VAT as input tax;
- The introduction of VAT group registration; and
- The reinstatement of the exemption of intermediary services supplied to financial institutions.

Self-supply taxation

VATCOM considered the implementation of self-supply rules and noted that VAT could distort present business practices and that the effect could be detrimental and of such magnitude that it could seriously affect vendors. VATCOM recommended that self-supply rules be introduced and that the goods or services to which it applies, be set out in regulations which can be changed by the Minister of Finance[123].

The VAT Sub-Committee to the Katz Commission also considered the application of self-supply rules and concluded that they proved to be complex and difficult to control in other countries, and that it is not clear whether there is any real financial benefit or business protection arising from this concept. The VAT Sub-Committee therefore recommended that this concept should not be introduced[124].

Although the introduction of self-supply rules may reduce or eliminate the effect of vertical integration, it will lead to increased administration and complexity of the VAT system, and is not recommended for the following reasons:

- The introduction of VAT on the self-supply of goods or services will require the identification and regulation of the goods or services which are to be subject to VAT for each sector that may be affected by vertical integration;

[122] Schenk & Oldman 317 - 318.
VATCOM paragraph 3.35 59.
[124] Katz Commission par 9.3.4 42.

The value of the self-supply on which VAT must be levied and accounted for should be determined and regulated, and could pose the following challenges:

- Self-supply taxation will not address the cascading effect of VAT on financial services supplied to taxable businesses;
- The value of self-supplies may bring financial institutions which are currently not registered into the VAT net as it will cause these institutions to register for VAT if the value of self-supplies exceeds the VAT registration threshold; and
- The value of self-supplies will affect the VAT apportionment ratios of financial institutions regarding the claiming of input tax deductions which will further distort parity between financial services organizations that self-supply and those that outsource support functions.

The introduction of a self-supply regime is not recommended for further consideration as a viable option.

Zero-rating of financial services

The zero rating of financial supplies to taxable businesses will eliminate the cascading effect of VAT and it is relatively simple to implement and to apply. It will also eliminate the need for vertical integration.

The zero rating of financial services made to taxable businesses appears to be successfully applied in New Zealand and Singapore. However, the implementation of the rate of zero per cent to financial supplies in New Zealand should be viewed in the context of the relatively small financial services sector in that country, which only has approximately 20 registered banks. The financial impact of the zero rating is also relatively small and is estimated to be less than 1% of the total annual VAT refunds made by the New Zealand Inland Revenue[125]. In Singapore the VAT rate is only 7%.

To apply the rate of zero per cent to financial services supplied to taxable businesses, the VAT status of the recipient needs to be established for each transaction to determine the VAT status of the supply. This is administratively burdensome and is contrary to some of the fundamental principles of a pure VAT system, i.e.:

- that all transactions should be subject to VAT if the supplier is registered for VAT, irrespective of the status of the recipient of the supply; and

[125] Pallot M. (2011) Financial Services under New Zealand's GST. In Annacondia F & van der Corput W (eds). *International VAT Monitor* September / October 2011 310 - 315 Amsterdam: International Bureau of Fiscal Documentation

- all transactions should be subject to VAT with as few as possible exclusions and exemptions.

The benefits of zero rating to VAT registered businesses need to be considered in view of the additional compliance costs and additional administration for both the financial institution and the South African Revenue Service.

An alternative option would be to zero rate all supplies of financial services, as was the case under the Quebec VAT system (see above).

The zero rating of financial services may potentially lead to significant VAT avoidance. The introduction of the zero rating of financial supplies would therefore have to be accompanied with anti-avoidance legislation to avoid aggressive VAT planning.

It is also anticipated that there will be a loss of revenue resulting from the zero rating of financial services, and the question arises as to whether financial institutions will pass the benefit of zero rating on to consumers in the form of lower charges.

If zero rating to certain or all financial services is implemented, the suppliers of financial services will enjoy an advantage over the suppliers of any other goods or services. The application of the perceived preferential treatment of financial services, which comprises a significant and profitable part of the economy, would also be difficult to justify[126].

The partial or full zero rating of financial services is not recommended for further consideration as a viable option.

Allowing of input tax or reduced input tax

Where a financial services institution is entitled to deduct a certain amount of input tax despite the fact that it makes supplies of VAT exempt financial services, it removes to a large extent the incentive for vertical integration and the cascading effect of VAT on supplies made to VAT registered businesses. The principal objective of the RITC scheme introduced by Australia is to eliminate the bias to vertical integration and to facilitate outsourcing from a cost efficiency perspective.

[126] Van Schalkwyk S & Prebble J (2004). Imposing Value-Added Tax on Interest-Bearing Instruments and Life Insurance. In Ponniah A & Kaur D (eds). *Asia-Pacific Tax Bulletin* December 2004. 451-468. Amsterdam: International Bureau of Fiscal Documentation. 453

In the Australian model a financial acquisition threshold is introduced which has the effect that if the threshold is not exceeded, the financial institution is entitled to claim the total amount of VAT incurred as input tax. The threshold must, however, constantly be monitored which contributes towards the institution's compliance costs[127].

Where the threshold is exceeded, the financial institution is entitled to claim a fixed percentage of the VAT incurred on specified expenses, to grant the financial institution a credit estimated to be equal to the VAT on the value added by the supplier[128].

This option was considered in some detail by PricewaterhouseCoopers in a study undertaken for the European Union in which they concluded that the RITC system could remove the bias in favour of vertical integration on the part of financial services firms. PricewaterhouseCoopers further stated this solution has a broad-based application, i.e. it applies to all financial services sectors, and will ensure a high degree of legal certainty for economic operators when interacting with revenue authorities[129].

Under a RITC scheme the expenses and supplies which will qualify for a reduced input tax deduction will have to be identified and be regulated which may lead to interpretational disputes and ambiguities. This is the main criticism of the Australian RITC scheme[130]. An appropriate rate at which the input tax may be claimed will also have to be determined.

The Australian Treasury released on 12 May 2009 a consultative paper[131] in which comments was invited on, *inter alia*, the RITC. The response from the majority of respondents was that the financial supply rules should either be retained or significantly retained, which seems to indicate that the Australian financial sector is relatively satisfied with the GST treatment of financial supplies with regard to the RITC scheme[132].
The benefits of a RITC scheme are as follows:

- It will contribute towards the elimination of vertical integration and the reduction of the cascading effect of VAT on financial services supplied to taxable businesses;

[127] De la Feria R & Walpole M. (2009). Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. In *International and Comparative Law Quarterly* vol 58 897-932

[128] McMahon & Macintyre (note 40 above) 193

[129] PricewaterhouseCoopers. (2006). *Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services*. Final Report to the European Union. Par 8.31

[130] Edmundson Peter, (2003) GST, Financial Supplies and Reduced Input Tax Credits. *Tax Specialist* Vol 6 No 3 February 2003 113 – 121; De la Feria R & Walpole M. (2009). Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared. In *International and Comparative Law Quarterly* vol 58 897-932

[131] Australian Treasury (2012), *Review of the GST Financial Supply Provisions – Consultative Paper*

[132] Walpole M. (2009). "The Miraculous Reduced Input Tax Credit for Financial Supplies in Australia". In *International VAT Monitor* September/October 2011 316-322

- It will provide certainty to financial institutions with regard to the amount which is deductible as input tax and will significantly reduce the need for the application of special VAT apportionment methods;
- All financial institutions will be treated equally from a VAT input tax deduction perspective; and
- It is relatively simple to implement and administer.

It is recommended that the introduction of a RITC or variation thereof be further considered to eliminate the vertical integration and cascading effect of VAT.

Option to tax

The option to tax financial services will eliminate the cascading effect of VAT on the supply of financial services to taxable consumers who can reclaim the VAT. It may also contribute to a certain extent to reduce the incentive of vertical integration.

In order to apply the option to tax, the transactions to which the option applies must be identified and regulated. The value on which VAT must be levied must also be clearly determinable, and it should be determined whether the option applies to all financial services or only to business to business supplies.

An option to tax is likely to give rise to difficulties, interpretive problems, complexity of the VAT system and legal uncertainty. It is also expected to increase the administration burden for financial institutions.

The introduction of an option to tax is not recommended for further consideration as a viable option.

VAT Grouping

VAT grouping implies that from a VAT perspective it is not relevant whether a financial services organisation operates under an organizational structure of branches or independent subsidiaries, and therefore gives precedence to economic substance over legal form[133].

VAT grouping will eliminate the incentive for vertical integration specifically with regard to inter-group supplies, and will alleviate the cascading effect of VAT caused by taxable inter-group transactions on financial supplies to taxable businesses that are entitled to recover VAT.

[133] Vyncke K. (2007) VAT Grouping in the European Union: Purposes, Possibilities and Limitations. In Annacondia F & van der Corput W (eds). *International VAT Monitor* July/August 2007 250 - 261 Amsterdam: International Bureau of Fiscal Documentation

VAT grouping will eliminate the competitive advantage that certain financial services organisations currently enjoy by self-supplying goods and services over financial services organisations that do not have the resources to vertically integrate. VAT grouping will also enable financial services organisations to structure their activities and investments in a business efficient manner without being penalised with irrecoverable VAT, and it will enable them to supply their financial services more efficiently and cost effective to consumers.

The Draft Bill provided for VAT grouping and these provisions were considered in some detail by VATCOM, who concluded that VAT group treatment holds more disadvantages than advantages and recommended that the relevant provisions not be implemented[134]. The Katz Commission VAT Sub-Committee recommended that VAT grouping be implemented on a voluntary basis and subject to the necessary anti-avoidance provisions[135]. However, The Katz Commission recommended that, notwithstanding the recommendation of the VAT Sub-Committee, VAT grouping provisions should not be implemented mainly due to the complexity of such a system[136].

The Joint Standing Committee on Finance noted in its report on the Katz Commission report that many submissions recommended that group taxation should extend to VAT as well as income tax and that the Katz Commission's grounds for not recommending this were felt to be insufficient and the matter was thus seen as requiring further investigation[137].
VAT grouping may have the following benefits[138]:

Administrative benefits to companies since only a single VAT return has to be prepared for the entire group;

Allowing VAT grouping may have no or an insignificant direct cost to State. Without it, financial services companies may continue to self-supply business support functions as divisions within their own companies, on which no VAT is payable.

VAT grouping may also have the following benefits for the South African Revenue Service[139]:

[134] VATCOM par 3.19
[135] VAT Sub-Committee 43
[136] Katz Commission par 14.4.6 p147
[137] Final Draft Report of the Joint Standing Committee on Finance on the Third Interim Report of the Katz Commission of Inquiry into Taxation 24
[138] The Impact of the Introduction of VAT Groupings on the Polish Economy. (2006). *Special Report by International Tax and Investment Center and Oxford Economic Forecasting*. 10
[139] Vyncke (note 68 above) 253

It safeguards the collection of VAT from members of the VAT group, as VAT grouping is generally accompanied by joint and several liability of the individual members of the group for payment of the VAT;

It may prevent avoidance practices where companies are split into smaller companies with a turnover below the VAT registration threshold to avoid charging VAT; and

It reduces administration and increases effective operation in that fewer VAT returns need to be processed and fewer vendors need to managed, which allows it to carry out more in-depth audits.

It is recommend that VAT grouping be considered further as an option to eliminate vertical integration and to alleviate the cascading effect of VAT.

Exemption of financial intermediary services

The provisions of section 2(1)(n) of the VAT Act which exempted the activities of agreeing to do or the arranging of any financial services specified in section 2(1) could be reinstated.

The reinstatement of section 2(1)(n) will exempt the activities of brokers, agents and other intermediaries that render services to financial organisations in relation to their financial services supplies, and will contribute to the elimination of vertical integration since many intermediary services carry a large labour component on which no VAT is incurred.

The difficulty that arises with these provisions is the identification of the services that should qualify for the exemption. It is also likely to give rise to interpretative issues due to the wide and unclear ambit of the term “agreeing to do or arranging”.

The provisions of section 2(1)(n) were originally deleted on the basis that all fee based financial services should in principle be subjected to VAT.

The expansion of the list of exemptions would further contribute towards the complexity of the VAT system, and would give rise to additional compliance costs for financial intermediaries.

This option is not recommended for further consideration.

Conclusion and summary

The exemption of VAT on financial services and the resultant prohibition on the claiming of input tax lead to a cascading effect for taxable businesses that are entitled to claim VAT on their business inputs. It also provides a substantial incentive for vertical integration which

leads to inefficiencies in the delivery and supply of financial services. However, due to the practical difficulties relating to the taxation of financial services, the current exemption provisions should be retained whilst further investigation is carried out in this regard.
Neither the zero rating of financial services nor the introduction of self-supply rules as a measure to eliminate the incentive for vertical integration or to eliminate the cascading effect that exemption causes seem to be viable options for further consideration. The same applies to the exemption of financial intermediary services.

Allowing financial services organisations to claim a reduced input tax deduction at a fixed rate on certain specified inputs (similar to the RITC scheme in Australia, refer above) should be further considered. Although a fixed input tax deduction may not be an accurate reflection of the value added by all financial services organisations, it eliminates the incentive for vertical integration and the cascading effect of VAT, it is simple to implement, to control and administer, and all financial services organisations are treated equally from a VAT perspective. It also eliminates the need for special VAT apportionment methods which may result in a competitive advantage.

VAT grouping is an effective manner in which financial services organisations can structure their business operations in a business efficient manner without being penalised by a non-recoverable VAT cost. VAT grouping has been successfully implemented in a number of European Union countries, as well as New Zealand, Australia and Singapore.

VAT apportionment

Financial Services organizations are subject to VAT apportionment as a result of the fact that they render both taxable and exempt supplies.
Two broad financial industries are affected by VAT apportionment, i.e.:

- Banking services and credit providers; and
- Life Insurance Companies and superannuation schemes.

The very nature of the services rendered by the financial services organizations lends itself to VAT apportionment as they supply services which are subject to VAT and services which are exempt from VAT. Due to the fact that financial intermediary services (other than loan intermediary services) are mainly subject to VAT, a substantial portion of such VAT is irrecoverable when supplied to a financial services organisation, which places an emphasis on the apportionment formula applied to minimise irrecoverable VAT cost. The principal purpose of an apportionment formula is to determine the extent to which taxable expenses are attributable to the making of taxable supplies on a fair and reasonable basis. If direct attribution and VAT apportionment are correctly applied, it would also reduce the cascading effect of VAT on financial services supplied to taxable entities.

Section 17(1) of the VAT Act requires a vendor to apply the standard turnover-based method of apportionment as prescribed by the SARS in Binding General Ruling 16, unless SARS has approved the application of an alternative apportionment method. However, the prescribed turnover-based method is often not an appropriate or fair basis of apportionment for financial institutions.

A turnover-based method of apportionment is only a fair and equitable method of determining the extent to which taxable expenses are attributable to taxable supplies in the following circumstances[140]:

- There is a correlation between the values of the different supplies made by a vendor with the taxable expenses incurred and taxable assets applied in making such supplies;
- There is a simple and constant relationship between the value of the vendor's supplies and the taxable expenses incurred, i.e. that each R1 of taxable output uses roughly the same amount of taxable costs and R1 of exempt output.
- There are no significant differences in the timing between costs incurred and corresponding taxable and exempt supplies; and
- There are no large one-off income receipts in respect of which few costs or expenses are incurred.

The prescribed turnover-based method hardly ever meets any of the above-mentioned criteria for a turnover-based formula to be a fair and reasonable basis for financial institutions. The fairness and reasonability of the prescribed turnover-based formula as set out in Binding General Ruling 16 for the purposes of section 17(1) of the VAT Act, is further distorted by the inclusion in the denominator of the formula of any amounts received by or accrued to the financial institution, irrespective of whether it comprises proceeds for a supply or not. The formula thus requires that receipts in respect of which very little, if any, taxable expenses are incurred are included in the apportionment formula, most notably dividends and income which is passive in nature. The inclusion of dividends and passive income in the denominator of the turnover-based apportionment formula is unique to South Africa.

[140] HM Revenue & Customs (2011) Partial Exemption Guidance Manual PE3020

The Banking Association South Africa ("**BASA**") (previously the Council of South African Banks (COSAB) as it was then known) and SARS agreed a well-documented methodology of the VAT treatment of supplies and apportionment in the banking industry, which is currently under review. However, there has been on-going debate as to which expenses are considered to be directly attributable to taxable supplies and amounts which should be included or excluded from the formula. SARS issued a Binding Class Ruling to certain BASA members with regard to the apportionment method to be applied by these members. [141] This method is a variation of the turnover-based method and requires, amongst others, the inclusion of net interest and a three year moving average of the net trading margin from financial asset trading activities in the denominator, and the exclusion of the capital value of rentals and instalment credit agreements.

The Life Insurance Industry and superannuation schemes do not have any specified or standardised basis of VAT apportionment. Certain life insurance companies approached SARS on an individual basis to agree an apportionment methodology for their respective businesses.

There are basically two apportionment methodologies which could be applied to life insurance companies and superannuation schemes, the appropriateness of which is discussed below:

- Turnover method - This method of apportionment is not a fair and reasonable basis if viewed in light of the criteria listed above. Consideration needs to be given to the treatment of premium income and contributions for purposes of applying this formula, and it is questionable as to whether the gross premium income or contributions comprises income or turnover in the hands of the life insurance company or superannuation scheme respectively for purposes of an apportionment formula based on turnover. For the Banking Industry it was agreed that only net interest (i.e. gross interest received less interest paid) be included as exempt income in the denominator of the apportionment formula, representing the actual exempt turnover of the institution. No similar concession is made for life insurance companies or superannuation schemes that receive and invest premiums or contributions for the benefit of policyholders and members, and only effectively retain an "administration fee" or underwriting margin as consideration for their services. The inclusion of dividend income and passive income in the apportionment formula also needs

[141] Value Added Tax: Class Ruling – Members of the Banking Association South Africa – Application for Alternative Method of Apportionment, 2 June 2015

to be reconsidered as no supply is made in respect of such income, and very little, if any taxable expenses are incurred in relation thereto.

- Varied input tax method - This may be a more appropriate method of determining the claimable portion of VAT incurred than the turnover-based method, but is limited to life insurance companies and superannuation schemes that have taxable expenses that can be directly attributable to taxable supplies, i.e. commercial rental income. On this basis the expenses incurred by these entities in relation to their mixed supplies are apportioned based on an expenses basis using a percentage of VAT incurred on expenses directly attributable to taxable supplies as a percentage of the sum of VAT incurred on expenses directly attributable to taxable and to exempt supplies. Where life insurance companies or superannuation schemes hold their commercial property portfolios in separate property companies, the application of this method of apportionment is not available as there are then no taxable expenses which can be wholly attributable to taxable supplies.

Neither of these apportionment methods seems to be appropriate. The varied input tax method is discriminatory towards life insurance companies and superannuation schemes that cannot apply the method, and both methods result in significant irrecoverable VAT cost to the entities concerned. This VAT cost is then passed on to the policyholder or member, who ultimately bears the VAT cost in the form of lower returns. Financial investments that do not yield any direct utility by the investor do not comprise private consumption of goods or services where the investment comprises a mere transformation of money into another form of monetary asset representing the potential for future consumption[142]. It is therefore questionable as to whether it is equitable that a policyholder or member of a superannuation scheme should bear this VAT cost in the first instance, as such VAT cost is in effect a tax on savings. When the savings are subsequently applied to acquire goods or services, such consumption is duly taxed.

South African policyholders and members of superannuation schemes are further placed at a disadvantage compared to policyholders and members in foreign countries, i.e. European Union countries and Australia in particular, who do not bear the same level of VAT cost.

The options discussed above could alleviate the irrecoverable VAT cost for life insurance companies and superannuation schemes, and ultimately for policyholders and members. It

[142] Englisch J. (2011). *EU Perspective on VAT Exemptions*. Oxford: Oxford University Centre for Business Taxation. 43

could also possibly address the necessity for an alternative apportionment method and financial institutions would generally be treated on an equal basis.

Submissions

The Committee received a submission from BASA in which it expressed concern that the existing SARS policies and practices do not recognise the full extent to which VAT expenditure incurred by banks relate to taxable activities, which results in double taxation and inflated banking costs. BASA also expressed the view that the current VAT apportionment method applied for banks prejudice them as VAT is not fairly apportioned to the making of taxable supplies.

The Committee received a submission from BDO in which it pointed out that VAT incurred by Long-term Insurers outsourced service functions is not deductible due to the exemption that applies to long-term insurance policies. The VAT cost on outsourced services lead to the self-supply of such services, but the self-supply result in inefficiencies. BDO submitted that the Australia model of allowing a fixed input tax percentage of financial services, and the exemption applied by the United Kingdom to insurers and reinsurers, and related services of insurance brokers and agents be further researched to achieve efficiency and equity pertaining to the VAT treatment of financial services.

The Committee considered, inter alia, the effect of VAT on inter-group transactions within financial services organisations. As part of this process, the DTC requested the Association for Savings and Investments SA ("ASISA") and BASA to obtain certain information in this regard from their members.

The Committee received 23 responses in total, of which 7 responses were received from BASA members, and 14 responses were received from ASISA members.
Of the 14 responses received from ASISA members, 8 responses were received from long-term insurers, and 6 were received from investment management and equity trading companies.

The majority of the BASA members indicated that the non-recoverable VAT is a factor that they consider in structuring their group, and that it has some impact on competitiveness. Two BASA members indicated that the VAT apportionment method applied for banks is not appropriate.

The majority of long-term insurance ASISA members indicated that they considered non-recoverable VAT in the structuring of the group and that non-recoverable VAT impacts on competitiveness. Two members indicated that non-recoverable VAT on outsourcing should also be considered whereas one member indicated that the VAT apportionment method of long-term insurers merits further consideration.

The responses received from investment management and equity trading members of ASISA indicated (with the exception of one respondent) that non-recoverable VAT on inter-group transactions is insignificant or non-existent, and is not a consideration in structuring the group and also does not impact on competitiveness.

The Committee received a further submission from BASA in which it recommended the following:

- The current VAT exemption of financial services should be retained, but consideration should be given to the redrafting of section 2 of the VAT Act to eliminate uncertainties as to the scope of the exemption;
- The zero rating for exported financial services remains appropriate;
- Research should be undertaken to implement a mechanism to prevent trapped VAT costs resulting from the exemption, and the implementation of measures to prevent the incentive not to out-source certain functions, and to prevent double taxation;
- The taxing of financial services should not be considered at this stage or in the near future;
- The VAT regimes implemented by New Zealand (relating to the zero rating of certain supplies made to vendors), and Australia (relating to the reduced input tax credit regime) should be researched in more detail, to determine the possibility to implement such systems in South Africa, to prevent the need for in-sourcing.
- The merits of VAT grouping, specifically in the context of outsourcing, as a measure to reduce the effects of cascading VAT and double taxation, should be considered further in the South African context; and
- The approach to VAT apportionment should be reviewed in order to reach equity, certainty and simplicity with a view to ultimately reduce the compliance cost incurred by banks in managing VAT apportionment.

The Committee received a submission from ASISA in which it endorses:

- The introduction of a RITC model similar to that of Australia with a single recovery rate of 75%;
- The introduction of VAT grouping on an optional basis and the ownership requirements be based on the existing ‘group of companies’ definition in the Income Tax Act, 1962;
- The determination of appropriate methods of VAT apportionment within different sectors within the financial services industry.

Recommendations

Consideration should be given to:

- Allowing financial services organisations to claim a reduced input tax deduction at a fixed rate on certain specified inputs (similar to the RITC scheme in Australia, refer above);
- VAT grouping be considered further as a measure to eliminate vertical integration and to reduce the cascading effect which the VAT exemption of financial services causes. Research should be undertaken to establish best practice, potential risks need to be identified and an anti-avoidance mechanism should be developed to counter abuse;
- Appropriate VAT apportionment methods for banks and credit providers, and for life insurance companies and superannuation schemes should be determined.

ANNEXURE C: PLACE OF SUPPLY RULES

An issue that continues to evoke significant interest is the question as to the place (jurisdiction) where VAT should be imposed and accounted for. This is especially important in the context of electronic commerce (see **Annexure D – Electronic Commerce**). While the destination principle, the foundation of the South African VAT system, is predicated on taxing end consumption where such consumption takes place, as noted by Rebecca Millar[143], VAT in practice in effect taxes consumption expenditures at the time they are incurred. In consequence, Millar argues that VAT is a predictive tax in that tax is imposed at the time the consumption expenditure is incurred and not at the time it takes place.

Millar argues that because VAT is a tax on consumption expenditures at the time they are incurred, it is not appropriate for place of taxation rules to depend on where actual consumption takes place after the time of supply. This is the approach taken in both the European and New Zealand models under which, with the possible exception of 'place of effective use or enjoyment' rules, the place of taxation rules do not require an analysis of where consumption takes place. Instead, recognising the transactional nature of VAT, and the fact that it is a tax on consumption expenditures at the time and in the place where they are incurred, place of taxation rules focus almost exclusively on using proxies to predict the expected place of consumption. The concept of consumption underlying a modern VAT can thus be understood by examining the proxies used for determining the place of consumption for particular types of supply.[144]

Millar suggest that there are a number of transaction-based features that could be used as proxies that are likely to bear some relationship to the place of consumption of the goods or services supplied:

- the location, residence, or place of business of the supplier
- the location, residence, or place of business of the recipient
- the location of the subject matter of the supply
- the place of performance of the supply
- the location of something else to which the supply relates.

It is noted that two additional proxies are commonly found:

[143] R Millar, "*Jurisdictional reach of VAT*", Legal Studies Research Paper No. 08/64, Sydney University, July 2008, at page 178.
[144] Ibid.

- the location, residence, or place of business of a person (other than the recipient of the supply) to whom the supply is provided or by whom the supply is received
- the place of effective use or enjoyment.[145]

These proxies are often referred to as "place of supply" rules. The UK HM Revenue and Customs (HMRC) website considers the concept of "place of supply rules" and provides the following simple explanation in respect of this doctrine:

> The place of supply is the place where a supply is made and where VAT may be charged and paid.
>
> With services, deciding the place of supply can be complicated. There are various rules that apply, depending on:
>
> - whether you have more than one business location
> - the kind of service you provide
> - the place where your business or your business customer 'belongs' [146]

Clear and decisive "place of supply rules" have become increasingly important due to globalisation which may be directly attributed to the proliferation of cross-border transactions. "Place of supply rules" provide assistance in determining whether a supply is regarded as being made within a jurisdiction.

In most jurisdictions these rules are explicit. South African VAT legislation, apart from specific provisions addressing specific types of transactions, generally lacks such explicit rules, frequently creating difficulty in determining where a supply has been made and as a result, if a transaction is taxable within South Africa and also whether a foreign entity has an obligation to register for VAT in South Africa. "Place of supply rules" may, arguably, be inferred from or implied within the current legislation; however, these rules may require clarification, especially given the increase in cross-border transactions of services. Specific place of supply rules may be found in certain instances in the South African VAT Act, primarily in respect of certain zero rating provisions.

An increasing number of VAT jurisdictions and international organisations have introduced, adopted and encourage the implementation of place of taxation rules. In line with the former

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[145] Ibid, at page 183.

[146] HMRC *How to Work Out Your Place of Supply of Services for VAT*. Available at http://www.hmrc.gov.uk/vat/managing/international/exports/services.htm [Accessed 07.04.2014]

part of this comment report, consideration and review should be a priority issue in respect of the implementation of such specific rules.

OECD

The Committee on Fiscal Affairs (CFA) in February 2006 agreed on two (2) fundamental principles with respect to effective imposition of VAT on cross-border supply of services and intangibles:

i. For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption;

ii. The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.[147]

To this extent it was noted that, "the transcription of these fundamental principles into guidelines requires a clearer definition of the meaning of 'jurisdiction of consumption'. **There is agreement that defining place of taxation under a 'pure consumption' test would, in most cases, be impractical and approximations (proxies) should be used as practical means for determining the place of consumption. In most situations, the place of consumption should be deemed to be the jurisdiction where the customer is located** (Main Rule)".[148] [Emphasis added]

The OECD published updated and new International VAT / GST Guidelines in 2017. Place of taxation rules are intrinsically linked to the OECD principle of neutrality.

The destination principle: "[f]or consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption"[149], remains the fundamental VAT principle proposed by the Guidelines. However, it has been acknowledged that "[d]etermining the place of business use in connection with a business-to-business supply is often difficult, particularly with regard to services and intangibles"[150]. Therefore, the Guidelines acknowledge that "[i]n applying the destination principle, it may be necessary in certain circumstances to apply different approaches to international supplies

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147 OECD Applying VAT / GST to Cross-Border Trade in Services and Intangibles, Emerging Concepts for Defining Place of Taxation – Outcome of the First Consultation Document (June 2008). Pg2. Available at http://www.oecd.org/tax/consumption/40931170.pdf [Accessed 07.04.2014]

148 supra

149 OECD *International VAT / GST Guidelines* (2017) (hereinafter referred to as "*OECD 2017 International VAT Guidelines*") p23

150 Ibid *OECD 2017 International VAT Guidelines.*

from business-to-business than to international supplies from business to final consumers…"[151] and that the guidelines, therefore, should "provide separate consideration for the business-to-business and business-to-consumer contexts"[152].

Therefore, the "main rule", which applies to B2B transactions, decrees that "the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles"[153] where the customer's identity is "normally determined by the business agreement"[154].

This approach is viewed as "relatively straightforward" in respect of supplies made to legal entities with a single location, as opposed to supplies made to entities with multiple locations. Thus, an additional place of taxation rule applies to B2B supplies where the supply is made to an entity with multiple locations:

> [W]hen the customer has establishments in more than one jurisdiction, the tax rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located.
>
> "Use of a service or intangible" in this context refers to the use of a service or intangible by a business for the purpose of its business operations. It is irrelevant whether this use is immediate, continuous, directly linked to an output transaction or supports the business operations in general.
>
> A number of possible approaches are currently adopted by jurisdictions to identify which customer's establishment is regarded as using a service or intangible and where this establishment is located. The following broad categories of approaches can be distinguished:
>
> - Direct use approach, which focuses directly on the establishment that uses the service or intangible.
> - Direct delivery approach, which focuses on the establishment to which the service or intangible is delivered.
> - Recharge method, which focuses on the establishment that uses the service or intangible as determined on the basis of internal recharge arrangements within the [Multiple Location Entity (MLE)]…, made in accordance with corporate tax, accounting or other regulatory requirements.

151 Ibid *OECD 2017 International VAT Guidelines.*
152 supra
153 Ibid *OECD 2017 International VAT Guidelines.*
154 supra

Additional rules and guidelines have been set out in the OECD 2017 Guidelines in respect of place of taxation rules and principles. The above extracts, however, have been provided for purposes of illustrating the main rule, as well as to show how additional rules have been introduced to address specific circumstances. The primary point at issue is that the OECD endorses place of supply / taxation rules and guidelines and, furthermore, recommends: "that jurisdictions take these guidelines into account the application of… [the main rule being] in a way that is consistent with the…[guidelines and commentary on how to apply the main rule]. Wherever possible, tax administrations are encouraged to communicate these approaches and relevant national laws as clearly and as widely as possible."[155]

As examined below, other VAT jurisdictions, and more importantly jurisdictions following the modern VAT system, have implemented forms and principles of place of supply rules.

Other Jurisdictions

Various prominent VAT jurisdictions (e.g. New Zealand, Australia, Canada, etc.), as well as other significant organisations (e.g. the European Union), have incorporated / adopted place of supply rules for purposes of determining and providing clarity on when a supply is subject to VAT in the respective VAT jurisdiction. It is inevitable and increasingly critical that place of supply rules are globally harmonised to ensure effective application and use of such rules. To this extent, it is prudent to follow OECD recommended place of supply rules over those of other jurisdictions or organisations.

The various "place of supply" rules incorporated into foreign legislation are, nevertheless, examined for purposes of demonstrating the applicable principle and rules.

The European Union has also adopted / incorporated "place of supply" rules within the VAT Directive. These rules may vary, depending on the transaction (i.e. B2B, B2C, exceptions to the general rule, etc.). Nevertheless, there is a "general rule" which applies for purposes of determining the place of supply. Article 44 provides the said general rule as follows:

> **Article 44** The place of supply of services to a taxable person acting as such shall be the place where that person has established his business. However, if those services are provided to a fixed establishment of the taxable person located in a place other than the place where he has established his business, the place of supply of those services shall be the place where that fixed establishment is located. In the absence of such place of establishment or fixed

[155] supra

> establishment, the place of supply of services shall be the place where the taxable person who receives such services has his permanent address or usually resides.

The above represents the current general rule. However, it should be noted that the place of supply rules changed in 2015 in respect of B2C transactions whereby the place of supply shifted from the supplier's location to the customer's location. However, such rules remain a crucial aspect of the VAT Directive in the endeavour to ensure that VAT is imposed in the correct VAT jurisdiction in order to avoid double taxation as well as double non-taxation. The changes scheduled for implementation in 2015 will in effect, result in greater harmonisation with the OECD principles.

The points at issue in respect of B2B and B2C treatment and making a distinction between the two in respect of cross-border transactions are further examined in Annexure D – Electronic Commerce. The matter and the points provided extend beyond Electronic Commerce and indubitably apply to all cross-border transactions, making the issue the most prevalent current concern in respect of cross-border electronic commerce supplies.

Place of supply rules may also be found in the New Zealand Goods and Services Tax Legislation (New Zealand GST Act). Diverse place of supply rules and commentary on the rules which have been adopted into the New Zealand GST Act may be found in *GST – A Practical Guide*[156], an extract from which is provided hereunder:

> Complex rules can deem supplies effected by non-residents to be made in New Zealand… The rules apply to the supply of goods which are in New Zealand at the GST time of supply, to the supply of services physically performed by any person in New Zealand, and to some cross-border supplies of telecommunication services…[157]
>
> The general rule for place of supply is unequivocally defined in section 8(2) of the NZ GST Act[158] as follows:

[156] Alastair McKenzie, '*GST – A Practical Guide'* CCH New Zealand Limited.

[157] McKenzie, A. *GST – A Practical Guide*, Edition 8. CCH New Zealand Limited, a Wolters Kluwer Business, New Zealand (2008) p6

[158] Additional place of supply rules, which may also be found in section 8, include inter alia:

> **8(3) [Deemed supply in New Zealand by non-resident]** Despite subsection (2), goods and services are treated as being supplied in New Zealand if the supplier is a non-resident and either –
> (a) The goods are in New Zealand at the time of the supply; or
> (b) The services are physically performed in New Zealand by a person who is in New Zealand at the time the services are performed;

8(4) [Deemed supply outside of New Zealand] Despite subsection (3), if a supplier who is a non-resident supplies goods and services, to which subsection (3) would apply but for this subsection, to a registered person for the purposes of carrying on the

Section 8 Imposition of Goods and Services Tax on Supply

8(2) [Supply in New Zealand] For the purposes of this Act, goods and services shall be deemed to be supplied outside of New Zealand if the supplier is a non-resident.

The New Zealand place of supply rules are similar in nature and principle to the place of supply rules found in the EU VAT Directive (i.e. one refers to the instance where the person is permanently established and the other to that of non-residents). The NZ GST Act includes, inter alia, a place of supply rule which is subject to a percentage use test, as follows:

8(4B) [Deemed supply in New Zealand by recipient of imported services] Despite subsection (2), a supply of services that is not treated as being made in New Zealand by subsections (3)(b) and (4) is treated as being made in New Zealand if –

(a) The services are supplied by a non-resident to a resident; and

(b) The recipient of the supply –

(i) Estimates at the time of acquisition that the percentage intended use of the services is less than 95%; or

(ii) Determines at the end of an adjustment period that the percentage actual use of the services is less than 95%; and

(c) The supply would be a taxable supply if made in New Zealand by a registered person in the course or furtherance of a taxable activity carried on by the registered person.

(d)

Section 8(4B) of the NZ GST Act provides further clarity in determining whether the supply should be taxable in New Zealand. The further test is still arguably "consumption" based and should, therefore, not create double taxation in respect of non-residents established in another "destination based" VAT jurisdiction. The further test may, however, assist with preventing double non-taxation as it sets out clear guidelines as to when a supply of services may be considered to have occurred in New Zealand.

registered person's taxable activity, the goods and services are treated as being supplied outside New Zealand unless the supplier and recipient of the supply agree that this subsection will not apply to the supply.

Additional place of supply rules have been adopted addressing "Telecommunication services". However, as these rules fall within a "telecommunication service" perspective they will be addressed and discussed under Point 5, Electronic Commerce, below.

While section 8(4B) of the NZ GST Act is provided above for purposes of illustrating a "percentage test" to determine place of supply in respect of services only, which arguably is more prevalent in cross-border supplies of services, the NZ GST general place of supply rules address both goods and services.

It was previously noted that the issue of B2B and B2C and the distinction thereof in respect of cross-border transactions would be further examined under Electronic Commerce. However, prior to examining "place of supply" rules adopted by other modern VAT jurisdictions in respect of a distinction not being made, it is essential to ensure that the OECD principles of neutrality, fairness and so forth, are adhered to. That is, if a foreign business is required to register for VAT in another jurisdiction as a result of being viewed as making taxable supplies in such jurisdiction then, accordingly, foreign businesses should be entitled to claim input tax deductions where the business incurs taxable expenses in such jurisdiction even if the business is not viewed as making taxable supplies within that jurisdiction. That is, the VAT principles of allowing input tax credits in the course or furtherance of making taxable supplies should be adhered to, even where supplies occur across jurisdictions. This principle has been adopted by New Zealand from 1 April 2014 and is briefly examined hereunder as it may arguably go hand-in-hand with the place of taxation principles.

The New Zealand Inland Revenue website provides the following explanation and overview of the change:

> **Non-resident businesses can now claim back GST**
> The Goods and Services Tax Act 1985 has been amended to allow businesses that are not resident in New Zealand to register for GST in New Zealand. This will allow the non-resident business to claim back the GST it has paid provided certain conditions are met.
> Non-resident businesses may also be able to register for and claim the GST paid as long as they:
>
> - receive goods or services in New Zealand, and
> - don't carry out a taxable activity or make taxable supplies in New Zealand
>
> …These changes are effective for periods on or after 1 April 2014…[159]

Furthermore, the following guidelines / principles in respect of when a foreign business will qualify to register to claim New Zealand GST back are as follows:

[159] New Zealand Inland Revenue *Industry Guidelines, Non-Resident Businesses and the GST law change*. Available at http://www.ird.govt.nz/industry-guidelines/non-res-bus-gst/intro/ [Accessed 29/06/2014]

Qualifying as a non-resident GST business claimant

There are some rules about qualifying as a non-resident GST business claimant.

"You must:

- expect the GST refund claim in your first GST taxable period to be more than $500, and
- in your country or territory of residence:

  be registered for a consumption tax, e.g. GST, VAT, or

  have a consumption tax which you're not required to be registered for, and you're carrying out a taxable activity with a turnover of more than NZ$60,000 in a 12-month period, or

  there isn't a consumption tax, and you're carrying out a taxable activity with a turnover of more than NZ$60,000 in a 12-month period, and

You must not:

- carry out or be intending to carry out a taxable activity in New Zealand, and are not a member of or intending to become a member of a GST group carrying out a taxable activity in New Zealand
- have a taxable activity that includes providing services, where it's reasonably foreseeable the service will be received in New Zealand by someone who is not registered for GST."[160]

"Place of supply" rules may also be found in the Australian Goods and Services Tax Act (Australian GST Act). Section 9-25 of this Act addresses "supplies connected with Australia" which constitute the Australian place of supply rules. In essence, a supply will only fall within the ambit of the Australian VAT regime if it can be said that the supply is "connected with Australia". The "supplies connected with Australia" rules effectively address supplies of goods wholly within this country, supplies of goods from the country, supplies of goods to Australia, supplies of real property and supplies of anything else, as well as when enterprises are carried on in Australia. The "supplies connected with Australia" rules are as follows:

9-25 Supplies connected with Australia

Supplies of goods wholly within Australia

(1) A supply of goods is **connected with Australia** if the goods are delivered, or made available, in Australia to the recipient of the supply.

[160] New Zealand Inland Revenue *Industry Guidelines, Qualifying as a non-resident GST business claimant.* Available at http://www.ird.govt.nz/industry-guidelines/non-res-bus-gst/qualifying/ [Accessed 29/06/2014]

Supplies of goods from Australia

(2) A supply of goods that involves the goods being removed from Australia is **connected with Australia**.

Supplies of goods to Australia

(3) A supply of goods that involves the goods being brought to Australia is **connected with Australia** if the supplier either:

(a) Imports the goods into Australia; or

(b) Installs or assembles the goods in Australia.

Supplies of real property

(4) A supply of real property is **connected with Australia** if the real property is in Australia.

Supplies of anything else

(5) A supply of anything other than goods or real property is **connected with Australia** if either:

(a) The thing[161] is done in Australia; or

(b) The supplier makes the supply through an enterprise that the supplier carries on in Australia.

When enterprises are carried on in Australia

(6) An enterprise is **carried on in Australia** if the enterprise is carried on through:

(a) A permanent establishment (as defined in subsection 6(1) of the Income Tax Assessment Act 1936); or

(b) A place that would be such a permanent establishment if paragraph (e), (f) or (g) of that definition did not apply.[162]

In addition to the adoption of "connected with Australia" rules, a legally binding ruling (Goods and Services Tax Ruling GSTR 2000/31) (GSTR 2000/31) has been published with the purpose or objective of explaining: "when a supply is connected with Australia under section 9-25"[163]. GSTR 2000/31 provides an explanation of and guidance on the application of each part of section 9-25; however, for purposes of this report only the commentary on "supplies

[161] "Thing" carries a broad dictionary definition which allows for potential debate with regard to its application. However, this does not detract from the principle of place of supply rules having been implemented and utilised in the Australian GST system. That is, the potentially broad application of the word does not detract from the fact that Australia, like New Zealand and other modern VAT system jurisdictions, has implemented place of supply rules. While the Shorter Oxford English Dictionary does give a broad definition of "thing", within the context of its intended use the import of the word "thing" is focused to its specific meaning.

[162] Australian A New Tax System (Goods and Services Tax) Act, No. 55 of 1999. Available at http://www.incl.org/research/library/files/Australia/taxsystem.pdf [Accessed 25/04/2014]

[163] Australian Government (Australian Taxation Office) *Goods and Services Tax Ruling, GSTR 2000/31 (Consolidated ruling)* (31 October 2012). Available at http://law.ato.gov.au/atolaw/view.htm?DocID=GST/GSTR200031/NAT/ATO/00001&PiT=99991231235958 [Accessed 25/04/2014] (hereinafter referred to as "*GSTR 2000/31*") p1

of anything else" will be examined as the other commentaries are relatively self-explanatory. However, commentary on "supplies of anything else" includes terminology such as "thing" and "done" and, therefore, the method of application of 9-25(5) may not be clear. The following extracts from GSTR 2000/31 provide further clarity on the application of 9-25(5):

> "Thing" done in Australia…
>
> 62. Thing is defined to mean anything that can be supplied or imported such as a service, advice, information or a right. It is the subject of the supply…
>
> 64. The meaning of "done" depends on the nature of the "thing" being supplied. "Done" can mean, for example, performed, executed, completed, finished etc. depending on what is supplied.
>
> Supply of a service
>
> 65. If the "thing" being supplied is a service, the supply of that service is typically done where the service is performed. If the service is performed in Australia, the service is done in Australia and the supply of that service is connected with Australia under paragraph 9-25(5)(a). This is the case even if the recipient of the supply is outside Australia…[164]

In addition, the Australian GST Act and GSTR 2000/31 address circumstances where supplies may be partly connected with Australia, as well as supplies of more than one kind that are partly connected with Australia. The latter is addressed by treating the actual supply as if it consisted of separate supplies.[165] This assists with ensuring that the portion of the supply which is connected with Australia is appropriately taxed. The relevance of citing the "connected with Australia" rules is to demonstrate that Australia has also adopted place of supply rules which do not appear to contravene the "destination based" principle of VAT. For example, even if the full supply is pulled into the Australian GST net in terms of the "connected with Australia" rules and a portion of the supply occurs outside of Australia, then even though the supply may have been drawn into the Australian GST net, that portion will be treated as GST-free (i.e. zero rated).

The final jurisdiction to be examined for purposes of this report is Canada.[166] Prior to examining the place of supply rules adopted by Canada, it is important to first understand

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164 Ibid *GSTR 2000/31* p14 -15

165 Ibid *GSTR 2000/31* p21

166 Globally, there are approximately 160 jurisdictions applying the indirect consumption tax: VAT. The purpose of this section of this report is to provide an overview of "place of supply" rules for purposes of reaching a recommendation as to whether

that Canada applies both retail sales tax (on a provincial level) and Goods and Services Tax (i.e. VAT) on a national / federal level, as well as Harmonized Sales Tax which is effectively GST, together with provincial retail sales tax imposed and collected together as one tax. As such, place of supply rules may arguably apply in a twofold manner:

- Supply is made in or outside a participating province in relation to cross-border provincial supplies
- Supply is made in or outside a participating province in relation to cross-border international supplies.

The Canadian Revenue Agency (CRA) has issued a guide for GST / HST Registrants which provides an explanation of, and guidelines for, the "place of supply" rules to be applied. The following extracts of the CRA General Information for GST / HST Registrants are reproduced for purposes of highlighting the type of place of supply rules applied by Canada:

> Specific rules apply to determine whether a supply that is made in Canada is made in or outside of a participating province and therefore whether suppliers must charge the HST…
>
> **Goods**
>
> **Sales**
>
> "You collect the HST if you sell goods and deliver or make them available to the customer in a participating province. Goods are also considered to be delivered in a province if you:
>
> - Ship the goods to a destination in the province that is specified in the contract for carriage of the goods;
> - Transfer possession of the goods to a common carrier or consignee that you retain on behalf of the customer to ship the goods to such a destination; or
> - Send the goods by courier or mail to an address in the province…"
>
> **Services – general rules**
>
> The general place of supply rules for services are subject to specific place of supply rules for certain services that are explained [within the CRA General Information for GST / HST Registrants guideline]…

South Africa should adopt "place of supply" rules. Just those countries which have adopted place of supply rules have been examined and furthermore, only a sample thereof. However, the sample was based on, arguably, countries and organisations of more prominent economic standing, including New Zealand, from which South Africa adopted its Value-Added Tax Act.

> A supply of a service will generally be regarded as made in a province where the supplier obtains a home or business address of the recipient in the ordinary course of its business and that address is situated in that province. Where the supplier does not obtain any home or business address, but obtains another single address in Canada of the recipient, that address will be used in determining the place of supply.[167]

An additional guideline provides information on the place of supply rules for non-residents. The place of supply rules pertaining to goods are the same as above. The general place of supply rules pertaining to services are also the same as above; however, additional guidelines / rules are provided in respect of the supply of services. Extracts from the additional commentary and rules are as follows:

> When a service is performed in whole or in part in Canada the DTC considers it to be provided in Canada.
>
> For supplies made in Canada after April 30, 2010, greater emphasis is placed on the location of the recipient in determining the province in which the supply is made…
>
> [To the extent that] no address in Canada of the recipient is obtained and the service that is performed in Canada is performed primarily in the participating provinces…, but a single participating province cannot be determined as being the participating province in which the greater proportion of the service is performed because the service is performed equally in two or more particular provinces, the supply will be regarded as made in the particular participating province for which the rate of the provincial part of the HST is highest…[168]

The additional rules may be attributed to the fact that Canada also applies retail sales tax on a provincial level, so that additional place of supply rules are required to determine the province the supply relates to, in order to ensure that the correct retail sales tax rate is applied as this varies in each province. Otherwise, the general principle applied in respect of the place of supply rules is similar to the other VAT jurisdictions and the OECD as well as the EU VAT Directive examined.

The above survey illustrates that an increasing number of VAT jurisdictions, including international organisations such as the OECD and EU, recognise the necessity for "place of

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167 Canada Revenue Agency *General Information for GST / HST Registrants RC4022(E) Rev. 13*. Available at http://www.cra-arc.gc.ca/E/pub/gp/rc4022/rc4022-13e.pdf [Accessed 25/04/2014] p38

168 Canada Revenue Agency *Doing Business in Canada – GST / HST Information for Non-Residents RC4027 (E) Rev. 13*. Available at http://www.cra-arc.gc.ca/E/pub/gp/rc4027/rc4027-13e.pdf [Accessed 25/04/2104] p19

supply" rules to assist with determining which VAT jurisdiction is entitled to impose VAT on a supply in order to prevent both double taxation and double non-taxation. Furthermore, while the exact phrasing of the place of supply rules may differ after the manner of each jurisdiction, the general principle applied by all remains the same, thereby further illustrating:

i. The importance of not implementing place of supply rules which differ in principle from those of other VAT jurisdictions
ii. The significance of acknowledgement of diverse jurisdictions to strive towards global harmonisation in application of place of supply rules

The above analysis demonstrates that "place of supply" rules and concepts are not limited to the traditional VAT system utilised by the EU, but extend to modern VAT systems as well. Furthermore, "place of supply" rules may vary in wording but not in principle and are in harmony with the OECD principle of consumption and taxation rules. In addition "place of supply" rules are regarded as being necessary for both the supply of goods and services.

South Africa's current legislation

As mentioned above, while the South African VAT legislation may contain ***implicit*** place of supply rules within certain / specific sections of the VAT Act, the legislation lacks ***general*** place of supply rules. South Africa does follow the OECD principle of "destination based" taxation which should, therefore, imply taxation where the customer is located. However, clear guidelines are sometimes required to assist in determining unequivocally the "place of supply" in order to ascertain whether the supply is subject to South African VAT.

Recommendations

Given the escalation of cross-border transactions, it is becoming increasingly important not only to harmonise VAT principles internationally, but also to ensure that clear and unambiguous place of taxation / supply rules, which do not contradict each other, are introduced in VAT jurisdictions. Place of supply rules assist in determining where a supply should be subject to tax in terms of the OECD endorsed destination principle.

Furthermore, reference to New Zealand's recent GST amendments, to allow non-resident business to claim input tax deductions in respect of taxable goods and services acquired in New Zealand, is in keeping with both the destination principle[169] and the input-credit method

[169] The destination principle in turn "facilitates the ultimate goal of ensuring that tax is paid and revenue accrues to the jurisdiction where the supply to the final consumer occurs. This ensures that services and intangibles supplied across borders are taxed according to the rules of the customer's jurisdiction irrespective of the jurisdiction from where they are supplied. It also ensures a level playing field for suppliers so that businesses acquiring such services are driven by economic, rather than tax considerations" Ibid *OECD 2014 International VAT Guidelines* p24

of VAT. In addition, introduction of such provisions is in keeping with the OECD principles of neutrality and will assist in ensuring the prevention of double taxation, which is a point at issue where input tax deductions are not allowed in a particular jurisdiction.

In terms of this point at issue, the following recommendations emphasised in the OECD 2017 Guidelines are significant -

- To ease burdens in practice for both tax administrations and business, it is recommended that jurisdictions take into account the application of the main rule (place of supply being where consumption takes place) in a way that is consistent with the guidelines on how to apply the main rule];
- To avoid unnecessary burdens on suppliers, it is recommended that the customer be liable to account for any tax due in respect of B2B transactions where the recipient business is a VAT registered entity. This can be achieved through the reverse charge mechanism (sometimes referred to as "tax shift" or "self-assessment"**), but it is emphasised that this must be consistent with the overall design of the national consumption tax system.** While the SA VAT Act includes what may be referred to as, "specific rules", as set out in the OECD guidelines on place of taxation, **it is recommended that** the SA VAT Act adopt what may be referred to as a "Main Rule" in respect of place of taxation.

The Committee **recommends** that the VAT Act be amended to ensure the inclusion of clearly stated "place of supply rules"; specifically, rules that are in harmony with the OECD 2017 Guidelines and which are, as previously discussed, supported and adhered to by other VAT jurisdictions.

Furthermore, **further consideration should be given** to evaluating and considering the implementation of an effective refund mechanism in respect of non-resident suppliers and the right to claim input tax deductions in respect of taxable goods and services acquired (e.g. similar to the provisions implemented in New Zealand's recent GST amendments).

ANNEXURE D: ELECTRONIC COMMERCE

The new frontier for VAT is its application in an electronic commerce **(e-commerce)** environment, where the supply of electronic services across jurisdictional boundaries has given rise to many compliance challenges for governments.

The OECD has been at the forefront of researching e-commerce and in 1998 hosted a conference in Ottawa, entitled *A Borderless World: Realising the Potential of Electronic Commerce*. The *Ottawa Taxation Framework Conditions* were subsequently issued, which amongst other recommendations essentially endorsed the destination principle: taxation should be imposed where consumption takes place.

Building on the Ottawa Conference, the Committee on Fiscal Affairs (CFA) of the OECD adopted the *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-Commerce*[170]. These Guidelines provide for place of taxation rules that draw a distinction between B2B (the jurisdiction in which the recipient has established its business presence) and B2C transactions (the jurisdiction in which the recipient has his usual place of residence). In 2006, the OECD launched the OECD *International VAT/GST Guidelines* project with the aim of providing governments with guidance on applying VAT to cross-border trade.

The Guidelines were completed in 2015. In November 2015, at the third meeting of the Global Forum on VAT, the high level officials of the participating 104 jurisdictions and international organisations endorsed the Guidelines as a global standard for the VAT treatment of international trade in services and intangibles to serve as a reference point for designing and implementing VAT legislation. (OECD, 2017).

The Guidelines were incorporated in the Recommendation on the Application of Value Added Tax/Goods and Services Tax to the International Trade in Services and Intangibles, which was adopted by the Council of the OECD on 27 September 2016. This Recommendation is the first OECD legal instrument in the area of VAT and the first internationally agreed framework for the application of VAT to cross border trade which aspires to a global coverage.

[170] OECD, *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce* (2001).

In light of the above, South Africa adopted its own rules regarding the taxation of the supply of “electronic services” as defined[171] from outside South Africa with effect from 1 June 2014. Essentially, a non-resident supplier is regarded as carrying on an "enterprise" for South African VAT purposes where such non-resident supplies “electronic services” to a recipient thereof of and two out of three qualifying criteria are met – namely, the recipient is a resident of South Africa; payment for such electronic services is made by that recipient from a bank registered or authorised in terms of the Banks Act, 1990 or the recipient has a business address, residential address or postal address in South Africa.

Non-resident suppliers of "electronic services" that meet the requirements for carrying on an "enterprise" are required to register and account for VAT in South Africa on any "enterprise" supplies made by them if their taxable turnover exceeds the specified registration threshold (R50 000 in any tax period - which has remained unchanged since implementation). It should be noted that the registration threshold applicable to non-resident suppliers of "electronic services" is substantially less than the R1 million annual registration threshold applicable to all other types of vendors making taxable supplies and no time period is stipulated.

It will be evident that the treatment of VAT in an e-commerce environment is complex and has enjoyed, and continues to enjoy, a significant amount of attention.

The number of jurisdictions which have implemented the principles of the Guidelines continues to increase. Notable additions at the time of issuing this report include the European Union, New Zealand, Australia, Taiwan and Russia.

New Zealand Goods and Services Tax

New Zealand does not make a distinction between “telecommunication services” and services supplied via the Internet. Section 2 of the New Zealand Goods and Services Tax

[171] The supply of “electronic services” was added to the definition of ‘enterprise’, as defined in section 1 of the VAT Act, as follows:

(c) …;

(d) … – …

(vi) the supply of electronic services by a person from a place in an export country, where at least two of the following circumstances are present:

(aa) The recipient of those electronic supplies is a resident of the Republic;

(bb) any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act, 1990 (Act No. 94 of 1990);

(cc) the recipient of those electronic services has a business address, residential address or postal address in the Republic.

Act 1985 (as amended) ("**NZ GST Act**") provides the following definition (which is very similar to the EU definition of the same) for “telecommunications services”:

> “telecommunications services” means the transmission, emission or reception, and the transfer or assignment of the right to use capacity for the transmission, emission or reception, of signals, writing, images, sounds or information of any kind by wire, cable, radio, optical or other electromagnetic system, or by a similar technical system, and includes access to global information networks but does not include the content of the telecommunication".

“Content” is further defined in section 2 of the NZ GST Act as follows:

> “…content” means the signals, writing, images, sounds or information of any kind that are transmitted, emitted or received by telecommunications services."

Slightly different place of supply rules apply in New Zealand with respect to “telecommunications services” whereby: “telecommunications services” are treated as being supplied in New Zealand if the supplier is a non-resident and a person, physically in New Zealand, initiates the supply from a telecommunications supplier, whether or not the person initiates the supply on behalf of another person.

Per the New Zealand Inland Revenue Department website and commentary on “telecommunications services”, the following examples have been provided as to what constitutes “telecommunications services”:

> "Based on this definition, examples of "telecommunications services" include a telephone call, accessing the internet via an internet service provider, a video conference, **or a facility such as a leased lines agreement, website hosting or server hosting**.
>
> Examples of **telecommunications content** include information obtained via an 0800 toll free number **and images downloaded** from an internet server. These **do not form part of the "telecommunications services**”[172] [Emphasis added]

[172] New Zealand Inland Revenue Department *Technical tax area: Operational statements, OS 06/01 GST treatment of supplies of telecommunications services [This statement also appears in Tax Information Bulletin Vol 18, No 3 (April 2006).]* Available at http://www.ird.govt.nz/technical-tax/op-statements/os-gst-treatment-telecom-services.html [Accessed 26 August 2013]

The EU listed supplies such as “website hosting or server hosting” as constituting “electronically supplied services” which differ from “telecommunications services”. New Zealand, therefore, attributes a slightly broader definition to “telecommunications services” by including website and server hosting.

The fact that “content of the telecommunication” is excluded from the definition of “telecommunications services” and, therefore, from the special place of supply rules which apply to “telecommunications services”, does not mean that “content of telecommunication” falls outside the ambit of the NZ GST legislation. As “content of telecommunication” is specifically excluded from the definition of “telecommunications services” and there currently are no specific place of supply rules which address “content of telecommunication”, the general place of supply rules apply.

However, it is important to note that a clearer and more distinct definition has been provided in New Zealand with respect to what constitutes “telecommunications services”, as well as “content of telecommunication”, compared to the current South African VAT legislation, thereby making it easier to identify supplies which constitute electronically supplied services.

Electronically supplied services

Electronic commerce will continue to evolve and develop. The point at issue is that the Ottawa Taxation Framework Conditions should be applied fully when addressing electronically supplied services. A crucial aspect of these Conditions is “flexibility”, and ensuring that legislation is not introduced which cannot evolve and develop effectively with the evolving and developing technology.

As previously examined in Annexure C, Place of Supply Rules, the OECD recommended that:

> "[t]o avoid unnecessary burdens on suppliers, it is recommended that the customer be liable to account for any tax due [in respect of B2B transactions where the recipient business is a VAT registered entity]. This can be achieved through the reverse charge mechanism (sometimes referred to as ‘tax shift’ or ‘self-assessment’) where that is consistent with the overall design of the national consumption tax system. Accordingly, the supplier should then not be required to be identified for VAT or account for tax in the customer’s jurisdiction."

The OECD further recommends the following in respect of distinguishing between B2B and B2C transactions and furthermore, highlights the advantages of applying the reverse charge mechanism:

> "Under the **Main Rule supplies of services and intangibles are subject to tax according to the rules of the jurisdiction where the customer is located**. This means that a **supplier of international B2B services and intangibles makes such supplies free of VAT** in its jurisdiction. The **tax administration of the supplier may require the supplier to produce evidence that the customer is a business** and that this business is located in another jurisdiction. To minimise compliance burdens on the supplier, tax administrations are encouraged to provide businesses with clear guidance on the evidence they require.
>
> It is recommended that the customer be liable to account for any VAT due to its local tax administration under the reverse charge mechanism where that is consistent with the overall design of the national consumption tax system. Tax administrations are encouraged to make businesses aware of the need to account for any tax on 'imported' services and intangibles from their suppliers in other jurisdictions. The normal domestic rate applicable to the nature of the services or intangibles involved should be applied. If the customer is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse charge to be declared on the local VAT return. In such cases tax administrations are encouraged to publicise this to business. Jurisdictions that require this declaration are likewise encouraged to make it clear that tax is required to be accounted for in this way.
>
> The reverse charge mechanism has a number of advantages. First, the tax authority in the jurisdiction of business use can verify and ensure compliance since that authority has personal jurisdiction over the customer. Second, the compliance burden is largely shifted from the supplier to the customer and is minimised since the customer has full access to the details of the supply. Third, the **administrative costs for the tax authority are also lower because the supplier is not required to comply with tax obligations in the customer's jurisdiction** (e.g. VAT identification, audits, which would otherwise have to be administered, and translation and language barriers). Finally, it reduces the revenue risks associated with the collection of tax by non-resident suppliers,

> whether or not that supplier's customers are entitled to deduct the input tax."[173] [Emphasis added]

It is evident that cross-border transactions will continue to grow at a rapid pace, increasing the crucial need to ensure global harmonisation of VAT principles. Any deviation from the OECD principles will cause increasing problems with administrative enforcement and create opportunities for double taxation and double non-taxation in the future. As such, treatment of electronic services should be aligned with international treatment and, especially, harmonised primarily with OECD principles.

Telecommunication services

In terms of the International Telecommunications Regulations (ITR), commonly referred to as the Melbourne Convention, and reconfirmed at the World Telecommunications Development Conference held in Dubai, April 2014, the following definitions are provided for "telecommunication" and "international telecommunication service" respectively:

> **Telecommunication**: Any transmission, emission or reception of signs, signals, writing, images and sounds or intelligence of any nature by wire, radio, optical or other electromagnetic systems.
>
> **International telecommunication service**: The offering of a tele-communication capability between telecommunication offices or stations of any nature that are in or belong to different countries.[174]

VAT jurisdictions and organisations have acknowledged that there is a distinction between electronically supplied services and telecommunications services. The EU VAT Directive includes the following definition of "telecommunication services":

> "**Telecommunications services"** shall mean services relating to the transmission, emission or reception of signals, words, images and sounds or information of any nature by wire, radio, optical or other electromagnetic systems, including the related transfer or assignment of the right to use capacity for such transmission, emission or reception, with the inclusion of the provision of access to global information networks.[175]

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[174] International Telecommunication Union. *International Telecommunication Regulations* Final Acts of the World Administrative Telegraph and Telephone Conference Melbourne, 1988. Available at http://www.itu.int/osg/csd/wtpf/wtpf2009/documents/ITU_ITRs_88.pdf [Accessed 27/04/2014]

[175] Chapter 3, Article 24(2), EU VAT Directive

As previously emphasised under "electronic services" above, New Zealand does not make a distinction between "telecommunication services" and services supplied via the Internet. New Zealand provides only a definition for telecommunication services, which is very similar to that of the EU definition:

> "telecommunications services" means the transmission, emission or reception, and the transfer or assignment of the right to use capacity for the transmission, emission or reception, of signals, writing, images, sounds or information of any kind by wire, cable, radio, optical or other electromagnetic system, or by a similar technical system, and includes access to global information networks **but does not include the content of the telecommunication**.[176] [Own emphasis]

The Canadian GST Act also provides a definition for "telecommunication services" which is distinct from electronically supplied services as "the transmission of any information by means of a system for telecommunication or any part thereof and includes the making available of such a system or part for that use, whether or not it is so used…".

The Canadian "telecommunication service" definition is not as specific as that of the EU or New Zealand, but, nevertheless, effectively covers the same type of services. Furthermore, all the definitions, especially those of the EU and New Zealand, are in accordance with the definition provided at the Melbourne Convention.

Telecommunication services effectively relate to services such as:

> "(l)ocal and long-distance telephone services, cable and pay television [however, treatment of pay television may vary in jurisdictions between telecommunication services and electronic services], electronic mail, facsimiles, data transmission, and video, audio and computer link-ups. The definition [may] also… [include the provision of] access to a telecommunications facility such as a dedicated line…, whether or not the facility is used[177].

The purpose or necessity for distinguishing "telecommunication services" from other intangible services is due to the nature of the supply of such services and they should be subject to specific "place of supply" rules. Thus there is effectively a twofold consideration in respect of telecommunication services:

- Telecommunication services should be specifically defined and distinguished from other intangible supplies, including electronically supplied services

[176] Section 2 of the New Zealand Goods and Services Tax Act 1985 (as amended)

[177] Canada Revenue Agency. *Place of Supply GST / HST Memorandum 3.3 April 2000*. Available at http://www.cra-arc.gc.ca/E/pub/gm/3-3/3-3-e.html [Accessed 25/04/2014]

- Telecommunication services should be subject to specific place of supply rules.

The place of supply rules addressing telecommunication services are dependent on various factors, such as where the supply is made available, where the telecommunication was transmitted from or to and so forth.

The manner in which data and communication is transmitted has changed significantly over the last decade or so and will continue to develop, especially in respect of the facility/ies used for the purposes of providing telecommunication services. The point at issue is that this may arguably be one of the more debatable supplies with regard to how to determine the place of supply. Canada, per the examples provided in Annexure C, deems the supply to be located in Canada, depending on where the telecommunication is emitted or received or in terms of billing location, regardless of where the telecommunications facility used may be located. This may be the best approach to adopt as the location of the telecommunications services may now be located in multiple jurisdictions, difficult to determine and likely to emigrate into space[178] in the near future, thereby increasing the challenges of determining jurisdiction.

Telecommunication services, nevertheless, constitute a supply of services which should be subject to VAT based on consumption and are currently not being effectively taxed where telecommunication services are not separately distinguished from other supplies and are not subject to their own specific place of supply rules.

However, to reiterate previous comments in respect of global harmonisation, while it is crucial to address telecommunication services, it is of greater importance to ensure that it is addressed in harmony with other VAT jurisdictions to guarantee that the OECD Ottawa Taxation Framework Conditions are adhered to and maintained.

South Africa

List of qualifying services and B2B and B2C distinction

The electronic service lists published by the EU and Canada (examined above) are very similar to each other. The final Regulations[179] published for purposes of determining

[178] The 'Inter Planetary Network', which is aimed at providing NASA with data communication, is a project to provide space with the Internet. Satellites are used to provide the necessary "gateway" to the interplanetary Internet and will operate and constitute a network. The locations of the "gateways" may also expand beyond satellites to the surface of planets or spacecraft, as well as also being earthbound.

[179] Notice No. 221, 28 March 2014, Pretoria, Government *Gazette* No. 37489.,

qualifying electronic services in terms of the South African VAT legislation interestingly deleted certain services, such as “web site hosting and data warehousing”, “subscription to databases” and the supply of software which is a form of “electronic ordering and downloading of digitised products”. It would appear that these items were deleted from the SA list of qualifying electronic services as a means of granting limited B2B concessions because a B2B and B2C distinction has not been made in SA.

Moving in a direction other than international harmonisation may potentially create problems in the future in respect of effectively imposing VAT on cross-border transactions and may lead to double taxation or double non-taxation. Editing the South African Regulations, which set out the qualifying electronic services, in order to provide limited concessions to B2B transactions has, furthermore, resulted in certain transactions which may also be found in B2C transactions (e.g. supply of software) being potentially excluded from the new electronic service VAT amendments.

As noted, South Africa has not made a distinction between B2B and business-to-consumer transactions. A B2B and business-to-consumer distinction has been recommended by the OECD where such treatment “*is consistent with the overall design of the national consumption tax system*”.

However, considering the fact that limited concessions have been granted in this regard, further consideration should be given to determining whether a distinction is preferable from a governmental objective perspective. Indeed, the fundamental principle is that the electronic service VAT provisions and list of qualifying services should not be manipulated in order to grant limited B2B concessions. That is, either a distinction must be made, or not made at all. The present seemingly half-way house approach adopted in the South African VAT system should be revised as a matter of urgency.

In terms of the above analysis and discussion, allowing for a distinction is recommended as the preferable course of action.

VAT Registration Threshold for Foreign Electronic Service Suppliers

An additional point for consideration is the current VAT registration threshold applicable to foreign electronic service suppliers. The current OECD guidelines on neutrality provide that “taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. **Taxpayers in**

similar situations carrying out similar transactions should be subject to similar levels of taxation”.[180] [Emphasis added]

The compulsory VAT registration threshold in South African is taxable turnover of R1 million in any 12 month period, whereas the current compulsory VAT registration threshold for foreign electronic suppliers applies if at the end of any month the supplier’s total taxable supplies have exceeded R50,000. The threshold applicable to non-residents supplying "electronic services" does not require a specific time period in which the R50 000 must be reached. This committee has not been provided with any cogent reason for the distinction. **In accordance with OECD neutrality principles, it is recommended that the registration threshold applicable to non-resident electronic service suppliers as well as the time period to reach/exceed such threshold, should be reconsidered and re-examined.**

Recommendations

The Regulation setting out qualifying electronically supplied services may not allow for the required “flexibility” legislation should carry in order to effectively adapt to technological amelioration. As noted, Canada provides “categories” of services and the EU has moved from an exhaustive list to “categories” as well, which assists with addressing various types of electronic services as they change and develop. **It is recommended that South Africa follow suit.** That is, supplies qualifying as electronically supplied services should be in terms of “categories” which are then further explained in a guide or interpretation note. Alternatively, should an exhaustive list be the preferable route then the Regulations should specify that the same will be reviewed and updated, say every 2 years.

Furthermore, as far as the debate relating to whether a distinction should be drawn between B2B and B2C, given its cross-border nature, South Africa should avoid implementing rules and provisions which are not harmonised with international principles. The point at issue is that the OECD recommendations and guidelines should be followed where possible or necessary for purposes of determining the treatment of e-commerce. Cognisance should be taken of other VAT jurisdictions and their treatment of electronic services and application of definitions. It is imperative that the OECD principles, especially that of neutrality, be adhered to.

[180] Ibid *OECD 2014 International VAT Guidelines*

South Africa, in implementing the specific imposition of VAT on electronic services, sought not to make a distinction between B2B and B2C transactions, but then proceeded to grant certain concessions in relation to B2B transactions by manipulating the list of qualifying electronic services. The provision of concessions for B2B transactions, by altering or manipulating the types of services which will qualify as electronically supplied services, may result in supplies made in terms of B2C transactions falling outside the scope of electronic service VAT provisions, which may therefore go untaxed.

Therefore, if "concessions", as a point of issue, are deemed to be necessary in respect of B2B transactions, then this point should be addressed by making a distinction between B2B and B2C transactions.

However, in terms of the above analysis and discussion, allowing for a distinction is recommended as the preferable course of action. Furthermore the VAT provisions relating to electronic services, including the list of qualifying services, should be reconsidered and re-examined in accordance with this recommendation.

A distinction should be made in respect of "telecommunication services" and, in harmony with other VAT jurisdictions, South Africa should incorporate provisions addressing "telecommunication services". That is, a definition for "telecommunication services" in accordance with the Dubai Convention should be included and specific place of supply rules to address the VAT treatment of such supplies should be provided for.

The specific place of supply rules should be as closely harmonised with the place of supply rules implemented by other VAT jurisdictions to prevent double taxation or double non-taxation. As regards the current provisions, the following is noted:

Accounting basis

As regards the issue relating to the possible adoption of the **payments basis** of accounting for VAT, it was **recommended** that the default (and legally mandated approach) position should be that the vendor is required to adopt the invoice basis but retain the option to adopt the payments basis if it meets the requirements set out in the law.

Invoicing

Consideration should be given to limiting the requirement to issue tax invoices to supplies of electronic services that are made to businesses.