

**International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa?**

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SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

In partial fulfilment of the degree MCom (Taxation)

Faculty of Commerce

UNIVERSITY OF CAPE TOWN

Date of submission: 12 December 2014

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## **ACKNOWLEDGEMENTS**

I wish to extend my heartfelt thanks to the following people -

To my supervisor, Prof. Jennifer Roeleveld, for her expert advice and guidance.

To Marc van Est and Lauren Tiplady-Brouwer from The Foshini Group for generously sharing their insight and information on this issue.

To my friend, Andrea Loubser, for suggesting the topic and patiently answering my numerous questions.

To my family for their constant love, encouragement and advice.

To my husband for his unwavering love and support and, without whom, this would not have been possible.

Monique Ritchie

Cape Town, December 2014

## **ABSTRACT**

Apportionment of input VAT and the mechanisms used to calculate apportionment have been a challenging issue since the inception of the Value-Added Tax Act No. 89 of 1991 in South Africa. This requirement to apportion input VAT has particular relevance to the retail industry due to the increase in the extension of credit which results in the receipt of taxable supplies (ordinary sales) and exempt supplies (interest income). As retailers are therefore making mixed supplies, they are required to apportion the input VAT paid on expenses. At present the standard method for input VAT apportionment in South Africa is the turnover basis however this method is not perceived as equitable by credit retailers.

After an in-depth analysis of the retail industry in South Africa, its relevance to the South African economy and the impact of the requirement to apportion input VAT using the turnover method on listed companies within the South African retail industry, this paper analyses the treatment of VAT apportionment by the South African Revenue Service within the context of the Value-Added Tax Act No. 89 of 1991 and relevant South African case law.

Recommendations for South Africa are then sought by studying the mechanisms for input VAT apportionment used in countries with VAT systems similar to that of South Africa. Included in this study are those countries which employ traditional VAT systems such as European Union member states and Mexico; and those countries which have implemented modern VAT systems such as New Zealand, Singapore, Australia and Canada. In addition, alternative approaches to address the root cause of the requirement to apportion input VAT used internationally are researched to the extent that these mechanisms have application to the retail industry in South Africa.

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## LIST OF ABBREVIATIONS

| <b>Abbreviation</b> | <b>Meaning</b>                                       |
|---------------------|--|
| ATO                 | Australian Tax Office                                |
| BGR 16              | Binding General Ruling (VAT): No 16 (2013)           |
| CRA                 | Canadian Revenue Authority                           |
| EU                  | European Union                                       |
| GST                 | Goods and Services Tax                               |
| GST/HST             | Goods and Services Tax/Harmonised Sales Tax (Canada) |
| IRAS                | Inland Revenue Authority of Singapore                |
| NZIR                | New Zealand Inland Revenue                           |
| RST                 | Retail Sales Tax                                     |
| SARS                | South African Revenue Service                        |
| Sixth directive     | Sixth Council Directive of 17 May 1977 77/388/EEC    |
| Stats SA            | Statistics South Africa                              |
| VAT                 | Value Added Tax                                      |
| VAT Act             | Value Added Tax Act No. 89 of 1991                   |
| VAT directive       | Directive 2006/112/EU                                |

## CHAPTER 1 : INTRODUCTION

### 1.1 Introduction

Apportionment of Value-Added Tax (VAT) input and the mechanisms used to calculate this apportionment have been a challenging issue since the inception of the Value-Added Tax Act No. 89 of 1991 (the VAT Act). In essence, if a vendor makes taxable and exempt supplies, they are required to apportion input tax paid on all purchases other than those directly attributable to either type of supply. If a vendor makes taxable supplies all inputs connected to these supplies are deductible against VAT outputs. However inputs connected to making exempt supplies are not deductible against VAT outputs.

This requirement to apportion input VAT has particular relevance to the retail industry. Since the liberalisation of the South African economy in the early nineties there has been a significant increase in lending activities by South African retailers. As the extension of credit has become a bigger part of retailers' business, there has been a concomitant increase in their interest income, which is an exempt supply for VAT purposes. As retailers therefore are making taxable and exempt supplies, they are required to apportion the input VAT paid on expenses.

At present the standard method to be used for input VAT apportionment is the turnover basis, as set out in Binding General Ruling (VAT) No. 16 (2013). This is the only method that can be used without prior written approval from the South African Revenue Service (SARS). All rulings previously issued to vendors allowing alternative methods were withdrawn in 2007 and since then SARS has not approved the use of any method other than the turnover basis.

In the 2013 Budget speech, Pravin Gordhan, the Finance Minister at that time, announced that the National Treasury would undertake research into the VAT treatment of financial services and VAT apportionment within the financial and non-financial sector, with specific reference to re-evaluating the turnover method as the standard apportionment mechanism (National Treasury, 2013a). These issues have been included in the terms of reference given to The Davis Tax Committee, which has been tasked with reviewing certain aspects of the current tax legislation (National Treasury, 2013b). This provides an indication as to the relevance of the issue of input VAT apportionment.

Given the current dissatisfaction on the part of South African retailers with regard to input VAT apportionment and the announcements by National Treasury in 2013 above, there appears to be a need for further research into this area. Preliminary investigations reveal that aside from VAT guides and textbooks, little formal research has been performed on the topic of input VAT apportionment in South Africa. Searches of the available South African databases found three papers specifically

addressing input VAT apportionment. Smit (2009) performed an in-depth study of input VAT apportionment mechanisms in South Africa focusing on three sectors, namely banking, universities and municipalities. Smit found that aside from the banking industry, which was in negotiations with SARS for an alternative method at the time, the turnover basis was the most popular method for apportionment across the universities and municipalities sampled. Cicero (2011) looked at input VAT apportionment from a South African perspective, comparing the VAT apportionment mechanisms in South Africa to the regimes in Australia and the United Kingdom. Cicero found that while the turnover basis is the default mechanism for apportionment in the United Kingdom, Australia does not have a prescribed input VAT apportionment mechanism and this flexibility allows vendors to choose the most appropriate mechanism for their business. Marais (2014) analysed the enterprise concept in South African VAT law and its effect on input VAT apportionment. Marais looked at the mechanisms of direct attribution for allocating supplies between enterprise and non-enterprise activities. Marais concluded that current treatment of the turnover formula to include certain income such as dividends in the denominator is inappropriate.

This research paper will seek to find recommendations for South Africa by studying the mechanisms for input VAT apportionment used in countries with similar VAT systems. In addition, alternative approaches to address the root cause of the requirement to apportion input VAT used internationally will be researched as these approaches may have application to the retail sector in South Africa.

## **1.2 Research objective**

The aim of this research paper is to determine whether the adoption by SARS of the turnover basis as the standard method for input VAT apportionment is consistent with apportionment mechanisms used internationally. These mechanisms are looked at specifically in the context of retail industries in South Africa.

Within this overarching objective, a number of sub research questions will be answered namely:

- i. Why has input VAT apportionment become relevant to retail industries in South Africa and what difficulties are experienced with the standard apportionment mechanism?
- ii. What has been the evolution of input VAT apportionment in South Africa that has resulted in the turnover method becoming the standard method of apportionment?
- iii. What are the current apportionment mechanisms for VAT utilised internationally, why are these methods used and what are the challenges of these mechanisms?
- iv. What recommendations can be made for South Africa based on international experiences?

### **1.3 Limitation of Scope**

As the central research question is one of apportionment of input VAT, only the VAT Act will be considered in this dissertation. The effect of the apportionment of VAT input on other taxes is beyond the scope of this paper. With respect to the consideration of the VAT Act, the research emphasis is placed on the effect of apportionment on input tax deductions. This is limited to apportionment due to different types of supplies (taxable, exempt and non-supplies). Apportionment due to change of use is not the focus of this research and therefore beyond the scope of this paper. Output tax will only be addressed to the extent that it impacts on the calculation of input VAT apportionment.

Information from relevant companies listed on the Johannesburg Stock Exchange will be obtained in order to gain insight into the retail sector of the economy and the impact of using the turnover basis as the standard method for input VAT apportionment. Due to the fact that listed company operations are generally on a much larger scale than that of private companies in this sector and hence the impact of input VAT apportionment is magnified in listed companies, the effect of the turnover basis for apportionment on private companies within retail industries will not be specifically considered. This could present an opportunity for further research.

With regard to the research into international apportionment mechanisms for input VAT, countries employing a traditional or modern VAT system similar to that used in South Africa will be discussed. Countries using a retail sales tax (RST) system are not relevant to this research as RST is purely a final tax on the end consumer and does not require the retailer to deduct input tax before it is paid over to the revenue authority. These systems are therefore excluded from the analysis of international apportionment mechanisms in this research paper.

### **1.4 Structure of dissertation and research method**

In order to address the research questions identified, the research method utilised in this paper will comprise an analysis of the retail industry in South Africa in order to place the VAT laws in question into context, a rigorous evaluation of the current VAT laws governing input apportionment mechanisms in South Africa and a comparative study of the relevant legislation in other countries with similar VAT systems to South Africa. In order to apply this research method, information will be gathered and analysed from relevant South African and international legislation, South African and international court judgements, annual reports and earnings call transcripts of listed companies in the South African retail industry, and the writings of experts. A full list can be found in the Bibliography.

This paper will be structured in the following way:

- Chapter 2: The retail industry in South Africa and the impact of input VAT apportionment
- Chapter 3: Input VAT apportionment mechanisms in South Africa
- Chapter 4: International VAT mechanisms in traditional VAT systems
- Chapter 5: International VAT mechanisms in modern VAT systems
- Chapter 6: Conclusion and recommendations

In **Chapter 2**, an in-depth analysis of all retail industries in South Africa will be performed. The method used to perform this analysis will be to first define the term “all retail industries” using the Standard Industrial Classification of all Economic Activities released by Statistics South Africa (2012). Literary research into the evolution of this industry in South Africa will be performed with specific reference to the economic and political changes in the country that have necessitated the policy shift of retailers from pure sale of goods to consumer financing. From here, the turnover of all companies in the retail sector listed on the JSE will be obtained from the Audited Annual Financial Statements of each company for a five year period for the years ended 2009 to 2013. This data will be used to determine the income split between revenue from sale of goods and interest income on trade receivables. This analysis will be used to illustrate the impact of the use of the turnover basis as the VAT apportionment mechanism. The chapter will conclude with a discussion of the current challenges faced by retail companies with regard to VAT apportionment.

In **Chapter 3**, the current method of input VAT apportionment in South Africa will be presented and analysed. This will include a discussion as to how input VAT apportionment has evolved from the methods first proposed by the Value-Added Tax Committee in February 1991 and detailed in the Explanatory Memorandum to the Value-Added Tax Bill, 1991 to the method described in Binding General Ruling No. 16 (2013) which is the current ruling released in this regard. A discussion of relevant case law will also be included in this chapter. Finally within Chapter 3, the distinction between taxable and exempt supplies will be discussed in detail, with specific reference to exempt supplies relevant to the retail sector. Research will be performed into why these types of transactions were and continue to be exempt and the consequences of this exemption.

**Chapters 4 and 5** will explore the treatment of input VAT apportionment internationally. The analysis will start with a brief history of the VAT system from its origin in France and the European Union (known as the traditional VAT model) to the development of what has been termed the modern VAT model (Krever, 2008). As all VAT legislations used internationally have either been adapted from one of these two models, research into the international treatments of input VAT apportionment for the retail industry will be split into these two broad categories.

Chapter 4 will discuss the traditional VAT model focusing on the European Union (EU) VAT directives, case law established by the European Court of Justice and the implementation of these forms of legislation within the EU Member States<sup>1</sup>. As the retail industry in South Africa has difficulty with input VAT apportionment due to the earning of exempt financial services income, treatment of financial services will also be analysed to determine whether a potential solution to the current problems faced with VAT apportionment lies in these alternative policies. Traditional VAT systems have attempted to deal with the difficulties arising from exempt financial services by allowing the option to tax. This policy will be assessed for its possible application to the credit retail environment. The chapter will conclude with a discussion of the traditional VAT system in place in Mexico, which has taken the option to tax one step further by deeming certain interest income to be fully taxable.

Chapter 5 will look at key countries that have adopted the modern VAT system, which originated out of New Zealand. This VAT system was developed to address the difficulties and inefficiencies that were experienced in a traditional European style VAT system. New Zealand's modern VAT model was viewed as economically superior by international tax experts and is arguably one of the most efficient VAT systems in the world (Krever, 2008). As a result, many countries opted to use the New Zealand example when designing their own VAT systems, including Australia, Canada, Singapore and South Africa. Therefore, the treatment of input VAT apportionment and exempt financial services relevant to credit retailers in these countries is particularly relevant to South Africa, considering the common ancestry of their respective VAT legislations.

Finally, **Chapter 6** will reflect on the various international apportionment mechanisms discussed in Chapters 4 and 5 in the context of the South African treatment and make recommendations based on these comparisons.

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<sup>1</sup> The European Union is made up of the following member states:  
Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, United Kingdom.

## CHAPTER 2 : THE RETAIL INDUSTRY IN SOUTH AFRICA AND THE IMPACT OF INPUT VAT APPORTIONMENT

### 2.1 Introduction

In this chapter, an in-depth analysis of all retail industries in South Africa will be performed. This analysis will include a discussion as to how retail industries are defined for the purposes of this research and what sectors are included within the collective term of “all retail industries”. The analysis will go further to understand the evolution of this industry in South Africa with specific reference to the economic and political changes in South Africa that have necessitated the policy shift of retailers from pure sale of goods to consumer financing. An analysis will be performed of the turnover of all retail companies listed on the JSE to determine the income split between revenue from sale of goods (taxable supplies) and income generated from interest on trade receivables (exempt supplies). This turnover analysis will be used to illustrate the impact of the use of the turnover basis for input VAT apportionment mechanism. The chapter will conclude with a discussion of the current challenges faced by retail companies with regard to VAT apportionment and where they currently stand on this issue.

### 2.2 Defining the retail industries in South Africa

In its manual for the Standard Industrial Classification of all Economic Activities (Statistics South Africa, 2012), Statistics South Africa (Stats SA) defines retail trade as

*“the resale (sale without transformation) of new and used goods mainly to the general public for personal or household consumption or utilisation, by shops, department stores, stalls, mail-order houses, hawkers and peddlers, consumer cooperatives, etc.”*

The goods referred to in this definition are generally those classed as retail or consumer goods that require either no processing or some amount of processing which is incidental to the selling thereof, such as repackaging. Primarily, businesses categorised as participating in retail trade will include those primarily selling goods to the general public although these goods do not have to be specifically for personal or household use. The Stats SA (2012) definition for retail trade goes on to state that goods such as personal computers, stationary, paint and timber will be included but the following are specifically excluded from the definition:

- *“sale of farmers’ products by farmers;*
- *manufacture and sale of goods;*
- *sale of motor vehicles, motorcycles and their part and automotive fuel;*
- *trade in cereal grains, ores, crude petroleum, industrial chemicals, iron and steel and industrial machinery and equipment;*

- *sale of food and drinks for consumption on the premises and sale of takeaway food;*
- and*
- *renting of personal and household goods to the general public.”*

The introduction to the Standard Industrial Classification of all Economic Activities manual (Stats SA, 2012) recommends that, in order to promote uniformity and comparability of statistics and findings, the industry classifications detailed in the manual should be used. For this reason, the above definition will be used for the purposes of this research paper.

Preliminary research in the retail industry in South Africa, as defined according to the Standard Industry Classification above, finds that this industry is dominated by a number of large retail groups listed on the Johannesburg Stock Exchange. These large listed retail groups can be split into two broad categories, those that sell their goods for cash only and those that offer their customers credit terms in addition to cash sales.<sup>2</sup> Some of the retailers categorised as cash retailers do offer store-branded or co-branded credit cards for purchase of merchandise within their stores however these store credit cards are not owned and managed by the retail group that owns the store. The vast majority of these cards are provided by RCS, a company previously majority owned by The Foshini Group (Bloomberg LP, 2012a and Bloomberg LP, 2013a). As this credit function is effectively outsourced to RCS, the cash retailer does not earn interest on customer accounts.

It is the interest earned due to extended payment terms offered to the customer and interest earned on overdue accounts, where customers have failed to pay their monthly instalment, which has become a separate revenue stream for the credit retailers. Interest is included in the definition of Financial Services in Section 2 of the VAT Act and therefore is an exempt supply for VAT purposes. The provision of taxable and exempt supplies necessitates the requirement for input VAT apportionment and hence, it is the credit retailers specifically that feel the burden of this VAT requirement. The mechanics of the VAT Act will be fully addressed in Chapter 3 of this paper. However before this can be explored, a better understanding of the credit retailers place in the economy and the intention of these retailer to provide credit is required in order to place the issue of VAT apportionment within this industry into context.

### **2.3 The evolution of the credit retail industry in South Africa**

Retail trade falls within the greater wholesale trade, retail, hotel and restaurant sector of the South African economy. This sector contributed 14.8% to South Africa’s overall GDP in 2013 and employs 21% of the national workforce. Retail trade makes up 46% of this sector which translates into a GDP

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<sup>2</sup> Refer Appendix A for a full list of JSE listed credit and cash retailers, including the major store brands that they own.

contribution of 6,8% and employment contribution of 9,7% (Stats SA, 2014b). The retail industry therefore is not an insignificant contributor to the South African economy and as the South African economy becomes more consumer driven, retailers are essential to economic expansion. They also play a valuable role in addressing the unemployment crisis in the country by providing employment opportunities to the youth (Gauteng Province Provincial Treasury, 2012).

The industry has expanded steadily over the last five years with inflation adjusted retail sales growth of 2,6% over this period (Statistics South Africa, 2014a). Growth within the retail industry and its impact on the economy can also be measured by the continuing establishment of shopping centres and malls in both cities and township areas throughout South Africa. Heavy growth of shopping centre space has been experienced since the opening up of the South African economy after 1994 and within the last 5 years alone, 4,8 million square meters was added to the total shopping centre space supply. This is expected to continue to grow at 4% annually between 2013 and 2015 (Prinsloo, 2013).

The change in the political climate in South Africa after 1994 allowed the previously marginalised majority of the population to begin legitimately participating in the South African economy. Pravin Gordon, the previous Finance Minister of South Africa, has described the circumstances under Apartheid as *“a huge repression of any class mobility”* (England, 2013). The effects of Apartheid were such that, according to the 1996 census (Statistics South Africa, 1999) only 16,5% of the entire population of South Africa over the age of 15 years earned more than R3,500 per month. Of the 83,5% earning below this figure, 31% of these people earned less than R500 per month. Therefore, even though the majority of the population now had the freedom to participate in the economy, practically they were unable to do so at their current levels of disposable income.

It is into this gap that the credit retailers stepped. By offering the consumer the option to pay off the cost of an item over a period of time, these retailers made it possible for the average South African to buy clothing, furniture, household items and building materials thereby improving their living conditions. The Policy Framework for Consumer Credit released by the South African Department of Trade and Industry (2010) recognises that the provision of credit has the potential to contribute to economic growth and address social inequality. It states the advantage of credit is that it enables people:

*“to have use of a product or service, at a cost represented by an interest rate, prior to their having paid for that product or service or, where an item cannot be afforded from a single month’s salary, to spread the payments over a number of months.*

*Consumers would generally not be able to purchase items such as houses or cars if it were not possible to obtain finance. In acquiring such items, it is necessary to be able to spread the payments over a number of months. For a huge number of people the same is true in respect*

*of the purchase of a fridge, bed, radio or television. It is also true in respect of the cost of a university education and even true for a great many South Africans in respect of the cost of items such as school fees and school uniforms, or the equipment or trading stock for a small business. Credit thus unlocks a diverse range of opportunities, some of which are economic, others educational and yet others simply improvement of 'standard of living'."*

The growth in consumer credit has been assisted by the expansion of the social grant system as it has provided poor South Africans with a source of income against which they could borrow. The rights-based system enshrined in the Constitution of the Republic of South Africa, 1996, is the main driver of the social grant expansion as it obliges the state to provide adequate food, shelter, education and social security to the people of South Africa (Hagen-Zanker, Morgan and Meth, 2011). As a result, coverage of social grants has grown from 2 million beneficiaries in 1996 to nearly 16 million people in 2014 (Kelly, 2014) and there has been a significant drop in the number of households reporting no annual income between 2001 and 2006 according to data collected by the Census (Hagen-Zanker *et al*, 2011).

Comments by Michael Mark, CEO of Truworths International Ltd, during Truworths International Ltd 4<sup>th</sup> Quarter 2012 Earnings Call (Bloomberg LP, 2012b), gives insight into the credit retailer's intentions in South Africa with regard to the provision of credit:

*"I think what I regularly say is that we offer what we hope is beautiful, appropriate, fashion merchandise at great prices, but more expensive because we think our quality and our fabrics are of better quality.*

*So we offer that to the consumer and we let them choose if they want to pay us by credit or they want to buy on cash, we have no preference, that is true. But we certainly use credit as a facility to drive sales. I mean, we spend a ton of money and effort in trying to acquire new credit account customers because that's a massive driver for our business. So yes, we do drive sales through credit. We could never say anything else if we don't – we do 73% of our sales on credit. And even in Identity, we've been driving account acquisition for years.*

*What you see in our numbers, without any doubt, is a massive growth in Identity, which is the lower end of the market business, because its younger people, they haven't got as much money. They're poorer. And we are driving credit with them. And although we apply the identical risk criteria in Identity as we do in Truworths, just because a lot of them are new customers, and you have a higher degradation with new rather than old as a proportion of the total, and because they're younger, the bad debt number is higher; it's the fact of it."*

This quote illustrates a reason for the increase in credit offered in South Africa since the opening up of the national economy after 1994. Driving sales in a country where the vast majority of the population

is slowly trying to find their way out of poor circumstances required retailers to aggressively issue credit to facilitate purchases.

When retail credit was initially introduced by fashion retailers, such as The Foshini Group Ltd, it was offered on a six month interest-free basis. The debt was interest free provided that the monthly instalments were paid on time. During this period, only 30 to 40% of their debtors' book earned interest. The credit offered facilitated retail sales and contributed to increased turnover as customers, who previously did not have the means to purchase fashion items for cash, could now obtain the items by paying them off over 6 months. The success of this provision of credit then resulted in further credit offerings such as 12 months' plans where interest is charged from the start on the outstanding balance. This resulted in 87% of the debtors' book earning interest and interest becoming a significant income stream for the credit retailer (Bloomberg LP, 2011a, 2011b and 2011c).

Similarly, Truworths International Ltd offers credit options including six months interest free and six, nine or twelve months payment plans accruing interest from day one. The credit terms available to customers will differ depending on the positioning of the stores within the group. For example, their Identity brand, which caters to the lower-middle mass market and is mainly aimed at younger people, does not offer interest free credit however Truworths Emporium stores will offer longer term interest bearing and 6 months interest free terms resulting in 75% of Truworths International Ltd's sales are made on credit (Bloomberg LP, 2011d).

This history of credit provision shows that credit retailers in South Africa provide credit in order to increase the market for their goods and their share within this market to drive their revenue growth (Bloomberg LP, 2011c). Having a large percentage of customers purchasing on account allows the retailer to more effectively communicate with their customer providing further advertising opportunities to encourage sales (Bloomberg LP, 2011d). The intention of the retailer is not to profit from the provision of credit and the earning of interest thereon, it is to facilitate their business of selling goods and maintaining their margin on these goods (Bloomberg LP, 2011d). The interest earned on the goods is seen by the retailer as secondary to the sale of that good and is required in order to offset the bad debt and associated costs that is inherent within the debtors book (Bloomberg LP, 2010, 2012b and 2013b).

In addition to the fashion retailers, the furniture, appliance and building material retailers have taken advantage of the provision of credit to grow revenue and increase the market for their goods. Credit is seen as the key driver of sales by the JD Group and it is crucial to the expansion and sustainability of their business (JD Group, 2013). The increase in store traffic as a result of credit purchases also drives revenue. The Lewis Group Ltd highlights this on page 7 of their 2013 Integrated Report (Lewis Group Ltd, 2013) stating that:

*“Interaction with customers visiting stores monthly to pay accounts creates opportunities for repeat sales.”*

The stated intentions by the above mentioned credit retailers are reinforced in a study performed by the FinMark Trust (FinMark Trust, 2013) to determine why retailers in South Africa offer financial services. It was found that the primary motives were to increase footfall and drive more profitable behaviour. Advertising sales on credit incentivises customers to enter the store and once sales are made, further opportunities arise to interact with customers and encourage repeat sales as customers visit the store regularly to pay their accounts. Offering longer payment terms allows customers to purchase larger ticket items or increase their basket size as their monthly repayments are broken up into manageable instalments.

Some credit retailers have ventured further into financial services beyond the provision of credit to providing bank and insurance products to their existing account holders. Edcon Holdings Ltd, for example, has begun to sell credit account protection plans, home and auto insurance and personal loans to its 4,2 million account holders. However, as Bruno *et al* (2013) point out in their article on The Digital Transformation of Merchant Credit, the potential VAT apportionment difficulties arising from these financial services have been mitigated within the Edcon group by the creation of a separate financial services company through which these financial services are sold.

In addition, Bruno *et al* (2013) find that retailers are often the primary source of credit as customers who have limited or imperfect credit records still need access to credit to buy the goods they need and want. To a certain extent, retailers are able to manage their exposure to credit through the income from increased sales. However, it is not sustainable for the retailer to carry large non-interest bearing debtor balances on their books as there is a great opportunity cost to carrying this debt if no interest was earned on the outstanding monies. Therefore the retailers prefer a higher percentage of their debtors' book to earn interest (Bloomberg LP, 2011b). In addition, the interest is required to offset the cost of bad debt experienced (Bloomberg LP, 2012a and 2012b).

Consumers appear to have a large appetite for credit in South Africa and the level of impaired debt and over-indebtedness is high. Credit retailers have their own selection criteria for granting sales on credit, and turn down between 69 and 74% of the applications for credit received (Bloomberg LP, 2014), however this does not mean that the accounts that are successful will not become impaired. The Current Bureau Monitor, a publication of the National Credit Regulator, recorded that in December 2013 there were 20.64 million credit-active customers in South Africa, 9.93 million of which have impaired records. This means that only 51.1% of current credit customers were in good standing (National Credit Regulator, 2013). The risk of impairment demonstrated by these figures is further evidence of the necessity for the credit retailer to earn interest on overdue accounts.

The National Credit Act No. 34 of 2005 was introduced in 2006 and regulates all credit transactions in South Africa. Section 105(1) read with section 42(1) of the Regulations thereto stipulate the maximum rate of interest that may be charged. Currently, the maximum prescribed interest rate for credit facilities is:

$$[(RR \times 2.2) + 10\%] \text{ per year}$$

and unsecured credit transactions have a higher rate of:

$$[(RR \times 2.2) + 20\%] \text{ per year}$$

where RR is the South African Reserve Bank Repurchase Rate. Therefore, these are the calculations used by credit retailers to determine the rate of interest charged to the customer (Bloomberg LP, 2011b).

#### **2.4 Turnover analysis of credit retailers**

The full mechanics of the VAT apportionment and how the turnover method is applied will be discussed in detail in Chapter 3. However, in order to put this into context, a brief analysis of the turnover of the major credit retailers in South Africa has been performed.

A list of all retail companies listed on the JSE can be found in Appendix 1. The information contained in this list was obtained from the respective companies' 2013 Audited Integrated Annual Reports. According to the data collected from these Integrated Annual Reports, nine companies offer credit on the sale of their goods and can to a greater or lesser extent be described as a credit retailer. The total revenue (including interest income) and interest income from trade receivables figures for each company for the last 5 years were obtained from the Audited Annual Financial Statements for the years ended 2009 to 2013<sup>3</sup>. This data was used to determine the average proportion of their turnover that is made up of interest income earned from trade receivables. Table 1 below gives a summary of these findings.

Table 1 illustrates that six out of the nine major credit retailers receive interest in excess of 5% of their total turnover, the highest being the Lewis Group Ltd with an average interest ratio of 20% to total revenue. The interest used in the analysis is only that earned from trade receivables. Most of the companies studied received interest on investments, dividends and other income that may be classified as exempt or non-taxable supplies for VAT purposes. This income was not included in the analysis as the purpose was to illustrate the effect of the credit sales on the total turnover. However it must be noted that any other income from exempt or non-taxable supplies will exacerbate the issue regarding VAT apportionment.

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<sup>3</sup> Aside from Woolworths Holdings Ltd, the Audited Annual Financial Statements are included in the Integrated Annual Reports.

**Table 1: Turnover analysis of large retailers in South Africa**

| <b>Credit Retailers<sup>1</sup></b> | <b>Interest from trade debtors<br/>as % total revenue - 5 year<br/>average<sup>1</sup></b> | <b>% of sales on<br/>credit<sup>1</sup></b> |
|-------------------------------------|--|---|
| Lewis Group Ltd                     | 20,1%  | 75%   |
| The Foshini Group Ltd               | 12,4%  | 60%   |
| Ellerine Holdings Ltd <sup>2</sup>  | 11,7%  | 61%   |
| JD Group Ltd                        | 9,4%   | 70%   |
| Truworths International Ltd         | 7,3%   | 72%   |
| Edcon Holdings Ltd                  | 6,8%   | 51%   |
| Mr Price Group Ltd                  | 1,6%   | 20%   |
| Woolworths Holdings Ltd             | 0,5%   | 20%   |
| Shoprite Holdings Ltd               | 0,3%   | 4%  |

1. All data obtained from the companies' Audited Annual Financial Statements for years ended 2009 to 2013

2. Figures represent the results for Ellerine Holdings Ltd only. For the financial years included in this report, Ellerine Holding Ltd was owned by African Bank Investments Ltd.

The figures in Table 1 above were obtained from Audited Group Annual Financial Statements<sup>4</sup>. The groups may be made up of more than one VAT vendor that will each submit their own VAT returns. Therefore, while this analysis does give an indication of the approximate revenue split between taxable supplies and exempt supplies, the proportion of taxable to non-taxable supplies may be greater in the individual VAT vendors depending on the group's operating structure.

Observing purely from the retailers' perspective, the use of the turnover method to apportion their input VAT would deem a substantial percentage of their expenditure on operational costs that attract VAT as non-deductible against the output VAT earned on the sale of their merchandise. When one takes into account their clearly stated intention to provide credit in order to increase sales of their goods and by extension increase their taxable supplies, it is understandable that the credit retailer would feel that this method of apportionment is inappropriate and does not accurately reflect the reality of their business.

If the issue is looked at from SARS perspective, there may be an argument that if as much as 20% of total revenue is earned from interest income on trade receivables, the intention of selling merchandise on credit is to generate a mixed supply. In other words, the retailer is selling the goods in order to earn income from the sale of the good and to earn interest on the credit provided.

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<sup>4</sup> Refer footnote 3.

However, as discussed in the previous section, the credit retailers are clear that this is not their intention.

This analysis of the proportion of interest earned on trade debtors to total revenue of the major credit retailers in South Africa demonstrates that this interest earned is not insignificant and will have an adverse impact on input VAT apportionment if the standard turnover method is applied to members of the credit retail industry.

## **2.5 Challenges credit retailers face with regard to VAT apportionment**

As the granting of credit has become more and more prevalent in the South African economy, the credit retailers have noticed a marked deterioration in claimable VAT inputs arising from the VAT apportionment ratio when applying the standard turnover method (Credit Retail Focus Group, 2010). The disallowance of an increasing proportion of the input VAT on their operational expenses has a tangible impact on the credit retailer's cash flow and profitability.

The main challenge of the standard turnover method is that by requiring a business to apportion their input VAT based on the ratio of exempt supplies to total supplies made, it assumes that the business can be split along these lines. Therefore, if 20% of total turnover is made up of exempt supplies then it assumes that 20% of the business efforts and therefore 20% of the expenses were put toward the generation of exempt supplies. However, in the view of the credit retailer this is simply not the case. The credit retailer's intention is to increase the sales of their merchandise and credit is a means to this end. The interest earned is not a goal of the transaction but rather a by-product.

The second challenge credit retailer's face with the standard turnover method of apportionment is the matter of which expenses should be apportioned and which are considered directly related to the making of taxable supplies and hence fully deductible. If it is argued by SARS that the objective of the credit retailer is to earn income on the sale of a good and the interest income on the granting of credit to purchase that good, then even the cost of the merchandise sold is vulnerable to input VAT apportionment.

The third challenge is the calculation of the *de minimus* rule. The first proviso to section 17(1) of the VAT Act allows the full input VAT deduction if it can be shown that 95% or more of the intended use of the good was in making taxable supplies. The calculation of the ratio of taxable supplies to total supplies is also problematic as there is much debate as to what should rightfully be included in the numerator and denominator of the calculation.

In an attempt to engage SARS on these challenges and to determine a more appropriate method that would address these concerns of the industry while at the same time being acceptable to SARS, a Credit Retail Focus Group was formed in 2010. This group was made up of representatives from most of the major credit retailers, namely Ellerines, Edcon, Truworths, JD Group, Foshini and Woolworths, in addition to representative from SARS and the major accounting and legal firms. The intention of this forum was to determine an apportionment method that was suitable for the credit retail industry resulting in SARS issuing a VAT Class Ruling to the specific members of the industry (Credit Retail Focus Group, 2010). Unfortunately this process was never seen to its completion, as the parties were unable to agree on an approach that could be applied to all business in the industry with a satisfactory result for both the credit retailers and SARS.

## **2.6 Conclusion**

The credit retailer plays an important role in South Africa, both in terms of their contribution to the economy and in addressing social inequality. The main motivation of the retailer in offering credit is to facilitate increased sales of the retailer's goods by increasing the foot traffic in stores and by encouraging the consumer to increase their basket size or purchase higher value items. The interest earned on outstanding accounts is required by the retailer in order to cover the cost of carrying outstanding debt in an economy where just less than half the total credit customers have impaired records and the rate of interest charged on these accounts is regulated.

An analysis of the ratio of interest earned on trade receivables to total turnover of the major credit retailers in South Africa reveals that while some of the retailers earned interest of less than 1% of total revenue, the majority of credit retailers receive interest in excess of 6%. This creates a real issue in determining input VAT apportionment on the turnover basis as the portion of input VAT, on operation expenses, excluded does not equate to the intention of the credit retailer when selling their merchandise on credit.

In addition, the retailers are experiencing a number of challenges with regard to the turnover basis for apportionment in terms of how this basis is calculated, particularly with regard to which income should be included in the turnover apportionment calculation, to which expenses the formula should be applied and the determination of the *de minimus* threshold.

A detailed discussion of the current VAT legislation in South Africa regarding input VAT apportionment is therefore required in order to understand these challenges and the reasons why the turnover basis was chosen as the standard method of apportionment better.

## CHAPTER 3 : INPUT VAT APPORTIONMENT MECHANISMS IN SOUTH AFRICA

### 3.1 Introduction

Statistics obtained from the 2013 Tax Statistics report published by the National Treasury and SARS reveal that VAT revenue makes up one quarter of the total tax revenue collected by SARS each year. This proportion rose from 24.7% in the 2008/09 tax year to 26.4% in the 2012/13 tax year. While this does not appear to be a large increase, it is significant as VAT overtook corporate income tax in 2012/13 as the second largest contributor to total tax revenue behind personal income tax, which contributed 34% (National Treasury and SARS, 2013). As at 31 March 2013 there were 650 540 registered VAT vendors, 65.4% of which were active, and the number has declined steadily over the last 5 years from 737 885 as at 31 March 2009. SARS attributes this to more stringent registration requirements and improved risk based vetting of refunds (National Treasury and SARS, 2013).

According to the 2013 Tax Statistics report (National Treasury and SARS, 2013), the wholesale and retail trade, catering and accommodation sector, within which credit retailers fall, contributed R35.9 billion to the total VAT revenue of R237.8 billion during the 2012/13 tax year which translates into a contribution of 15.1%. This sector contains 20% of the total registered VAT vendors, second only to the financial intermediation, insurance, real estate & business services sector, which contributed 41.4% (National Treasury and SARS, 2013). Vendors with turnover over R30 million in a 12 month period make up 9% of the total registered vendors however this group accounts for 75.1% of the total VAT payments and 87.5% of total VAT refunds (National Treasury and SARS, 2013). The retail trade sector makes up 14% of this category of vendor, the second largest sector in this category (National Treasury and SARS, 2013).

These statistics reveal that VAT is an important revenue stream for the South African Government. In addition, vendors in the retail sector are significant contributors of VAT revenues. This lends colour to the debate regarding the best method for input VAT apportionment as, while the retailers may feel that they are unfairly treated by the prevailing apportionment method, VAT revenues earned from retailers are substantial. Therefore SARS is likely to resist any method that is seen to diminish this income.

In this chapter, the current method of input VAT apportionment utilised in South Africa is presented and analysed. This will include a discussion as to how input VAT apportionment evolved from inception and the methods first proposed by the Value-Added Tax Committee in their February 1991 report and detailed in the Explanatory Memorandum to the Value-Added Tax Bill, 1991.

A discussion of relevant case law is included in this chapter. While the South African courts have not been called on yet to decide on input VAT apportionment within the retail industry specifically, a

small number of cases have touched on this issue of apportionment and the interpretation of Section 17 of the VAT Act.

Finally the distinction between taxable and exempt supplies will be discussed in detail, with specific reference to exempt supplies relevant to the retail sector, such as financial services income in the form of interest. Research will be performed into why these types of transactions were, and continue to be, exempt.

### **3.2 Brief explanation of the VAT system**

VAT is the taxation levied on the supply of goods and services in South Africa and on the importation of goods into South Africa. As stated in the VAT 404 Guide (SARS, 2013c), it is a destination tax as the tax is levied on the consumption of a good or service and it is based on the credit input method of collection. This means that output tax collected on the supply of goods and services is reduced by input tax paid on the purchase of goods and services and the importation of goods, before the tax is paid over to the authorities by the vendor in South Africa. In *ITC 1841* (2009) 72 SATC 92, Van Oosten J stated at 8 that:

*“The supply of goods and services by a vendor lies at the heart of the VAT system. The supply of goods and services, in the course or furtherance of any enterprise, is the precondition for the vendor’s liability under the VAT Act.”*

This taxation system is governed by the Value-Added Tax Act No. 89 of 1991 (VAT Act), which was introduced into the South African system in 1991 to replace the Sales Tax Act of 1978 and the general sales tax (GST) system. According to the Explanatory Memorandum to the VAT Act, the basic concepts were drawn from systems in place in various countries at the time of drafting and then amended for the specific conditions prevailing in South Africa.

### **3.3 Input VAT apportionment**

The concept of VAT apportionment was included in Section 17 of the first version of the VAT Act and has remained largely unchanged since inception. Apportionment of input tax was discussed in the Explanatory Memorandum to the VAT Act in the context of the intended use of the good or service acquired, namely that:

*“the extent to which such tax may be treated as input tax when goods or services are acquired or imported by a vendor partly for consumption, use or supply in the course of making taxable supplies and partly for another intended use is the amount which bears to the full amount of the tax payable in the same ratio as the intended use, consumption or supply*

*of the goods or services in the course of making taxable supplies bears to the total intended use of the goods or services.”*

This implies that the most important determinant for establishing the extent to which input tax can be deducted is the intention of the vendor in acquiring the good or service and the proportion of that intention which relates to its taxable supplies. This is embodied in Section 17(1) of the VAT Act, which states:

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

Section 17(1) has been interpreted by the Tax Court which provides further insight into how the deduction of input tax against output tax should be treated. In *ITC 1744* (2002) 65 SATC 154, the court was called upon to decide whether the input tax paid on services acquired in order to make exempt supplies (in this case the allotment of shares in order to raise capital which falls into the definition of the supply of financial services, an exempt supply in terms of Section 12) could be deducted against output VAT charged on the sale of manufactured containers. It was contended by the Appellant that the containers could not be manufactured unless the capital was raised and therefore, on this basis, it should be allowed to deduct the input VAT. In response to this, Conradie J states at 156 that:

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

The learned judge goes on to say at 157 that:

*“The difficulty with [the Appellant’s] submission is that although the raising of the capital might have been indispensable to the making of the taxable supplies, one would, if he were right, have to interpret the expression ‘in the course of the making of taxable supplies’ to accommodate the remuneration paid for the raising of the appellant’s capital. The raising of capital seems rather to be preparatory to the making of the taxable supplies. It does not seem to me that one can reasonably say that A’s services were acquired in the course of manufacturing the shipping containers. Capital goods such as machinery bought with the raised capital can be said to have been acquired in the course of making taxable supplies. But there the connection is closer. And it is the closeness of the connection that counts... The principle is that where goods or services are used for an exempt supply it is not legitimate for the taxpayer to look through that supply to an ultimate purpose of carrying out taxable supplies.”*

The case law used by Conradi J to substantiate this statement was a judgment from the European Court of Justice [*BLP Group plc v Commissioners of Customs and Excise* [1995] C-4/94 (6 April 1995)]. However, subsequent decisions of this court have contradicted the BLP Group plc decision specifically with reference to the share issue costs being a non-supply rather than an exempt supply as this judgment finds (van der Zwan and Stiglingh, 2011).

Despite this, the principle expressed by Conradi J, that it is the closeness of connection that counts and that it is not legitimate for the taxpayer to look through the exempt supply to an ultimate purpose of carrying out taxable supplies, may have application to credit retailers in South Africa. As discussed in Chapter 2, the main intention of credit retailers in earning interest is to facilitate increased sales (i.e. increase taxable supplies). However if the principle laid down in *ITC 1744* were applied, it could possibly be argued that you cannot look through the earning of interest on outstanding debts to the sale which gave rise to the outstanding debt. Needless to say, credit retailers have never called on the courts to consider this matter and have preferred to dispute the method for VAT apportionment.

In a recent Supreme Court of Appeal judgment (*Commissioner for SARS v De Beers* (2012) 74 SATC 330), learned judges Navsa and van Heerden JJA state at 39 that:

*“...it is necessary to set out the rationale behind and method of application of VAT. On this aspect we can do no better than to cite an English case which deals directly with this aspect in Customs and Excise Commissioners v Redrow Group plc [1999] 2 All ER 1 (HL) at 9g-h:*  
*‘These provisions entitle a taxpayer who makes both taxable and exempt supplies in the course of his business to obtain a credit for an appropriate proportion of the input tax on his overheads. These are the costs of goods and services which are properly incurred in the*

course of his business but which cannot be linked with any goods or services supplied by the taxpayer to his customers. Audit and legal fees and the cost of the office carpet are obvious examples.'

*These considerations apply equally to the VAT regime in this country and in other comparable jurisdictions."*

The judgment proceeds to adopt the purpose test in determining whether the input VAT on the legal expenses may be claimed.

There are three provisos to Section 17(1) that must be considered before the apportionment method is determined. The first proviso is referred to as the *de minimus* rule and results in the full VAT input being claimed if exempt supplies make up less than 5% of the total intended use of goods and services acquired by a vendor. Therefore, input VAT apportionment only becomes relevant to a vendor if their provision of exempt supplies makes up a greater than insignificant portion of their business (i.e. greater than 5%). The *de minimus* rule is discussed further in part 3.5 below.

The second proviso to Section 17(1) deals with successive supplies and the treatment thereof. The third proviso sets out the timing of the implementation of the method for determining the apportionment ratio. This proviso states that:

*"(iii) where a method for determining the ratio referred to in this subsection has been approved by the Commissioner, that method may only be changed with effect from a future tax period, or from such other date as the Commissioner may consider equitable..."*

Therefore, the vendor cannot apply an apportionment method, once approved by the Commissioner, retrospectively.

The VAT 404 guide instructs vendors that the starting point for input VAT apportionment is to determine whether expenditure was incurred wholly or exclusively for the purpose of making either taxable supplies, exempt supplies or non-supplies. Where it is clear that the taxable expense can be directly attributed to one of these purposes only, it must be treated accordingly, i.e. if it is exclusively attributable to the making of a taxable supply it is fully deductible or if it is wholly attributable to an exempt or non-supply the entire input is not deductible. Only where an expense cannot be wholly or exclusively attributed to one particular type of supply, must it be apportioned.

The Report of the Value-Added Tax Committee (VATCOM) in February 1991 discusses the intention for the apportionment basis of inputs for the proposed VAT Bill in 1991 (de Koker and Kruger, 2013).

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

*“where the particular good or service can be related wholly to the making of taxable supplies, a full input tax credit is claimed. In the case of a good or service which can be related wholly to non-taxable activities, no credit can be claimed. Those inputs which cannot be attributed directly to taxable or non-taxable activities need to be apportioned on some other basis. The main advantage of the direct attribution method is its accuracy, while its disadvantages are increased record-keeping required and that it can only be used in tandem with some other basis of apportionment.”*

However in the case of vendors that make mixed supplies, such as credit retailers, it can be difficult to determine whether an expense can be directly attributed to the making of taxable supplies. For example, expenditure on shop fittings would appear to be incurred wholly for making taxable supplies as the retailer requires the shop fittings in order to display merchandise and enable customers to pay for this merchandise at check-out counters. However, customers may also come into the store to pay their outstanding accounts. Therefore it can be argued that these shop fittings are attributed to both the making of taxable supplies (sale of merchandise) and the making of exempt supplies (interest on overdue accounts).

Ernst & Young (2011) find that SARS is of the view that if it is possible for an expense to be used to make supplies other than taxable supplies, it is considered “tainted”. This is seen as the case even if the use for making exempt or non-taxable supplies is minimal, as discussed further in part 3.5 below.

Where the direct apportionment method is not possible, VATCOM recommended that the turnover method of apportionment should be used unless this method created undue disadvantage to the taxpayer. Therefore, even at the inception of the VAT Act, the turnover method of apportionment was preferred.

### **3.4 The standard method of apportionment**

Section 17(1) of the VAT Act provides that the ratio which must be applied in order to apportion the input VAT is:

*“as determined by the Commissioner in accordance with a ruling as contemplated in Chapter 7 of the Tax Administration Act or section 41B”*

Previously, the VAT 404 guide allowed two methods of input VAT apportionment, namely the input-based method or the turnover-based method. Vendors were allowed to choose the method they

deemed most appropriate or they could apply to SARS for approval of an alternative approach. Examples of the methods that were approved by SARS were (Silver and Beneke, 2013):

- The varied input-based method which determines the apportionment ratio as the ratio of input VAT incurred wholly for making taxable supplies to the total input VAT incurred wholly for the making of taxable or exempt supplies (inputs for making mixed supplies was excluded from the calculation)
- The floor space method which determines the apportionment ratio based on floor space used to make taxable supplies to total floor space of the business
- The transaction-based method which determines the apportionment ratio according to the number of transactions that gave rise to taxable supplies over the total number of transactions
- The employee time method which determines the apportionment ratio according to ratio of employee time spent generating taxable supplies to total time spent.

In August 2000 SARS released a notice announcing that, as of 1 November 2000, the only standard method for calculating the apportionment ratio would be the turnover method (SARS, 2000). Despite this, vendors were still allowed to use a reasonable alternative to the turnover method provided that they applied for written approval from SARS.

The turnover-based method has evolved somewhat since it became the standard method of apportionment in November 2000. However the ratio formula for calculating the apportionment ratio has largely remained unchanged and is as set out in Binding General Ruling (VAT) No. 16 (BGR 16) issued by SARS in 2013:

$$Y = \frac{a}{(a + b + c)} \times \frac{100}{1}$$

Where

Y = the apportionment ratio

a = value of all taxable supplies for the period

b = value of all exempt supplies for the period

c = value of all other amounts received or accrued over the period (whether in respect of a supply or not)

It is the determination of what constitutes “b” and “c” in the formula above that has evolved since implementation of this formula as the standard apportionment method. For example, in terms of a

written ruling by SARS to the Banking Association dated 13 May 1998, banks were allowed to exclude dividend income and include only net interest when determining the denominator of the apportionment ratio calculation (Edward Nathan Sonnenbergs, 2007). This dividend exclusion was not extended to other vendors in South Africa however.

In June 2007, all rulings were withdrawn by SARS and the apportionment rulings previously granted have not been reconfirmed (Ernst & Young, 2011). The VAT 404 guide specifically states that items such as dividends and statutory fines should be included in “c” of the formula. The only receipts or accruals that are specifically excluded are the supplies of capital goods other than under rental or operating lease agreements. This means that SARS expects receipts such as gains on foreign exchange transactions and proceeds of debtor’s book securitization also to be included in the denominator for the purpose of determining the apportionment ratio. Ernst & Young (2011) argue that the inclusion of these types of receipts distort the ratio as they are not the result of any effort by the vendor and often no inputs are acquired in order to earn these amounts. Badenhorst (2007) makes the point that the wide reference to “all other amounts” could also include donations, proceeds on the sale of investments and even loan proceeds. In their view this results in the apportionment of inputs that have no relation to the income used to determine the apportionment ratio. Marais (2014) found that it was inappropriate to include income such as dividends in the denominator of the apportionment ratio.

This issue of the distortion in the apportionment ratio has been acknowledged by SARS and the National Treasury by the inclusion of the following statement regarding apportionment for non-financial sectors in Appendix C to the 2013 Budget Speech (National Treasury, 2013a):

*“The default apportionment method, which is based on turnover, appears to be inequitable at times because there may not be a direct correlation between expenditure incurred versus turnover generated. It is proposed that the default application of this method be re-evaluated.”*

This was then included in the terms of reference for The Davis Tax Committee, which has been tasked with reviewing certain aspects of current tax legislation (National Treasury, 2013b).

Immediately following this announcement, BGR 16 was released by SARS on 25 March 2013, which reconfirmed the turnover basis as the only method of input VAT apportionment. Therefore, until the review of this method has been completed, the turnover basis will continue to be the standard method of apportionment.

Aside from BGR 16, the only other binding ruling that has been issued by SARS, and has been made public on the SARS website, is Binding General Rule (VAT) No. 4 (Issue 2) (2013) which relates specifically to municipalities. This ruling was also issued on 25 March 2013 and overrules all previous rulings issued for municipalities. This ruling, however, does not appear to be substantially different to BGR 16 as it uses the same apportionment formula and does not allow any specific exclusions for municipalities other than the supply of capital goods.

Both the VAT 404 guide and BGR 16 state that where the standard apportionment method produces an unfair, unreasonable or absurd result, the vendor may apply to SARS for a ruling on an alternative method. However Gad, Badenhorst and Vogelmann (2012) have found that rulings sought in various instances in this regard have been disallowed.

In the context of the credit retailers, the turnover-based method of apportionment may not be the most appropriate to accurately represent the intended use of the goods and services acquired. As illustrated in Chapter 2, the turnover based apportionment method may create an apportionment percentage that is unreasonably higher than the actual intended use for the inputs incurred. In addition, it was shown in Chapter 2 that the focus for the credit retailer is to sell merchandise, not earn interest, therefore the majority of the entity's resources are put toward this intention to make taxable supplies.

### **3.5 The *de minimus* rule**

According to the first proviso of section 17(1), if the intended use of goods or services in making taxable supplies is equal to or greater than 95% of the total intended use, the full input can be deducted. This is known as the "*de minimus* rule".

The threshold of 95% has not always been this high. It was originally set at 90% however it was changed to the current level in the Revenue Laws Amendment Act No. 53, 1999. The Explanatory Memorandum to this Act explains that the reason this threshold was increased was due to substantial revenue loss to the fiscus as a result of this concession. The Explanatory Memorandum also claims that the increase in the threshold is in line with similar steps taken by other countries.

SARS only applies the *de minimus* rule to the apportionment ratio, not to a decision as to whether an input should be apportioned (Ernst & Young, 2011). In other words, SARS does not allow vendors to consider each input in terms of its intended use. Therefore, even though substantially the whole of an input is used to make taxable supplies, if there is any aspect of the input that could be said to be used for the making of exempt supplies it is deemed by SARS to be 'tainted' as it is used for the purpose of mixed supplies and must therefore be apportioned according to the turnover ratio. Only where the

formula for the standard turnover ratio results in a percentage greater than 95% can the vendor then deem all input VAT incurred as deductible.

This creates headaches for the credit retailer especially considering that interest income arises as a result of store credit granted to purchase merchandise. SARS could argue that merchandise could have been purchased by the credit retailer with the intention of using it to produce taxable supplies (the sale of the merchandise) and to produce exempt supplies (interest income) especially if the store credit granted bears interest from day one. Even though the proportion of intended use to sell the merchandise could easily be greater than 95%, the fact that it may also be used to earn interest to a very minimal degree will mean that it is a tainted input and therefore must be apportioned according to the apportionment ratio calculated.

### **3.6 Taxable and exempt supplies**

The difficulty credit retailers experience with the apportionment formula is due to the fact that their main receipts and accruals during any period are made up of income from the sale of merchandise and interest received on overdue accounts.

Both of these types of income fall into the definition of “supply” as set out in section 1 of the VAT Act, which states that a “supply” includes:

*“performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of ‘supply’ shall be construed accordingly”*

However, only the sale of merchandise is a “taxable supply” as defined in the same section and read with section 7(1)(a) and section 11. Interest on overdue accounts is deemed to be a financial service by section 2(f) and is therefore an exempt supply in terms of section 12(a).

Since the inception of the VAT Act in 1991, interest has been deemed an exempt supply. The reasons for this were numerous as laid out in the 1991 VATCOM report (Barter, 2010). These reasons include:

- The cost of borrowing would increase for private persons by the full rate of VAT.
- There will be strong incentive to bypass financial intermediaries, particularly by private households who will look to private non-vendor investors for funding.
- The number of vendors required to register will increase if interest is taxed as wealthy private investors may earn interest above the VAT threshold.
- Financial intermediaries would be required to determine whether investors are VAT vendors and obtain VAT invoices from these investors. This creates additional

administrative burden for the financial intermediary and the investor in addition to incentivising investors to falsely classify themselves as vendors to obtain a higher interest rate that includes VAT.

Therefore, due to the increased cost and impracticality of taxing interest, interest has remained an exempt supply for VAT purposes.

### **3.7 Conclusion**

VAT is an important revenue stream for the South African government and the apportionment of input VAT contributes to this income generation. Therefore, SARS will be reluctant to change the apportionment method to one that creates an unfavourable result for revenue collection.

The turnover method of apportionment has evolved since the inception of VAT to become the standard method of apportionment and other methods previously allowed by SARS have been withdrawn in favour of this standard approach. However, the formula is fraught with difficulties regarding what income should be included in the calculation of the apportionment ratio and how it should be applied to input VAT. A further level of complexity is the *de minimus* rule and the way it is currently applied. SARS and the National Treasury have acknowledged that the standard turnover method appears to be inequitable.

Therefore, to attempt to answer the central question of whether this standard method adopted by SARS is the best method, the apportionment mechanisms used internationally will be examined in the next two Chapters.

## CHAPTER 4 : INTERNATIONAL VAT MECHANISMS USED IN TRADITIONAL VAT SYSTEMS

### 4.1 Introduction

In order to answer the central question of this research paper, that international experience shows that the turnover method is the best mechanism for input VAT apportionment for credit retailers, it is important to understand that this question contains two aspects. The first aspect is the reason why apportionment is necessary and the second is which method used for apportionment leads to the most appropriate result.

It may be the case that the answer lies in the former aspect, that is in determining whether it is feasible to render apportionment unnecessary by bringing interest earned on retail credit into the taxable supplies net. On the other hand, the study of international application may present an alternative apportionment method that is more elegant than the current system in South Africa. Therefore focus will be placed in this chapter not only on input VAT apportionment methods used internationally but also on the treatment of financial services, specifically interest received, for VAT purposes.

In order to commence the analysis of the international input VAT treatments, it is important to understand the history of the VAT system. VAT legislations in place across the world have originated either from the European VAT system (known as the traditional VAT model) or what has come to be termed the “modern VAT” model (Krever, 2008).

A limited system of VAT was first introduced in France over a period of 4 years commencing in 1948 (Krever, 2008). However, according to the European Commission website (2014), it was over a decade later that the first full VAT system was introduced into Europe with the first directives released by the European Union in 1967. This traditional VAT system was slowly adopted by countries outside the EU until the 1980s when Japan and New Zealand developed their own systems of VAT which sought to overcome the difficulties experienced with the traditional VAT system. While the Japanese model did not have much application internationally due to its unique structure and administrative system that was geared to specific Japanese business practices, the New Zealand model quickly found popularity and was copied by many countries that had yet to adopt a VAT system, including Australia, Canada, Singapore and South Africa (Krever, 2008).

In light of this, the analysis in this research paper of the international input VAT mechanisms and the treatment of financial services relevant to credit retailers has been split across two chapters according to the VAT model implemented. This chapter will focus on the traditional VAT system addressing mainly the treatment in EU member states. The VAT directives laid down by the European Union will be discussed in addition to the case law established by the European Court of Justice. The discussion

will then progress to the treatment of these issues by certain Member States that have opted for alternative mechanisms to the standard method laid down in the EU VAT directive. The option to tax financial services, which has been elected by some EU Member States, is then assessed for its possible application to the credit retail environment. The chapter will finish with discussion of the traditional VAT system in place in Mexico, which has taken the option to tax one step further by deeming certain interest income to be fully taxable.

The next chapter will look at key countries that have adopted the modern VAT system and how they have chosen to address the relevant issues in their VAT legislation.

## **4.2 Analysis of the traditional VAT system in the European Union**

### **4.2.1 European Union VAT directives**

According to the European Commission website (2014), the EU adopted its first VAT directives in 1967. These directives were not prescriptive to Member States and only formed the general structure for a VAT system, allowing the Member States discretion in determining the details of their VAT legislation regarding coverage and rates. On 17 May 1977, the Sixth Directive for VAT was adopted (Council of the European Union, 2006). The intention of this directive was to set a uniform VAT policy across all member states.

On 1 January 2007, Directive 2006/112/EU was adopted which replaced all previous VAT directives including the Sixth Directive. This directive is commonly known as 'the VAT directive' and, with regard to the sections relating to input VAT apportionment, is substantially similar to the Sixth Directive.

Articles 17 & 19 of the Sixth directive dealt with input VAT and the method of apportionment to be used. The VAT directive uses substantially the same language in Articles 173 and 174 as that of Article 19 in describing the apportionment method. Article 173(1) sets out the requirement to apportion input VAT while Article 173(2) allows member states some discretion in deviating from the apportionment method laid out in Article 174 and in setting a *de minimus* threshold. The relevant clauses in Article 173 are as follows:

#### *"Article 173*

*1. In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to Articles 168, 169 and 170, and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible.*

*The deductible proportion shall be determined, in accordance with Articles 174 and 175, for all the transactions carried out by the taxable person.*

2. Member States may take the following measures:

...

(c) *authorise or require the taxable person to make the deduction on the basis of the use made of all or part of the goods and services;*

(d) *authorise or require the taxable person to make the deduction in accordance with the rule laid down in the first subparagraph of paragraph 1, in respect of all goods and services used for all transactions referred to therein;*

(e) *provide that, where the VAT which is not deductible by the taxable person is insignificant, it is to be treated as nil."*

Article 173(2)(e) above allows member countries to set a *de minimus* threshold, under which apportionment is not necessary. However, contrary to the practice in South Africa, the guideline for determining the *de minimus* rule in Article 173(2)(e) states that the threshold is determined based on the proportion of the non-deductible inputs to total inputs. This implies that once the inputs have been apportioned, the ratio of non-deductible inputs to total inputs must be insignificant, not the ratio of exempt supplies to total supplies.

Article 174 goes into specific detail on how the formula for apportionment must be calculated namely:

*"Article 174*

*1. The deductible proportion shall be made up of a fraction comprising the following amounts:*

*(a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;*

*(b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.*

...

*2. By way of derogation from paragraph 1, the following amounts shall be excluded from the calculation of the deductible proportion:*

*(a) the amount of turnover attributable to supplies of capital goods used by the taxable person for the purposes of his business;*

*(b) the amount of turnover attributable to incidental real estate and financial transactions;*

*(c) the amount of turnover attributable to the transactions specified in points (b) to (g) of Article 135(1) in so far as those transactions are incidental.”*

The basic formula given in the first section of Article 174 is substantially the same as that used in the South African VAT Act. It is in the second section where a subtle difference between South Africa and the EU emerges. This section excludes not only the supply of capital goods (as does the South African formula) but certain real estate and financial transactions too that are seen as incidental. Article 135(1) referred to in this section details the kind of financial transactions that are considered exempt for the purposes of the VAT directive.

The EU exemptions for financial services as listed in Article 135(1) is very broad and includes all possible categories of financial supplies including all types of insurance, financial service fees and commissions, margins and interest. As discussed in chapter 3, South Africa has a much more reduced definition of financial services which does assist in elevating some of the negative consequences of exemptions. However this does not assist the credit retailer as interest falls squarely into the exempt financial services basket.

The intention of the Sixth Directive and the subsequent VAT directive is to harmonize the VAT system across all Member States. As a result, the European Court of Justice has become the court of final appeal for most VAT disputes arising in the EU Member States (Laule and Weber, 2011). Therefore, the judgments of the European Court of Justice should be analysed in order to determine how these directives have been interpreted.

#### **4.2.2 European Union case law regarding input VAT apportionment**

The VAT system in the European Union has been in place for over 40 years, allowing ample time for the legislation to be tested by the courts. However, as the current VAT directive was only introduced in 2006, the majority of case law is based on the Sixth Directive. This case law is still valid in relation to the current VAT directive as the wording of the relevant articles relating to input VAT apportionment does not substantially differ.

To understand the case law principles laid down by the European Court of Justice it is necessary to examine how this court has interpreted the relationship between inputs and outputs. This informs the decision as to which vatable expenses incurred require apportionment. As discussed in chapter 3, this is a particular area of disagreement between SARS and the credit retailers.

In the *BLP Group plc v Commissioners of Customs and Excise* [1995] C-4/94 (6 April 1995), the court states at 19 that the ultimate aim pursued by the taxpayer is irrelevant, it is the “*direct and immediate*

link” between the goods or services purchased and the taxable transactions that dictates whether the input tax can be deducted. The court concludes at 28 that:

*“where a taxable person supplies services to another taxable person who uses them for an exempt transaction, the latter person is not entitled to deduct the input VAT paid, even if the ultimate purpose of the transaction is the carrying out of a taxable transaction.”*

This interpretation of the wording in Article 173 as requiring a “direct and immediate link” between the taxable transaction and the goods or services acquired in order to determine whether the input tax is deductible, and what proportion is deductible, was confirmed in *Commissioners of Customs and Excise v Midland Bank plc* [2000] C-98/98 (8 June 2000) and the *Investrand BV v Staatssecretaris van Financiën* [2007] C435/05 (8 February 2007). The judgment in the *Investrand BV* case emphasises at 24 that a good or service acquired by a taxpayer may be part of his general costs and therefore, while there is no direct or immediate link between this good or service acquired and a specific taxable income received, there is a direct and immediate link to the taxpayer’s economic activity as a whole (this was also confirmed in *Portugal Telecom SGPS SA v Fazenda Pública* [2012] C-496/11 (6 September 2012) and *Kretztechnik v Finanzamt Linz Case* [2005] C465/03 (25 May 2005)).

This principle requiring a “direct and immediate link” between inputs incurred and outputs generated has been drawn on by the South African courts in order to establish the concept of “closeness of connection” (*ITC 1744*), as discussed in Chapter 3 of this research paper.

In *Fazenda Pública v Banco Mais SA* [2013] Case C-183/13 (12 April 2013), the court was called upon to determine how the apportionment formula should be calculated, with specific reference to a financial leasing contract, i.e. should the entire rental be included in the denominator or only the interest portion. The learned judge in this case states that:

*“the Sixth Directive does not preclude Member States from using, for a given transaction, a method or formula other than the turnover-based method, provided that the method used guarantees a more precise determination of the deductible proportion of the input VAT than that arising from application of the turnover-based method”.*

The judgment also makes mention of the key points coming out of previous EU court judgments (*Royal Bank of Scotland Group plc v The Commissioners for Her Majesty’s Revenue and Customs* [2008] Case C-488/07 (18 December 2008) in particular) which should be taken into consideration when determining an appropriate apportionment method, namely that:

- Member states are allowed “to take account of the specific characteristics of some activities of taxable persons in order to achieve greater accuracy in determining the extent of the right to deduct”
- “The principle of neutrality, which forms an integral part of the common system of VAT, requires that the method by which the deduction is calculated objectively reflects the actual share of the expenditure resulting from the acquisition of mixed use goods and services that may be attributed to transactions in respect of which VAT is deductible”

The Advocate General, in providing his opinion for *Régie Dauphinoise — Cabinet A. Forest SARL v Ministre du Budget* [1996] C-206-94 (11 July 1996), addresses directly the challenge with the turnover method of apportionment and why it can become distorted. He explains at 39 that:

*“the criterion for the application of Article 17(5) [of the Sixth Directive] and with it the calculation of the deductible proportion is the use of the taxable person's business assets for taxed transactions, which thus entail a right to deduct, and of transactions which do not entail such a right. But the turnover attributable to every transaction is included in the calculation of the deductible proportion. That is, as long as the resources utilized are to some extent related to the transactions arising (taxed or untaxed), there are no difficulties. The position is different, however, if the resources applied are slender but the transaction for which they are used is proportionally much greater. Then this relatively substantial transaction has the effect of reducing the deduction. The relevant turnover is included in its entirety in the denominator although only slender resources were used for the transaction. The diminution of the deduction therefore becomes disproportionately high.”*

It is clear the European courts favour an approach to apportionment that reflects the principle of VAT neutrality and seek to apply an apportionment method that achieves the greatest accuracy. It is acknowledged that for this reason, the turnover method may not always be the most appropriate.

In line with this conclusion, Article 173(2)(c) allows Member States to use a method other than turnover apportionment. On this issue the court has ruled in *Finanzamt Hildesheim v BLC Baumarkt GmbH & Co. KG* [2012] C-511/10 (8 November 2012) at 26 that, so long as another method provides a more precise determination of the deductible proportion, the Member State is allowed to authorise an alternative method. In this case, the construction of a mixed-use building was at issue and the allocation method of floor space rather than turnover was allowed.

The exclusion of incidental real estate and financial transactions as per Article 174(2)(b) and (c) of the VAT directive has received some attention in the European Court of Justice. This may have application to the credit retailer if it can be shown that interest on overdue accounts is incidental.

The opinion provided by the Advocate General in the BLC Baumarkt case *supra* dealt with the exclusion of incidental financial transactions from the apportionment formula stating at 64:

*“That provision must be seen in the light of the fact that the incidental transactions referred to there may constitute a large part of the total transactions, without however making any significant contribution to the overheads. In those circumstances it would be inappropriate to include the incidental transactions in the calculation of the proportion under Article 19(1). Instead those transactions are 'excluded' in accordance with Article 19(2).”*

With regard to what constitutes an incidental transaction, the EU Court of Justice has dealt with this issue both in regards to dividends and interest. *Sofitam SA v Ministre chargé du Budget* [1993] C333/91 (22 June 1993) deals with the earning of dividends by a holding company and whether the dividends should be included in the apportionment formula. The court found that in this instance the earning of dividends did not constitute an economic activity in terms of the Sixth directive and as such it was against the objective of a wholly neutral taxation ensured by the common system of VAT to include the dividends in the denominator of the formula for revenue apportionment.

The Régie Dauphinoise case *supra* deals with the earning of interest by a property management company on deposits received from lessees or co-owners. In this case, the court did not find that the earning of this interest was incidental. In fact the court states at 18 that the interest earned on the investment of such deposits is a *“direct, permanent and necessary extension of the taxable activity”* and it would go against the objects of neutrality of the common VAT system to deem this interest to be incidental and exclude it from the denominator.

In dealing with a similar matter, the judgment in *Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v Fazenda Pública* [2002] C-77/01 (12 September 2002) at 80 also makes reference to the fact that incidental transactions are likely to be those that *“involve only very limited use of assets or services subject to VAT”*. The court notes that even where income from financial transactions is greater than the income generated from the taxpayer’s main activity, this does not automatically exclude such transaction from the classification as an incidental transaction.

In making his argument, the Advocate General for the EDM case *supra* uses an example at 42 of a supplier who grants credit to his customer for payment of goods and receives interest thereon. In this instance, the Advocate General argues that the supplier would have been acting *“in the framework of his principal activity”* and the interest earned is *“inherent”* to this activity. The interest earned in this instance must be included in the denominator of the apportionment formula.

Therefore, it appears from the case law that where credit retailers in the EU are required to use the turnover method for input apportionment, they would be required to include interest on overdue accounts in the denominator of the apportionment formula. They would have little grounds to argue that this interest was incidental and therefore should be omitted.

#### **4.2.3 Treatment in Member States**

Despite the turnover apportionment method set out in Article 174, Article 173(2)(c) gives Member States the option to require taxpayers to apportion input deductions based on the use of the input rather than turnover. In essence this means that the apportionment method is based on how the input is used in the business as opposed to the ratio of taxable outputs to total outputs produced by the business. Zacharopoulos (2001) explains that, in relation to EU member states, input apportionment methods based on use include direct apportionment, where inputs used wholly for taxable supplies are deductible and inputs used wholly for exempt supplies are not deductible, and indirect input attribution methods where the inputs that cannot be allocated to one type of supply are apportioned based on a measure indicating their use. In most instances the indirect input attribution method will follow the cost allocation method used by the business in their internal accounting systems.

A survey performed by International Bureau of Fiscal Documentation (IBFD, 2006) at the request of the European Commission found that of the 27 Member States surveyed<sup>5</sup>, 19 Member States favour the turnover method, 6 Member States favour input allocation methods based on actual use and 2 Member States were indifferent as to which method could be used. Of the 19 Member States that favour the turnover method, 14 Member States allow input based apportionment methods to be used as an alternative to the turnover method. Therefore, it appears that while the turnover method as laid out in Article 174 is the most popular method for input VAT apportionment amongst EU member states, many member states have taken the liberty granted to them in Article 173(2)(c) and reinforced by EU case law, to recognise that turnover based apportionment cannot be universally applied to all types of business and in many cases other input allocation methods may be more appropriate.

While the differing approaches taken by Member States may appear to provide the taxpayer some flexibility in applying the most appropriate apportionment method, it has been criticised by Kerrigan (2010) as the *“EU tax administrations seem to have opted collectively for a degree of slackness in using different approaches for allocating inputs”*. In addition, de la Feria and Walpole (2009) maintain that the methods are complex and can result in high compliance costs and significant discrepancies. They note that the European Commission has acknowledged that:

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<sup>5</sup> This survey was performed before Croatia joined the European Union therefore it was not included.

*“This process generates considerable administrative charges for economic operators and fiscal authorities and is a continuous source of litigation, creating an atmosphere which reduces the level of legal certainty for businesses and increases budgetary insecurity for Member States.”*

One way of assisting in alleviating the compliance burden is to allow taxpayers to allocate inputs related to mixed supplies in the same proportion as costs are allocated within the business for internal accounting purposes. An example is the treatment imposed in the United Kingdom. Even though this Member State favours the turnover allocation method, where it is considered fair and reasonable it will allow allocation based on economic use as per Article 173(2)(c) of the VAT directive. According to the Partial Exemption Guidance issued by HM Revenue & Customs, the United Kingdom revenue authority, in August 2014:

*“[t]he method the business uses to allocate its costs for the purpose of operating and managing its business would normally be the most suitable when outputs is not considered appropriate. The purpose of a partial exemption allocation is to fairly share the residual input tax bearing costs between sectors in proportion to their economic use; the purpose of a cost accounting system is to fairly share costs between business sectors. We would normally accept that the cost accounting system used by the business gives an accurate use calculation for the costs allocated using it... Even where the input tax on costs cannot be separately identified (often because they are stripped out of the cost allocation system before the costs are allocated), the management cost allocation system may produce a fair and reasonable result.”*

Pichhadze (2013) points out that in practice, most businesses in the United Kingdom that make mixed supplies are given permission to use an alternative input allocation method as opposed to using the turnover method. Zacharopoulos (2001) has found that many other Member States such as Sweden, Ireland and Germany also allow input apportionment based on the business’s internal accounting function.

With regard to the application of the *de minimis* rule within Member States, the IBFD survey (2006) mentions 7 Member States that have implemented a form of the *de minimis* threshold. As is the case with apportionment methods, there are great discrepancies amongst these countries as to how the *de minimis* rule is applied. Latvia and Lithuania apply the same *de minimis* rule as South Africa, that is 95% based on the turnover ratio. Poland’s rule is on the same principle but the threshold is set at a lofty 98%. Luxembourg bases its *de minimis* rule on the turnover ratio and the significance level is set at 90% however there is a proviso that the fiscal advantage of the taxpayer cannot exceed €250 per year. Malta’s *de minimis* rule is not percentage based. Sweden and Cyprus base their *de minimis*

rules on the ratio of deductible inputs to total inputs. The *de minimus* rule in place in the United Kingdom was not mentioned in the IBFD (2006) report however, according to the Partial Exemption Guidance (HM Revenue and Customs, 2014), the threshold is based on the input tax ratio and requires that the application of the rule is only made after the appropriate apportionment method is determined and the input apportionment calculated. If at this point the exempt inputs are not greater than 50% of total inputs and are less than £625 per month, the exempt inputs are deemed insignificant and may be deducted.

Remembering the difficulties credit retailers are experiencing with the *de minimus* rule in South Africa, basing the rule on inputs rather than outputs would go some way to address these problems. However, it is likely that if this change results in substantially greater input VAT deductions, the revenue loss to the fiscus will be too great making it unattractive for SARS.

#### **4.2.4 Option to tax financial services**

One of the ways in which the EU has tried to deal with the complexity and inefficiency that apportionment creates is to address the root cause of the problem, exemptions. In addition to the difficulties experienced due to apportionment, de la Feria and Walpole (2009) argue that exempting certain supplies goes against the fundamental principle of VAT, namely that it is intended to be a tax on the final consumer. To address this, Article 137(1)(a) read with Article 135(1)(b) to (g) of the VAT directive allows Member States the option to tax financial services that would otherwise have been exempt.

Gendron (2007) argues that the option to tax is only used by a handful of Member States and is not yet fully developed. This is echoed in the conclusions reached by the report prepared by Ernst & Young for the European Banking Federation (2009) regarding the Option to Tax system in the EU where it was found that in the six countries that allow the option to tax – Austria, Belgium, Estonia, France, Germany and Lithuania – the models used by these countries are inconsistent.

For the purposes of determining whether the option to tax has application to credit retailers in South Africa, the system used in Austria is the most relevant. The systems in Germany, France, Belgium and Lithuania either only allow the option to tax where the customer is a taxable entity or interest is not an exempt financial service for which the option to tax is available (Ernst & Young, 2009). Therefore the policies in these countries do not have application to credit retailers. In Estonia, once the option to tax is selected, the decision is irrevocable and applies to all transactions of the same nature. This has made it unpopular and not widely used.

The option to tax was specifically introduced in Austria to alleviate the adverse consequences of input VAT apportionment in credit retailers and credit card suppliers. As described in the Ernst & Young

report (2009), Article 6(2) of the Austrian VAT Act limits the option to tax to only two types of financial service:

1. The granting of credit in order to enable a customer to pay the purchase price of a taxable supply; or
2. The supply of liabilities and debts specifically in relation to credit card transactions.

As a result, it is widely chosen by retailers who use the option when selling goods on credit in order to ensure the full deduction of their inputs. The option may be applied on a transaction-by-transaction basis and no registration is necessary. If a supplier decides to exercise their option, the only requirement is that a tax invoice must be generated.

The Austrian model of option to tax could therefore be a possible solution to the current difficulties experienced by credit retailers in South Africa with regard to input VAT apportionment. However, as Kerrigan (2010) argues, the additional revenue earned from taxing interest may not outweigh the revenue lost from the non-recovered input as a result of apportionment. In addition, as the credit retail customers are generally individuals who are not VAT registered, the option to tax will increase the interest cost considerably.

#### **4.3 Analysis of the traditional VAT system in Mexico**

Similar to Austria's option to tax rules, Mexico adapted its traditional VAT model to address the difficulties experienced with exempt financial services by introducing a policy in 1992 of only exempting interest earned on corporate and housing loans, thereby deeming all other forms of interest income a taxable supply for VAT purposes. Therefore interest earned by credit retailers on the granting of consumer loans, including credit cards and retail credit, was brought into the VAT net.

Schatan (2003), in his in-depth analysis of the Mexican VAT treatment for financial services, notes that the inclusion of certain interest within the scope of taxable transactions did not simplify input apportionment problems. As a result, the law was changed a number of times to try and address this problem, often as a result of taxpayer disputes landing up in court. Initially, the apportionment method allowed was a two-stage approach, i.e. input VAT directly attributable to either taxable or exempt transactions were to be identified and deducted or not deducted accordingly. The residual amount was then apportioned according to the turnover method. However this approach was greatly abused by taxpayers making mixed supplies, especially the banks where taxable income (fees and interest on consumer credit) only made up 5 to 15% of total income. These banks would apply creative strategies in order to ensure most of their input VAT incurred was directly attributed to taxable transactions resulting in these taxpayers attempting to deduct close to 90% of their inputs.

As a result of the erosion in the tax base that this caused, Schatan (2003) found that the amendments to the VAT laws in Mexico were introduced in 1999 to remove the direct apportionment method altogether. Taxpayers earning interest did not receive this news favourably and many of these parties took *Hacienda*, the Mexican Ministry of Finance, to court. The courts ultimately ruled in the taxpayers favour reasoning that if taxpayers making exclusively taxable supplies are allowed to deduct the related inputs, it is not fair to disallow taxpayers making mixed supplies from the same procedure. As it was the banks specifically that had taken the most liberties with the direct allocation mechanism, the *Hacienda* and the banks finally came to an agreement on a list of expenses that would be considered directly attributable and the rest had to be apportioned on the turnover basis.

Schatan (2003) therefore concludes of the Mexican experience with taxing certain interest income, that while this policy creates difficulties with regard to the deduction of input tax that must be carefully controlled especially with regard to direct allocation and how the turnover formula is calculated, the domestic banks in Mexico are put in a more favourable position compared to other systems where financial services are generally exempt.

While the experiences of credit retailers were not covered by Schatan (2003), it can be speculated that they would also find themselves in a more favourable position with regard to the deduction of input tax if interest on consumer credit is taxable. However charging VAT on interest on overdue accounts will increase the cost of the interest to the consumer dramatically. In addition, it would need to be assessed whether there would be any erosion of the VAT revenue as a result of taxing interest.

#### **4.4 Conclusion**

Within the European Union, there appears to be a substantial preference for the turnover method of apportionment. The formula used to determine apportionment does have slight differences to the South African method and the components of the formula have been interpreted by the European Courts over a number of years. Due to this, there appears to be more subtlety and nuance in the application of the turnover ratio, with specific reference to the denominator. However, in substance the treatment is the same as that of South Africa.

Despite the turnover method being the standard apportionment mechanism in the majority of EU Member States, a large proportion have opted to allow other input based methods that more accurately reflect the use of the input. In particular, methods based on the business's internal accounting function are favoured by a number of member states. This is echoed in the case law emanating from the European Court of Justice that favours apportionment methods that are aligned with the neutrality principle of VAT and foster greater accuracy.

While there is much discrepancy in the application of *de minimus* rules across member states, rules based on the ratio of inputs rather than outputs could be useful in addressing the difficulties currently experienced with the output based *de minimus* rule in South Africa. However the resulting revenue loss may be too great for this to become a viable alternative to the current method.

Finally the traditional VAT model has evolved in countries such as Austria and Mexico to provide the option to tax or require interest on the provision of trade credit to be a taxable supply. Despite the lack of popularity of this treatment amongst traditional VAT users, taxing certain interest would alleviate the administrative burden and cost to credit retailers of VAT apportionment. However this advantage may be outweighed by the adverse effects on the customers' desire to purchase on credit due to the increased interest charges.

As the South African VAT system was largely based on the New Zealand model, it is considered a modern VAT system. Therefore, the mechanisms used in other modern VAT systems internationally may provide better insight into the most appropriate treatment for credit retailers in South Africa.

## CHAPTER 5 : INTERNATIONAL VAT MACHANISMS USED IN MODERN VAT SYSTEMS

### 5.1 Introduction

The modern VAT system, which largely originated out of New Zealand, was born out of the difficulties and inefficiencies that were experienced in Europe and other countries that have adopted a traditional VAT system. Krever (2008) states that the law introduced in New Zealand in 1986 utilised the format and administrative structure of the traditional VAT system as its base, however the substance of the law was adapted to rid it of the complexity and shortcomings of the traditional system. These changes included only using a single VAT rate, keeping exemptions to a minimum, writing clear definitions and less complicated rules.

New Zealand's modern VAT model was viewed as economically superior by international tax experts and is arguably one of the most efficient VAT systems in the world (Krever, 2008). Dickson and White (2008) describe the favourable comparisons made between the New Zealand model and traditional VAT systems as *"a case of same wine, different bottle"*. As a result, many countries opted to use the New Zealand example when designing their own VAT systems. While the systems implemented were more efficient than the traditional VAT model, most countries were not able keep their systems quite as pure due to prevailing political circumstances. It is noted by Muir (1993) that South Africa adopted New Zealand's laws with minimal changes and Canada wrote their own legislation after comprehensively reviewing the New Zealand model.

It is therefore logical that this chapter starts with an analysis of the treatment of input VAT apportionment and exempt financial services relevant to credit retailers in New Zealand. From there, countries which have followed the modern VAT system, namely Singapore, Australia, and Canada, will be analysed to determine whether any policies relating to input apportionment and the treatment of financial services in these countries may inform the discussion of input VAT apportionment for the credit retailer.

Even though Japan, like New Zealand, is also considered to have originated the modern VAT system, its VAT system is distinguished from the New Zealand model by applying what is referred to as the subtraction-method. Grinberg (2009) explains this method as follows:

*"a subtraction-method VAT does not use credits and ... tax due is not calculated by subtracting tax paid from gross tax liability. Instead, registered traders subtract the value of their total non-labour inputs from the total value of their sales and then multiply by the VAT rate to determine their tax liability"*

As this method is fundamentally different to that of the South African VAT system, policies relating to credit retailers in the Japanese VAT environment do not have application to South Africa. Therefore the analysis of the VAT system in Japan is out of the scope of this research paper and will not be discussed further.

## **5.2 New Zealand**

Considering the origins of the South African VAT legislation, it is no surprise to find that the sections regarding input VAT apportionment in the VAT Act closely echo those found in the New Zealand GST law. Specifically, section 20(3C) of the New Zealand Goods and Services Tax Act No. 141 of 1985 (GST Act) requires taxpayers to apportion inputs based on intended use:

*“(3C) (a) input tax ... may be deducted to the extent to which the goods or services are used for, or are available for use in, making taxable supplies”*

In addition, section 20(3G) of the GST Act requires that the formula used to apportion the inputs based on use must achieve a fair and reasonable result.

The GST Guide IR 375 (2009) released by New Zealand Inland Revenue (NZIR) states that there are three apportionment methods available to taxpayers, namely direct attribution, turnover method or another special method. The taxpayer must determine which method ensures the most fair and reasonable result.

This GST Guide (2009) specifically states that the turnover method is only available when apportioning inputs due to exempt supplies. In addition, a special method can only be used if approved by NZIR. The Tax Information Bulletin released by NZIR in February 2011 states that if a special method is chosen, this can be based on any records that are available, previous experience, business plans or any suitable method and the formula used will largely depend on the nature of the good or service acquired. With regard to the turnover method, the GST Guide does not go into detail regarding what must be included in the denominator of the formula for determining the apportionment ratio. However it does allow interest earned to be netted off interest paid before inclusion in the denominator.

There have been two court cases dealing with the apportionment method in New Zealand. In *Case M106* (1990) 12 NZTC 2,674, the court found that the turnover method of apportionment was the most appropriate method for an insurance broker who made taxable and exempt supplies in the form of selling short term and life insurance policies respectively as it was the actual supplies made that informed the use of inputs for purposes of apportionment, not the intention or nature of the taxpayer.

A second case 2 years later, *Case P62* (1992) 14 NZTC 4,427, found that the turnover method was not the most appropriate method for determining input apportionment as it produced a misleading result. The court found that the apportionment should rather be based on time and effort of the taxpayer required to produce its taxable and exempt supplies. This judgment was overturned in the New Zealand High Court (*CIR v BNZ Investment Advisory Services Ltd* (1994) 16 NZTC 11,111) where the learned judge found that the turnover method was the most appropriate by applying the principle purpose test. However, as the principle purpose test was removed from the GST Act in 2011, it is questionable whether this judgment still has application.

The mechanism for dealing with inputs incurred on the purchase of capital assets used for mixed supplies has not always been to apportion the input initially according to use. Before, April 2011, the GST Act required that the principle purpose of the asset was determined at acquisition and the input treated accordingly. This way, if the principle purpose was determined to be a taxable purpose, the full input VAT was claimed as a deduction. Conversely, if the principle purpose at acquisition was an exempt or non-taxable purpose, then none of the input VAT deduction could be claimed. Elaborate change of use rules then came into play at the end of each reporting period. Due to a number of difficulties experienced with this treatment of inputs on mixed supply assets, the Taxation (GST and Remedial Matters) Act 2010 replaced this with the apportionment approach discussed above.

The Tax Information Bulletin (NZIR, 2011) states that the apportionment rules were introduced to reduce compliance costs of the business and be simpler to apply. However Pallot and Fenwick (2000) find that this is not necessarily the case and that in fact, there is not a considerable difference between the methods in terms of complexity. While the treatment of input VAT for change of use is beyond the scope of this research paper, it is interesting to note that these changes to the New Zealand law show a movement toward reinforcing the turnover apportionment method rather than shying away from it.

With regard to *de minimus*, once again the New Zealand rules are largely similar to that of South Africa. The *de minimus* rule laid out in section 20(3D) allows the taxpayer the full input deduction if exempt supplies make up less than 5% of the total of taxable and exempt supplies and if exempt supplies are less than NZ\$90,000. As the *de minimus* rule is based on outputs not inputs, credit retailers would suffer the same difficulties as their counterparts in South Africa in applying the *de minimus* rule. However, the monetary threshold placed on the *de minimus* rule could have the effect of being less advantageous than the South African rule in larger business where their exempt supplies may be less than 5% but greater than the capped amount.

With regard to the exemption of financial services, New Zealand has attempted to address the inherent problems this creates by allowing financial service providers to elect to zero-rate financial supplies. As per section 11A(1)(q) and (r) read with section 20F of the GST Act, zero-rating can only be elected if the customer to which the financial services are supplied is a GST registered taxpayer and the customer's taxable supplies make up 75% or more of their total supplies. If the election is made, the need to apportion inputs is eliminated.

This treatment of financial supplies in New Zealand does not have application to the credit retailer, as their customers would not meet the zero-rating requirements of the GST Act. Zee (2006) proposes a modification by removing this restriction therefore allowing all financial supplies to be zero-rated, regardless of the status of the customer. However this has the limitation of under-taxing the final consumer resulting in VAT revenue loss to the fiscus. Zero-rating would before be an unattractive solution for the South African government.

### **5.3 Singapore**

The input apportionment mechanism set out in Singapore's Goods and Services Tax (GST) law centres on the *de minimus* rule. It is the starting point in the decision making process for whether and how inputs must be apportioned.

The *de minimus* rule in Singapore is a carbon copy of the New Zealand rule, save for the quantity of the monetary threshold, which is set at 40,000 Singapore dollars per month. This rule is detailed in Regulation 28 of the GST (General) Regulations read with section 20(3) of the Goods and Services Tax Act No 31 of 1993.

However, where Singapore differs from New Zealand is that it has passed Regulation 33, which deems certain exempt financial services to be treated as taxable supplies for the purpose of deducting input tax and does not require these services to be supplied to a GST registered entity. The GST: Partial Exemption and Input Tax Recovery e-Tax Guide released by the Inland Revenue Authority of Singapore (IRAS) in December 2013 explains that the exempt financial services listed in Regulation 33 are effectively zero-rated as they are considered to be "*necessary and integral to the making of taxable supplies*". The full list of financial services is itemised in the guide however of interest to this research paper is:

*"(j) The receipt of interest in respect of the provision of credit for any trade receivable"*

This sentiment, that interest from the provision of credit on trade receivables is considered a necessary and integral part of the making of taxable supplies, corresponds with the opinions

expressed by the credit retailers in South Africa, i.e. that the sale of merchandise is facilitated by the provision of credit.

As the receipt of interest is therefore treated as a zero-rated supply, a credit retailer making taxable supplies through the sale of merchandise and earning interest on overdue debtor accounts will not be required to apportion their input tax as all income received is considered to be taxable supplies. This would then alleviate the burden on the credit retailer to apportion its input tax.

However, according to the GST: Partial Exemption and Input Tax Recovery e-Tax Guide (IRAS, 2013), a taxpayer will not be allowed to treat the Regulation 33 exemptions as zero-rated supplies if:

- the taxpayer is a Regulation 34 business or
- the taxpayer makes exempt supplies not listed under Regulation 33 and the value of these exempt supplies do not satisfy the test set out in Regulation 35

A Regulation 34 business is a financial services institution that makes predominately exempt supplies such as a bank, life insurance broker, finance company, moneylender, credit card company or unit trust. A full list is detailed in Regulation 34, however a credit retailer does not appear to fall within any of the entity types listed. While a credit retailer does provide consumer credit facilities it is unlikely that it would be considered a credit card provider as the predominate supply of the credit retailer would be sale of merchandise which is a taxable supply.

The Regulation 35 test is essentially another *de minimus* rule. The test is satisfied if the taxpayer makes Regulation 33 exempt supplies and non-Regulation 33 exempt supplies, and if the latter exempt supplies are not greater than 5% of the total value of all taxable and exempt supplies (including both Regulation 33 and non-Regulation 33 exempt supplies). This would apply to credit retailers if they had earned any other exempt income such as dividends or interest on investments. If these non-Regulation 33 exempt supplies were more than 5% of total income then the credit retailer would not be entitled to zero-rate the interest earned on credit offered to customers.

If a taxpayer fails the *de minimus* rule in Regulation 28 and the taxpayer makes exempt supplies other than those listed under Regulation 33, the taxpayer must apportion its input tax. The GST: Partial Exemption and Input Tax Recovery e-Tax Guide (IRAS, 2013) states that the taxpayer must first apply direct attribution. Where inputs cannot be directly attributed to either taxable supplies, Regulation 33 exempt supplies or non-Regulation 33 exempt supplies, the input must be apportioned according to the turnover method. Section 20(4) allows the IRAS to determine a method of attribution of input tax that is fair and reasonable, however it does not state that an alternative method to the one prescribed by the IRAS may be applied. The GST: Partial Exemption and Input Tax Recovery e-Tax

Guide (IRAS, 2013) makes no mention of the taxpayer being allowed to apply to use an alternative method. Therefore it appears that where inputs are used to make mixed supplies, only the turnover method can be applied.

This input apportionment treatment is almost identical to that used in South Africa, save for the presumption that South Africa may be slightly more flexible as there is the opportunity to apply to use an alternative method to the turnover method, however remote the granting of this request may be.

In contrast to South Africa, the Singapore legislation sets clear guidelines for the taxpayer as to what is considered directly attributable and what are residual inputs that should be apportioned. The GST: Guide on Attribution of Input Tax e-Tax Guide issued by the IRAS in May 2014 states that an input will be directly attributable if the purchase on which the input arises is either a “*cost component*” of a supply or it is “*used as an input or will be used as an input to make a supply*”. The guide explains that the latter part of the definition means that the good or service must have been actually used to make the supply and not merely linked to the supply. This may provide some assistance to credit retailers in determining directly attributable inputs as it would be very difficult to argue that expenses such as the purchase of merchandise is not a cost component or not used as an input to make a taxable supply.

#### **5.4 Australia**

Before delving into the detail of Australia’s policies with regard to input apportionment and financial supplies, it is important to note that while the basic concepts in Australia’s A New Tax System (Goods and Services Tax) Act 1999 are similar to that of Singapore, New Zealand and South Africa, the terminology used to describe these concepts is different. Where an entity makes supplies against which input tax can be deducted, these supplies are called “*creditable supplies*”, not taxable supplies. Exempt supplies in Australia are referred to as “*input taxed supplies*”, as inputs related to exempt supplies cannot be deducted therefore the inputs are effectively taxed. The *de minimus* rule for determining whether input taxed financial supplies can be considered creditable supplies (i.e. zero-rated), is called the “*financial acquisitions threshold*”. Finally, “*financial acquisitions*” is the term used for goods and services acquired that relate to the making of input taxed financial supplies.

Similar to Singapore, Australia allows the zero-rating of input taxed financial supplies if the financial acquisition thresholds are not exceeded. However unlike Singapore, these thresholds are not determined according to the level of output, but rather the level of inputs, which relate to the making of input taxed financial supplies.

According to Binding Ruling GSTR 2003/9 first released by the Australian Tax Office (ATO) in May 2003 and updated in December 2013 (ATO, 2013a), the financial acquisitions threshold requires the taxpayer to compare both current and future financial acquisitions to this threshold to determine whether the threshold is exceeded. This means that even if financial acquisitions for the previous 12 months do not exceed the threshold, if anticipated financial acquisitions for the current month and next 11 months exceed the threshold, the threshold will be exceeded. The financial acquisition threshold is exceeded if either:

- financial acquisitions exceed 150,000 Australian Dollars; or
- input tax related to financial acquisitions is greater than 10% of total input tax.

Where a taxpayer falls below this threshold, they are entitled to deduct the full input tax incurred on financial acquisitions. As this threshold is determined based on inputs rather than outputs, the taxpayer will first have to determine which inputs relate to financial acquisitions. Given the definition above, Binding Ruling GSTR 2003/9 (ATO, 2013a) goes into some detail as to how to determine if an acquisition “relates to” a financial supply. This ruling states that:

*“relates to ... requires a nexus, link or connection between an acquisition and the making of a financial supply”*

The ruling goes on to explain that this relationship can either be direct, in which case the full input relates to a financial supply, or indirect, in which case the input must be apportioned. Therefore, before a taxpayer can determine whether they fall below the threshold and may treat their financial supplies as zero-rated, they must first allocate their input tax credits between their creditable supplies and input tax financial supplies.

Binding Ruling GSTR 2006/4 first released on 12 April 2006 by the ATO and updated in December 2013 (ATO, 2013b) deals with input tax apportionment where the taxpayer falls below the financial acquisition threshold. This ruling states that for each acquisition of a good or services, the taxpayer must determine the extent to which it is used for a creditable or input taxed purpose. If it is not used wholly for making either a creditable or input taxed purpose it must be apportioned. Ruling GSTR 2006/4 (ATO, 2013b) allows the taxpayer to use any method of apportionment provided that it:

- is fair and reasonable;
- reflects the planned use of the good or service; and
- is appropriately documented.

The ruling makes it very clear that, so long as the method meets the above criteria, the taxpayer is not required to use the methods suggested in the ruling. However the suggested methods are provided to give the taxpayer guidance as to which apportionment methods are available. These methods include:

1. Direct methods based on factors that indicate a “direct link” between the good or service acquired and its planned use. Examples suggested are methods based on distance, time, volume, space or staff numbers.
2. Indirect methods, either input or output based:
  - a. Input based are those that use the ratio of directly allocated acquisitions relating to creditable supplies to total directly allocated acquisitions
  - b. Output based includes the turnover apportionment method or apportionment based on gross or net profit.

If indirect methods are used, these should be adjusted for distorting factors such as once off expenditure and capital items. It is noted in the ruling that the ATO prefers direct methods as they generally result in greater accuracy however the taxpayer must consider the nature and value of the acquisition to assess the feasibility of the apportionment method chosen.

If the financial acquisitions threshold is exceeded, the taxpayer is considered a financial services provider. It is acknowledged by the ATO that these types of taxpayers may have difficulty using direct or indirect methods of apportionment as described in Binding Ruling GSTR 2006/4 (ATO, 2013b) and has therefore released Binding Ruling GSTR 2006/3 (ATO, 2013c) which allows these taxpayers to use direct and indirect estimation methods for apportionment of mixed purpose acquisitions:

1. Direct estimation methods are allocations based on the internal cost allocation systems of the taxpayer. Examples include allocation based on specific transactions, product lines, functions, activities, cost or profit centres, or business units of the taxpayer.
2. Indirect estimation methods are based on output or input formulas such as entity wide turnover ratio, business division or unit turnover ratio, or non-turnover ratios such as number of transactions, floor space, profit or hours. These ratios should be adjusted for any distorting factors.

In addition to these extensive apportionment rules for financial service providers, Australia has attempted to address the difficulties resulting from input taxed supplies by allowing taxpayers that exceed the financial acquisitions threshold to deduct a reduced input tax credit of either 55% or 75% of the input tax incurred on certain financial supplies listed in Regulation 70-5.02(2) of the GST Regulations. Carter (2013) notes that, while this does not completely remove problems associated with exempt supplies such as cascading, it is an interesting development.

However, as far as credit retailers are concerned, interest on trade debtors is not one of the financial supplies listed in Regulation 70-5.02(2) for which partial input credits are allowed. Therefore, a partial input credit would not be granted to credit retailers for inputs related to their interest earned on overdue accounts.

As the Australian version of the *de minimus* rule is quite generous – 10% of inputs as opposed to 5% of outputs – it is possible that some credit retailers may fall below this threshold resulting in them being able to claim their total input tax by effectively zero-rating their financial supplies. If the credit retailer's financial supplies exceed the financial acquisition threshold, they will need to apportion their input tax credits however the apportionment methods available to the taxpayer are broad and, by being able to use existing business systems such as cost or management accounting functions within the business, the compliance and administrative burden of the credit retailer would be greatly reduced and the apportionment ratio would more accurately reflect the use of the expenses incurred.

## **5.5 Canada**

Canada is one of a handful of countries that use a state and a federal VAT system (Bird, Mintz and Wilson, 2006). The federal VAT system is called Goods and Services Tax (GST) and five states have harmonised their provincial VAT systems to create a harmonised system called Harmonised Sales Tax. Together these two systems are known as GST/HST.

The Excise Tax Act 1998, which governs GST/HST, includes financial services under the list of goods and services exempt from GST/HST in Schedule V to Part IX of this Act. As a result of these exemptions, the Excise Tax Act requires the apportionment of input tax credits were a registrant makes both taxable and exempt supplies, however, this Act does not specifically prescribe a method to be used for the input credit apportionment. The GST/HST policy statement P-063 (CRA, 1993) clearly states that input allocation mechanisms are the preferred method for allocation and only where none of these input methods may apply should a registrant consider using an output based method to allocate input tax credits. This policy statement considers input methods to be either direct allocation of inputs to taxable or exempt supplies, or the use of an input based formula to allocate the residual inputs that cannot be directly allocated. Examples given of input formulas are allocations based on:

- Square footage
- Time
- Some other directly measurable factor

Only in the limited circumstances where one of the above methods cannot be used does the policy statement (CRA, 1993) then require the use of an output allocation method based on revenue. However, it is only acceptable to the Canada Revenue Agency (CRA) if it *“reasonably reflects the use or intended use of the property or service”* and *“is fair and reasonable in the circumstances”*. GST/HST memorandum 8.3 (CRA, 2014a) expands on the policy set out in P-063 (CRA, 1993), providing clear definitions of what is considered *“fair”* and *“reasonable”*. Fair is defined as *“equitable, impartial, objective, unbiased and consistent with the applicable rules”* in reflecting the purpose for which the input was acquired. Reasonable is defined as *“logical, rational, sensible, based on reason and within the bounds of common sense”* and therefore should demonstrate a logical link to the purpose for which the input was acquired. It is therefore on these criteria that a taxpayer is entitled to select the method with which to allocate its inputs.

The only other condition stipulated in the Excise Tax Act at section 141.01(5) is that the method selected by the taxpayer must be *“used consistently by the person throughout the year”*.

The formula provided in the policy statement (CRA, 1993) for the output method is taxable revenue divided by total revenue. However, the ratio must follow the principle of reflecting the use or intended use and for this purpose the basic formula must be adjusted for any factors that may make this revenue ratio inappropriate. The policy statement lists the factors that would require the formula to be adjusted namely:

1. *“where different profit margins exist for different products, adjustments should be made to minimize the distorting effect of these differences;”*
2. *“any revenue that reflects inputs used in a prior period should be backed out of the formula, e.g. recovery of a bad debt from a prior period;”*
3. *“any amount received or receivable for the supply of capital goods should be excluded from the formula;”*
4. *“the value of the sale of the business as a going concern should be excluded from the formula.”*

Finally the policy statement states that the taxpayer does not have to use one allocation method only and are encouraged to use an output method in conjunction with an input method where this will achieve the most fair and reasonable result. Whichever methods are chosen are at the option of the taxpayer and, while they must retain comprehensive documents to support their choice, they do not have to apply to the CRA prior to implementing their chosen methods.

The methods described above is the general policy for all GST/HST registrants however, financial institutions are treated separately for Canadian GST/HST purposes and have their own set of

requirements when determining how input credits should be apportioned. The requirements are set out in section 140 of the Excise Tax Act and the CRA has released a number of technical information bulletins explaining these requirements.

GST/HST Technical Information Bulletin B-097 (CRA, 2011a) discusses the definition of a financial institution and the requirements for determining whether the financial institution is a qualifying financial institution. Qualifying and non-qualifying financial institutions are dealt with differently for the purposes of input credit deductions. Qualifying financial institutions are only banks, insurers or security dealers and are required to apportion input credits according to a fixed rate set by the revenue authority. The qualifying financial institutions input credit allocation requirements are therefore not relevant to the discussion of credit retailers as, while some retailers may sell insurance and similar financial services products, it is not their principle business and therefore they fall out of this definition.

However, the definition of financial institution is broad. Financial institutions are defined in section 149 of the Excise Tax Act and include listed financial institutions and *de minimus* financial institutions. Listed financial institutions are those institutions that are considered “traditional providers of financial services” such as banks, investment brokers, credit unions and insurers. *De minimus* financial institutions are those entities that earn investment or financial services income over one of two thresholds namely:

1. where “*financial revenue*” in the previous tax year exceeds 10% of total revenue and this “*financial revenue*” was greater than 10 million Canadian dollars. “*Financial revenue*” includes interest, dividends and financial services fees; or
2. where interest or separate fees/charges generated from issuing credit cards or granting loans, advances or credit exceeds 1 million Canadian dollars.

Based on the criteria above, it is likely that interest income received by large credit retailers in Canada could exceed the second threshold and therefore they could be considered *de minimus* financial institutions for the purposes of the Excise Tax Act. In fact, the GST/HST Technical Information Bulletin B-097 (CRA, 2011a) uses an example of a credit retailer to illustrate the type of entity that would be defined as a *de minimus* financial institution when applying the second threshold test.

The apportionment rules for financial institutions are far stricter and more complicated than the standard allocation requirements described above. GST/HST Technical Information Bulletin B-106 (CRA, 2011b) sets out in detail how financial institutions should go about allocating their input credits in terms of section 141 of the Excise Tax Act. In essence, each input incurred first must be analysed to determine whether it is exclusively used for a purpose of making a certain type of supply (exclusive

input), whether it can be directly allocated between taxable and exempt supplies (direct input) or whether it cannot be attributed to any particular supply (non-attributable input). Once the type of input has been determined, the method of allocation must be selected that most accurately reflects its use. As explained in Bulletin B-106 (CRA, 2011b):

*“The concept underlying ITC [input tax credit] allocation methods is that a method or methods used must link a particular property or service on which tax was paid or payable to its use for the purpose of making taxable supplies for consideration and for purposes other than making taxable supplies for consideration.”*

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

1. Tracking – Considered the most accurate method of allocation as the actual use of the input incurred is tracked and allocated between taxable and exempt supplies on this basis.
2. Causal allocation – The second most accurate method of allocation, used where the input tax credit has a direct or causal relationship with another factor of the business i.e., there is a direct correlation between the expenditure on which GST/HST is paid and a particular factor.
3. Input-based allocation – Less accurate than the first two methods and generally used for non-attributable inputs that cannot be allocated based on tracking or causal allocation. Input-based allocation uses the ratio of direct and exclusive inputs allocated to taxable supplies and allocates non-attributable inputs in the same proportion. This method would only be acceptable if substantially all of the financial institution’s inputs were either exclusive or direct inputs and the ratio used to allocate these inputs would approximate the use of the non-attributable inputs.
4. Output-based allocation – Considered the least accurate method, it uses a measure such as revenue to allocate input tax credits. It is clearly communicated in the bulletin that this method should only be used when the output measure gives a reasonable approximation of the use of the input. This measure must also be adjusted for any distorting factors than may result in a misrepresentation of the ratio.

Finally, Bulletin B-106 (CRA, 2011b) states that the methods chosen by the registrant to allocate input tax credits must meet the criteria, rules, terms and conditions in order for these methods to be acceptable to the CRA. While the methods do require pre-approval, adequate documentary evidence must be maintained to demonstrate that these criteria have been met. The criteria, rules, terms and conditions to which the allocation methods must conform are:

*“The method must employ an objective measure of use which is meaningful, unbiased and verifiable. The method must be applied in a manner that accurately reflects the use of the input, including providing comparable results, and using cost pools only if they are appropriate cost pools.”*

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

What is most interesting about the Canadian method is that they welcome complexity as great importance is placed on the accuracy of the allocation method. Not only does each and every expense need to be analysed into its individual type, be it exclusive, direct or non-attributable, Bulletin B-106 (CRA, 2011b) goes so far as to state that where a particular input cost may only be able to be tracked or causally allocated to a certain extent (for example only 80% of an expense can be allocated using tracking or causal allocation), the remaining unallocated portion of the cost (in our example 20%) must be treated as non-attributable and allocated on an appropriate input- or output-based method.

The level of detail required to prepare GST/HST returns for entities such as credit retailers must be extraordinarily time consuming however the result must be satisfactory to all parties as the input tax credits are so accurately allocated. Due to the level of complexity, Bulletin B-106 (CRA, 2011b) makes special mention that where the financial institution uses a cost or management accounting system that allocates its expenses according to their use within the organisation, this system may be used for the allocation of the associated input tax credits incurred on these expenses. Therefore, an effective management accounting system that also meets the above stated criteria, rules, terms and conditions would assist in reducing intricacy of the work required to complete the GST/HST returns while ensuring the input tax credits are equitably allocated.

Canada provides a GST/HST tax credit to low income individuals and families in order to assist with the burden of GST/HST. According to the tax guide RC4210(E) Rev. 14 (CRA, 2014b) published on the CRA's website, this tax credit is paid quarterly and based on the family net income as declared in the individual's income tax return from the previous year. As Bird and Gendron (2005) point out, this credit can be utilised to assist lower income families that may be over taxed by GST/HST while having the added benefit of incentivising individuals to submit their income tax returns resulting in improved tax compliance.

## **5.6 Conclusion**

The South African treatment for input VAT apportionment has closely followed that of New Zealand and Singapore. Small differences in the *de minimus* rules are not significant and it can therefore be

concluded then that South African laws are in line with these international treatments. However this does not imply that these apportionment methods are the best mechanisms for credit retailers, as they do not address the difficulties experienced in South Africa.

Canada and Australia have developed far more comprehensive laws and guidelines for the determination of the apportionment mechanism. These countries allow their taxpayers to choose the most accurate, fair and reasonable apportionment method from a wide array of possible options. They do not limit the taxpayer to only one method and in fact insist that each input is analysed to determine the most appropriate apportionment mechanism. While the rules are highly complicated, both countries have assisted in addressing the administrative burden for taxpayers by allowing apportionment mechanisms based on the taxpayer's internal accounting system or cost allocation method.

New Zealand, Singapore and Australia have attempted to address the challenges with apportionment and inefficiencies created by exempt financial services, while at the same time attempting to limit revenue loss, through policies such as the *de minimus* rules, zero rating and partial input credit deductions. The New Zealand policy does not assist credit retailers as zero-rating is only allowed between GST registered businesses. The Australian *de minimus* rules are more liberal as they are based on a higher percentage and are determined according to inputs not outputs. Therefore if credit retailers fall below this limit, they are able to zero-rate their financial supplies. This is similar to the treatment in Singapore however the *de minimus* rule is more restrictive and the types of financial services that are allowed to be zero-rated are limited. Credit retailers are able to take advantage of this policy in Singapore as interest on retail credit is considered a necessary part of the business and therefore is a financial supply that can be zero-rated. Partial input credits are available to financial service providers in Australia however credit retailers are not able to utilise this mechanism as the type of financial supplies they create are not eligible for this deduction.

Due to the varied nature and broad discrepancies of the policies applied internationally, it is possible that the solution to the problems experienced by credit retailers in South African may lie in a hybrid approach of more than one mechanism used internationally. The next chapter will look at the recommendations for South Africa based on the knowledge gained of alternative treatments worldwide.

## **CHAPTER 6 : CONCLUSIONS AND RECOMMENDATIONS FOR SOUTH AFRICA BASED ON INTERNATIONAL EXPERIENCES**

### **6.1 Introduction**

This final chapter reflects on the South African and international experiences of input VAT apportionment due to the earning of exempt financial services income (interest) by credit retailers. It endeavours to understand the complexities and to analyse solutions proposed in previous research. Based on this, recommendations for the South African VAT system are proposed and areas for further research identified.

### **6.2 Difficulties experienced with current apportionment mechanisms in South Africa**

When the issue of VAT apportionment for credit retailers in South Africa is discussed it is important to remember that there are two opposing forces at play. On the one hand is the credit retailer, who has built a business of generating taxable supplies by selling merchandise to the general customer in South Africa. Due to the political and economic circumstances in South Africa, these credit retailers have determined that the best way to do business and thereby boost the South African economy is to offer credit to facilitate their merchandise sales. However, as their businesses grew and the ratio of credit sales increased, they ran into serious difficulties in the treatment of their input VAT credits.

The standard turnover method of apportioning input VAT credits and the *de minimis* rules that set the thresholds for requiring the credit retailer to apportion do not appear to be correctly geared toward the operating environment of the credit retailers. They perceive the turnover ratio to be a poor representation of the use of their inputs in generating taxable sales of merchandise and exempt interest income. The *de minimis* ratio used to assess the requirement for apportionment is based on the business's overall turnover ratio and not on an input level or even a business division or unit level. They are also experiencing difficulties as to how to allocate direct and residual inputs and are being challenged by SARS as to which inputs are "tainted" and must be apportioned. Therefore, expenses such as merchandise acquired, which are arguably directly used in a taxable supply are at risk of requiring apportionment. Finally, as only one method may be used the accuracy is questionable, as the degree of use of each input will vary depending on its nature.

On the other hand, SARS is tasked with collecting revenue for the South African government. VAT payments account for one quarter of the total revenue collected by SARS and is therefore an important revenue stream that needs to be maintained. It cannot apply tax laws that will greatly erode these earnings and these laws must be in line with the greater policy goals for the South African government. Finally, it must administer the tax system and apply treatments that do not overly burden both taxpayers and itself with high administrative and compliance costs.

Therefore, any recommendation made for the improvement of the current system of input VAT apportionment in South Africa must balance the objectives of these two stakeholders. A solution based on experiences internationally will not be viable if either side is unduly prejudiced.

### **6.3 Recommendations based on international experiences**

Before this research paper proposes its own recommendations, it is useful to consider solutions that have been proposed by other researchers. Most propose a hybrid approach that borrows aspects of the laws in a number of countries in order to counteract the disadvantages of each system.

Firstly, Zacharopoulos in his paper entitled *Value-Added Tax: The Partial Exemption Regime* (2001) recommends an approach to input VAT apportionment that places taxpayer businesses into different classes. A standard apportionment method for each class is then determined based on the nature of the business in each class. While the individual taxpayer may not be able to choose its own method of apportionment, it will at least be able to use a method that is related to its type of business.

This method will allow for greater consistency across the tax base and achieve a similar reduction in the compliance burden that is associated with a single standardised approach. This approach is similar to the industry specific Binding General Rulings that were in place in South Africa before their withdrawal in 2007. However the downside of this proposal is that it requires a one-size-fits-all solution to groups of taxpayers that on the surface may appear similar but in fact are not quite the same. The accuracy of the apportionment method will therefore be compromised where the standard method chosen does not reflect the actual use within a particular business.

Despite this solution proposed, Zacharopoulos (2001) concludes that all apportionment methods, to a lesser or greater degree, erode the basic principle of VAT, as the apportionment methods are as a result of exemptions. He argues that apportionment is burdensome to operate and can lead to undesirable economic effects. This conclusion has paved the way for later researchers to propose solutions that focus on addressing the exemption of financial services.

Bird and Gendron (2005) propose a somewhat radical solution that brings financial services into the taxable net while addressing the increased cost to the final consumer. They favour the approach of taxing all financial services including gross interest receipts and they list four advantages to this approach namely:

*“First, since all services are taxable, the scheme reduces the incentive to institutions to substitute margins for fees, the incentive for self-supply, and the import bias ... Second, it keeps the VAT chain intact all the way to non-registered persons. Third, it provides full input*

*VAT credits to all registered traders without the need for complex input allocation mechanisms and the attendant distortions. Fourth, the tax ultimately falls on final consumption, the intended base.”*

However Bird and Gendron (2005) do acknowledge that while taxing gross interest may increase the VAT revenue for the government, it will also greatly increase the cost of living for individual consumers. Their solution to alleviate this problem is found in the Canadian GST/HST rebate for lower income earners by providing a refundable income tax credit to those final consumers who are the hardest hit. Bird and Gendron (2005) reason that this solution has the added advantage of linking the VAT and income tax systems thereby encouraging overall compliance as the consumer will need to submit their income tax return to obtain their VAT rebate.

Borselli (2009) agrees that taxing financial services including interest income has become a more viable option in recent years as the advances in information technology dispute the assumption that financial services are too complicated to tax.

De la Feria and Krever (2012) agree with the approach taken by Bird and Gendron (2005) in taxing all financial services including interest received. They do not however go as far as proposing the income tax rebate. They also reinforce Borselli's (2009) conclusion by stating that:

*“[t]he efficacy of explicit exemptions that supposedly further equity or merit good objectives is questionable and the logic for retaining all exemptions supposedly needed for technical reasons is no longer convincing”*

However, de la Feria and Krever (2012) do argue that while this will remove the burden on taxpayers to apportion their inputs, revenue gained from full taxation of financial services may not outweigh the revenue lost from allowing business to deduct their total input tax credits.

Taking the view of these researches into account, the full taxation of financial services does appear to be the general consensus. South Africa has already taken steps to narrow the definition of financial service to include supplies such as transaction fees and short term insurance. However taxing interest will greatly increase the cost of financial services to the final consumer. It is difficult to see that this will be accepted by the political structures in South Africa if it causes considerable increase in the cost of living. The income tax rebate is a novel idea to address this problem but the link may be too tenuous for it to achieve the desired result.

It is recommended that if the taxing of interest income is considered the treatment in Mexico and Austria is followed whereby the taxable interest supplies are limited to short term loans and

consumer credit while interest on longer-term loans such as mortgage bonds remains exempt. The advantage of this is that it assists credit retailers by removing the requirement to apportion input tax while not inflating the largest interest costs of final consumers.

There is merit in the Singapore policy of zero-rating certain financial services. This achieves the purpose of mitigating the need for credit retailers to apportion their inputs. The downside of this approach is the revenue lost as the full input tax credit is deducted against zero-rated supplies. The revenue loss can be managed by the *de minimus* rules that Singapore has instituted however there is a fine balance to be found here in order for this treatment to be successful. Keeping the *de minimus* threshold low will minimise the revenue loss but defeat the purpose of eliminating apportionment as the credit retailers may exceed the threshold.

It is therefore concluded that a long-term solution may be achieved in changing the way interest is treated for VAT purposes to a situation where certain types of interest are considered taxable. However, before this can be determined, further research is required to understand the economic consequences of this type of decision.

In the short term, the input VAT apportionment difficulties can be addressed by applying the practice used in Australia, Canada and the majority of EU Member States of allowing the credit retailer to apportion its input costs according to its internal accounting or cost allocation system. As demonstrated by these countries, this provides a far more accurate measure of the actual use of the inputs and it will assist in relieving the compliance burden of the credit retailers as they will not be required to perform separate calculations for accounting and VAT purposes. To reduce the compliance burden further, it is recommended that the taxpayer should not be required to seek prior approval for using this method, provided that accurate records are kept enabling SARS to audit the method in full if required. This method should also alleviate some of the difficulties currently experienced with the *de minimus* rule regarding which inputs require apportionment.

While the most accurate solution would be to adopt the Australian or Canadian apportionment policy of analysing inputs on the individual cost level according to their actual use, it is acknowledged that the compliance cost for the taxpayer of this type of input allocation is significant. In addition it will be very difficult for SARS to administer this type of system.

An ideal solution to the problems experienced with the *de minimus* rule would be to change the rule to an input basis as per the examples for some EU member countries and Australia. However, as per the findings in section 5 of Chapter 3 of this research paper, it is likely that this will be unfavourably received by SARS due to the loss of revenue that would result.

#### **6.4 Conclusion**

It is concluded from the above that the turnover basis is not the best mechanism for credit retailers in South Africa. This is supported by the conclusions drawn in sections 3 and 4 of this chapter above. While the turnover method is still available for use in most countries, it is considered less accurate than more direct methods of apportionment and not favoured by most of the countries studied.

It is recommended that a more appropriate method of apportionment would be a direct allocation based on the internal accounting or cost allocation systems of the taxpayer. This would result in a reduced compliance burden and more accurate allocation of input costs according to their intended use.

A long-term solution may be to reassess the treatment of interest income for VAT purposes to bring it within the taxable supplies net. This would alleviate the burden of apportionment however it would need to be carefully implemented to prevent a steep rise in the cost of living and to prevent revenue loss. It is suggested that this could be an area for further research.

*(24,984 words, excluding footnotes)*

## APPENDIX A

All information in the tables below was obtained from the respective companies' 2013 Audited Integrated / Annual Reports.

| Credit Retailers      |   |
|-----------------------|---|
| Retailer              | Store Brands  |
| Edcon Holdings Ltd    | <p><u>Fashion</u><br/>Edgars, Red Square, Jet, Legit, Jet Mart, Topshop</p> <p><u>Furniture &amp; home appliance</u><br/>Boardmans</p> <p><u>Stationary</u><br/>CNA</p> <p>Edcon is a credit retailer and although it sold R8,667 million in trade receivables to ABSA in November 2012, it is still able to provide credit to customers and practically continues to do so.</p>  |
| Ellerine Holdings Ltd | <p><u>Furniture</u><br/>Ellerines, Bears, Furniture City, Geer &amp; Richards, Wetherlys, Dial-a-Bed</p> <p><u>Insurance</u><br/>Relyant</p> <p>For the financial years included in this research paper, Ellerine Holdings Ltd was owned by African Bank Investments Ltd.</p>   |
| JD Group Ltd          | <p><u>Furniture</u><br/>Barnetts, Bradlows, Joshua Doore, Morkels, Price 'n Pride, Russells, Supreme</p> <p><u>Consumer electronics &amp; appliances</u><br/>HiFiCorp, Incredible Connection</p> <p><u>Building Materials &amp; DIY</u><br/>Hardware Warehouse, Pennypinchers, The Tile House, Timbercity</p> <p><u>Automotive retail</u><br/>Unitrans, Hertz</p> <p><u>Insurance &amp; financial services</u><br/>JDG Insurance, Blake</p> |
| Lewis Group Ltd       | <p><u>Furniture</u><br/>Lewis, My Home</p> <p><u>Consumer electronics &amp; appliances</u><br/>Best Home and Electric</p> <p><u>Insurance</u><br/>Monarch Insurance</p>   |
| Mr Price Group Ltd    | <p><u>Fashion</u><br/>Mr Price, Miladys</p> <p><u>Home décor</u><br/>Sheet street</p>   |
| Shoprite Holding Ltd  | <p><u>Groceries &amp; household general merchandise</u><br/>Shoprite, Checkers, Checkers Hyper, USave, LiquorShop</p> <p><u>Furniture &amp; consumer appliance</u></p>  |

|                              |  |
|------------------------------|--|
| Shoprite Holding Ltd         | <p>OK Furniture, OK Power Express, House &amp; Home</p> <p><u>Pharmacy</u><br/>Medi+Rite, Transfarm</p> <p><u>Fast food</u><br/>Hungry Lion</p> <p>Only the furniture and consumer appliance stores offer credit.</p>  |
| The Foshini Group Ltd        | <p><u>Fashion</u><br/>Foshini, Donn Claire, Fashion Express, Luella, Charles &amp; Keith, Hi, Exact!, Markham, Fabiani, G-Star Raw</p> <p><u>Jewellery</u><br/>American Swiss, Sterns, Matrix, Mat &amp; May</p> <p><u>Furniture &amp; home décor</u><br/>@home, @home living space</p> <p><u>Sport</u><br/>Sportscene, Totalsports, Due South</p>   |
| Truworthis International Ltd | <p><u>Fashion</u><br/>Truworthis Emporium, Identity, Uzzi, Young Designers Emporium</p>  |
| Woolworths Holdings Ltd      | <p><u>Fashion, home décor and groceries</u><br/>Woolworths, Country Road</p>   |
| <b>Cash Retailers</b>        |  |
| <b>Retailer</b>              | <b>Store Brands</b>  |
| Clicks Group Ltd             | <p><u>Pharmacy &amp; cosmetics</u><br/>Clicks, The Body Shop, UPD</p> <p><u>Entertainment retail</u><br/>Musica</p>  |
| Massmart                     | <p><u>General dealer</u><br/>Game, Makro, Cambridge Food, Rhino Cash and Carry</p> <p><u>Consumer electronics &amp; appliances</u><br/>DionWired</p> <p><u>Groceries</u><br/>The Fruit Spot</p> <p><u>Building Materials &amp; DIY</u><br/>Builders Warehouse, Builders Express, Builders Trade Depot</p> <p><u>Wholesale food &amp; cosmetics</u><br/>CBW, Jumbo Cash and Carry, Trident, Cellshack, Shield</p> |
| Pick 'n Pay                  | <p><u>General dealer</u><br/>Pick 'n Pay, Boxer</p>  |
| The Spar Group               | <p>The Spar Group is not a retailer as defined in Chapter 2 of this research paper as it provides procurement, warehousing, distribution and retail support to its Franchisees however it does not own any of the Spar, SaveMor and BuildIt stores. Therefore it is a wholesaler, not a retailer.</p>  |

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