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A research report submitted to the Faculty of Commerce, Law and Management, University of Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

VAT TREATMENT OF FINANCIAL SERVICES: A COMPARATIVE ANALYSIS BETWEEN METHODOLOGIES APPLIED IN SOUTH AFRICA AND OTHER TAX JURISDICTIONS

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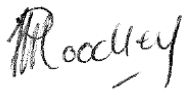
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Degree: Master of Commerce (specialising in Taxation)

Date: 31 March 2016

DECLARATION:

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



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Perushka Moodley

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ABSTRACT

The taxation of financial services is challenging from a Value-Added Tax (VAT) perspective. Conceptually, VAT should apply to any fee for services but where financial services are concerned, there is difficulty in quantifying the value-added by these institutions. According to the *First Interim Report on Value-Added Tax for the Minister of Finance* (the Davis Tax Committee report) most jurisdictions have therefore opted to exempt financial services from VAT.

In South Africa, financial services are exempt from VAT, however, where an explicit fee is charged as consideration for a supply, it will be taxed. The South African VAT legislation provides for the denial of input tax on costs incurred to generate exempt supplies. The burden of an irrecoverable VAT cost exposes the financial industry to hindrances such as vertical integration and tax cascading.

Certain VAT jurisdictions have however implemented policies to reduce the overall cost of financial institutions. This study will therefore analyse the alternate VAT methods to determine whether a more viable mechanism of taxing financial services in South Africa, exists.

Key words:

Apportionment, cascading, implicit fees, input tax, efficiency, exemption, explicit fees, equity, full taxation approach, neutrality, simplicity, standard rate, reduced input tax credit, value-added, VAT grouping, vertical integration, zero-rating

CHAPTER 1: INTRODUCTION

1.1. Background

In September 1991, VAT was introduced as a broad-based indirect tax on the consumption of goods and services in South Africa. This introduction resulted in most supplies of goods or services attracting VAT however certain exemptions from VAT were also promulgated.

In the *South African Report of the Value-Added Tax Committee* (the VATCOM report), signed 19 February 1991, the committee had stated that although theoretically, there did not appear to be any reason as to why financial services were not subject to VAT (that is, financial services were consumption expenditure just like any other services), due to the practical and conceptual complexities, financial services were exempted from VAT.

It was only a few years later, following the *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (the Katz Commission report) that a wider range of financial services where an explicit fee was charged as consideration for a supply, was brought into the VAT net. It was considered unjustifiable to treat these services as being different from other administration or professional services.

This amendment signalled a fundamental shift in South Africa's taxation landscape. Implicit fees however, (that is, fees for services provided which are not separately identifiable but included rather as part of the interest margin or investment return) were still exempted from VAT due to valuation difficulties.

In terms of the *South African Value-Added Tax Act 89 of 1991* (SA VAT Act), the basic principles for claiming input tax deductions are as follows:

- where expenses are wholly incurred to generate taxable supplies, a full input tax deduction is permitted;

- where expenses are wholly incurred to make exempt supplies, no input tax deduction is permitted; and

- where costs are incurred to make both taxable and exempt supplies (that is, mixed costs), in the event that the de minimis rule does not apply, input tax recovery is restricted to an apportioned rate.

  (Note: the de minimus rule allows for a full input tax deduction where taxable use is equal to or greater than 95 percent of the total use or consumption).

As South African banks generate significant values of exempt supplies, the de minimus rule is generally not met. Consequently, South African banks are required to restrict their input tax deductions to an apportioned rate.

Where a supplier of financial services cannot recover the VAT paid on its services, the irrecoverable VAT forms part of the cost. It may choose to either raise the price of its services, absorb the VAT cost or find another way of delivering the same service without the VAT cost.

In July 2013, the Minister of Finance announced the appointment of the Davis Tax Committee to investigate the South African tax policy framework, and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability.

The Davis Tax Committee report released in July 2015 reiterated that the taxation of financial services continued to challenge VAT design due to the cost of cascading. Cascading, better explained, is where further tax is paid on an already taxed goods or services with no credit for taxes paid previously. The tax is included

into the final price to consumers on which additional tax is charged, that is, a tax on a tax occurs.

The Davis Tax Committee also found that financial institutions were not incentivised to outsource certain administrative functions to third-party service providers due to the additional VAT cost it would incur. It would therefore seek to undertake the required services itself (vertical integration) which has the effect of reducing competition, specialisation and potentially growth in the South African economy.

1.2. Research problem

Is the current method of taxing financial services from a VAT perspective in South Africa the most appropriate, given the identified limitations of cascading and vertical integration?

As the financial services industry plays a significant role in the South African economy, the large VAT cost burden placed upon financial service providers and the negative effects of cascading and vertical integration is worrisome to both the financial services industry and the South African Revenue Service (SARS).

Certain tax jurisdictions for example Australia, New Zealand and the United Kingdom (UK) have however managed to introduce policies which mitigate the additional VAT costs.

This research will therefore delve into the current VAT treatment of financial services in South Africa and will analyse the alternate VAT methods adopted in the above mentioned VAT jurisdictions to determine whether a revision in South African VAT policy is required.

1.3. The sub-problems

1.3.1. Is there a legitimate need to revise the current VAT treatment of financial services in South Africa?

The first sub-problem is to evaluate the design of the current VAT treatment of financial services in South Africa. This will look at the history of VAT on financial services in South Africa. Further, the study will analyse the weaknesses in the current system including whether the exemption applied is consistent with the underlying principles of neutrality, efficiency, simplicity and fairness of a VAT system.

In addition, a critical analysis of the current mechanisms in place to alleviate some of the VAT burden in South Africa will be performed. This will include an analysis of the reasonability and appropriateness of the class ruling issued by SARS to the Banking Association of South Africa (BASA) regarding the agreed alternative method of VAT apportionment to be applied by the applicants to such request.

1.3.2. Conceptually, does a better method exist to tax financial services from a VAT perspective in South Africa?

The second sub-problem is the crux of the study. The task here is to compare and contrast alternative VAT methods in other tax jurisdictions to determine whether a more appropriate method exists to taxing financial services in South Africa, from a VAT perspective.

An analysis of the following tax jurisdictions will be performed:

- New Zealand - As the South African VAT Act mirrors that of New Zealand's Goods and Services Tax (GST) regulations in many ways as

both taxes are similar, the zero-rated VAT treatment of financial services in New Zealand will be analysed.

- Australia- Moving across the Tasman Sea, the Australian Government introduced the Reduced Input Tax Credit method to curb the effects of vertical integration and cascading which were identified as being the fundamental weaknesses of the South African VAT treatment of financial services; and

- United Kingdom - UK VAT grouping rules were also implemented to eliminate the effects of cascading and the incentive for vertical integration specifically with regards to intra-group supplies and therefore is of interest to this study.

1.3.3. How will a potential new method impact the financial service providers, SARS, consumers etc.?

The third sub-problem will stem from the results of the above analysis. If a more viable method of taxing financial services in South Africa exists, an analysis will be performed in theory to consider the potential impact of a new method on the economy.

1.4. Purpose of the research

This research report will give an overview of the current method of exempting financial services from VAT in South Africa and its weaknesses in relation thereto. It will also address current SARS practices put in place to limit the VAT burden placed on financial service providers. By analysing the VAT treatment adopted in alternate VAT jurisdictions, this study will provide the reader with further insight as to whether a more suitable approach to taxing financial services in South Africa exists for further consideration by South African policy makers.

1.5. Significance of the study

Following the Davis Tax Committee report released in July 2015, the current method of exempting financial services from VAT in South Africa has resulted in negative effects of tax cascading and vertical integration. The Davis Tax Committee recommended that alternative methods to reduce the VAT cost in the financial services industry should be further investigated.

In response thereto, this study provides the much needed analysis of alternative VAT methods adopted by other jurisdictions to taxing financial services, the primary intention of the study being to determine whether a revision in South African VAT policy is required.

1.6. Scope

The scope of this study will focus on:

- An analysis of the history of VAT on financial services in South Africa;
- It will consider the underlying nature of financial services and the appropriateness of the VAT exemption applied in relation thereto;
- A review of the alternative method of apportionment agreed between SARS and BASA; and
- A review of the VAT treatment of financial services in the following tax jurisdictions: New Zealand, Australia and UK. These VAT jurisdictions have implemented policies to reduce the overall cost of financial institutions and are therefore of relevance to the study. In addition, we will review the merits and/ or demerits of a full taxation approach i.e. taxing financial services at the standard rate of 14 percent of VAT.

1.7. Limitations

The financial services sector in South Africa consists primarily of banks, short term and long terms insurers, brokerage firms, asset managers and collective investment schemes.

This study is however restricted to an analysis of the VAT treatment of financial services in the banking industry only.

1.8. Methodology

The research method adopted is of a qualitative, interpretive nature, based on a detailed interpretation and analysis of the relevant source information.

An extensive literature review and analysis will be undertaken that includes the following sources –

- Books;
- Cases;
- Electronic databases;
- Electronic resources – internet;
- Journals;
- Magazine articles;
- Publications; and
- Statutes.

CHAPTER 2: VAT ON FINANCIAL SERVICES IN SOUTH AFRICA

2.1. Introduction of VAT in South Africa

In South Africa, a general sales tax (GST) operated from 1978 until 29 September 1991. It was at the opening of Parliament on 5 February 1988 that the State President announced that GST was to be abolished and replaced by a value-added tax system.

Under the GST system, tax was generally only charged on the sale to the final consumer.

Under a VAT system however, the tax is charged along many stages of the production and distribution process. Output tax is levied on goods or services supplied by VAT registered businesses (vendors) and a credit is given for the tax paid on the inputs (that is, input tax) used to produce the taxed output. The tax is paid by the buyer and collected by the seller. For each business, the net VAT to be remitted to the government would be its output tax (collected from its customers) less its input tax (paid to its suppliers). In certain instances, where input tax is more than output tax, a net VAT refund is due to the business. It is this crediting mechanism that allows most businesses to bear no VAT burden.

As commented by Beneke and Silver (2015), ‘VAT is essentially a tax on the expenditure in the domestic economy rather than a tax on the output of the domestic economy’.

2.2. The VATCOM report

Subsequent to the State President's announcement of VAT, the draft Value-Added Tax Bill was issued for general comment on 18 June 1990. The then Minister of Finance simultaneously appointed a committee (VATCOM) consisting of members from both the public and private sectors to consider the comments and representations made by interested parties on the draft VAT Bill.

VATCOM released a comprehensive report on 19 February 1991, setting out its findings and recommendations in relation thereto. Despite VATCOM's suggestion that exemptions, zero-ratings and exceptions should be kept to a minimum, it recommended that financial services should be exempted from VAT. VATCOM concluded that as no country was yet able to overcome the difficulties foreseen with the taxation of financial services, it did not recommend that South Africa perform the pioneering work in this regard (Marais 1991, p. 31).

(Note: VATCOM's analysis in considering whether financial services should be brought into the VAT net or not will be later discussed in Chapter 5 where alternative methods to taxing financial services are considered.)

2.3. Implementation of VAT in South Africa

Following VATCOM's recommendations, the SA VAT Act was implemented with effect from 30 September 1991.

Section 12(*a*) of the SA VAT Act provided for the exemption of financial services from VAT. Financial services were defined in section 1 of the SA VAT Act, read in conjunction with the list of exempt services as set out in section 2 of the SA VAT Act. The list of exempt services included various banking services, the provision of credit under a credit agreement, dealings involving various kind of securities, life insurance and superannuation schemes.

‘Agreeing to do’ or ‘arranging’ activities were also viewed as financial services however the advising thereon for which a separate fee was charged was not viewed as an exempt financial service.

In addition the exemption did not apply where such financial services were taxed at the rate of zero percent instead.

(SARS 1991)

2.4. Subsequent amendments to the SA VAT Act

In 1992, section 12(*a*) of the SA VAT Act was amended to exempt the supply of any other goods or services by the supplier of the financial services, which were ‘necessary’ for the supply of such financial services (SARS 1992, p. 17).

By way of example:

A bank’s administration of a client’s cheque account was viewed as a financial service under section 2(1)(*b*) of the SA VAT Act. In addition, the bank charged the client separately for the issue of a cheque book. As the client requires a cheque book in order to operate his cheque account, it was considered that the supply of the cheque book was ‘necessary’ for the supply of financial services and similarly should be exempt from VAT (SARS 1994, p.21).

‘Necessary’ as defined by Oxford Dictionary Online, means ‘needed to be done, achieved, or present, essential’ (Oxford University Press 2016).

Interpretative issues however arose as a result of the insertion of the word ‘necessary’ into Section 12(*a*) of the SA VAT Act for both taxpayers and revenue authorities.

Consequently in 1994, section 12(*a*) of the SA VAT Act was amended to include that the 'incidental' supply of goods or services by the supplier of financial services, where the supply of such goods or services was necessary for the supply of the financial services should be exempt from VAT (SARS 1994, p. 21).

'Incidental' as defined by Oxford Dictionary Online, means 'the happening as a minor accompaniment to something else or the happening as a result of an activity' (Oxford University Press 2016). The insertion of the words 'incidental' as opposed to 'necessary' was intended to provide the clarity required.

With effect from 1 April 1995, section 2 of the SA VAT Act was further amended to delete section 2(1)(*m*) of the SA VAT Act which provided that the payment or collection on someone else's behalf of any amount in respect of a debt security, equity security or participatory securities were exempt financial services. The debt collection services were similar to any other administrative or professional service and it was therefore considered unjustifiable to treat such services differently for VAT purposes (SARS 1994, p. 10).

Similarly, section 2(1)(*n*) of the SA VAT Act which exempted the activity of 'agreeing to do' or the 'arranging of' financial services which were exempted under section 2(1) of the SA VAT Act, was amended by the deletion of the words 'arranging'. 'Arranging' referred to instances where brokers' agents and other intermediaries provided services which were viewed as being no different to any other administrative or professional service provided (SARS 1994, p. 11).

The amendments to the above two sections was a prelude to what was to be a significant shift in SA's tax landscape.

2.5. Appointment of the Katz Commission

Included in its mandate, the Katz Commission was appointed by the South African government to investigate the inclusion of a wider range of financial services into the VAT system (that is, as a means to broaden the VAT base).

The Katz Commission (Katz 1995, p. 30) proposed that the following should be brought into the VAT net, ‘all fee based financial services and all fee based services in respect of life insurance and other superannuation funds’.

Following the Katz Commission’s recommendations, the SA VAT Act was subsequently amended with effect from 01 October 1996.

Section 12(*a*) of the SA VAT Act was amended to include that only underlying financial services as defined in section 2 of the SA VAT Act are exempt from VAT. The supply of goods or services incidental to and necessary for the supply of those financial services were now subject to VAT for example, the supply of a cheque book to a customer was now subject to VAT.

The below amendments were further necessary to give effect to the recommendations of the Katz Commission (Davis 2014, p. 42), (SARS 1996, p. 8-11):

- The deletion of section 2(1)(*e*) of the SA VAT Act, which previously exempted the underwriting or sub-underwriting of the issue of an equity security, debt security or participatory security;

- The deletion of section 2(1)(*g*) of the SA VAT Act which provided that the renewal or variation of a debt security, equity security or participatory security or credit agreement constituted a financial service;

- The deletion of section 2(1)(*h*) of the SA VAT Act which related to the provision, taking, variation or release of a financial guarantee, indemnity, security or bond in respect of the performance of obligations under a cheque, credit agreement, debt security, equity security or participatory security as a financial service. The effect of the deletion was that the transactions in relation to the services listed in section 2(1)(*h*) of the SA VAT Act should be treated in the same manner as taxable short-term insurance;

- The scope of section 2(1)(*i*) of the SA VAT Act, which provided for the supply of a long-term insurance policy to be an exempt financial service, was reduced to exclude from the definition of a 'financial service', the management of a superannuation scheme by long-term insurers;

- The scope of section 2(1)(*j*) of the SA VAT Act, which included the provision or transfer of ownership of an interest in a superannuation scheme or the management of a superannuation scheme as a financial service, was limited by the exclusion of the activity of the management of a superannuation scheme. The service of managing a superannuation scheme by an intermediary therefore became a taxable service in line with the recommendations of the Katz Commission;

- Section 2(1)(*n*) of the SA VAT Act, which provided for the activity of 'agreeing to' do any of the activities specified in section 2(1) of the SA VAT Act, was deleted; and

- A proviso was added to section 2(1) of the SA VAT Act to stipulate that the activities contemplated in section 2(1)(*a*) to 2(1)(*f*) of the SA VAT Act shall not be considered to be a financial service to the extent that the consideration payable in respect thereof is any fee, commission or similar charge, but excluding a discounting cost.

With effect from 1 March 1999, the scope of financial services was further limited by the inclusion of a merchant's discount in the proviso to section 2(1) of the SA VAT Act (that is, the merchant's discount became subject to VAT from that date) (SARS 1998, p. 35-36).

2.6. Current SA VAT legislation

In terms of the prevailing SA VAT Act, the following provisions exist:

- Section 12 (*a*) provides that the supply of any financial services, but excluding the supply of financial services which, but for this paragraph, would be charged with tax at the rate of zero percent under section 11 of the SA VAT Act, are exempt from VAT.

- Section 1 of the SA VAT Act defines financial services as 'activities which are deemed by section 2 of the SA VAT Act to be financial services'.

- Section 2(1) of the SA VAT Act provides that the following activities shall be deemed to be financial services: '
    a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise);
    b) the issue, payment, collection or transfer of ownership of a cheque or letter of credit;
    c) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security;
    d) the issue, allotment or transfer of ownership of an equity security or a participatory security;
    e) . . . . . .
    f) the provision by any person of credit under an agreement by which money or money's worth is provided by that person to another person

who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth;

g) . . . . . .

h) . . . . . .

i) the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance in respect of any such policy: Provided that such an activity shall not be deemed to be a financial service to the extent that it includes the management of a superannuation scheme;

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: Provided that where a supply of the underlying goods or services takes place, that supply shall be deemed to be a separate supply of goods or services at the open market value thereof: Provided further that the open market value of those goods or services shall not be deemed to be consideration for a financial service as contemplated in this paragraph:

l) . . . . . .

m) . . . . . .

n) . . . . . .

Provided that the activities contemplated in paragraphs (*a*), (*b*), (*c*), (*d*) and (*f*) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost.'

- Section 2(2) and 2(3) of the SA VAT Act provide further meaning to certain terms included in section 2(1) of the SA VAT Act; and

- Section 2(4) of the SA VAT Act sets out exclusions from the definition of financial services.

CHAPTER 3: CRITICAL ANALYSIS OF THE SA VAT EXEMPTION METHOD

3.1. The underlying nature of financial services

As stated by Merrill (1997, p. 16):

> Most of consumption tax literature regarding the taxation of financial-intermediation services implicitly accepts the proposition that financial services should be subject to tax in the same manner as other goods and services. This proposition was further clearly articulated in Alan Tait's treatise on value-added taxes: 'Value-added in banking and insurance is no appropriate for inclusion in the VAT base than any other service or provision of goods. Indeed, to exempt financial services from VAT excludes from taxation a sector that is often perceived as extraordinarily remunerative, has a high visibility in terms of its physical assets, and is seen as a bastion of traditional orthodoxy'.

A few writers, however, have questioned the above conventional view.

Grubert and Mackie for instance viewed that almost all financial-intermediation fees (whether explicit or implicit) inherently were charges for investment rather than consumption activities, and they took the position that such fees were not the proper object of a consumption tax. In their view, investment services affected the price of buying an investment good, not the price of buying a consumption good. The borrowing of funds was merely a means for shifting consumption forward in time. As the services related to non-consumption goods, such financial services should not be in the base of a consumption tax. Further if a consumption tax were imposed on financial intermediation services, the result would be to reduce the rate of return to savers (Grubert & Mackie 2000, p. 24), (Merrill 1997, p. 16-17).

It appears that the above view seemed to approach the problem from the point of view of an investor or depositor (that is from the perspective of the person who deposits funds with the bank for safe-keeping) rather than from the perspective of the borrower who consumes the service and bears the tax (for example the borrower who requires a loan to purchase goods or services for immediate

consumption). (Note: For purposes of this study, the words ‘investor’ or ‘depositor’ are interchangeable).

It also placed a higher reliance on the bank being in a position to know what the intended use will be with the funds provided, which is not always the case. For example, if the bank were to provide car financing, then yes it would be considered fair to say that the bank is aware of the intended use (that is, the customer is to purchase a car for immediate consumption). However, if a bank was providing a personal loan, the specifics of the customers’ use thereof, may not always be known (that is, whether the customer is taking out a loan to purchase a consumption good or not?).

With the Grubert and Mackie argument, the VAT treatment of the supply is very much based on the customers’ use of the services which appears to go against the basic principles of the VAT Act. In terms of section 7(1)(*a*) of the SA VAT Act, it is the supplier’s responsibility to levy VAT based on the nature of the supply of the good or service, not based on the recipient’s intended use of such good or service.

As previously stated in Chapter 2, VATCOM agreed that there did not appear to be any reason as to why financial services should not be subject to VAT. Financial services were consumption expenditure just like any other services and as they formed a higher proportion of budgets and higher income households, there was every reason to subject them to VAT (Marais 1991, p. 29).

These sentiments were equally shared by the Davis Tax Committee in June 2015. The Davis Tax Committee did not disagree that the supply of financial services should be subject to tax when supplied to a final consumer, however determining the consideration for that supply had proved elusive (Davis 2014, p. 16).

(Note: The above-mentioned valuation difficulties are further discussed in Chapter 5, where the option to tax financial services at the standard rate is considered).

3.2. Basic principles of a VAT system

To evaluate the weaknesses of any tax system it is important to measure such system against the very foundation (that is, the underlying principles) upon which it was built.

While South Africa is not currently a member of the Organization for Economic Co-operation and Development (OECD), South Africa has a 'working relationship' with the OECD, participates in a variety of OECD events and has entered into an 'enhanced engagement' programme with the OECD.

As such, South Africa follows OECD guidelines and it is of relevance to the study.

Following a review of both the VATCOM report and International VAT GST guidelines which were released in November 2015, the main principles of a VAT system are outlined below (Marais 1991, p. 5-7), (OECD 2015, p. 15-16):

3.2.1. VAT is a consumption type tax

VAT is a tax on final consumption by households. As a matter of elementary logic as businesses are not households they are incapable of final or household consumption. The burden of the VAT should therefore not rest on businesses.

This central design feature of the VAT system, therefore requires a mechanism for relieving businesses of the burden of the VAT they pay when they acquire goods, services, or intangibles. Under the invoice-credit method each supplier charges VAT at the rate specified for each

supply and passes to the purchaser an invoice showing the amount of tax charged. The purchaser is in turn able to credit that input tax against the output tax charged on its sales, remitting the balance to the tax authorities and receiving refunds when there are excess credits.

3.2.2. Neutrality

In domestic trade, tax neutrality is achieved in principle by the multi-stage payment system: each business pays VAT to its providers on its inputs and receives VAT from its customers on its outputs. To ensure that the 'right' amount of tax is remitted to tax authorities, input VAT incurred by each business is offset against its output VAT, resulting in a liability to pay the net amount or balance of those two. This means that VAT normally 'flows through the business' to tax the final consumers. It is therefore important that at each stage, the supplier is entitled to a full right of deduction of input tax, so that the tax burden eventually rests on the final consumer rather than on the intermediaries in the supply chain. This design feature gives to VAT its essential character in domestic trade as an economically neutral tax.

The OECD further provides the following guidelines on the basic principles of neutrality:

- Guideline 2.1

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

- Guideline 2.2

  Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation. The tax should be neutral and equitable in similar circumstances. This is to ensure that the tax ultimately collected along a particular supply chain is proportional to the amount paid by the final consumer, whatever the nature of the supply, the structure of the distribution chain, the number of transactions or economic operators involved and the technical means used.

- Guideline 2.3

  VAT rules should be framed in such a way that they are not the primary influence on business decisions. It is recognised that there are, in fact, a number of factors that can influence business decisions, including financial, commercial, social, environmental and legal factors. Whilst VAT is also a factor that is likely to be considered, it should not be the primary driver for business decisions. For example, VAT rules or policies should not induce businesses to adopt specific legal forms under which they operate (for instance, whether it operates in a subsidiary or a branch structure).

- In addition, to support the neutrality principle, the VAT rules should be accessible, clear and consistent.

3.2.3. Equity

According to Adam Smith (1776, p. 451):

> The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to its respective abilities that

is in proportion to the revenue which they respectively enjoy under the protection of the state.

It follows that equity refers to the tax's ability to treat all concerned parties equally.

3.2.4. Efficiency, productivity and simplicity

An efficient and productive tax should be able to collect large amounts of revenue without distorting consumer or producer choice, investments or savings.

3.3. Weaknesses identified with the exemption method:

3.3.1. Contravention of the consumption rule

Due to the VAT exemption applied, financial services are denied input tax relief on costs incurred to generate exempt supplies. A VAT cost is borne by the financial service provider which contravenes the fundamental consumption rule that the final tax burden should be borne by the household not the suppliers in the chain.

3.3.2. Contravention of the neutrality and equity principle

Having regard to the consumption rule above, OECD Guideline 2.1 provides that the burden of value-added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.

Although financial services are specifically exempt from VAT in the legislation, it does not alleviate the fact that the underlying consumption principle has been breached. Further, despite the exemption being

stipulated in the legislation, it does not necessarily mean that the exemption is correct.

OECD Guideline 2.2 provides that businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Without having to compare two businesses, if an analysis is performed by looking at a single financial service provider who provides services to a customer outside of South Africa and similarly provides services to a local customer, clear differences in the VAT treatment are identified.

In the former, the services are zero-rated in terms of the SA VAT Act. As a taxable supply is made, the vendor is entitled to deduct input tax deductions on expenses incurred to generate the taxable supply.

In the latter, the supply of financial services takes place locally, therefore the supply of financial services is exempt from VAT and the supplier is denied input tax relief on expenses incurred to generate such supplies.

Arguably, the same service has been provided irrespective of who the recipient of the service is, however in the former case, the financial service provider bears a VAT cost and in the latter, it doesn't. This appears to undo the principle of neutrality and equity. Further, as financial services are not taxed in the same way or to the same extent of other services, this appears inequitable.

As commented by de la Feria & Walpole (2009, p. 911):

> Some authors have drawn attention to the phenomenon of 'creeping exemptions'. They contest that, as more exemptions are granted, other sectors of the economy will be tempted to claim exemptions for themselves thus further eroding the tax base.

According to Ebrill, Keen & Summers (2001), VAT exemptions were considered to be an ‘aberration in terms of the basic logic of VAT’.

Exemptions appear to go against the core principle of VAT as a tax on all consumption, and also undermines the efficiency and neutrality of the tax.

The contraventions of the fundamental principles are further elaborated by the weaknesses in the exemption system, identified below:

3.3.3. Tax Cascading

Tax cascading is one of the main side effects of treating activities as exempt.

Where a financial institution who provides exempt financial services is denied input tax relief in respect of VAT borne by it on the acquisition of goods and services from third parties, the financial institution may choose to recover the cost by including it in the price of its services.

In a situation where the services are provided to another VAT registered business who on sells to the final consumer, the sales price to a final consumer will typically be calculated as cost plus a mark-up added by the VAT registered business. The VAT registered business’s cost will include the portion of VAT cost charged by the initial financial services provider to the VAT registered business. Consequently, the VAT registered business’s sales price to the final consumer includes a portion of VAT which is then subjected to further VAT at 14 percent. Essentially a tax on a tax occurs which fundamentally contravenes the principles of VAT being a neutral tax.

3.3.4. Vertical integration

A bank or other supplier of exempt financial services is denied input tax credits on acquisitions (domestic purchases and imports) used in rendering those exempt services. If a bank provides needed services in-house rather than purchasing them from outside suppliers, the bank can avoid some of that non-creditable input tax.

For example, assume that a bank maintains its own internet technology department Instead of outsourcing this function. Such service is used exclusively in connection with the bank's exempt financial services.

If this service were outsourced, assume that the bank would pay R 100 000 plus R 14 000 VAT. As long as the bank can provide the same service for less than the R 114 000, the bank has an incentive to provide this service in-house.

Examples of outsourced transactions which result in a non-recoverable VAT cost to a financial services provider includes:

- The supply of support services such as human resources, information technology, treasury, finance and legal services etc.;
- Centralised customer call and service centres;
- Management and administration services; and
- Provision of infrastructure such as buildings and equipment.

As set out in the Davis Tax Committee report, vertical integration creates the following problems (Davis 2014, p. 45):

- Discrimination against third party suppliers. These suppliers will no longer be used as they are considered to be expensive;

- Discrimination against smaller financial institutions that are not in a position to vertically integrate. This results in smaller financial institutions potentially being outpriced in the market (that is, due to the added VAT cost, it will have a higher sales price than the larger financial institutions); and

- It frustrates the natural development of specialisation and creates inefficiencies in the production and delivery of financial services. To avoid the VAT cost, financial institutions may seek to perform activities in house. Should a financial institution not have the necessary skill level or expertise, this may lead to unnecessary errors.

In addition, the non-deductible VAT cost also impacts on the manner in which a financial services group is structured. For example, a bank may invest directly in fixed property in order to avoid any irrecoverable VAT cost on inter-company rentals. Further, banks who own their property investments directly also enjoy a higher VAT apportionment ratio compared to banks that invest via property companies. The decision to restructure is directly as a result of the VAT burden imposed on financial service providers. This highlights a further contravention of the OECD Guideline 2.3 which states that the VAT rules should be framed in such a way that they are not the primary influence on business decisions.

3.3.5. VAT apportionment

Where costs are incurred to make both taxable and exempt supplies (that is, mixed costs), in the event that the de minimis rule does not apply, input tax recovery is restricted to an apportioned rate. (Note: the de minimus rule allows a full input tax deduction where taxable use is equal to or greater than 95 percent of the total use or consumption).

As South African banks generate significant values of exempt supplies, the de minimus rule is generally not met. Consequently, South African banks are required to restrict is input tax deductions to an apportioned rate. South African banks therefore incur an irrecoverable VAT cost which contravenes the consumption rule.

Currently, the only approved method of VAT apportionment as set out in South African VAT legislation is the standard turnover-based method of apportionment which calculates an apportionment rate by dividing the value of taxable supplies for that period over (taxable supplies + exempt supplies + the sum of any other amounts of income not included in taxable or exempt, which were received or which accrued during the period, whether in respect of a supply or not).

If the standard-turnover based method yields an unfair result, alternative methods of apportionment can be agreed with the SARS.

In this regard, an alternative method of apportionment has been agreed between BASA and SARS. The method applied is however by no means simple. The lack of simplicity contravenes an underlying principle of a VAT system. In addition, it poses administrative and interpretative difficulties for banks which are further discussed in Chapter 4.

3.3.6. Aggressive VAT planning

According to de la Feria and Walpole (2009, p. 909), a bank is presented with two basic methods of curtailing VAT costs:

1) Minimize VAT input, by acquiring less goods and/or services which are subject to VAT; or

2) Maximizing VAT output, by increasing the number of taxable supplies and therefore, the overall percentage of deductible input VAT…

Whilst the legitimacy of engaging in VAT planning is acknowledged often non-tax reasons will prevent legal persons from adopting measures which will reflect either of these methods. It is in this context that so-called aggressive VAT planning, or VAT avoidance, schemes will often emerge.

An example of how financial institutions' VAT costs, resulting from the exclusion of the right to deduct input tax, can act as a catalyst for engagement in aggressive VAT planning was illustrated in the *Halifax* case.

As stated in (Taxation 2012), the facts of the case were as follows:

A bank (H) wished to construct a number of 'call centres'. If it had arranged for this itself, most of the input tax would have been attributed to its exempt supplies and would have been irrecoverable.

It therefore granted a leasehold interest in the relevant sites to an associated company (L), which was not a member of its VAT group.

L then arranged for another associated company (C) to carry out the work. C engaged builders to undertake the construction.

C reclaimed input tax on the amounts charged by the builders and charged output tax to L, which reclaimed these amounts as input tax.

The European Court of Justice (ECJ) held that the abuse of rights doctrine applies to VAT where a transaction results in the accrual of a tax advantage. The result for *Halifax* was that input tax was blocked for the entities which sought to deduct such tax 'abusively'.

3.3.7. Adapting to new developments in the banking industry

Cognizant of the fact that things may change over time, de la Feria and Walpole (2009, p. 900-908) acknowledged that there were significant new developments in financial products, as well as the emergence of new supply structures, which make use of, inter alia, outsourcing,

subcontracting and pooling techniques as well as the rise of the internet as a medium for Business to Business (B2B) and Business to Consumers (B2C) transactions.

In the European Union (EU), traders and national tax administrations were becoming increasingly unsure as to whether these new products, and the new supply structures fall within the scope of the exemptions. As a result, there was a growing level of case law emerging from the ECJ on the scope of the exemptions which were applicable to financial supplies.

This climate of uncertainty will in turn have the effect of increasing compliance and administrative costs, as more time and resources will be devoted to establishing the correct VAT treatment of each financial supply.

CHAPTER 4: CURRENT MECHANISMS IN PLACE TO REDUCE VAT COSTS IN SOUTH AFRICA

As set out in Chapter 3, there are many weaknesses which have arisen from the VAT exemption of financial services in South Africa.

In an effort to reduce some of the VAT costs imposed on banks, the following measures were introduced by SARS in South Africa.

4.1. Taxation of explicit finance charges

As discussed in Chapter 2.5, following the recommendation of the Katz Commission, fee based financial services were brought into the VAT net because it was considered unjustifiable to treat these services differently from other administration or professional services.

The rationale behind the decision was that financial service providers who supplied financial services for a fee would now be entitled to claim a larger percentage of its VAT incurred on taxable expenses as input tax.

As commented by the Davis Tax Committee, the reality however was that the expenses incurred to provide the above services mainly comprised of staff costs for which no input tax deduction was available. It was found that the taxable expenses in relation to the provision of such services, which qualified for input tax deductions were generally not significant (Davis 2014, p. 45).

Further, even if all financial services with explicit fees were taxed, a significant share of the value–added of the banking industry (that is, the value of its intermediation services which are included in its interest margins between lending

and deposit–taking activities), would still be exempt resulting in irrecoverable VAT cost.

In addition, Merrill (1997, p. 21) commented that ‘Any attempt to tax explicit fees while still exempting implicit fees, may create an incentive for financial service institutions to alter fee structures to minimize tax’.

4.2. Agreement of an alternative method of apportionment to claim input tax deductions on mixed expenses.

4.2.1. General Principles- standard turnover-based method of VAT apportionment

As set out in the Introductory Chapter, in terms of the SA VAT Act, the basic principles for claiming input tax are as follows:

1) Where expenses are incurred wholly to generate taxable supplies, an input tax deduction is permitted;

2) Where expenses are incurred wholly to make taxable supplies, an input tax deduction is denied; and

3) Where expenses are incurred to make both taxable and exempt supplies (that is, mixed costs), an input tax deductions is restricted to a calculated apportionment rate, where the de minimis rule does not apply.

Steps 1 and 2 refers to the principles of direct attribution. Direct attribution calls for the attribution of the VAT expense according to the intended purpose for which the acquired goods or services will be used. It is only when an expense has been incurred partly for the purpose of consumption, use or supply in the course of making taxable supplies and

partly for exempt and other non-taxable purposes, that the VAT must be apportioned.

The most common expenses that need to be apportioned are the general overheads of the business.

Currently, the only pre-approved method which may be used to apportion VAT incurred on mixed purposes without specific prior written approval from SARS, is the standard turnover-based method.

The standard turnover-based method of VAT apportionment as set out in the SARS VAT 404 Guide for Vendors is as follows (SARS 2015a, p. 49):

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

Where:

y = the apportionment ratio/percentage;
a = the value of all taxable supplies (including deemed taxable supplies) made during the period;
b = the value of all exempt supplies made during the period; and
c = the sum of any other amounts of income not included in “a” or “b” in the formula, which were received or which accrued during the period (whether in respect of a supply or not).

Notes:

1. The term “value” excludes any VAT component.

2. “c” in the formula will typically include items such as dividends and statutory fines (if any).

3. Exclude from the calculation the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease or instalment credit agreement).

4. Exclude from the calculation the value of any goods or services supplied where input tax on those goods or services was specifically denied.

5. The apportionment percentage should be rounded off to two decimal places.

6. Where the formula yields an apportionment ratio/percentage of 95 percent or more, the full amount of VAT incurred on mixed expenses may be deducted (referred to as the *de minimis* rule).

Conditions:

The aforementioned method is subject to the following conditions:

1. The 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 to use an alternative method.

2. Vendors using their previous year's turnover to determine the current year's apportionment ratio are required to do an adjustment (that is, the difference in the ratio when applying the current and previous years' turnover) within six months after the end of the financial year.

*Vendor as defined in section 1 of the SA VAT Act means 'any person who is or is required to be registered under this Act'.

Where, however, the standard turnover-based method yields an unfair, unreasonable or distortive result, a vendor may approach SARS to obtain an alternative method of VAT apportionment.

4.2.2. Alternative BASA method of VAT apportionment agreed with SARS

Due to the unfairness of applying the standard turnover-based method in the banking industry, BASA approached SARS to obtain an alternative method of apportionment.

An alternative method of apportionment was agreed between the two parties dated 13 May 1998 (SARS 1998). This method was subsequently withdrawn and replaced with a new VAT apportionment ruling issued by SARS to BASA on 2 June 2015 which is effective from the date of issue and is applicable to all applicants in respect of financial years commencing on or after 1 July 2015 for a period of five years (SARS 2015b).

The alternative method of apportionment is set out below:

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

Where:

y= apportionment ratio relating to taxable supplies
a= the value of all taxable supplies made during the period
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)

(Note: The classification of income into the different categories is difficult. Fortunately, the Commissioner, in conjunction with the Council of South African Bankers (COSAB),

developed a schedule listing most of the services rendered by large South African banks and stipulates whether each service is taxable, exempt, or zero-rated). (SARS 2007)

Determination of A

The value of total taxable supplies subject to VAT in terms of section 7(1)(*a*) of the SA VAT Act excluding VAT for the financial year, adjusted by the following:

Exclusions

1. *The cash value of goods supplied under an instalment credit agreement (ICA) or a floor plan agreement which complies with the definition of ICA as per the SA VAT Act.*

   The exclusion is based on the principle that banks do not enter into these types of arrangements to make a profit on the underlying item but rather to provide finance, on which interest and fees are earned. As a result the cash value of goods supplied under an ICA must be excluded from the apportionment method. The only income resulting from an ICA to be reflected in the apportionment method would be interest income included under B and fee income included under A.

2. *The portion of rental payment relating to the capital value of goods supplied under a rental agreement which is entered into as a mechanism of finance. In addition rental payments must be reduced by the cost of funding (that is, interest paid) pertaining to those agreements*.

   Any arrangement which falls within the ambit of a rental agreement as defined in the SA VAT Act which is entered into as a mechanism of financing must for the purposes of this method abide by similar rules to that of an ICA. As a result the value of the underlying asset must be excluded from the apportionment value and the cost of funding in relation to rental agreements must be deducted from the value of the rental payment to be included in the formula.

3. *Consideration received in respect of the disposal of capital assets whether fixed or movable.*

   The disposal of capital goods is not a normal business activity of a bank. As a result, the inclusion of the value of the disposal of capital assets in the apportionment method will result in a distorted apportionment ratio which does not accurately reflect the business activities of a bank that is the purpose for which a mixed expense was incurred.

4. *Consideration received from the disposal of business activities.*

   A bank does not dispose of business activities as a normal part of its business. Being an abnormal event which will result in extraordinary income for apportionment purposes the disposal of business activities is excluded from the apportionment method.

5. *Change in use adjustments as envisaged in sections 18 and 18A of the SA VAT Act.*

   A change in use adjustment adjusts the input tax deducted to reflect the actual use as opposed to the intended use of the goods or services and are to be excluded from the apportionment formula.

6. *Deemed supplies in respect of indemnity payments received as envisaged in terms of section 8(8) of the SA VAT Act to the extent that the indemnity payments relate to extraordinary income*.

   Indemnity payments that do not comply with section 8(8) of the SA VAT Act usually comprise abnormal events or the loss of a capital asset applied towards the making of taxable supplies.

7. *Extraordinary income*

This is non-recurring income received due to exceptional circumstances that are unlikely to be repeated. The inclusion of extraordinary income will result in the apportionment ratio being distortive as it will not fairly reflect the extent to which the expenses were incurred for the purposes of making taxable supplies.

Adjusted values:

8. Include a 3 year moving average of the net trading margin from taxable (including zero rated) financial asset trading activities.

9. Reduced zero rated interest income with the cost of funding allocated to such income.

Specific inclusions:

10. Gross proceeds resulting from the disposal of properties in possession and repossessions.

Determination of B

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:

11. Extraordinary non-taxable income

12. *The capital value of loans*

Based on the fact that the income derived by a bank as a result of the provisions of loans is that of interest and fees, the capital value of the loan should not be included in the formula.

13. *Fair value gains and losses reflected as income for Financial Reporting Standards (IFRS) purposes*

Any fair value gains and losses reported in income as a result of revaluations on assets as required by IFRS is not regarded as income for VAT purposes. As a result such income may be excluded from the method. This exclusion does not apply to the trading of financial assets.

14. Foreign exchange gains and losses not subject to any hedging activities

This includes both realized and non-realized gains however the exclusion does not apply to the trading of financial assets or where the exchange gains or losses result from the normal trading activities of a bank (that is the exchange of currency on behalf of a customer).

<u>Adjusted values</u>

15. *Dividend income*

All dividend income is included except for Section 8E and 8EA instruments of the South African Income Tax Act 58 of 1962 (SA Income Tax Act) which are deemed to be interest received. Section 8F and 8FA instruments of the SA Income Tax Act, the interest received thereon will be deemed to be dividends in species for purposes of the apportionment method. Where a member of the class 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.

16. *Include a 3 year moving average of the net trading margin from financial asset trading activities*

'Financial asset' refers to any commodity and other financial asset which can be traded on an exchange or over the counter and includes but is not limited to repurchase agreements, debt securities, equity securities and derivatives.
'Net trading margin' refers to the net profit or loss recorded in the financial records as either realized or unrealized from a banks trading activities and does not include any other expenses which may be allocated to the trading activities. The objective of the banks in this regard is not the acquisition of financial assets to be held over long term but rather the trading thereof at the highest profit possible. The trading of financial assets can either be done as principal or as agent on behalf of customers. In both instances, the objective and activities remain the same. The inclusion is only appropriate to the extent that a bank's net trading margin is positive for all years in the consecutive 3 year period used to calculate the average net trading margin to be included in the formula. Should class members net trading margin result in a loss for any one of the 3 years, the specific member is required to approach SARS for an alternative method of recognizing the net trading margin in the apportionment method.

17. *Reduce interest income with the cost of funds allocated to such income.*

A bank takes on the role of intermediary between lenders and borrowers. Its main objective in this regard is the borrowing and lending of money (which constitutes a single activity) for a profit. This profit is represented by the net interest margin derived from the aforementioned activities. With the view of recognizing a banks role as intermediary in the lending process, the margin from lending (that is interest received less interest paid) should be included in the apportionment method as opposed to gross interest received. This principle will only apply in respect of interest paid on

funds borrowed to on-lend and is extended to any zero rated interest received by a bank. Based on the above, interest income must be reduced with the cost of funding allocated to such income.

18. Bad debts/ impairments

The actual amount of bad debts written off during a year may be used to reduce income already included in the apportionment formula as follows:

The interest portion of bad debts written off must be applied towards reducing the net interest income (exempt and zero rated interest respectively) included in the formula; and the portion of bad debts written off relating to fee income must be applied towards reducing the fee income included in A.

No portion of the capital amount written off as bad debts may be applied towards reducing income in the apportionment method. This is on the basis that the capital value of the loan is excluded from A and B in the method.

4.2.3. Analysis of the BASA VAT apportionment method

- A positive addition to the new VAT apportionment ruling was the reduction of bad debts from both interest and fee income. An argument may however exist that when a bank prices the interest rate margin, the full bad debt cost is priced into the calculation of the interest rate margin (that is, it would include the capital portion as well). Consequently it is a reasonable consideration that the full impairment should be allowed as a deduction against interest income.

- The exclusion of the capital value of rentals from the VAT apportionment method was a new change in comparison to the previous SARS/ BASA ruling. SARS appears to draw a link between

ICAs and rentals (that is, both mechanisms are methods of financing) and therefore the treatment should align. This treatment however has the effect of reducing the overall VAT apportionment rate and consequently increases the VAT burden for banks.

- Arguably, the most contentious issue with this method is the inclusion of all dividends into the denominator of the ratio which has the effect of reducing the ratio and therefore the bank's VAT claim on mixed expenses. It may be argued that no effort is expended to earn dividends. The income received is purely passive in nature and as such, no costs are incurred to earn the dividend income.

  Dependent on a bank's group structure and flow through of dividends the inclusion of dividends into the denominator of the calculation could have a severe impact on the bank's VAT apportionment rate. This concept is best illustrated by way of example.

Example 1: Impact of dividend inclusion on apportionment ratio

Bank A and Bank B have taxable income of R 100 and net interest income of R 200. Both banks incur similar costs to generate the above mentioned income streams. Bank A receives dividends of R 50 from its subsidiary and pays dividends to its holding company. Bank B receives no dividends but also pays a dividend to its holding company.

Using the agreed method of apportionment, Bank A's recovery rate= R 100/ R (100+200+50) = 28.57%.

Bank B on the other hand has an apportionment ratio of R 100/ R (100+200) = 33.33%.

This example illustrates how companies by having different group structures could have very different apportionment ratios. Bank B is entitled to a larger input tax credit purely because of its group structure (that is, it does not receive dividends from any subsidiaries).

Due to the above result, it may in reality affect the way in which groups are structured going forward. This appears to contravene the OECD Guideline 2.3 as set out in Chapter 3. VAT rules should be framed in such a way that they are not the primary influence on business decisions. For example, VAT rules or policies should not induce businesses to adopt specific legal forms under which they operate (for instance, whether it operates in a subsidiary or a branch structure).

In addition, OECD Guideline 2.2 provides that businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation. The tax should be neutral and equitable in similar circumstances. Despite Bank A and Bank B carrying out similar activities, generating similar income and having similar costs, both entities are not subject to similar levels of taxation, Bank A has a higher VAT burden than Bank B.

The above said, SARS has given the vendor the opportunity to negotiate an alternative ruling in the event that the inclusion of dividends has a distortive effect on the ratio.

- In addition, the application of the above method is far from simple and this in itself may lead to additional compliance costs for the bank.

- It may also be argued that a turnover-based method for banks is probably not the most optimal solution when VAT apportionment is

calculated. Apportionment should be about effort expended and the vatable costs in relation thereto.

The costs incurred and effort expended to issue a R1 000 loan and a R100 000 loan may in fact be the same. Logic would therefore imply that the input tax claims should be similar in both cases. This logic is tested by way of example below.

Example 2: Reasonability of applying a turnover-based method in the banking industry

Bank A incurs costs of R 50 to initiate and maintain Loan 1 and Loan 2.

Loan 1: Bank A issued a R 1000 loan and earns fee income of R 100 and interest of 10% per annum= R 100. The apportionment rate calculated based on Loan 1= R 100/ R (100+100) = 50%

Loan 2: Bank A issued a R 100 000 loan, and as the same costs are incurred to issue Loan 2 as with Loan 1, Bank A earns a standard fee income of R 100 and interest of 10%= R 10 000. The apportionment rate = R 100/ R (100+10000) = 0.99%

Assuming in Loan 2, the fee income was calculated using a sliding scale (R100 for every R 1 000), fee income of R 10 000 and interest of 10% per annum= R 10 000 was earned. The apportionment rate is now R 10 000/ R (10000+10000) = 50%.

The results of this example shows that in order for Bank A to claim a similar amount of tax on the same amount of expenses incurred to generate Loan 1 and then Loan 2, the fee income in Loan 2 had to increase. If the standard fee income is charged, reasonably expected

as the same costs have been incurred to generate that income, the apportionment ratio for Loan 2 is however worsened.

Based on the above, it appears that a turnover-based approach may have a distortionary effect when applied.

In this regard, the alternative method of VAT apportionment used in the UK is now considered below that is, the sectorisation approach (HMRC PE3200).

Instead of one overall apportionment ratio for a bank, the sectorised method allows for the allocation of input tax to sectors where costs are similarly used to make supplies. The non-attributable input tax may be allocated between different sectors using similar ratios for example using:

- Transactional count for trades;
- Head count for recharges / recoveries;
- Square meterage/ floor space for property rentals etc.

A sectorised method is appropriate where there are different business activities that use costs in different ways. Such methods are inevitably more complex but ultimately should be more accurate and thus can be more likely to give a result that is fair and reasonable. Sectors may also be appropriate when there is a management accounting system that allocates costs to different business profit/cost centres.

(Note: The scope of this study does not include the investigation of alternative methods of VAT apportionment for the banking industry however it is recommended that a further study is performed in this regard.)

CHAPTER 5: VAT ON FINANCIAL SERVICES IN OTHER TAX JURISDICTIONS

In the previous chapters we delved into the weaknesses of the current VAT exemption and the mechanisms that were put in place by SARS to seemingly 'reduce' the VAT cost burden of banks in South Africa.

In Chapter 3, it became apparent however that the exemption method was used not because it is thought to be the theoretically correct method of taxation, but because it proved difficult to measure the implicit financial-intermediation fees (that is, the necessity outweighed the principle).

In this Chapter, an analysis is performed on the alternative methods that exist to taxing financial services from a VAT perspective. The advantages and/ or disadvantages of each method will also be discussed.

5.1. Taxing financial services at the standard rate

The standard rate of VAT in South Africa is 14 percent.

Consideration for the supply of a financial service can either be in the form of an explicit fee or commission **or** a financial margin.

As commented by Kerrigan (2010, p. 2):

> Where specific prices in the form of fees or commissions are identifiable, there will be little difficulty in imposing VAT on financial services. The problem however is that most of the commercial activities of financial institutions are intermediation services which generate revenue in the form of a margin.

It is the basic activities of a financial institution to borrow money from depositors and to lend out a higher rates to borrowers. The interest it pays to depositors is essentially consideration for the rental of the use of money and similarly the bank's borrowers pay a rental to the bank for the use of its money. The consideration for

the service in these cases is normally the margin that remains with the bank, after all cash inflows and outflows have been taken into consideration.

Example 3: Interest margin

Bank A pays interest to its depositor of 5% and charges interest of 15% to its borrowers. Consequently, the margin representing the value-added by the bank is 10% (15%- 5%).

On the basis that financial services are consumption expenditure just like any other services, if interest was subject to VAT and the depositors were VAT registered vendors, they would charge VAT on the interest for the use of their money to the bank. The bank would then be entitled to claim an input tax deduction. Similarly the bank would charge VAT on the interest they charge to the borrowers. The bank would also charge VAT on any fees and other charges made. This would bring the institutions on the same footing as any other VAT registered vendor.

Factually, the depositors will not all be vendors as many will have supplies (that is, interest) which does not meet the VAT threshold for compulsory VAT registration which is currently R 1 000 000 in South Africa. Financial institutions will therefore not pay output tax on the interest charged by the depositors. This is however no different to any other VAT registered vendor who acquired the goods or services from a non VAT registered vendor.

Practically, the margin represents a consideration for a bundle of transactions (deposits and loans), which cannot be easily attributed to individual transactions, therefore making it difficult to identify the appropriate tax base in such cases.

In addition, the complexity arises in that the interest paid by/to financial institutions comprises of different elements namely:

- the return to investor/depositor or the real cost of capital;
- a factor for inflation to maintain the value of the capital; and
- the cost of intermediation.

Arguably, it is only the cost of intermediation element which should be subject to tax as this is the service provided by the bank. The return on capital and inflation adjustment should not be subject to tax as this represents savings. (Grubert & Mackie 2000).

As stated in the VATCOM report however, this argument appeared to approach the problem from the point of view of the investor rather than the borrower who consumes the service and bears the tax.

It also seemed to ignore the legal reality that the bank is acting as principal that is, for its own account as opposed to acting as agent on someone else's behalf. A case in point would be where interest is paid to private investors by VAT registered vendors without the intermediation of a financial institution, such interest is included in the VAT base. For example, a manufacturer who borrows money to finance the manufacturing of a stove would cost the interest he pays into his price which will form part of the VAT base. It therefore begs the question, 'Why should the return on capital be excluded from the base merely because it is made through a financial institution?' (Marais 1991, p. 29).

If the loans were made available to the final consumers, the final consumer would bear the VAT which would be consistent with the underlying principles of the SA VAT Act.

If the interest paid by borrowers were to be taxed, the borrower, where VAT registered would be entitled to claim an input tax deduction.

Despite intermediaries being in a position to identify the aggregate value created (refer to Example 3, the calculated interest margin was 10%), to the extent that financial services are used by VAT registered persons, the bank will need to allocate the aggregate value between two sides of the transaction. The borrower will need to how much of input tax credits it can claim as a deduction.

Example 4: Determining value added for depositor and borrower

In Example 3, the interest paid by the borrower to the bank was 15% and interest paid to the depositor was 5%. Assuming, a pure interest rate of 12%, the value added provided to the borrower is therefore (15%-12%) = 3%. The remaining 12%-5% of interest paid to the depositor, i.e. 7 % is now value added to the depositor. In reality, this split is difficult to perform and hence is the reason for the exemption (Ebrill *et al.* 2001).

Advantages:

1. The taxing of financial services in South Africa would eliminate the problem of double taxation or tax cascading which would arise if services were exempt and rendered to vendors. The vendor would be entitled to claim back the input tax credits on its acquisition. It would therefore not cost the unclaimed VAT into the price of its goods. It will not form part of the VAT base of the final price charged to consumers. It will eliminate a tax on a tax situation.

2. As the services would now be taxable, banks will be entitled to claim an input tax deduction on the acquisition of goods or services acquired for the purposes of making taxable financial services. The decision to vertically integrate therefore becomes somewhat less of an issue as the banks will potentially not incur a VAT cost by outsourcing its activities. Banks that already apply vertical integration, may however continue to do so as structures have already been established, the vertical integration effect however will be limited going forward.

3. In many instances, due to the fact that the supply of financial services is now classified as taxable supplies, it may eliminate the need to apply an apportionment rate to mixed expenses. If the de minimis threshold is met (that is, the bank generates taxable supplies of 95 percent or more of the total supplies), a full input tax deduction is permitted. If an apportionment rate is still applicable, due to the bank generating other non-taxable supplies, the inclusion of additional taxable supplies into the numerator of the apportionment calculation will increase the VAT apportionment rate, resulting in a lower VAT cost for the bank.

Disadvantages:

As set out in VATCOM (Marais 1991, p.30), there are several practical difficulties of taxing financial services in South Africa at the standard rate. This includes the following:

1. The cost of borrowing by private persons for housing, consumable durables etc. will increase by the full rate of VAT. It could be argued however that the price of many goods or services also increase by a similar amount and that there is no reason for the special treatment of financial services.

   Exempting financial services from VAT results in consumers and other unregistered purchasers of exempt services having a lower after-tax cost for the services because the value added by the exempt service provider will not be taxed. On the other hand, a VAT registered person who buys exempt financial services has a higher after-tax cost than if the financial services were taxable.

   As demonstrated by Krever in (Krever ed, p. 36), an example best illustrates this concept.

Example 5: Taxing financial services- after tax cost implications for VAT registered and non VAT registered consumers

A bank charges R 100 for the issue of a derivative instrument. The financial institutions pays R 3 VAT on its business inputs for example legal costs on the above issue.

If the banking fee is subject to VAT AT 14%, the bank is entitled to recover the R 3 input tax on costs incurred in relation to such activity. The customer would be charged R 114 (R 100 + 14%) for the service performed.

If the customer is a VAT registered person making taxable sales, that person can claim R 14 input tax as a deduction, resulting in a R 100 after-tax cost for the service acquired by the VAT registered customer.

If a non VAT registered consumer purchased the same service, similarly he would be charged R 114. He however would not be entitled to claim the R 14 VAT as a deduction, resulting in a R 114 after-tax cost for the service.

If the banking fee for the issue of a derivative was exempt from VAT, the VAT registered customer presumably would be charged R 103 (R 100 fee plus R 3 cost incurred with the activity) in order for the bank to recoup the disallowed input tax of R 3.

The VAT registered customer would not be able to recoup the R 3 VAT buried in the fee, resulting in a R 103 after-tax cost for the service. This would be R 3 more than as per the taxing option above.

The non VAT registered consumer however would pay the same R 103 for the acquisition of the financial service, it’s after tax cost being R 11 less than if the service was taxable.

It would therefore appear that non VAT registered consumers would prefer the exempt method to the extent that VAT is not imposed on the value-added by the financial institutions but registered businesses may prefer the taxable alternative.

2. The full taxation method will create a strong incentive for disintermediation particularly in the case of household borrowers. Buyers will bypass the financial institutions and go directly to the private investor for funds. Financial institutions will be encouraged to act as agents bringing the non-vendor investors and private borrowers together as opposed to its current capacity of acting as principal in the market.

3. The taxation of interest will also increase the number of vendors who will have to register for VAT where the VAT threshold is met. Depositors or investors who are often people who are not in business for example widows, pensioners etc. will now be required to register for VAT in South Africa and will need to submit VAT returns to SARS. This will place a large administrative burden on the depositor and furthermore on SARS to manage the process.

4. Additional administrative burden will also be placed on the financial institutions in order to verify the depositors' status. Further, as the VAT status of a vendor could change over time, if regular activity exists with the depositor, it would be in the best interest of the financial institution to monitor the status on a regular basis.

   In order to claim an input tax deduction, financial institutions will also be required to obtain tax invoices from the vendor. This will place an additional documentary compliance burden on the financial institution.

   Banks will also need to investigate whether their systems could handle the storage of large volumes of data and transactions.

5. The above situation may also provide incentive for investors who are not VAT registered vendors to have themselves falsely classified as such. As a result, the investor would receive VAT in addition to the rate of interest. The bank on the other hand would claim an input tax deduction based on receipt of a fictitious tax invoice. The VAT paid by the financial institution would not be paid over to SARS resulting in a loss to the fiscus.

   In terms of section 102 of the Tax Administration Act, SARS however places the burden of proof on the taxpayer to prove that an amount or item is deductible. Consequently, the bank could be exposed to the risk of penalties and interest imposed by SARS where input tax claimed was based on receipt of an invalid/ fictitious tax invoice.

6. The tax will also have to be imposed on existing loans as banks would otherwise suffer losses. Transitional arrangements will therefore have to be put in place which will result in additional complexities.

5.2. Zero-rating option: New Zealand

The standard rate of GST in New Zealand is 15 percent.

In the case of financial services, the New Zealand GST Act initially followed the approach adopted in the UK. It contained a broad range of exempt financial services. Due to the cascading effect of exemptions, Pallot (2011, p. 312) commented that ‘the government decided to zero-rate B2B financial services in order to align the burden of GST in the financial services sector with that applicable to other business sectors’.

In accordance with New Zealand GST guidelines (Inland Revenue 2004) with effect from 1 January 2005, the New Zealand zero-rating rules allow financial

service providers to elect to zero-rate supplies of financial services to customers who:

- are registered for GST if the level of taxable supplies made by the customer in a given 12-month period (including the taxable period in which the supply is made) is equal to or exceeds 75 percent of their total supplies for the period; or

- may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12-month period (including the taxable period in which the supply is made). For example, the treasury or finance function of a group of companies who receives financial services.

As the supplier has the option to elect to apply the zero-rate or not, if the compliance costs of zero-rating outweigh the benefits, providers can choose not to elect into the new provisions.

When establishing whether or not a customer qualifies under the 75 percent test, all taxable supplies made by the customer should be considered, except for supplies of financial services that are zero-rated under the new rules. Imported services that are treated as supplies for the purpose of the 'reverse charge' should also be excluded for the purposes of this test.

Consequently, financial services supplied to another financial services provider generally cannot be zero-rated because most financial service providers will not satisfy the requirement that 75 percent of their supplies are taxable supplies.

The New Zealand GST Act however provides for an additional deduction from output tax in respect of supplies of financial services made to another financial services provider, who in turn makes supplies to businesses that would qualify to receive zero-rated financial services. The amount that can be deducted will be determined by the ratio of taxable to non-taxable supplies made by the recipient

financial services provider and is calculated in accordance with a formula which is discussed later on in this section.

The treatment of financial services supplied to unregistered persons remain unchanged. Supplies to final consumers in New Zealand are still exempt supplies and cannot be zero-rated under these guidelines. Input tax cannot be recovered in respect of supplies to these customers.

Application of guidelines:

Zero-rating

The application of the zero-rating rules requires financial service providers to know, at a minimum, whether their customer is registered for GST and the ratio of taxable supplies to total supplies made by the customer. The zero-rating rules impose a requirement that financial service providers obtain information about their customers. It is expected that the determination of the taxable status of a customer will be made by the financial service provider supplying the financial services.

Identifying eligible customers should be first performed on a transaction-by-transaction basis. However, as additional costs may arise in meeting the above requirements, financial services providers may approach the New Zealand Inland Revenue with the view to using an alternative method to determine whether or not a customer is registered for GST. Approval of an alternative method will depend on the level of existing information that the financial services provider holds on its customers and whether the alternative method provides a fair and reasonable result.

Whether the customer meets the 75 percent test must be determined either on the basis of information held by the financial service provider on the customer or by

using the Australian and New Zealand Standard Industrial Classification codes (ANZSIC codes).

If over 50 percent of a provider's financial services are to qualifying GST-registered customers, or those supplies together with other taxable supplies exceed the 50 percent threshold, the provider will be able to deduct 100 percent of the GST paid on goods and services acquired in making those taxable supplies as its principal purpose is to make taxable supplies. Adjustments to input tax may be required to the extent that there are non-taxable supplies.

If however the provider's principal purpose remains that of making exempt supplies, it will not be able to deduct 100 percent of the GST paid but may, instead claim input tax using change-in-use provisions. Such provisions allow a deduction when goods and services acquired for the principal purpose of making non-taxable supplies are applied to making taxable supplies.

Financial service providers are encouraged to keep adequate books and records to substantiate any decisions to zero-rate financial services to customers. It will also need to undertake regular reviews of any systems and procedures used to categorise customers. If the financial services provider is aware that a customer is no longer eligible to receive zero-rated supplies, the zero-rating should cease.

Deductions from output tax

The GST Act provides a further deduction from output tax in relation to supplies of financial services made to another financial services provider (the direct supplier). The deduction relates only to exempt supplies of financial services made to the direct supplier and is limited to the extent that the direct supplier makes taxable supplies, including supplies of zero-rated financial services, to business customers that meet the 75 percent taxable supplies threshold. The deduction is calculated in accordance with the formula below:

Formula for calculating the deduction for supplies of exempt financial services to other financial services providers

$$a \times \frac{b}{c} \times \frac{d}{e}$$

Where:

a is the total amount in respect of the taxable period that the registered person –

(i) would not be able to deduct under section 20(3); and

(ii) would be able to deduct under section 20(3),

other than under section 20(3)(h), if all supplies of financial services by the financial services provider were taxable supplies

b is the total value of exempt supplies of financial services made to the direct supplier in respect of the taxable period:

c is the total value of supplies made in respect of the taxable period:

d is the total value of taxable supplies made by the direct supplier in respect of the taxable period as determined under section 20D:

e is the total value of supplies made by the direct supplier in respect of the taxable period as determined under section 20D.

In summary, it is calculated by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by the provider that consists of exempt supplies of financial services to a recipient financial services provider (the direct supplier). The second fraction is the proportion of the total value of supplies made by the direct supplier that consists of taxable supplies (including zero-rated supplies of financial services).

The formula is limited to the activities of the direct supplier. Further supplies of financial services for example, by the direct supplier to a third or subsequent financial services provider, are not included in the formula.

The method used to determine the deduction is based on statistical information that is provided by the direct supplier in relation to its ratio of taxable supplies to total supplies (items “d” and “e” of the formula). The presentation of this statistical information can be in the form of a percentage or fraction.

Providers must obtain the ratio from the direct supplier before making the deduction. If a ratio is not provided, the deduction cannot be claimed.

To claim the deduction, providers are expected to have written notice or other permanent records of the direct supplier’s ratio of taxable to total supplies. This written notice can be in the form of an e-mail or letter. If the information is given by telephone, it must be followed up in writing for evidential purposes. The direct supplier must also state the period of time for which the ratio applies. If providers choose to disclose their ratio of taxable to total supplies to other financial services providers, in addition to providing the ratio in writing, they must maintain a regularly updated database of those persons that have received that ratio. The database should also detail the date that the ratio was disclosed and the period to which it applies. If providers become aware that the disclosed ratio is materially incorrect they must notify those financial services providers on their database, advising them to cease using the ratio until a new correct ratio is provided.

Advantages:

1. The tax cascading effect that is integral to exemption is removed where transactions are zero-rated. Financial service providers are able to claim all input tax deductions where transactions are zero-rated and as a result, no irrecoverable VAT is passed on to customers.

2. In addition, the zero rating option will also eliminate the need for vertical integration.

3. Although the zero-rating option will not eliminate the need for VAT apportionment of mixed expenses between taxable and exempt supplies (that is, the bank will still be required to exempt supplies of financial services where the required criteria is not met), the zero-rating option will result in a larger proportion of zero-rated supplies (that is, taxable supplies) being included in the numerator of the calculation which will have the effect of increasing the apportionment rate and reducing the VAT cost.

4. As referred to in Chapter 3, the main reasons for exempting financial services were the difficulties faced in valuing the implicit fees included in the margins. With the zero-rating option, these difficulties continue to exist however are less of a concern as it will not affect the supplier's overall right to deduct input tax. If financial services were taxed at the standard rate, the supplier would need to correctly determine the value for each supply.

Disadvantages:

According to the Davis Tax Committee report (Davis 2014, p. 52):

1. To apply the rate of zero percent to financial services supplied to taxable businesses, the VAT status of each recipient needs to be established and the level of taxable supplies made by the recipient must be known by the supplier. This is administratively burdensome to the supplier and is contrary to some of the basic principles of a VAT system :

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

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

It will also place an administrative burden on Revenue Authorities. Due to the complexity of the system, the inherent risk with the system is heightened. A process to audit the above system needs to be strictly defined.

2. If zero-rating to certain or all financial services is implemented, perceived violations of the principles of neutrality may arise. It may be viewed that the suppliers of financial services will enjoy an advantage over the suppliers of any other goods or services. As the financial services industry forms a significant and profitable part of the economy, the decision not to tax the supplies would be difficult to justify.

3. The zero-rating of financial services may potentially lead to significant VAT avoidance and would therefore have to be accompanied with anti-avoidance legislation to avoid aggressive VAT planning. For example: The introduction of the zero-rate for B2B financial services may result in providers of financial services over deducting input tax by overvaluing financial services supplied to such associated parties. In New Zealand, anti-GST avoidance measures were enforced to ensure that the open-market value of services had to be applied in such cases.

4. It is also anticipated that there would be a loss of revenue to the fiscus resulting from the zero-rating of financial services.

   With the exempt option, the supplier is not entitled to input tax deductions. Further the cost is included in the sales prices of assets which when eventually factored into a supply to the final consumer results in a tax on a tax leading to the larger collection of revenue for government.

With the zero-rating option, when applied, tax cascading is eliminated. Furthermore, the financial service provider is able to claim input tax deductions. It is debatable as to whether the financial institutions will pass the benefit of zero-rating on to consumers in the form of lower charges.

5. The zero-rating option also appears to leave unaddressed the problem of the under taxation of consumption of financial services by final consumers.

Using Example 5 above:

If the fee charged for issuing a derivative was zero-rated, the VAT registered customer would be charged R 100 which would represent its after tax cost for the service (same as the taxable option, R 3 less than the exempt option).

If a non VAT registered consumer purchased the same service, he would be charged R 100 which would represent its after tax cost for the service, (being R 14 less than the taxable option and R 3 less than the exempt option). Arguably this service has preference over other taxable/ exempt services consumed by the final consumer.

As a final note, and echoed by the Davis Tax Committee (Davis 2014, p 52), it is important to keep in mind that New Zealand's financial services sector is relatively small when compared to many other developed countries. It consists of about 20 registered banks with the predominant ownership being Australian. The financial impact of the combination of the zero-rating rules and the reverse charge mechanism at the time of introduction, amounted to less than 1 percent of the total annual refunds made by the New Zealand Inland Revenue. Accordingly, the impact of the zero-rating system on a larger South African market will need to be further analysed by means of performing an empirical study.

5.3. Australia- Reduced input tax credit

The standard rate of GST in Australia is currently 10 percent.

In Australia, the financial supply provisions are not found in the body of the legislation. Instead, they are set out in a separate Regulations.

As commented by Benedict (2011), the Australian GST system has a very comprehensive list of supplies which would or would not constitute a financial supply. The items provided in the list of financial supplies must be read with the requirements that there should be a 'provision acquisition or disposal of interest' in the said list of specified items. Only supplies made by a financials service provider qualify within the ambit of financial supplies. Supplies made by a financial supply facilitator i.e. an entity facilitating the supply of the interest for a financial service provider do not qualify as a financial service supply.

In the Australian model, a financial acquisition threshold was introduced which had the effect that if the threshold was not exceeded, the financial institution would be entitled to claim the total amount of VAT incurred as input tax.

Where the threshold was exceeded, the financial institution is entitled to claim a fixed percentage of the VAT incurred on specified expenses.

Both instances are further discussed below.

Financial acquisitions threshold (FAT)

FAT applies to input tax relating to acquisitions made in the course of making financial supplies and has the effect that an entity (meaning a legal entity or individual) is entitled to full deduction of GST on inputs relating to financial supplies, if the total input tax (in that month and the preceding 11) that relates to

the supplies is less than AUD 50,000 and/ or is less than 10 percent of the total amount of input tax.

Since, the Australian rules contemplate that a borrowing might be a financial supply, the threshold has been made more generous and, therefore, more effective, by excluding from the threshold borrowings that are not entered into for the purposes of making financial supplies. Therefore, as illustrated by Walpole (2009, p. 318) ‘A plumber who grants loans to his customers in the form of granting credit on bills for repairs will not be drawn into the financial-supply regime merely by reason of giving credit’.

Reduced input tax credits regime (RITC)

If the FAT threshold is exceeded, financial service providers have access to the RITC rules which allows financial institutions to claim a credit for a stipulated proportion of the VAT they have paid on inputs, even if such inputs were used to produce exempt supplies.

According to Davis Tax Committee (Davis 2014, p.47), the RITC scheme allows suppliers of financial services to claim 75 percent of the GST paid on specified inputs as listed in the GST regulation. These transactions include the following:

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

Advantages:

1. Despite the fact that a financial services institution still makes exempt supplies of financial services, where a financial services institution is entitled to deduct a certain amount of input tax, to a large extent it removes the incentive for vertical integration.

   The principal objective of the RITC scheme introduced by Australia was in fact to eliminate the bias to vertical integration and to facilitate outsourcing from a cost efficiency perspective.

2. The RITC method therefore provides a degree of neutrality between large financial suppliers, who have the ability to insource the activity (and hence not bear GST on this activity when it is performed in house), and those that are required to outsource the same activity where GST would be charged. All financial institutions (small or large) are treated equally from a VAT input tax deduction perspective.

3. It also goes some way to reducing the effect of tax cascading by removing from the financial supply regime some, indeed significantly large, costs of input tax. These costs are therefore not passed on to the customers of the financial supply providers. In addition, many peripheral supplies, associated with financial supplies without being financial supplies, are kept within the normal GST regime and do not result in a cascade of tax disguised in pricing.

4. Further, based on the Davis Tax Committee report, the RITC method is relatively simple to implement and administer as it requires no separation of taxable from exempt supplies. (Davis 2014, p. 54)

Disadvantages

1. As commented by de la Feria & Walpole (2009, p. 920):

   > FAT is, of course, another aspect of the financial institutions' tax affairs that must be monitored. This will add to further business tax compliance costs. The practical difficulty of this process is exacerbated by the fact that the threshold must be monitored not only currently and having regard to the previous 11 months but consideration must also be given to future acquisitions and an assumptions must be made regarding the input tax credits on financial acquisitions made during the month and the next 11 months.)

2. Further, as pointed out by Hill as being one of the main criticisms of the Australian RITC scheme the expenses and supplies which will qualify for a reduced input tax deduction will have to be identified and be regulated which may lead to many interpretational disputes and ambiguities (Hill 2001).

   It would require very clear and detailed invoicing by the supplier, although in certain instances, it may still sometimes be impossible to disaggregate the fee for apportionment purposes.

   Hill's problems with apportionment practices were echoed by Edmundson who commented that the 'practical application of the RITC rules is littered with unjustifiable glitches and ambiguities'. (Edmundson 2003)

3. Further, commented by de la Feria & Walpole (2009, p. 924-925), another apportionment problem that arises is the application of the de minimis rule set by the FAT. This has attracted criticisms because of the need to monitor acquisitions and supplies for purposes of the threshold. An acquisition of an item to be used in part for making some exempt financial supplies and some taxable supplies might require the entire acquisition to be counted as a financial acquisition and '. . . inadvertently "tip" an entity over the threshold in circumstances where this was not intended.'

This area of potential dispute has been cleared up, to a great extent, by the Australian Taxation Office in a GST Ruling (Australian Taxation Office 2006(3)) which not only describes several acceptable apportionment methods, with an emphasis on acceptability of direct apportionment methods, but also indicates that other methods of apportionment will be accepted provided they are fair and reasonable.

4. The availability of mechanisms in place which allow large scale suppliers of financial services to claim 75 percent% of its input tax deductions and to allow those that make minor financial supplies to claim full input tax credits will also surely result in a cost to the public purse as compared to a system where input tax credits in relation to the making of exempt financial supplies are denied (de la Feria & Walpole 2009, p. 928-929).

5. Due to the FAT and RITC method, financial service providers may create structures and distort the nature or transactions to ensure that meet the required standard. Anti- avoidance measures will need to be formulated to address aggressive VAT planning structures.

6. Despite achieving neutrality between small and larger financial service providers (refer to point 2 under advantages), policy makers will need to consider the perception that may be created as a result of introducing the RITC method in the financial services sector on other sectors that offer predominantly exempt supplies for example the educational services sector, the transport sectors etc. It may be perceived that a breach in neutrality has occurred that is why should banks be allowed input tax credits on exempt supplies when the educational institutions who provide exempt supplies do not have the same concession? This perception will need to be managed by authorities.

5.4. EU/UK VAT Grouping provisions

In the EU, the VAT law allows for companies which form part of the same group to register for VAT as a single person.

As set out in the VAT Expert Group's report to the European Commission (VAT Expert Group 2015, p. 6-7), in summary, Article 11 to Council Directive (European Union 2006) sets out the following:

- It is an optional provision which gives Member States the freedom to introduce VAT grouping schemes in their national legislation or not. If not implemented, it will not be applicable in that Member State, as Article 11 has no direct effect. If a Member State adopts the provision, it has a significant margin of discretion over how to implement it. However, the court has set some specific parameters to it.

- VAT grouping arrangements are a 'fiction' where a Member State may regard two or more closely bound persons established in that Member State, as a single taxable person for VAT purposes. Consequently, in the event of VAT grouping the members of the VAT group are disconnecting themselves from their legal form and the way that they do business commercially not only within the group but potentially also externally and becomes part of a fictitious (taxable) person for VAT purposes.

- The third important feature of Article 11 is its broad application regarding the notion of 'persons', which includes also non-taxable persons. Member States can 'restrict the right to belong to a VAT group only 'provided that they remain within the objectives of the VAT Directive to prevent abusive practices and behaviour or to combat tax evasion or tax avoidance'.

- The fourth important feature is the aspect of territoriality (linked to the principle of fiscal neutrality), as the members of a VAT group, the ‘persons’, should be established in the territory of that Member State, so cross-border groupings are not allowed. However, Member States have in general two types of approaches to the concept ‘to be established within the meaning of Article 11 of the VAT Directive’. These are:

    - a broad interpretation, meaning that if a head office (or branch) is member of a VAT group within their territory, the foreign head office (or branch) is also considered as being a member of that VAT group. This approach is adopted in the UK and the Netherlands.

    - a narrow interpretation which implies that the foreign branch (or head office) cannot be member of the VAT group. This approach is adopted in Belgium, Sweden and Germany.

- The last feature is the possibility for Member States to implement anti-abuse measures. Article 11 however does not give further guidance on the specificities of such anti-abuse measures.

Focusing on the VAT grouping rules in the UK only, in terms of the UK VAT Act 1994, section 43A provides that only corporate bodies, which are *established* or have a *fixed establishment* in the UK are entitled to be members of a UK VAT group.

In terms of Her Majesty Revenue and Customs (HMRC) guidance provided (HMRC, VGROUPS02400):

A business is usually regarded as being "established" where the essential management decisions are undertaken. It is normally the headquarters or head office.

A “fixed establishment” on the other hand is an establishment of business that has a sufficient degree of structure and permanence in terms of human and technical resources to enable it provide the services that it supplies.

Consequently, for grouping purposes, a company have a “fixed establishment” in the UK if:

- It has a permanent place of business in the UK, and
- that place of business comprises sufficient human and technical resources for it to carry on its business activities.

A company is not considered to have a “fixed establishment” in the UK for grouping purposes merely as a result of the fact that:

- it has a “brass plate” presence in the UK
- it carries on business through a UK agent, or
- it has a UK subsidiary.

When an overseas company is included in a UK VAT group, it is that company in its entirety which is included in the group not just the UK branch or establishment.

This means that any supplies of goods or services between any of the branches or establishments of the overseas company anywhere in the world and UK based members of the same group are disregarded for purposes of UK VAT.

A VAT group is treated in the same way as a single taxable person registered for VAT on its own. The registration is made in the name of a ‘representative member’. The representative member is responsible for completing and submitting a single VAT return and making VAT payments or receiving VAT refunds on behalf of the group. All the members remain jointly and severally liable for any VAT debt.

Advantages

1. The effect of the VAT group registration is that supplies of goods or services between members of the group are ignored for VAT purposes and do not attract any VAT, thereby eliminating any non-recoverable vat cost on centralised functions.

2. It eliminates the cascading effect of any non-recoverable VAT cost on intercompany supplies where financial services are supplied to taxable consumers.

3. It will also eliminate the need for vertical integration where services are performed by group entities.

4. VAT grouping also reduces the administration cost associated with the completion and submission of VAT returns for the entities within a VAT group that is less VAT returns have to be prepared and filed by businesses, no tax invoices are required for intra-group transactions which all leads to a lower compliance cost. Similarly for SARS, the checking of fewer VAT returns will lead to a lower administrative cost on its side as well.

In term of the comments made by the VAT Expert Group (2015, p. 8):

5. Corporate groups often consist of a variety of legal entities, some in a VAT payment position and others could be in refund position. The VAT grouping method allows for a consolidate VAT payment to be made, thereby mitigating any negative cash flow impacts for businesses and reducing the amount of refunds and related audits that may arise with tax authorities.

6. VAT grouping will also give tax authorities a single point of audit with a clear picture and good overview of the legal entities that belong to a corporate group, allowing audits to be efficient and targeted.

7. The VAT grouping method also helps corporate groups to manage VAT and the associated risks more efficiently for all the legal entities that belong to the corporate group by making it easier for them to implement consistent internal risk management procedures, which tax authorities have access to and can base their audits on.

8. In addition, as set out in the SA VAT Act, current VAT provisions exist with regards to the timing and valuation rules of supplies made between connected persons. These rules often raise practical difficulties with taxpayers resulting in unnecessary assessments being raised by SARS. On the basis that intra-group transactions could be ignored for VAT purposes, a VAT group is therefore likely to make fewer errors in this regard.

Further, as set out by Davis Tax Committee (Davis 2014, p.57):

9. As VAT grouping is generally accompanied by joint and several liability of the individual members of the group for payment of the VAT, VAT grouping will safeguard the collection of VAT from members of the VAT group for the Revenue Authorities. As a large quantity of transactions can be taken out of the scope of the tax, it will allow Revenue Authorities to potentially reallocate resources to be other priority risk areas.

10. Further, it may prevent avoidance practices where companies are split into smaller companies with a turnover below the VAT registration threshold to avoid charging VAT.

Disadvantages:

1. Firstly, it will come as no surprise that the enforcement of such provisions may lead to anti avoidance schemes. Group registration may lead to a higher risk of tax evasion.

   Borselli (2009, p. 380) wrote that:

   > The application of less detailed accounting rules to intra-group transactions and the absence of direct links between inputs and outputs may lead to fake transactions and, in general, to an unjustified increase of the right to deduct input VAT.

   In this regard however, the UK has introduced certain anti-avoidance measures to limit the risk of tax evasion. In the event that VAT grouping is considered to be a favourable method of choice, such anti-avoidance measures must be further reviewed.

2. Other service providers not forming part of a VAT group may view the implementation of grouping provisions as a violation of the fundamental principles of neutrality and equity of a VAT system. Why should an entity providing a similar service not attract VAT due to the nature of the recipient (that is being a group company) as opposed to the underlying nature of the service? In terms of the SA VAT Act, VAT should be levied by the supplier based on the nature of the service or good not based on who the recipient of the service or good is.

With the implementation of a VAT grouping method, we will potentially see many new merger/ acquisitions in the market (i.e. the acquisition of more entities into a group structure) to limit the VAT cost of the financial service provider. Being part of the same VAT group will result in the transactions between the entities not attracting VAT.

CHAPTER 6: CONCLUSION

In the words of Van Schalkwyk & Prebble (2004, p. 452):

> Indeed, neutrality is breached on every level by the exemption of financial services from VAT. Nevertheless, breaches in neutrality alone are not sufficient to justify the abolition of the exemption. The exemption can only be abolished if a replacement that is more neutral than exemption and that maintains a high level of simplicity can be found.

Having regard to Chapter 5, the table below summarizes the advantages and disadvantages of each method when compared to the exempt method.

Reference to Chapter	*3*	*5.1*	*5.2*	*5.3*	*5.4*
Weakness	**Exempt method of taxing financial services**	**Taxing financial services at standard rate of VAT (14%)**	**Option to zero-rate B2B financial services**	**Reduced input tax credit method**	**VAT grouping provisions**
Tax Cascading	Yes	Eliminated	Eliminated/ reduced to a large extent (where zero-rated supply criteria not met)	Reduced (portion of VAT cost is recoverable, therefore not included in sales price to final consumer)	Eliminated to the extent where costs are incurred with group companies, the VAT cost will not be included in sales

					price to consumers
Vertical integration	Yes	Eliminated	Reduced (certain B2B customers may not meet criteria for zero-rating)	Reduced	Eliminated to the extent where costs are incurred with group companies
Banks incur significant irrecoverable VAT cost	Yes	Eliminated or reduced to large extent (in cases where banks continue to receive income from other sources of a non-taxable nature)	Reduced to a large extent (Banks will still incur exempt supplies to persons not meeting zero-rating criteria)	Reduced (entitled to claim a fixed % of credits against exempt supplies, minor suppliers may be entitled to claim all input tax credits)	Reduced as a result of intra-group transactions not attracting VAT
Contravention of basic principles of VAT	Yes	Appears to bring banks on same footing as other vendors	Potential perceived violation of the principles of neutrality.	Achieves a degree of neutrality between small and larger financial institutions	Perceived violation of neutrality and equity.

				however may create a potential perceived violation of neutrality principles between financial services sector and other exempt supply sectors for example the educational sector	
Administrative burden leading to higher administrative costs	Yes For banks, Revenue Authority (Preparation of complex apportionment calculations)	High For banks, consumers and Revenue Authority (more vendors being registered resulting in more VAT return	High For banks, Revenue Authority (compliance burden with zero-rating criteria, complex system)	High: For banks, Revenue Authority (monitoring of threshold, allocation of input tax credits creates interpretative difficulties/ ambiguities)	Lower For banks/ Revenue Authority (less VAT returns filed, tax invoices issued, creates a single point of contact, facilitates

		submissions etc.)			more efficient audit).
VAT Avoidance risk	It is the unfortunate reality that in all options there will be an incentive for certain parties to develop schemes in order to avoid VAT. It is difficult to assess the level of risk in each option i.e. low medium or high however it would be the responsibility of policy makers to ensure that appropriate measures are put in place with each method.				
Examples of potential avoidances risks	Halifax case-setting up structures to claim input tax credits	Fictitious creation of vendors to collect VAT which is not paid over to SARS	Over-valuing financial services supplied to B2B customers resulting in inflated input tax deductions.	Creation of structures and distorting the nature or transactions to ensure FAT threshold is met or supplies qualify for RITC	The application of less detailed accounting rules to intra-group transactions and the absence of direct links between inputs and outputs may lead to fake transactions and, in general, to an unjustified increase of the right to

					deduct input VAT.
Without having done a detailed study of the financial impact, in theory it appears that the financial impact of alternative methods will be as follows when compared to the exempt method:					
After tax cost for VAT registered consumer	High (No deductibility of VAT credits)	Lower (VAT cost not included in purchase price)	Lower (VAT cost not included in purchase price)	Lower (To a certain extent, VAT cost is not included in purchase price)	Lower (To a certain extent, VAT cost on group transactions are not included in purchase price)
After tax cost for non VAT registered consumer	Low (Not taxed on value added)	Higher (Value added is taxed)	Lower (VAT cost is not included in purchase price)	Lower (To a certain extent, VAT cost is not included in purchase price)	Lower (To a certain extent, VAT cost is not included in purchase price)

Government collection of revenue	Input tax credits not claimed by banks. Additional revenue collected from consumers as a result of cascading	Lower (VAT cost of banks are reduced, no tax cascading)	Lower (VAT cost of banks are reduced, no/ reduced tax cascading) .	Lower (VAT cost of banks are reduced, tax cascading is reduced)	Lower VAT cost of banks are reduced, tax cascading is reduced)

From the table above, it is clear that each alternative method has its own advantages and disadvantages. However in attempt to reduce the effects of tax cascading and vertical integration, the choice of any alternative method appears to be an improvement on the current exemption method of taxing financial services in South Africa.

Arguably, taxing financial services at the standard rate of VAT or applying the zero-rate of VAT to B2B transactions produces the best result in terms of eliminating or reducing tax cascading and vertical integration. However, the administrative cost and burden that will be placed on the financial institutions, Revenue Authorities and/ or consumers cannot simply be ignored. The increase in administrative burden may very well throw an already complex VAT system into total disarray.

In addition, applying 14 percent VAT to financial services will result in a higher after tax cost for the final consumer.

Although, the Reduced Input Tax Credit method, does not completely eliminate tax cascading and vertical integration, it does go a long way in reducing the VAT cost of financial services institutions. It too however, places an additional administrative burden on financial institutions and Revenue Authorities.

From the above analysis, it is clear that if any one of the first three alternative methods of taxation had to be implemented, an increase in administrative burden is likely. A cost benefit analysis will therefore need to be performed in each instance to determine whether the increased administrative burden is perhaps a small price to pay for the reduced VAT cost?

With the RITC method further consideration must be made by policy makers regarding:

- The determination of a Financial Acquisition Threshold. It needs to be set at the appropriate level; and

- The RITC rate. In Australia, the rate of 75 percent was determined after extensive consultation with the financial sector and, at that time represented a generous average rate for the types of acquisitions identified as being eligible for a reduced input tax credit. Similar discussions and further studies will need to be performed by policy makers with regards to determining the said rate.

It is however interesting to note that the Australian Treasury released a consultative paper on 12 May 2009 to which comments were invited, *inter alia*, on the RITC. The responses received from the majority of respondents was that the financial supply rules should either be retained or significantly retained, which seemed to indicate that the Australian financial sector was relatively satisfied with the GST treatment of financial supplies with regard to the RITC scheme.

If a reduced administrative burden is of focal point to policy makers, the VAT grouping provisions appears to tick the box on that front.

The VAT grouping provisions however has a limited effect of reducing cascading and vertical integration in the industry. Similarly, it has a limited effect on the VAT cost burden of banks.

As a result of the current exempt method, vertical integration has been adopted in many of the larger banks resulting in the bank providing infrastructure and shared services functions to other entities in its group. Consequently, the bank in many group transactions is the supplier of the service or good. By introducing VAT grouping provisions, the result is that transactions between group companies will not attract any VAT. Theoretically, as stated in the table above, the VAT grouping provisions should result in a lower VAT cost for banks as services acquired from group companies will no longer attract VAT. In practice however, the introduction of VAT grouping provisions may have a limited or no effect on reducing the VAT cost for banks, where the bank is the supplier rather than the purchaser in most group transactions.

The extent to which the VAT cost will reduce will need to be further investigated by performing a study into the various group structures of financial institutions in South Africa to determine the potential financial impact of applying the VAT grouping provisions.

The Katz Commission VAT Sub-Committee had initially recommended that VAT grouping should be implemented on a voluntary basis subject to necessary anti-avoidance provisions. However, the Katz Commission finally recommended that, notwithstanding the recommendations of the VAT Sub-Committee, the VAT grouping provisions should not be implemented, principally due to the complexity of such a system.

Perhaps, the perceived violation of the principles of neutrality and equity that is, it would be unfair and unjustified to treat an entity providing a similar service differently for VAT due to its recipient not being part of the same group structure, was the influential factor in the Katz Commission arriving at its decision.

With all options considered above, it would appear that the government's collection in revenue would decrease in comparison to its collection from the current exempt method. This revenue gain from the exemption method however is largely derived from cascading which cannot be said to be a desirable means of raising revenue.

Given that our current economy is facing challenges, it is recommended that a detailed public finance study is performed to consider the financial impact of each method on the economy.

As a closing note, the success of any new tax depends on the acceptance of it by the parties concerned. Throughout the history of tax, we have seen many examples of revolts against taxes that were considered to be unfair and unjust. Fortunately, we now live in a democratic society where the government is ruled by the people. It is strongly recommended that the acceptance levels of the relevant parties concerned must be tested before any revision in VAT policy is implemented.

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