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A critical analysis of the vat apportionment method in the banking sector in South Africa

Chitando, Makgolane Kutlwano

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University of the Witwatersrand, Johannesburg

A CRITICAL ANALYSIS OF THE VAT APPORTIONMENT METHOD IN THE BANKING SECTOR IN SOUTH AFRICA

Applicant: Makgolane Kutlwano Chitando
Student Number: 746853
Supervisor: Mr Roy Blumenthal
Head of Programme: Prof A P De Koker
Degree: Master of Commerce (Specialising in Taxation)
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ABSTRACT

Value-Added Tax (VAT) has the standing of being a fairly simple tax. Where vendors solely supply taxable goods and services, the VAT on expenditure acquired for the sole mandate of making taxable supplies may be recovered from the VAT imposed on their output. VAT is therefore a tax on the value added at every stage of production. Accordingly, the tax is levied on the value of the final product but is collected in small portions from each part in the supply chain.

"In the banking sector, consumers are not purchasing financial services from the bank, so there is no sale on which VAT must be imposed. This has resulted in the VAT exemption of financial transactions as it is difficult to define the value added of financial services". (Mirrlees *et al* 2011:196).

The exemption of financial transactions raises a number of complicated issues for banks as there is a requirement to apportion input credits. This is common to all countries operating a VAT system, although the basis of apportionment differs.

The intention of this research report is to draw a distinction between the taxing of financial services in South Africa compared to other countries. This research report will analyse the appropriateness of the apportionment method approved by SARS for the banking sector in light of the concept of direct attribution of costs.

Through an analysis of the foreign treatment on the matter of VAT apportionment and the taxation of financial transactions, this study will seek to determine whether the taxation of financial transactions in the South African VAT System and the VAT apportionment method approved by SARS for the South African banking sector is consistent with international best practice.

Key words:
Apportionment, input tax, direct attribution, financial services, VAT cascading, efficiency, neutrality, simplicity, value-added tax,

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

Kutlwano Chitando

30 April 2018

DEDICATION

This thesis work is dedicated to my late Mother, Mmakgotso Kate Chele, who was a constant source of support and encouragement during the challenges of writing this report while battling cancer. This work is also dedicated to my daughter, Tinashe Rorisang Chitando, you have been my inspiration and have made me stronger, better and more fulfilled than I could have ever imagined.

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1 CHAPTER 1: INTRODUCTION

1.1 Background

"South Africa has a well-developed and proactively regulated banking system which compares favourably with those of industrialised countries. The South African banking sector has, as a result, attracted a lot of interest from abroad with a number of foreign banks establishing offices in the country and others acquiring stakes in major South African banks" (The Banking Association of South Africa 2014:1).

Value-Added Tax (VAT) is very significant to governments around the world, as tax authorities have been able to effectively collect substantial tax revenue through indirect taxes at a low cost when compared to direct taxes globally.

The South African Revenue Service has collected R321.1 billion in 2016/17 fiscal year (SARS media statement 2016/17). VAT as a basis of income has amounted to a quarter of tax income collected over the past number of years. At 28.05%, VAT remains the second significant basis of income in South Africa, with Personal Income Tax being the first source.

Section 12(a) read together with section 2 of the Value-Added Tax Act (VAT Act) originally provided that the supply of any financial services, including the incidental supply of goods or services by the same suppliers are exempt from VAT. These provisions were amended by the Taxation Laws Amendment Act, 1994 [No. 20 of 1994] (Government Notice 2009 in Government Gazette 16104) on the 25 November 1994 and provided that all fee based financial services became taxable. The possible implications of taxing fee based financial services will be examined in comparison to other VAT systems. For this purpose, the following major first world countries operating a European-style, invoice VAT system will be used for the analysis as they treat financial services in a similar way to South Africa. These are:

- European Union countries with attention on the United Kingdom, Germany and France
- New Zealand on which the South African VAT system is modelled; and
- Canada and Singapore.
- Australia

The fundamental principle applied in the above-mentioned countries is that financial services are exempt from VAT.

The conclusion to exempt financial services revolves around the issue of recognizing and measuring the value-added by financial services on a transaction by transaction basis. In contrast to the values added for non-financial services, which are generally represented by the explicit charge for the goods or services, value-added in the case of financial services is often hidden in the margin between the payments to depositors and the charges to borrowers. (Katz, 1995:1).

"While the exemption approach has been widely adopted, there are significant economic and compliance difficulties in operating the exemption system. The main economic problem is that of cascading" (Katz, 1995:1). Cascading is the imposing of tax on things that have already been taxed. VAT systems include some form of cascading in the form of exemptions. For example, VAT is not imposed on financial services and nor is any tax levied on the inputs refundable.

The significance of the exemption approach will be analysed in light of the economic and compliance consequences and any unintended consequences of the exemption system will be highlighted in this report.

"A further consequence of the exemption of financial transactions, is that there is a requirement to apportion input credits.
The VAT Act provides that VAT input credits may only be claimed to the extent that goods and services are acquired in the course of making taxable supplies. The principle 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" (Davis,2014:61).

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

- "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 once-off income receipts in respect of which few costs or expenses are incurred in making them. (Davis, 2014:61).

The Banking Association of South Africa (BASA) of which most banks are members of has agreed with SARS on an apportionment method to be followed. This method is not essentially the most effective as VAT is not equitably allocated to the making of taxable supplies.

This research paper will analyse the inadequacies of the apportionment method agreed to by SARS and BASA members and will consider conceptual similarities between the said method and that of other countries. Foreign precedent will also be examined to

find the most suitable form of taxation for the South African banking sector by drawing on experiences of other jurisdictions.

1.2 The research problem

1.2.1 The statement of the problem

The aim of this study is to determine whether the standard apportinment method used in the banking sector by BASA members is effective in recoverigng input tax and whether this method is consistent with VAT apportinment methods used internationally in the banking sector.

1.2.2 The Sub-problems

- The principle purpose of the VAT apportionment method used in the banking sector, whether it is fair and reasonable in that it recognises the full degree to which VAT on expenses acquired by the banks relates to taxable supplies. The meaning of fair and reasonable will be explored.
- Challenges experienced with the current South African VAT apportionment method by the banking sector;
- Analysis of selected foreign precedent on the matter of VAT apportionment in the banking sector.

1.3 Scope and Limitations

The aim of this study is to determine the effect of the apportionment methodology in the banking sector limited to the field of VAT. The effect on other taxes is out of the scope of this study. The study will not deal with the effect of apportionment on change in use provisions contained in section 18 of the VAT Act.

The discussion on the international treatment of VAT apportionment will be limited to the following major first world VAT systems that are similar to South Africa.

- European Union countries with attention on the United Kingdom, Germany and France
- New Zealand on which the South African VAT system is modelled; and
- Canada; Singapore and Australia

All other VAT systems are thus not considered for the analysis of international apportionment methods in this study.

1.4 Research methodology

The main research objectives will be achieved by performing a literature review to understand the current taxation of the Banking Sector focusing on the VAT apportionment method under the South African VAT System and comparing this method to international VAT apportionment methods.

The research methodology includes the collection of data from the South African VAT laws governing apportionment methods. Further, an understanding will be obtained from the European Union and other countries with similar VAT systems. The writing by authors in this field have been referred to wherever appropriate. Journal articles, correspondence from and to the South African Revenue Service together with current rulings published on the related topic will be used, analysed and compared.

1.5 Structure of dissertation

Chapter outline is as follows:

Chapter 2: This chapter will provide the history of the VAT treatment of banks since the introduction of VAT in South Africa on the 29 September 1991. A discussion on the unintended consequences for bringing fee based financial services into the VAT net. Further, a distinction will be drawn between the taxing of financial services in South Africa compared to those of some other countries.

Chapter 3: This chapter will look at the Impact of the VAT exemptions in the banking sector, whether it's an indication that the VAT apportionment applied in this sector is a representative of the actual taxable supplies made and consequently the VAT cascading effect thereof. The issue of double taxation and inflated banking costs resulting from SARS' policies and practices not recognising the full extent to which VAT expenses incurred by banks related to taxable supplies.

Chapter 4: In this chapter, an analysis of the issue of the VAT apportionment method within the banking sector will be considered. The agreement between the Banking Association of South Africa (BASA) and SARS on the methodology of the VAT treatment of supplies and apportionment in the banking industry will be examined. The

fairness and reasonability of the prescribed methodology will be undertaken. This chapter will close with a brief summary of the challenges met by the banking sector with regards to the VAT apportionment methodology.

Chapter 5: This chapter will explore the international treatment of VAT apportionment and the various approaches adopted by the banking sector internationally. Krever (2008:18) states that The New Zealand VAT system is the world's most efficient VAT system and has been promoted by international experts on the basis of its economic superiority. The South African VAT system is modelled on the New Zealand VAT legislation and most countries including Australia, Canada and Singapore have adopted this system. The VAT apportionment methods in the countries that have adopted the New Zealand model VAT system, their relevance and possible application to the banking sector in South Africa will be explored.

Chapter 6: The final chapter will provide a summary of the report and a conclusion will be reached and recommendations will be made in order to address the problem statement and may identify a suitable alternative to the taxing and VAT apportinment methodology of the current South African banking sector.

2 CHAPTER 2: THE TAXATION OF THE BANKING SECTOR IN SOUTH AFRICA

2.1 Introduction

This chapter will provide the history of the VAT treatment of banks since the introduction of VAT in South Africa on the 29 September 1991. A discussion on the unintended consequences for bringing fee based financial services into the VAT net. Further, a distinction will be drawn between the taxing of financial services in South Africa compared to those of other countries.

2.2 History of the VAT treatment of Banks in South Africa

In November 1986 the Margo report was published on the tax structure of South Africa. The report suggested that a broad based tax on sales and services should be implemented and should be relied upon to produce a substantial part of the total tax revenue. It emphasised that such a sales tax, without distinguishing between a retail sales tax and a VAT has overall advantages due to the wide base and relative simplicity. (Katz, 1995:6)

The recommendations of the Margo report were acknowledged in 1988 and an invoice based VAT would be introduced in South Africa. “The white paper on the Margo report noted that the application of VAT would give rise to a range of problems for different taxpayers, in particular specialised financial institutions” (Katz, 1995:6).

The draft Value-Added Tax Bill (Draft Bill) that followed the Government White Paper was published on 18 June 1990 and proposed the invoice/credit value-added tax system and provided for the exemption of financial services.

Davis Tax Committee report states that

“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. VATCOM noted, inter alia, the following with regard to financial services”:

- 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 akin to any other services and, 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. (Davis, 2014: 42)

"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". (Davis, 2014: 42)

Katz,(1995:7) states that:

"the VAT Act was implemented with effect from 29 September 1991, Section 12(a) of the VAT Act provided that the supply of any financial services, including the incidental supply of any other goods or services by the same supplier is exempt from VAT".
"The following services were deemed by section 2 to be financial services and, therefore, exempt:

(a) The exchange of currency
(b) The issue, payment, collection or transfer of ownership of a cheque or letter of credit
(c) The issue, allotment, drawing, acceptance, endorsement, transfer of ownership of a debt security
(d) The issue, allotment or transfer of ownership of an equity security
(e) The issue, allotment or transfer of ownership of a participatory security
(f) The provision of credit
(g) The renewal of variation of debt, equity or participatory security of a credit agreement
(h) The provision, taking, variation or release of a financial guarantee, indemnity, security or bond
(i) The provision or transfer of ownership of a long-term insurance policy or the provision of reinsurance for any such policy
(j) The provision, or transfer of ownership, of an interest in a superannuation scheme
(k) The buying or selling of any derivative or the granting of an option
(l) The activities of a Provincial fund for the promotion of horse racing
(m) The payment or collection on someone's behalf of debts in respect of a financial transaction;
(n) The agreeing to do, or arranging, the above financial transactions (with the exception of the provisions of advice for which a separate feed is levied.

Over the years the section 12(a) and section 2 of the VAT Act has been amended as follows:

Year	Section	Amendment	Reason for amendment
1992	12(a) "the supply of any financial services, including the incidental supply of any other goods or services by the same supplier is exempt from VAT"	"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"[1]	"to extend the scope of the exemption to include those goods or services which were necessary for the supply of the financial services by the supplier thereof"[2]

1994	12(a) "the supply of any financial services, including the incidental supply of any other goods or services by the same supplier is exempt from VAT"	"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"[3]	"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".[4]
1995	2(1)(m) "The payment or collection on someone's behalf of debts in respect of a financial transaction"	Deleted	"had the effect that rent and debt collection services were exempt from VAT and was deleted, as these activities comprise either administrative or professional services and it was considered that there was no justification to treat these services differently from other administrative or professional services" [5]
1995	2(1)(n) "The agreeing to do, or arranging, of section 2 transactions (with the exception of the provisions of advice for	"deletion of the words "or arranging". [6]	"it was considered that the rationale for exempting financial services did not apply to these services and there appeared to be no reason to exempt them from VAT".[7]

	which a separate feed is levied".		

"The Katz Commission appointed a specialist Sub-Committee to investigate the inclusion of a wider range of financial services in the VAT system. Following the recommendations of the Katz Commission, the VAT Act was amended with effect from 1 October 1996 as follows" (Davis, 2015:43):

Year	Section	Amendment	Reason for amendment
1996	2(1)(e) "The issue, allotment or transfer of ownership of a participatory security"	Deleted	"it comprises the supply of a service comprising the acceptance of a risk for which a consideration is paid and as such, should be taxable"[8]
1996	2(1)(g) "The renewal of variation of debt, equity or participatory security of a credit agreement"	Deleted	"any fee payable for these services became taxable",[9]
1996	2(1)(h) "The provision, taking, variation or release of a financial guarantee, indemnity, security or bond"	Deleted	"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"[10]
1996	2(1)(i) The provision or transfer of ownership of a long-term insurance policy or the provision	"reduced to exclude from the definition of a "financial service" the management of a superannuation	

	of reinsurance for any such policy"	scheme by long-term insurers"[11]	
1996	2(1)(j) "The provision, or transfer of ownership, of an interest in a superannuation scheme"	"was limited by the exclusion of the activity of the management of a superannuation scheme"[12]	"service of managing a superannuation scheme by an intermediary therefore became a taxable service in line with the recommendations of the Katz Commission"[13]
1996	2(1)(n) "The agreeing to do, or arranging, of section 2 transactions (with the exception of the provisions of advice for which a separate feed is levied".	Deleted	"This was in line with the recommendation of the Katz Commission that all fee based financial services should be subjected to VAT"[14]
1996	2(1)(a) –(f)	"Proviso added - stipulate that the activities contemplated in these sections 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"[15]	

1996	"12(a) the supply of any financial services, including the incidental supply of any other goods or services by the same supplier is exempt from VAT"	"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"[16]	"Any incidental supplies to financial services such as the supply of a cheque book to a current account holder became subject to VAT"

The above amendments have resulted in South Africa adopting a narrow exemption approach in dealing with financial services. By applying VAT to almost all explicit fees, more VAT revenue is collected.

2.3 Bringing fee based financial services into the VAT net

Section 12(a) of the VAT Act originally provided that exemption would apply to the supply of financial services, including the supply of such goods or services that are necessary to the supply of financial services. This provision was amended by section 14(a) of the Taxation Laws Amendment Act No 20 of 1994 to exempt the incidental supply of goods and services by the seller of financial services.

"From 1 April 1995, section 2 of the VAT Act was amended by the removal of the word "arranging" from section 2(1)(n). The removal of the word arranging from section 2(1)(n) brought fee based services into the standard rated VAT net. The basis according to the Explanatory Memorandum of the Taxation Laws Amendment Bill, 1994, was that the rationale for exempting financial services does not apply to these services and therefore, they should be subject to VAT in the same way as other professional and administrative services". (Katz,1995:8)

The taxation of fee based financial services also caused financial service providers of that charge a fee to become entitled to claim a bigger percentage of the VAT incurred in expenses that relate to taxable supplies 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

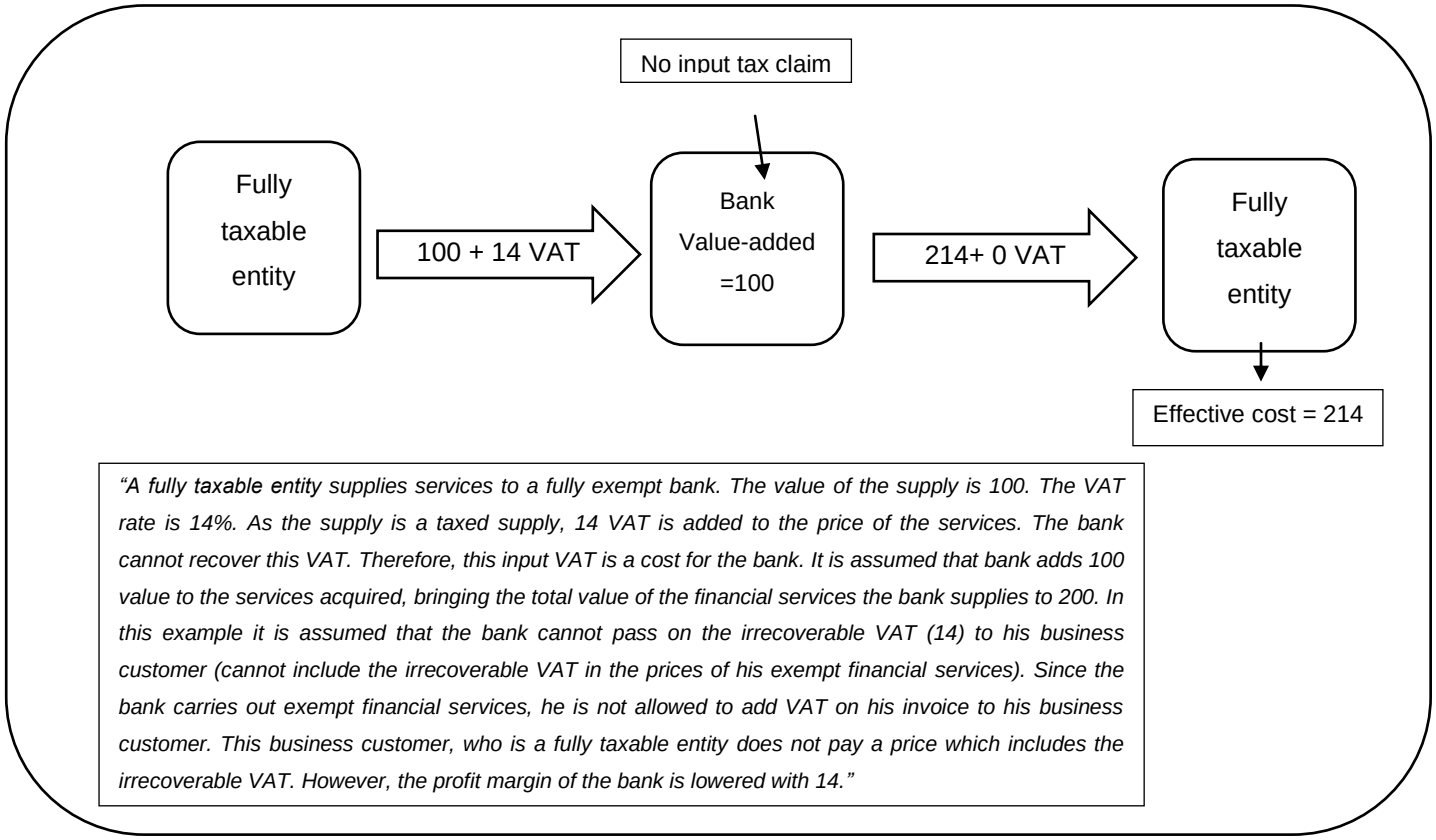
organisation is only entitled to claim a portion thereof as input tax. The increase in the VAT cost is mainly due to the VAT exempt personnel cost which is included in the fee that is charged for the outsourced service on which VAT is levied, for which there is no corresponding input tax deduction". (Davis 2014: 8).

If banks pass on the irrecoverable VAT to VAT registered entities as a cost of their financial services, the overall charge of the financial services acquired will be higher than for a fully taxable entity. The VAT that cannot be recovered signifies a cost for the banks, whereas for the fully taxable, this would not be the case. That VAT would not be a cost and would be recoverable.

"Passing on the VAT to VAT registered entities leads to the cascading of VAT. These businesses will (also) calculate VAT over the irrecoverable VAT which is included in the prices of their supplies of goods and services. This is contrary to the principle of neutrality. Neutrality refers to the taxes ability to be non-discriminatory between different sectors of the economy, between the different participants in that sector, protects the local sectors and is fair in all ways". (Barber 2010:8).

Where banks cannot pass on the irrecoverable VAT to VAT registered entities, this results in lower profit margins for the banks and the VAT becomes a tax on the banking sector rather than a tax on consumption, which goes against the legal framework of the South Africa VAT system.

"*This is known as the VAT paradox: businesses that perform VAT exempt activities are in fact taxed and businesses that perform VAT taxable activities are in fact exempt" (PWC 2011:28), this is illustrated below:*



"A fully taxable entity supplies services to a fully exempt bank. The value of the supply is 100. The VAT rate is 14%. As the supply is a taxed supply, 14 VAT is added to the price of the services. The bank cannot recover this VAT. Therefore, this input VAT is a cost for the bank. It is assumed that bank adds 100 value to the services acquired, bringing the total value of the financial services the bank supplies to 200. In this example it is assumed that the bank cannot pass on the irrecoverable VAT (14) to his business customer (cannot include the irrecoverable VAT in the prices of his exempt financial services). Since the bank carries out exempt financial services, he is not allowed to add VAT on his invoice to his business customer. This business customer, who is a fully taxable entity does not pay a price which includes the irrecoverable VAT. However, the profit margin of the bank is lowered with 14."

Most of the major countries operating a European-style, invoice system treats financial services in a similar way. European-style VAT system often comprise multiple exemptions. The fundamental principle applied is that financial services are exempt from VAT, with a corresponding block on the recovery of input tax relating to the exempt supplies. A summary of the major points at issue in some of the main countries follows:

2.4.1 European Union Countries

In 1967, the European Union Council adopted the First VAT Directive which required Member States to replace their various systems of indirect taxation with a general tax on consumption.

Under this Directive, Member States retained great discretion and applied different tax rates to the same products, granted their own exemptions for particular products, and maintained different administrative procedures.

"*The Sixth VAT Directive of 17 May 1977 was enacted, in large part, to correct the differences that such discretion caused in the Member States and provided new rules and more harmonized standards for territorial application, types and places of taxable transactions,*

chargeable events, rates, exemptions, deductions, and persons liable for payment of tax". (Hart 1994:6)

"With respect to the banking sector, exemptions apply to the granting of credit, dealings in credit guarantees, transactions concerning payments, transactions concerning currency, bank notes and coins, transactions in shares and other securities and the management of special investment funds. Also intermediary services in respect of most financial services are VAT exempt. However, not all financial services are exempt. Services like investment advice, safekeeping and debt collection are taxed". (PWC 2011:23).

"In some Member States, banks have the option to tax rather than to exempt their financial services. The VAT Directive allows Member States to introduce an option to tax otherwise VAT exempt financial services. The option for banks to tax their financial services removes one of the striking systematic disadvantages of the VAT exemptions." (PWC 2011:23)

As a result of the above, VAT cascading is detached from the production line where a bank elects to tax its financial services to an entity that can fully recover the VAT on the services acquired.

In turn, banks can opt not to tax the end user, usually not registered for VAT and cannot deduct input tax. The effect is exempting financial services for end users lowers the prices of the services compared to taxed financial services.

2.4.2 United Kingdom

In terms of the UK VAT Act of 1994, section 31 and Schedule 9, contain exemptions from VAT. Schedule 9, Group 5 provide for exemptions with regard to financial services.

"In line with the provisions of the Directive 2006/112/EC, the exemptions are divided into exemptions without the right to deduct and exemptions with the right to deduct. In general, inter alia, financial and insurance transactions belong to the former category and therefore do not entitle the entrepreneur to deduct the input VAT. However, a right to deduct the input VAT is provided if financial or insurance services are supplied to an entity located outside the European Union or if they relate to an export". (Survey 2006:84)

The supply of financial intermediary services can qualify for exemption under the UK VAT Act.

UK VAT 1994 Schedule 9 Group 5 item 5 provides that for the purposes of item 5 *"intermediary services" consist of bringing together, with a view to the provision of financial services—*

> *(a) persons who are or may be seeking to receive financial services, and*
>
> *(b) persons who provide financial services,*
>
> *together with (in the case of financial services falling within item 1, 2, 3 or 4) the performance of work preparatory to the conclusion of contracts for the provision of those financial services, but do not include the supply of any market research, product design, advertising, promotional or similar services or the collection, collation and provision of information in connection with such activities.*
>
> *(5A) For the purposes of item 5 a person is "acting in an intermediary capacity" wherever he is acting as an intermediary, or one of the intermediaries, between—*

(a) a person who provides financial services, and

(b) a person who is or may be seeking to receive financial services

The above provision is illustrated by the following example of a customer seeking a loan:

An intermediary company presents a customer to a bank. The intermediary company can exempt its services because it satisfies the following conditions per the UK VAT Act:

- The customer is a person who is seeking financial service of a loan and therefore satisfies condition (a) of the definition of intermediary services above.
- The bank being the lender and the provider of financial services satisfies condition (b) of the definition of intermediary services above.
- The introductory services for purposes of a loan qualifies as a financial service under item 2.
- Finalization of the loan is not a requirement in order to qualify for the exemption, the intention was to provide a loan and that is sufficient.
- Note 5 further makes reference to …."*the performance of work preparatory to the conclusion of contracts for the provision of those financial services"*, thus, the planning phase that is the preparatory work will be an additional test in this example.
- "EC VAT Directive 2006/112/EC refers to 'the granting and the negotiation of credit and the management of credit by the person granting it' (art 135(1)(b))"
- The intermediary company will qualify for the exemption if, as part of the preparatory work, they negotiate the terms between the bank and the customer.

"In practice, the HMRC accepts that helping a client to an application form, checking it and forwarding it to the lender can qualify as preparatory work (VAT Manuals VATFIN7250)". (Hall 2013:18).

2.4.3 France

France elected to adopt article 137 which allows Member States a right of option for taxation in respect of the financial transactions. In terms of France's election, where a financial institution opts to tax, it must levy VAT on all relevant transactions regardless of whether the customer is a vendor or an end user.

Pons (2006;182) states:

"The French law provides for an option for taxation in respect of banking and other financial services. In theory, the French system enables financial institutions to avoid passing on non-deductible input VAT to their business customers by opting for taxation. Until 2005, the option was binding on affected financial institutions negatively for the following reasons:

- the option was not available on a 'client-by-client' basis. Ideally, financial institutions should be able to opt for taxation depending on the VAT status of their customers, i.e. they should be able to opt for taxation in respect of services rendered to customers entitled to deduct input VAT, and apply the exemption to services rendered to final consumers, such as private individuals and institutional customers.
- The option applies regardless of the nature of the services. Financial institutions are unable to exclude specific services from the option for taxation, which may produce adverse effects where, even though the financial institution's customers are corporate entities, their entitlement to deduct input tax is restricted on the basis of case law.
- Thirdly, the current method of determination of the entitlement to deduct input tax deprives the option for taxation of a full effect on input VAT incurred by financial institutions. In this respect, it should be noted that, under French law, businesses engaged in both taxable and exempt transactions must determine the amount of deductible input VAT on the basis of the pro rata, in other words, the proportion of turnover giving right to recovery to the total turnover. France does not enable businesses carrying out "mixed" transactions, to deduct input VAT on the basis of actual use of the goods and services in question".

2.4.4 Germany

Germany has also elected to introduce Article 137 for financial services and allows the option to tax. The German authorities have adopted this provision on the basis that VAT at the standard rate may be levied on exempt supplies to another VAT vendor. German vendors may opt on a transaction by transaction basis whether to tax or exempt a financial transaction. (PWC 2011:25).

2.4.5 New Zealand

The VAT legislation in New Zealand on which the South African system is modelled, is basically the same as the South African VAT Act with a few exceptions to section 2 in that the arranging services and debt collection remain exempt.

New Zealand has also addressed the issues of exemption by letting financial service providers to select to zero-rate financial supplies.

"Section 11A(1)(q) and (r) read with section 20F of the GST Act provides that zero-rating can only be elected if the customer to which the financial services are supplied is a GST registered taxpayer and the customer's taxable supplies make up 75% or more of their total supplies".

Further, there is an option to tax for exempt supplies. Suppliers of financial leases may choose to treat interest income as taxable instead of exempt supplies.

2.4.6 Canada

Canada operates a system very similar to the EU system.

Most financial services are exempt from VAT (GST) but no option to tax exists. In addition, some administrative type of services may be exempt in certain circumstances, dependant on the relationship of the supplier to the recipient, or the involvement of the supplier with the original issue of the instrument.

"Financial services are exempt from GST under section 14 of the Excise Tax Act if:

- the activities undertaken involve the supply of "financial services" in terms of section 3; or
- the services are not in themselves "financial services", but are supplied together with a supply of "financial services", and those other services are reasonably incidental and necessary to that supply of financial services, and are not otherwise specifically excluded from being exempt supplies.

Activities that involve the provision of advice are generally excluded from the meaning of "financial services". (Inland Revenue Department Tax Information Bulletin: 37).

The nature of the service and whether these fees are in respect of a "financial service" in terms of section 3 is determined by whether the services are reasonably incidental and necessary to that supply of financial services and would therefore be exempt.

2.4.7 Singapore

Singapore classifies exempt financial institutions into the following five categories:

- full banks,
- merchant banks,
- wholesale banks,
- offshore banks, and
- finance companies.

The input tax claimable by these exempt institutions is determined as a fixed percentage and issued on a yearly basis.

"*The recovery percentages generally are based on the share of services estimated to be provided to VAT registered customers and overseas customers. Thus, the Singapore system is an alternative approach to zero rating transactions with VAT-registered and overseas customers that does not require a financial company to determine the VAT registration or residence status of its customers. However, the lower compliance burden on financial companies comes at the expense of accuracy, as the share of VAT-registered and overseas customers may vary*

considerably among companies within each of the five institutional categories". (Merrill 2011:171)

Financial services in Singapore are exempt in terms of Part 1 of the Fourth Schedule of the GST Act. As a result, financial services provided by banks in Singapore fall within the provisions of the said section of the GST Act. Similar to South Africa, services for the facilitation of financial services are taxable. Examples of these taxable services include fees in respect of the arranging, advising, broking provided by banks. In addition, exempt financial services provided by bank to non-residents of Singapore are zero-rated provided the services meet the definition of international services in terms of section 21(3) of the GST Act. (Inland Revenue Authority of Singapore 2014:1)

"Singapore GST classifies fees charged by banks into three categories:

- Fees charged for services provided as part of a main exempt supply – these are fees that are viewed as being incidental to the provision of a financial service. Even though they are separately charged, they are exempt from GST.
- Fees charged for additional value added services – these are fees that might be available separately for example, foreign exchange, money market platforms. These services are treated as additional value added service and are therefore taxable.
- Fees charged for leveraging on the bank's network- these are services which enable other businesses to access to the banks customer database. These services are value-added services and are therefore taxable". (GST guide for the banking Industry 2014:2):

2.4.8 Australia

A new tax system (Goods and Services Tax) Act 1999 Subdivision 40-A provides that:

> (1) A financial supply is *input taxed*. [In the Australian law, the term "input taxed" is used for exempt supplies.]
>
> (2) *Financial supply* has the meaning given by the regulations.

The Australian law defines financial supplies that are exempt as the provision, acquisition or disposal, for consideration, of property in the following types of transactions:

- deposit accounts with authorized deposit-taking institutions;
- credit facilities (i.e., borrowing and lending);
- security charges over property;
- superannuation schemes, annuities and pensions;
- life insurance business including re-insurance;

- guarantees and indemnities (but not warranties for goods or contracts of general insurance and reinsurance);
- currency and arrangements to buy and sell Australian or foreign currency
- securities, including shares, stocks, bonds, debentures and interests in partnerships and trusts; and
- derivatives.

The arranging or negotiating of a financial transaction by a facilitator and the supply of non-life insurance is subject to GST. However, the narrower definition of financial supplies is accompanied by a special regime that grants recipients (being financial service providers) input tax relief for costs of specified kinds that relate to making financial supplies. The relief that is granted is 75% of the input tax that would otherwise be denied because of the financial services exemption.

2.5 Conclusion

The overall international VAT model is to embrace financial services within VAT regimes.

The initial response of countries to the difficulties posed by financial services has been to apply exempt VAT treatment to a very wide definition of financial services. If services are exempt, the vendor does not apply VAT to the goods or services supplied and no input tax credits can be claimed in respect of these supplies. As VAT is not applied to supplies made to final consumers, the value of the financial services provider is not taxed. (KPMG 2011:16).

The exemption provisions in the VAT Act has evolved since the inception of VAT and South Africa has over the years extended its VAT base tax to more financial services. The VAT amendments of 1996 saw the inclusion of intermediation services into the taxable VAT net.

For those countries that apply exempt VAT treatment to financial services, the general approach has been to apply the exemption very broadly, including to financial services that have explicit fees and could be taxed directly. While a wide exemption achieves greater neutrality across the financial services sector it does so at the cost of denying input tax credits on financial services that would otherwise be fully taxable and eligible for input tax credits. There is no empirical evidence to indicate which of these approaches is costlier to the economy. However, it will certainly be the case that a broad financial services exemption will not come without a cost to economic efficiency. Finally, the broad exemption ensures neutrality of treatment for consumer expenditures

for financial services and thus minimizes competitive non-neutrality between suppliers of financial services.

In order to attempt to answer the key question of whether the South African exemption provisions are efficient, the impact of these exemptions will examined in the next chapter.

3 CHAPTER 3: THE IMPACT OF THE VAT EXEMPTIONS IN THE BANKING SECTOR

3.1 Introduction

The primary operations of commercial banks include the safe storing of money, the issuance of a debit card which enables one to withdraw and spend money without having to carry cash around. Banks will also provide insurance products or discounts via loyalty programmes. If the bank charged plainly for these services, VAT could be charged on the sale of the storing money facility, a debit card and an insurance cover. Instead, some banks provide a trivial interest rate on the account.

The bank also provides savings accounts for fixed terms and all the other benefits and will pay a higher interest rate. Likewise, with the granting of a loan, the bank will charge a higher interest rate for the service of providing funds that are needed. The bank therefore covers the cost of providing its services and makes profit through this margin of the interest rate charged to borrowers in excess of the interest rate given to savers. Standard VAT systems cannot deal with this difficulty as it falls outside the scope of a consumption tax.

"To date, most governments around the world have resigned themselves to this, and have exempted financial services from VAT. Exemption is seen as taxing what can be taxed: anything the bank purchases from registered traders to enable it to provide its services bears VAT that the bank cannot reclaim, so the government gets some revenue, paid for by customers if the bank passes on this VAT in its interest rates. But exemption taxes only the value of the inputs the bank purchases; it does not tax the additional value-added by the bank through the labour and ingenuity of bankers in transforming those inputs into the services customers enjoy" (Mirrlees et al 2011:81)

In this Chapter, the inefficiencies of the exemption model and its impact on the banking sector will be discussed.

3.2 Tax cascading

Tax cascades arise when a bank is unable to claim the VAT paid on goods and services acquired. The non-recoverable VAT forms part of the cost of services. As a result, the banking sector will either increase the price of the service or absorbs the VAT cost. If the cost is passed on to businesses through price increase, businesses face the same decision, to increase the prices charged for their products or absorb the additional VAT cost. On the other hand, if the non-recoverable VAT is absorbed, the

VAT is effectually being paid by the business through a reduction in profits rather than being passed onto the price of goods and services supplied to final consumers.

"Even the best designed VATs embody some degree of cascading in the form of 'exemptions': provisions by which the sale of some commodity financial services are a very common example are not subject to VAT but nor is any refund given for the tax charged on the inputs used in their production, so that this input tax 'sticks' with tax then levied on top of that tax when the exempted item is used as an input into production. So understanding cascading is also critical to understanding the imperfections of real-world VATs themselves" (Keen 2013:4.)

3.3 Inflated banking costs

Globalization has triggered Banks to establish presence in several countries worldwide. Banks have also evolved in terms of the products they offer in order to remain competitive and relevant. Through technological advancement the sector has had to adapt to innovative ways of processing.

With transactions between the banks group of companies in different jurisdictions result in VAT on intercompany costs and the sector seeking to implement effective VAT structures.

"The use of information technology can be an important source of competitive advantages for banks as it leads to better products and processes, which are important to clients, and enhance overall operational efficiency, resulting in variable cost savings. The expenditure on IT costs is relatively high in the financial sector. The main effects of automation in the banking sector can be summarized as improved data transmission both internally and externally, and cost savings through reduction in labour and processing costs. However, the use of more technological processes may have added to higher fixed costs in the banking sector due to the initial investments made by banks. From a VAT perspective, automation within the banking sector has therefore in principle led to an increase in VAT costs, due to the increase in the input VAT incurred". (PWC 2011:34)

3.4 Self-supply

As mentioned above, the banking sector is vastly competitive and reducing costs becomes a central drive for banks. Striking the balance between concentrating on core banking business and reducing costs often leads to outsourcing of activities within the banking sector.

"The idea that outsourcing has the potential for significant cost savings is supported by various studies touching on the subject. In fact, a willingness to outsource where appropriate (e.g., non-core banking activities to other entities that have operating efficiencies in those areas) has been identified as one of the key success factors for global commercial banks.
Outsourcing may, however, lead to additional VAT costs. This depends on whether the activities are outsourced in-house or to a third party. Activities carried out in-house do not lead to any VAT costs. However, if a bank outsources services to a third party, it may very well be confronted with VAT on these services, unless an exemption applies.
In practise, outsourced services, such as IT and administrative services, tend to be outside the scope of the current financial services VAT exemptions. Therefore, generally outsourcing leads to additional VAT costs". (PWC 2011:37)

The term self-supply describes the notion of providing required goods and services "in-house". In the case of banks, self-supply arises from the inability to recover the VAT paid on the purchases of goods and services. If the bank cannot pass on these costs, or faces tightening margins, it may elect to reduce the cost of supplies by replicating external supplies internally. Often referred to as a vertical integration bias.

"Vertical integration in turn creates certain problems, including:

- Discrimination against third party suppliers
- Discrimination against smaller financial institutions that are not in a position to vertically integrate
- It frustrates the natural development of specialisation and creates inefficiencies in the production and delivery of financial services" (Davis 2014: 31).

3.5 Apportionment

Taxpayers who make both taxable and exempt supplies are required to apportion their purchases between taxable and exempt supplies when claiming input tax. Where purchases are acquired for the making of both exempt and taxable supplies an apportionment is required. In practice, apportionment is the most challenging matter facing banking sector with regards to VAT compliance.

The complexity and compliance costs associated with apportionment of acquisitions between exempt and non-exempt activities (including exports). A financial service provider is likely to have a mix of both exempt financial services as well as fully taxable services, such as the provision of financial advice. As input tax credits will be denied for the exempt services, but allowed for the fully taxable services, financial service providers will be required to allocate their business inputs between the exempt and taxable components. Many regimes adopt design rules and anti-avoidance rules (such as deemed supplies at market value between associates and self-assessment of offshore acquisitions) to counteract the distortions. These 'integrity' measures add further complexity, compliance costs and risks. (KPMG 2011:19).

3.6 Conclusion

This non-recoverable input tax gives rise to the inefficiencies addressed above and economic non-neutralities.

To address these economic distortions, several countries outside South Africa have adopted special measures to reduce the scale of non-recoverable input tax.

- Quebec provides for the zero-rating of financial transactions under its GST Act.
- New Zealand and Singapore apply various methods including the zero-rating of supplies between businesses which reduces the irrecoverable input VAT; and
- Australia, allows 75% of input tax to be claimed on specified financial services under its 'Reduced Input Tax Credit' system,

While the above measures attempt to address economic distortions brought about by exemption of banking services, banks will seek to maximise their input tax recovery. In order to achieve this, the apportionment of Input VAT is necessary and vital that the basis is all-encompassing.

The following chapter will analyse the standard VAT apportionment method in South Africa and the agreement between the Banking Association of South Africa (BASA) and SARS on the methodology of the VAT treatment of supplies and apportionment in the banking industry will be examined.

4 CHAPTER 4: FUNDAMENTALS OF THE VAT APPORTIONMENT METHOD IN THE BANKING SECTOR

4.1 Introduction

This chapter, an analysis of the issue of the VAT apportionment method within the South African context will be considered. The agreement between the Banking Association of South Africa (BASA) and SARS on the methodology of the VAT treatment of supplies and apportionment in the banking industry will be examined. The fairness and reasonability of the prescribed methodology will be undertaken. This chapter will close with a brief summary of the challenges met by the banking sector with regards to the VAT apportionment methodology.

4.2 VAT apportionment in the South African Context

4.2.1 The Basis of apportionment

The VAT Act defines input tax in section 1 as:

> "(a) tax charged under section 7 and payable in terms of that section by—
> (i) a supplier on the supply of goods or services made by that supplier to the vendor; ….
>
> where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies or, where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services concerned are acquired by the vendor for such purpose".

A bank will thus be allowed to claim input tax on the goods or services acquired for purposes of consumption, use or supply in the course of making taxable supplies.

Where goods or services are acquired partly for purposes of making taxable supplies, input tax will be claimable to the extent that the goods or services are utilised in the course of making taxable supplies. As a consequence, input tax will be apportioned between the recoverable and non-recoverable portion.

In ITC 1*744(2002) 65 SATC 154* ("ITC 1744"), A vendor requiring capital to manufacture containers acquired the services of a venture capital company. The venture capital company took on two share placings for the vendor and levied output tax on its fee for services in respect of the allotment of shares which is an are exempt supply for VAT purposes. The vendor claimed the equivalent input tax deduction. The court had to rule on whether the input tax deduction could be brought within definition of input tax in section 1 of the VAT Act as being services 'acquired by the vendor

wholly for the purpose of consumption, use or supply in the course of making taxable supplies.

Conradie J states at 156 that:

"Section 17(1) of the Act reinforces the definition by providing that where services are obtained by a vendor partly for use or supply in the course of making taxable supplies and partly for another purpose, input tax is claimable only in respect of supplies by the vendor which are taxable. Indeed, proviso (v) to the definition of 'enterprise' in section 1of the Act makes it clear that a vendor who makes exempt supplies does not even, in relation to such supplies, carry on an 'enterprise'. He is in the position of an (unregistered) end user, VAT is really a consumption tax: its effect on a vendor is neutral except if that vendor makes exempt supplies. To the extent that he does so, his activities do not amount to the carrying on of an 'enterprise' and he falls outside the tax net"

.

Conradie J further stated at 157 that:

"The difficulty with Mr Van Rooyen's (the appellant) submission is that although the raising of the capital might have been indispensable to the making of the taxable supplies, one would, if he were right, have to interpret the expression 'in the course of the making of taxable supplies' to accommodate the remuneration paid for the raising of the appellant's capital. The raising of capital seems rather to be preparatory to the making of the taxable supplies. It does not seem to me that one can reasonably say that A's services were acquired in the course of manufacturing the shipping containers. Capital goods such as machinery bought with the raised capital can be said to have been acquired in the course of making taxable supplies. But there the connection is closer. And it is the closeness of the connection that counts".

The court referred to BLP Group plc v Commissioners of Customs and Excise in its ruling.

"BLP Group plc was a management holding company which disposed of shares in a subsidiary. The sale of shares was an exempt transaction in terms of the VAT legislation. It sought to deduct as input tax VAT paid on professional services supplied by merchant bankers, solicitors and accountants in connection with the sale on the basis that the purpose of the sale was to pay off debts that had arisen directly from its taxable transactions. The European Court of Justice held that where a taxable person uses services for an exempt transaction, he is not entitled to deduct the input tax even if the ultimate purpose of the transaction is the making of taxable supplies".

The principle relied upon was that of the immediate link test. The was no direct link between the professional fees incurred and the taxable supplies. The held that the issue of shares was not in the making of taxable supplies.

"In the SKF case the taxpayer held shares in various subsidiaries, from which subsidiaries it earned substantial management and administration fees. As part of a restructuring process SKF disposed of all the shares in one subsidiary and of 26.5% in another company to obtain funds to finance other activities of the group. The court held that the costs relating to the sale of shares, valuation services and legal advice, can be considered to be part of its taxable business activities. The court concluded that the VAT may be partly or wholly recoverable". (Badenhorst *et al* 2010:1)

The principle expressed in the SFK case is that the VAT associated with the issue of shares or debt in financial institution making both taxable and exempt supplies will be partially recoverable.

"*The current policy of SARS is that they follow the judgment in ITC 1744, requiring that there be a direct or immediate link to a taxable supply for VAT on an expense to qualify as input tax, and the ultimate purpose for incurring the expense is irrelevant. However, the definition of 'input tax' requires that goods or services must be acquired for the purpose of use, consumption or supply in the course of making taxable supplies". (Badenhorst et al 2010:1)*

4.2.2 Standard turnover-based method of apportionment

"The VAT Bill was the predecessor to the VAT Act of 1991. Specifically, it encourages the direct apportionment method, as stated in the report" (de Koker and Kruger, 2013):

"where the particular good or service can be related to the making of taxable supplies, a full input tax credit is claimed. In the case of a good or service which can be related wholly to non-taxable activities need to be apportioned on some other basis. The main advantage of the direct attribution method is it accuracy, while its disadvantages are increased record-keeping required and that it can only be used in tandem with some other basis of apportionment".

Section 17 of the VAT Act dealing with VAT apportionment has remained unchanged since the first version of the VAT Act and it provides that:

"*Where goods or services are acquired or imported by a vendor partly for consumption, use or supply… in the course of making taxable supplies and partly for another intended use, the extent to which any tax which has become payable in respect of the supply to him or the importation by him, as the case may be, of such goods or services or in respect of such goods under section 7 (3) or any amount determined in accordance with paragraph (b) or (c) of the definition of 'input tax' in section 1, is input tax, shall be an amount which bears to the full amount of such tax or amount, as the case may be, the same ratio…as the intended use of such goods or services in the course of making taxable supplies bears to the total intended use of such goods or services"*

The Direct-attribution method requires the attribution of VAT expenses according to the intended purpose for which it will be used.

VATCOM recommended that where the direct-attribution method was not possible, the turnover method should be used, but only if appropriate. (de Koker and Kruger, 2013).

SARS confirmed in its *Guide for Vendors* that the formula in respect of the turnover-based method of apportionment constitutes a Binding General Ruling issued in accordance with section 89 of the Tax Administration Act, and is effective from 1 April 2007. On 25 March 2013 SARS issued a separate Binding General Ruling in terms of s

89 Tax Administration Act in which it sets out the formula to be applied in respect of the turnover-based method of apportionment and which is effective from 1 April 2013. On 30 March 2015 SARS issued an updated Binding General Ruling in this regard which is effective from 1 April 2015.

"In terms of the standard turnover-based method, the deductible input tax may then be determined by applying the following formula:

$$Y = \frac{A}{(A + B + C)} \text{x } 100$$

where –

Y = the apportionment ratio relating to taxable supplies;

A = the value of all taxable supplies including deemed taxable supplies, made during the tax period;

B = the sum of exempt supplies made during the tax period; and

C = the sum of any other amounts not included in 'A' or 'B' in the formula, which were received or which accrued during the period whether in respect of a supply or not. The ruling stipulates that these amounts would typically include dividends."

Dividends to not comprise consideration for any supply. The payment of dividends depends on the availability of distributable reserves of the company concerned, and no taxable resources are applied by a shareholder to generate dividend income. The inclusion of dividend income in the apportionment formula by SARS is also in direct contrast with a number of European Court of Justice judgments which have determined that dividend income should be excluded from a turnover-based apportionment formula. The inclusion of dividend income in the apportionment formula will almost certainly give rise to an inappropriate apportionment ratio, which will necessitate the vendor to apply for approval of an alternative apportionment formula. (de Koker and Kruger, 2013)

SARS states that the following amounts must be excluded from the formula:

- *"The value of capital goods or services supplied. The exclusion only applies to a vendor that does not usually supply capital items on a regular basis as a normal part of the business, unless such items are supplied under an instalment credit agreement. No guidance is provided as to what is considered to be 'capital' goods or services.*

- *The value of goods or services supplied for which an input tax credit is specifically denied".*

"The ruling stipulates that the apportionment percentage should be rounded off to two decimal places. Where the formula yields an apportionment percentage of 95% or more, the full amount of VAT incurred on mixed expenses may be deducted".

"The ruling specifies that a vendor may only use this method if it is fair and reasonable. Where the method is not fair and reasonable or inappropriate, the vendor must apply to SARS for approval to use an alternative method".

"The prescribed turnover method uses the proportion of taxable supplies (excluding VAT) to total supplies (excluding VAT) made during a tax period as the appropriate measure. In determining these ratios, the cash value of goods acquired and resupplied under and instalment credit agreement (typically in a bank) must be excluded, as must the value of supplies of capital goods, and the value of goods or services supplied for which an input credit was denied. In the case of banks, the turnover figure to be used for interest is the net margin of interest earned less interest paid. The value of total supplies includes the consideration for taxable supplies, exempt supplies and other non-supplies. The value of total supplies thereof includes, e.g. interest, dividends, received and foreign exchange gains". (de Koker and Badenhorst. 2016)

The turnover-based formula implies that there is a necessary correlation between amounts of costs incurred and amounts of income generated, directly or indirectly, the banking sector differs from this positon. Further, the inclusion of dividend income in the apportionment formula gives rise to an appropriate apportionment ratio, which necessitate the banking sector to apply for an alternative apportionment formula.

4.3 Banking Association South Africa VAT ruling

SARS issued a Binding Class Ruling in terms of section 41B of the VAT Act read with Chapter 7 of the Tax Administration Act on 2 July 2015 to members of the Banking Association South Africa.

"This ruling modifies the VAT class ruling issued by the Commissioner on 7 December 2011 and modified on 21 November 2012 and is subject to the conditions and assumptions set out in the said VAT class ruling" (de Koker and Badenhorst. 2016)

> "The formula for the variation to the standard turnover-based method of apportionment is as follows:
>
> $$Y = \frac{A}{A+B} \text{ x } 100$$
>
> where –
>
> Y = the apportionment ratio relating to taxable supplies;
>
> A = the value of all taxable supplies subject to VAT in terms of section 7(1)(*a*) (excluding VAT) as calculated using various guidelines);
>
> B = the sum of exempt supplies made during the period and all other amounts of income which accrued during the period (whether in respect of a supply or not), as calculated

using the guidelines discussed below. Specifically excluded is the value of those supplies taken into consideration in determining 'A'.

For the purposes of the above formula, '*A*' excludes:

1. the cash value of goods supplied under an instalment credit agreement;
2. the portion of the rental payments relating to the capital value of goods supplied under a rental agreement which is entered into as a mechanism of finance (rental payments must be reduced by the cost of funding pertaining to these agreements);
3. consideration received in respect of the disposal of capital assets (whether fixed or movable);
4. consideration received from the disposal of business activities;
5. change-in-use adjustments;
6. deemed supplies in respect of insurance indemnity payments to the extent that the indemnity payments relate to extraordinary income; and
7. extraordinary income.

Adjusted values include a 3-year moving average of the net trading margin from taxable (including zero-rated) financial asset trading activities, and zero-rated interest income must be reduced with the cost of funding allocated to such income. Specific inclusions are the gross proceeds resulting from the disposal of properties in possession and repossessions.
'*B*' represents the value of exempt supplies made as well as any other income generated during the financial year, whether in respect of a supply or not, adjusted with the following exclusions:

8. extraordinary non-taxable income;
9. the capital value of loans;
10. fair value gains and losses reflected as income for Financial Reporting Standards purposes;
11. foreign exchange gains and losses not subject to any hedging activities.

It is also subject to the following adjusted values: dividend income, the inclusion of a 3-year moving average of the net trading margin from financial asset trading activities and a reduction of interest income with the cost of funds allocated to such income".

4.4 The challenges of the BASA ruling

"BASA (previously the Council of South African Banks (COSAB), objective behind standardising the turnover apportionment method is to provide a consistent, equitable and measurable basis for the recovery of input tax that complies with the framework of the VAT Act for all financial institutions" (COSAB correspondence 1997:1).

"The explanatory memorandum in respect of specific inclusions and specific exclusions of the submission provided that accepting the principle that net interest is the consideration for the supply of intermediary services, this amount should be discounted further by the value of risk, which is attached to it. (i.e. interest is inflated by a risk factor"). (COSAB correspondence 1997:1).

The way this works is outlined below:

"When a financier lends out funds, he is exposed to credit risk (the risk of credit default by borrowers). This exposure is confirmed by the stringent regulatory requirements of the Bank's Act. Therefore, a financier's success relies heavily on the adequate spread of this risk. He makes an allowance for this risk by setting a price (the interest rate) for the lending of money. By adding a risk factor to the interest rate, bad debts are in fact recovered by the interest margin in total. The fact that high-risk clients are charged higher interest rates is proof of this. (Note that the credit risk relates to the repayment of both capital and interest components and this factor is discounted in the price of interest)". (COSAB correspondence 1997:1).

This concept of bad debts was not accepted by SARS at the time, however in the new agreement of June 2015. SARS has allowed the reduction of bad debts from both interest and fee income.

The new agreement provides that all dividend income must be included subject to section 8E and 8EA (of the income tax Act) instruments, which are deemed to be interest received and section 8F and 8FA (of the income Tax Act) instruments which are deemed to be dividends in specie for purposes of the apportionment method.

The inclusion of dividends is unique to South Africa and remains a significant challenge to the underlying rationale for VAT.

"*The main aim of apportionment is to attribute VAT on inputs to the extent that the vendor makes taxable supplies. The method applied must correctly reflect the use to which inputs are put, and also the vendor activities. Therefore, if amounts are received which are not generated by the use of goods or services, their inclusion in the apportionment formula will severely distort the apportionment of VAT incurred on goods or services that have no relation to such income. There are a number of European Court judgments which ruled that dividends must be excluded from the denominator on the basis that they do not relate to any supply, they merely result from the ownership of shares and are only paid when there are distributable profits. These judgments support the aim of VAT apportionment to correctly reflect the use to which inputs are put. SARS ignores these judgments and holds the view that VAT will be incurred throughout the period an asset is held and presumably for this reason seeks to attribute VAT to the income that will ultimately be derived from such asset, irrespective of the fact that the expenses on which the VAT was incurred may have absolutely no bearing on the asset or the income generated from it" (Badenhorst 2007:1).*

The inclusion of dividends misrepresents the attribution of VAT to taxable supplies.

In lieu of the above, the Binding Class ruling for BASA members provides that:

"were a member finds that the inclusion of dividends unfairly distorts the ratio, the member may apply to SARS for an alternative arrangement relating to the inclusion or exclusion of such dividend income".

The above said, the apportionment method tries to reverse the effects of exempting financial services, however the distortions within the method lead to the test of fairness and reasonability not being met. In addition, the apportionment method is left to interpretation which could result in manipulation.

4.5 Fair and reasonable test – South Africa

The guide for Vendors VAT 404 (SARS, 2017:62) states:

"In deciding whether the turnover-based method is appropriate, the vendor must apply a common-sense approach which would be applied by a reasonable person. The method must therefore achieve a "fair and reasonable" result which is a proper reflection of the manner in which the vendor's resources (business inputs) are applied for making taxable and non-taxable supplies respectively"

The words fair and reasonable are not defined in the VAT Act, therefore, as a general rule, it is settled in law that ordinary words in daily use must be assigned their ordinary grammatical meaning. Fair is defined in the English Oxford Living Dictionaries as "*treating people equally without favouritism or discrimination"*, and reasonable is defined as to "*have a sound judgement" or "as much as is appropriate or fair".*

In applying the definitions above, it could be understood that the method should *achieve fair and equal representation for both SARS and the banking sector and not be more or less favourable to either party.*

In the 1993 ITC 1589 (57 SATC 153: 158) the court cited Local Investment Co v Commissioner of Taxes (SR) 22 SATC 4 where the court considered the question of apportionment and stated the following with regard to the method to be used:

'*How is the apportionment to be made? This, to my mind, is essentially a question of fact depending upon the particular circumstances of each case:*

The court then stated:

"It does not seem possible to me to lay down any general rules as to how the apportionment should be made, other than saying that the apportionment must be fair and reasonable, having regard to all the circumstances of the case. …., in one case an apportionment based on the proportion which the different types of income bear to the total income might be proper, …. In another case, however, such an apportionment might be grossly unfair." (57 SATC:158)

The above supports the view that a method of apportionment should be determined on the facts of each case and not be grossly unfair to either party.

The court further stated:

"in all cases dealing with apportionment, the objective is to reach a solution which is fair and reasonable in the circumstances of the particular case. If the taxpayer in not satisfied with the apportionment made by the Commissioner of Taxes, the onus is on him to establish that the apportionment is not fair and reasonable". (57 SATC:159)

The above, follows the outline laid down in the SARS VAT 404 Guide for vendors which states:

"that the requirements for an apportionment method to be fair and reasonable are:

- *SARS and the vendor must be of the view that the apportionment method results in a fair and reasonable basis*
- *The method should reflect the extent to which the expenses are incurred for the making of taxable supplies*
- *The method should not be more or less favourable to either party" (SARS,2017:63).*

4.6 Fair and reasonable test - other jurisdictions

The question of what is fair and reasonable has been considered by other jurisdictions and will therefore be examined for South African purposes.

4.6.1 Australia

In GSTR 2006/4 'the Commissioner outlines his views on this issue. Paragraphs 32-34 of the Ruling provide as follows:

"32. You may choose your own apportionment method, but the method you choose needs to be fair and reasonable in the circumstances of your enterprise. It needs to appropriately reflect the intended or actual use of your acquisitions or importations."

"33. The 'fair and reasonable' principle was used by the High Court in Ronpibon Tin v. FC of T , in the context of the apportionment of expenditure serving more than one object 'indifferently'. The High Court did not, in that case, apply this principle in relation to the allocation of specific acquisitions wholly to specific ends, or to apportioning items of expenditure 'distinct and severable parts of which' can be identified as being devoted to such specific ends. The Commissioner's view is that the 'fair and reasonable' principle applies equally to the choice of method for allocating or apportioning acquisitions in all circumstances".

"34. Following the principles set out by the High Court, the apportionment method you choose needs to:

- *be fair and reasonable;*
- *reflect the planned use of that acquisition (or in the case of an adjustment, the actual use); and*
- *be appropriately documented in your individual circumstances"*

The Commissioner therefore leaves it to the taxpayer to choose its own apportionment method, noting the following requirements:

- the method is fair and reasonable in the circumstances of the taxpayer's enterprise;

- the method appropriately reflects the intended or actual use of the acquisitions

4.6.2 New Zealand

Section 20(3F) provides that:

"in determining the extent to which goods or services are used for making taxable supplies, a person must estimate on acquisition how they intend to use the goods or services, and choose a determination method that provides a fair and reasonable result. The estimate could be made on the basis of:

- any records that are available,
- previous experience,

- business plans or other suitable methods".

The position in New Zealand is similar to Australia in that the taxpayer is free to choose a method as long as it provides a fair and reasonable result.

4.6.3 United Kingdom

The VAT notice 706 provides that:

There are two types of partial exemption method that you can use:

- the standard method which is specified in the law; or
- a special method which is devised by you to reflect your unique business circumstances

The VAT Partial Exemption Guidance (PE2400): fair and reasonable (HM Revenue & Customs, 2016) states:
"Fair and reasonable does not mean that there is only one acceptable method for a business, rather there are likely to be a number of fair and reasonable methods that are equally acceptable. They may give different tax results, although variances are unlikely to be large. The business can choose between them and will probably do so with regard to complexity and compliance cost, as well as tax result"

The positon in the UK is that the standard method must be used, therefore you start with a statutory presumption that the "standard method" will produce a fair and reasonable result and it is up to the taxpayer to adopt a different method if the standard method is not fair and reasonable.

From the above, the South African context is similar to the UK regime but differs slightly to Australia and New Zealand. The central requirement is that the method elected by the taxpayer must be validated by appropriate data to settle that the method is fair and reasonable.

4.7 Conclusion

Fair and reasonable is defined by the Oxford dictionary as "Just or appropriate in the circumstances" and "having a sound judgement" respectively. In applying this meaning, a fair method would reflect as close as possible the extent to which the VAT incurred is

used in making taxable supplies. Reasonable on the other hand, would be applied a comprehensive understanding of the supplies made by the banking sector and the attribution thereof to taxable and exempt.

5 CHAPTER 5: INTERNATIONAL VAT APPORTIONMENT PRECEDENCE

5.1 Introduction

This chapter will explore the international treatment of VAT apportionment and the various approaches adopted by the banking sector internationally. Krever (2008:18) states that The New Zealand VAT system is the world's most efficient VAT system and has been promoted by international experts on the basis of its economic superiority. The South African VAT system is modelled on the New Zealand VAT legislation and most countries including Australia, Canada and Singapore have adopted this system. The VAT apportionment methods in the countries that have adopted the New Zealand model VAT system, their relevance and possible application to the banking sector in South Africa will be explored

5.2 New Zealand

Section 20(3C), of the GST Act 1985, provides that:

"a purchaser can deduct input tax on the acquisition of goods and services to the extent to which the goods or services are used for, or are available for use in, making taxable supplies".

Section 20(3G) of the GST Act 1985 provides that:

"in determining the extent to which goods or services are used for making taxable supplies, a person must estimate on acquisition how they intend to use the goods or services, and choose a determination method that provides a fair and reasonable result".

Section 20(3H) of the GST Act 1985 provides that:

"The estimated intended taxable use of the goods or services will determine the proportion of the input tax that can be deducted. Under the apportionment rules, input tax may be deducted to the extent that goods and services acquired are used or available for use in making taxable supplies. In the event that acquisitions will be used in making both taxable and non-taxable supplies, input tax needs to be apportioned initially and actual use is subsequently periodically assessed and adjustments made to the apportioned deduction".

Financial services in New Zealand are exempt from GST and therefore GST is not imposed on financial service supply, and the input tax in relation to that supply is not deductible.

"*The policy rationale for this treatment is that the nature of financial services makes them difficult to integrate with the GST system, where liability for tax arises on a transaction-by-transaction basis throughout the production and distribution chain. This is because it is difficult to measure the amount paid for a financial service, as the financial services provider may be compensated through a margin or spread rather than an explicit fee. Due to the difficulty in taxing the value of services supplied by a financial service provider, the next best option is to effectively tax the supply by denying input tax deductions". (Policy and Strategy, Inland Revenue 2015: 3)*

In New Zealand, where a GST-registered person makes supplies of financial services and these supplies are more than 75 per cent of their total supplies, the GST Act provides that the GST-registered person may elect to zero-rate the supplies. This provision has been effective from January 2005.

The rationale for this provision was to reduce the potential tax cascades that resulted from the exemption of financial services which meant that the irrecoverable input tax had to be absorbed or passed on to the final consumer.

The New Zealand Inland Revenue in its 2009 GST Guide 375 makes mention of three apportionment methods being:

- direct attribution,
- turnover method; and
- another special method

The guide also states that the turnover method is the standard method of apportionment for purposes of exempt supplies and that any other special methods must be approved by the New Zealand Inland Revenue.

The February 2011 Tax Information Bulletin provides that if a special method is chosen, this can be based on:

- any records that are available,
- previous experience,
- business plans or
- any suitable method and
- the formula used will largely depend on the nature of the good or service acquired.

The above rules were established to reduce financial institutions compliance costs.

5.3 Australia

"*The GSTR 2006/3 Goods and Services Tax Ruling which deals with determining the extent of creditable purpose for providers of financial supplies provides guidance on methods that can be used for calculating input tax credits and adjustments for change in use by providers of financial supplies under the A New Tax System (Goods and Services Tax) Act 1999 (GST Act)".*
(Australian Taxation Office, 2013)

GSTR 2006/4 'Goods and services tax: determining the extent of creditable purpose for claiming input tax credits and for making adjustments for changes in extent of creditable purpose' paragraphs 32-34 of the Ruling provide as follows:

"You may choose your own apportionment method, but the method you choose needs to be fair and reasonable in the circumstances of your enterprise. It needs to appropriately reflect the intended or actual use of your acquisitions or importations".

GSTR 2006/4 discusses a number of different apportionment methods, described as direct and indirect methods (paragraphs 108-120).

"Direct methods – These methods seek to identify a direct measure of the use of the acquisition. The Commissioner is of the view that these methods will usually best reflect the extent of creditable purpose. However, the Commissioner accepts that a taxpayer could choose not to use a direct method where, for example:

- an indirect method is considered to be more appropriate;
- the cost of measuring the use of the acquisition is disproportionate to the cost of the acquisition; or
- it is impracticable to use a direct method in the context of the particular business.

Indirect methods – These methods use information that is not directly identifiable with the particular acquisition. The methods operate on the assumption that measures of inputs and outputs of an enterprise may provide a basis upon which to estimate the application of certain acquisitions which relate to making both taxable and input taxed supplies. Indirect methods can be "input based" or "output based".

GSTR 2006/3 paragraph 101 provides that:

"the Commissioner recognises that, from a practical point of view, it may be difficult to fully attribute individual costs via existing direct estimation systems in many organisations. If financial supply providers are unable to match individual acquisitions with individual revenue streams, other apportionment methods (including combinations of direct and indirect methods) may need to be used".

The Australian GST system has a unique system known as the reduced input tax credit (RITC) scheme. In terms of the RITC, providers of financial supplies may claim 75% of input tax credits for specified input GST costs which are incurred for the purpose of making financial supplies. As a consequence, the recipient of the financial supplies will not be entitled to a full input tax credit but will recover the 75% of the input GST costs.

"The Australian GST legislation also allows relief from the denial of input tax credits for financial supply providers who do not exceed certain financial acquisition thresholds; acquisitions relating to making financial supplies consisting of borrowings where the borrowings relate to making non-input taxed supplies". (McMahon and MacIntyre 2000:168)

5.4 United Kingdom

Section 31 and schedule 9 of the UK VAT Act contain all VAT exemptions, while exemptions in respect of financial services are provided for in Schedule 9, Groups 2 and 5.

The exemptions are classified into two categories being exemptions with and without the right to deduct. Financial services are generally in the category of “without the right to deduct” This classification is in line with the provisions of the VAT Directive

“It is a fundamental principle that deduction is only allowed to the extent the goods or services purchased are used to make supplies with the right to deduct. Therefore, input VAT attributable to exempt supplies is not normally deductible. A taxable person who supplies goods and services, only some of which carry a right of deduction, is partly exempt. Input VAT is first recovered on the basis known as direct attribution. This means input tax must be directly attributed to each liability of supply, and recovered, according to where there is a right to deduct, as far as is possible. The residual element - that which cannot be directly attributable - must be apportioned. The normal method of apportionment is to use the ratio of taxed supplies to all supplies in the relevant tax period. This is known as the "standard pro rata method" of apportionment:” (Survey 2006:84)

“The formula is as follows:

$$\frac{\text{value of taxed supplies}}{\text{value of all supplies}} \times \text{non-attributable input tax}$$

The standard method can be used without prior approval by the UK Tax Authority, however, it is normally only suitable for small or medium sized businesses and not for businesses in the finance and insurance sector.

If the standard method does not produce a fair and reasonable result, taxable persons may seek approval from the UK Tax Authority to use a “special method”. Most large businesses and businesses in the finance and insurance sector, operate a special method. The special method to be used will often depend on the nature of the business activity. Examples of special methods include:

- *the number of staff used for making supplies with the right to deduct expressed as a percentage of the total number of staff;*
- *the number of taxable transactions made and/or received expressed as a percentage of the number of total transactions made and/or received;*
- *the area of a building used for the purposes of making taxable transactions expressed as a percentage of the total area of the building*”.

The VAT apportionment methods in the United Kingdom banking sector,

The banking Sector in the United Kingdom applies separate apportionment method to different parts of the business. These methods are knowns as sectors. An example would be the leasing business would have a different method to the asset finance business. The principle of direct attribution would apply first to the different sectors based on management accounting rules. Subsequent to this, any other special method to a specific sector would be applied.

The requirement for this VAT apportionment of inputs is that:

- the methodology must be supported by documentary evidence,
- meet the conditions of the legislation and
- written approval must be given, (Survey 2006:85).

5.5 Canada

GST/HST Technical Information Bulletin 106 -2011:1 provides the following:

"Section 141.02 includes some provisions that apply to financial institutions that are qualifying institutions (e.g., the application to use pre-approved methods); some provisions that apply to financial institutions that are not qualifying institutions (e.g., the election to use the prescribed percentage); and some provisions that may apply to all financial institutions (e.g., the allocation rules for excluded inputs)".

GST/HST Technical Information Bulletin 097 -2011: 2 provides that:

"a qualifying institution for a particular fiscal year is a person that meets the following conditions:

- it is a "*financial institution*" of a *"prescribed class*" at any time in the particular fiscal year of the person; and
- it has two fiscal years immediately preceding the particular fiscal year and, for each of those two fiscal years:

Financial institution
"A financial institution is a person that is a financial institution under section 149. A financial institution includes persons listed in paragraph 149(1)(a) such as banks, trust corporations or insurers, and persons described in paragraphs 149(1)(b) and (c) (referred to as de minimis financial institutions)".

Prescribed classes

"Section 2 of the Input Tax Credit Allocation Methods (GST/HST) Regulations (the Regulations) provides that the following are prescribed classes of financial institutions for purposes of the definition of qualifying institution:

- *banks,*
- *insurers, and*
- *securities dealers"*.

"Under subsection 123(1), the term "bank" means a bank or an authorized foreign bank within the meaning of section 2 of the Bank Act. Under section 1 of the Regulations, a bank does not include an insurer".

GST/HST Technical Information Bulletin B-106 – 2011 provides in detail how banks should apportion their input credits in terms of section 141 of the Excise Tax Act.

The core of the methodology is that each expense must be analysed to determine whether it as incurred for the following three purposes:

- purpose of making a specific type supply which is referred to as exclusive or

- direct attribution that is the VAT expense can be assigned between taxable and exempt supplies (direct input) or
- whether the VAT expense is cannot be attributed to any specific supply (non-attributable input).

GST/HST Technical Information Bulletin (B-106 – 2011) provides that once the type of input has been determined, the method of allocation must be selected that most accurately reflects its use.

"There are four methods explained in this bulletin, 2011 that may be selected for input tax credit apportionment:

- ***Tracking:*** *Tracking is recording to the extent possible the actual use of a particular input so that the actual use is linked to the purpose of making taxable supplies for consideration and to purposes other than making taxable supplies for consideration. Considered the most accurate method of allocation as the actual use of the input incurred is tracked and allocated between taxable and exempt supplies on this basis.*
- ***Causal allocation:*** *Causal allocation directly approximates to the extent possible the use of a particular input using a systematic approach and an appropriate allocation base. i.e., there is a direct correlation between the expenditure on which GST/HST is paid and a particular factor.*
- ***Input-based allocation:*** *An input-based allocation uses a calculation based on the use of other inputs to allocate inputs to the extent that they cannot be allocated using either tracking or causal allocation generally used for non-attributable inputs that cannot be allocated based on tracking or causal allocation. This method would only be acceptable if substantially all of the financial institution's inputs were either exclusive or direct inputs and the ratio used to allocate these inputs would approximate the use of the non-attributable inputs.*
- ***Output-based allocation:*** *Considered the least accurate method, an output-based allocation uses a calculation based on an output measure (e.g., revenue) to allocate the use of inputs to the extent that they cannot be allocated using tracking or causal allocation. The bulletin states that this method should only be used when the output measure gives a reasonable approximation of the use of the input. This measure must also be adjusted for any distorting factors than may result in a misrepresentation of the ratio".*

"While the methods do require pre-approval, adequate documentary evidence must be maintained to demonstrate that these criteria have been met. The criteria, rules, terms and conditions to which the allocation methods must conform are:
The method must employ an objective measure of use which is

- *meaningful,*
- *unbiased and*
- *verifiable.*

The method must be applied in a manner that accurately reflects the use of the input, including:

- *providing comparable results, and*
- *using cost pools only if they are appropriate cost pools."*

"In addition to these criteria, rules, terms and conditions, the methods selected must also be fair and reasonable and used consistently throughout the financial year".

The Canadian method places great importance on the accuracy of the allocation method for example where tracking or casual allocation applies to a VAT expense at 80% the unallocated 20% must be treated as a mixed supply and the one of the other methods of allocation must be used that is the appropriate input- or output-based method.

5.6 Singapore

Inland Revenue Authority of Singapore website provides that:

"for ease of compliance, banks are approved to adopt a fixed input tax recovery ratio for the purposes of claiming input tax (excluding disallowed expenses) on an industry basis. This ratio is reviewed on a yearly basis".

The website goes on to state that banks are also granted some administrative concessions to ease GST compliance. Banks that require more details can enquire with us or the Association of Banks of Singapore. If you are a tax agent representing a banking client and require more information on concessions specific to banks, please write in to us with your name, the tax firm and details of the bank that you are representing and your contact details.

As the definition of financial services is narrower input tax relief is granted to many providers of financial services.

First, the Special Method treats otherwise exempt financial supplies made to registered persons as zero-rated. This requires an allocation of both outputs and inputs and the tracking of transactions and customers.

Second, under the Fixed Input Recovery Method, financial service providers are able to claim a fixed percentage of total input tax credits. The percentages are allocated according to the type of financial institutions and reflect an allowance for B2B relief.

While the compliance costs of this approach may be less than under the Special Method, the fixed percentage is only an approximation and will not accurately reflect the true input costs of providing the services. The input tax recovery rate is not legislated. Rather, the Singapore GST legislation allows Regulations to be made to treat exempt supplies as taxable supplies so as to determine the entitlement to input tax credits.

The Regulations also allow the Comptroller to determine a method of calculating input tax credits including one that treats exempt B2B as zero-rated supplies. (KPMG 2011:34)

Burns 2008 explains the Fixed Input Recovery Method system as follows:

"The Inland Revenue Authority of Singapore uses current statistics submitted to the banking regulator, the Monetary Authority of Singapore, to determine, on an annual basis, a separate input tax recovery ratio for each category of banking licence (i.e. full banks, restricted or wholesale banks, offshore banks, merchant banks) and finance companies". (KPMG 2011:34)

"The fixed input tax recovery rates for banks is financial institutions is currently:

- Full banks – 78%
- Wholesale banks – 96%
- Offshore Banks – 96%
- Merchant banks – 96%
- Finance Companies – 49%". (KPMG 2011:34)

5.7 Conclusion

Canada and Australia's methods of apportionment are more wide-ranging mechanism. The taxpayer is not limited to one method but have an option to choose the most accurate, fair and reasonable apportionment method from a variety of possible options. The most suitable apportionment method is applied to each input and though this methodology might seem complex, both countries allow the apportionment methods to be based on the taxpayers' internal accounting system or cost allocation method.

New Zealand, Singapore and Australia approach has been to utilize policies such as the de minimis rules, zero rating and partial input credit deductions to address apportionment method challenges. From the polices applied internationally, the south African Banking sector apportionment difficulties might be tackled through a fusion of more than one mechanism used internationally.

6 Chapter 6: Conclusion

6.1 Introduction

This final chapter will provide a summary of the report and a conclusion will be reached and recommendations will be made in order to address the problem statement and may identify a suitable alternative to the taxing and VAT apportinment methodology of the current South African banking sector.

6.2 Summary of recommendations based on the international models

6.2.1 Broad Based Exemption – Option to tax (France and Germany)

The method allows the taxpayer to decide whether to treat the financial transaction as either exempt or taxable. The option could be applied on a transaction by transaction basis, by the type of transaction, by customer or by sector. The benefits of this method are:

- Allows for business to business transactions to be taxable, thus giving rise to input tax deductions.
- Works well for types of transactions or certain sectors.
- Addresses cascade to a certain extent
- Can apply to services acquired from non-residents
- Offers flexibility to suppliers

6.2.2 Narrow Exemption: Reduced Input Tax Credit (“RITC”) Australia

Currently in use in Australia, the method introduce a narrower exemption of financial services accompanied by a special regime that grants financial service providers input tax relief for costs of a specified kind that relate to making financial services. The amount of relief granted would be roughly equivalent to the labour/profit component of the identified service. In Australia the relief that is granted is 75% of input tax that would otherwise be denied because of the exemption for financial services and is described as an RITC. The remaining 25% is subject to normal allocation methodology. (KPMG 2011:30)

The benefits of the method are:

- Addresses the self-supply bias / outsourcing concerns
- Addresses distinction between domestic branch to branch v. subsidiary to subsidiary
- Address neutrality of the exemption regime for intermediation services by principals to facilitators and agents
- In synch with industry drive for efficiency and Competitiveness

6.2.3 Narrow Exemption: Special Deduction Regime - Singapore

Currently in use in Singapore, the regime allows for ‘effective zero-rating’ of financial services to GST registered customers. The regime is essentially exemption with recovery of attributable input tax. Each year the tax authority publishes a fixed input tax recovery rate for specified types of financial institutions. These rates are calculated annually based on industry statistics and focus on domestic consumption.

The rates vary:

- *Offshore banks 96%*
- *Wholesale banks 96%*
- *Merchant banks 96%*
- *Full banks 76%*
- *Finance companies 43%*

The benefits of the method are:

- Narrow exemption for financial services addresses the cascade
- No need to track transactions, therefore simplified administration and compliance
- Focus on international competition
- Less input taxation of sector improves efficiency generally
- Ease compliance for large and small businesses
- Less compliance and administration

6.2.4 Broad Base Exemption: B2B Relief via Legislation – New Zealand

Introduce a zero-rate for business to business (B2B) financial services. This rule allows a GST registered person to make an election to treat, as zero-rated, financial services that are provided to a customer registered for GST and entitled to recover 75% or more of their input tax. The result is additional input tax deduction to a financial service provider by reference to the taxable status of the recipients of its financial services. The broad exemption can remain essentially the same.

Benefits of this approach:

- Competitive for different types of sectors
- Increased efficiency through less input taxation of sector
- Outsourcing issues addressed somewhat by virtue of broader input tax relief

6.2.5 Hybrid Cash Flow + B2C Taxation –Australia's future Tax System review.

The approach separates the components of full GST taxation of financial intermediation into its component parts and apply individual treatment:

- For B2C, where explicit fee is charged, full GST applies
- For B2C, where a margin is charged, a cash flow base would be used to tax financial intermediation, at an aggregate level
- B2B financial services would be zero-rated
- Exported financial services would be zero-rated

Benefits of this approach:

- Maximize application of GST B2C
- Addresses cascade
- Addresses outsourcing
- Accurate taxation of consumption of financial intermediation service, not taxation of the financial services sector
- Zero-rating of B2B should create a competitive advantage for a Canadian financial institution

6.2.6 Full Zero-Rate

Full, broad based zero-rate of all financial intermediation. Formally considered in Hong Kong and recommended by IMF. Under consideration in the UAE

Benefits of this approach:

- No cascade
- Promotes investment
- Greater ease of administration and
- compliance – "simple"
- Addresses outsourcing concern
- Removes self-assessment obligation
- Internationally competitive
- Removes the "spread" tendency

6.3 Conclusion

It is concluded from above that there are various alternatives to the taxation of financial service and each of these approaches would benefit the banking sector and alleviate some of the difficulties currently experienced with the current South African approach.

The Australian way provides relief of 75% of the input tax that would otherwise be denied because of the financial services exemption. Though this approach does not address tax cascading directly it removes the motivation for self-supply and the cascading effect of VAT and further, achieve neutrality for intermediation services.

This approach is in line with the banking industry drive for efficiency and competiveness and all financial services organisations will be treated equally with no need for complex VAT apportionment methods which are currently open to manipulation.

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