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A critical analysis of the VAT Act amendments relevant to South African municipalities

by

OLGA GRANOVA

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Study leader: Mr. T. Steyn NOVEMBER 2008

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ABSTRACT

A critical analysis of the VAT Act amendments relevant to South African municipalities

by

OLGA GRANOVA

SUPERVISOR: MR. T. STEYN
DEPARTMENT: TAXATION
DEGREE: MAGISTER COMMERCII (TAXATION)

The purpose of the study was two-fold: firstly to perform a critical analysis of the VAT amendments, relevant to municipalities as introduced by the Small Business Amnesty and Amendment of Taxation Laws Act No. 9 of 2006 with effect from 1 July 2006. Secondly, to perform exploratory practical research by means of a custom-designed questionnaire. The aim of the questionnaire was to assess whether or not the potential problems, as identified by the critical analysis, may be prevalent in practice. Six municipalities, mostly metropolitan (metros) provided their responses to this questionnaire. The study has indicated that the VAT amendments and transitional provisions were generally well received by municipalities. However, there appears to be an indication that the training on the VAT amendments received by municipalities may not have been effective. This may be an area for consideration for future taxation laws amendment and implementation process. Moreover, the initial cost, effort and time required by the taxpayers to implement the VAT amendments has shown to be onerous. Further research is needed to establish whether or not the VAT amendments will continue to be beneficial to the municipalities in the upcoming fiscal-years.

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OPSOMMING

‘n Kritiese ontleding van die BTW Wet wysigings van toepassing op Suid Afrika se munisipaliteite

deur

OLGA GRANOVA

OMSIENER:	MNR. T. STEYN
DEPARTEMENT:	BELASTING
GRAAD:	MAGISTER COMMERCII (BELASTING)

Die doel van hierdie studie is tweeledig van aard: eerstens om ‘n kritiese ontleding uit te voer van die wysigings aan die BTW Wet wat munisipaliteite raak en wat teweeg gebring is met die Wet op Kleinbesigheidsbelastingamnestie en Wysiging van Belastingwette, No. 9 van 2006, wat op 1 Julie 2006 in werking getree het. Tweedens, om ondersoekende praktiese navorsing te doen deur gebruik te maak van ‘n vraelys wat vir die doel ontwerp is. Die vraelys is daarop gemik om vas te stel of potensiële probleme wat geindentifiseer is deur middel van die kritiese ontleding in die praktyk voorkom al dan nie.

Ses munisipaliteite, meestal metropolitaans (metros), het gereageer en die vraelyste voltooi. Hieruit blyk dit dat die BTW wysigings en die oorgangmaatreëls oor die algemeen ‘n positiewe reaksie ontlok het by die munisipaliteite. Desondanks wil dit voorkom asof daar tekens is dat die opleiding wat, met betrekking tot BTW wysigings. aan munisipaliteite verskaf is, nie so effektief gewees het nie. Voorts blyk dit dat die aanvanklike koste, werk en tyd wat benodig was vir die implementering van die BTW wysigings by die munisipaliteite die proses bemoeilik het.Verdere navorsing is nodig ten einde te bepaal of die BTW wysigings steeds voordele gaan inhou, al dan nie, vir munisipaliteite in die komende fiskale jare.

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TABLE OF CONTENTS

PAGE

CHAPTER 1: INTRODUCTION AND PROBLEM STATEMENT

1.1	BACKGROUND	1
1.2	NEED FOR THE STUDY	2
1.3	RESEARCH OBJECTIVES	4
1.4	RESEARCH STRATEGY	4
1.4.1	Sampling method	5
1.4.2	Pre-testing	6
1.5	LIMITATIONS OF THE STUDY	6

CHAPTER 2: HISTORICAL BACKGROUND TO MUNICIPALITIES AND LITERATURE REVIEW

2.1	INTRODUCTION	8
2.2	HISTORICAL BACKGROUND OF THE VAT SYSTEM OF TAXATION	8
2.3	LEGAL FRAMEWORK FOR THE MUNICIPALITIES	11
2.3.1	The Constitution	12
2.3.2	Municipal Structures Act	13
2.3.3	Municipal Finance Management Act	14
2.3.4	Municipal Systems Act	14
2.3.5	Municipal Fiscal Powers and Functions Act	14
2.3.6	Sources of funds for municipalities	14
2.4	CURRENT STATUS OF THE TOPIC AND LITERATURE REVIEW	18

2.5	SUMMARY	18

CHAPTER 3: CRITICAL ANALYSIS OF THE VAT AMENDMENTS

3.1	INTRODUCTION	19
3.2	VAT AMENDMENTS RELATED TO THE DEFINITION OF ENTERPRISE	20
3.3	VAT AMENDMENTS RELATED TO THE ZERO-RATING OF PROPERTY RATES	24
3.4	VAT AMENDMENTS RELATED TO TRANSITIONAL PROVISIONS	27
3.5	SECTION 40(B) LIABILITY FOR TAX AND LIMITATION OF REFUNDS	39
3.6	AMENDMENTS RELATED TO CAPITAL ASSETS	41

CHAPTER 4 : ANALYSIS OF QUESTIONNAIRE

4.1	INTRODUCTION	44
4.2	ANALYSIS	46
4.2.1	Pre-consultation and RSC abolishment	46
4.2.2	Information and consultants	47
4.2.3	RSC levies	48
4.2.4	Transitional provisions per Regulation R.270	49
4.2.5	VAT amendments	53
4.2.6	General	57
4.3	CONCLUSION	58

CHAPTER 5: EXECUTIVE SUMMARY 60

CHAPTER 1
INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

Since the promulgation of the Value-Added Tax Act (Act No. 89 of 1991), henceforth referred to as 'the VAT Act', most municipalities have been operating as VAT Vendors. However, the provisions of the VAT Act were not comprehensive enough to cater for the unique type of supplies made by municipalities, such as supply of street lighting, municipal roads, parks, abattoirs etcetera.

In order to address these, the South African Revenue Service (SARS) had to issue municipality-specific VAT rulings (Eagar, 2007b:10) as well as promulgate 'special rules' in Regulation No. 2570 (2570/1991) which used a profitability test in order to determine whether or not a certain type of supply was subject to VAT.

These rules proved to be somewhat complicated and resulted in municipalities having to face significant VAT apportionment difficulties and administration problems. (South African Revenue Service. n.d:6).

The National Budget review of 2004 (2004:73) highlighted the importance of simplified and administratively simple tax strategy, with a view of ensuring effectiveness in the implementation of the policy reforms.

To this end, with effect from 1 July 2006, the Small Business Amnesty and Amendment of Taxation Laws Act (9/2006), henceforth referred to as 'the Amendment Act', has introduced significant VAT amendments for municipalities.

The main aims of the Amendment Act were to unlock the input tax which municipalities could previously not claim due to the non-taxable nature of their activities, as well as to assist the municipalities to simplify their accounting records. The larger scope for claiming of VAT input has, by way of reducing the net VAT payable to SARS, freed up some funds which were previously not available for spending.

This increase in available funds has coincided with the phasing-out of the Regional Service Council levy (RSC levy), a unique type of tax which provided an important source of revenue to municipalities up until 1 July 2006.

Preamble to the Government Notice (8655/2007), henceforth referred to as 'the Transitional Regulation', states that these VAT amendments are intended to counter-act the effects of the lost RSC revenue stream and the Minister of Finance, Mr. Trevor Manuel has acknowledged that many municipalities may experience difficulties in "… complying fully with the [VAT amendments] law in the short-term", due to the lack of the necessary administrative capacity.

The Transitional Regulation provides for 'transitional arrangements', to be applied during the 'transition period' of 12 months, which commenced on 1 July 2006 and ended on 30 June 2007, with the intention that normal VAT rules (as amended) will apply to municipalities henceforth.

1.2 NEED FOR THE STUDY

The VAT amendments, as relevant to municipalities, were promulgated to achieve the strategic objectives as discussed above. However, it is not clear whether practical implementation thereof has identified any significant shortcomings in the design of these VAT amendments.

Pressly (2008) points that the 2007/8 capacity assessment report of the Municipal Demarcation Board, indicates that most municipalities face a severe skill shortages, which have a direct effect on their capacity to deliver goods as per their mandates.

This is further confirmed by the outcomes of the regularity audits performed by the Auditor-General at municipalities for the financial year ended 2006/07. Meyer (2008:8) reports that "… inexperience in financial management and associated capacity problems in councils, particular in rural areas, … [are] reasons for municipal woes".

It is considered necessary to establish whether the above challenge may have also impacted on the success of the implementation of the VAT amendments as relevant to municipalities.

The VAT amendments were proposed in the 2007 Budget Speech on 23 February 2006. The Amendments Act (9/2006) was legislated four months later, effective from 1 July 2006.

On 28 March 2007, the Minister of Finance has announced the Transitional Regulation with certain interim arrangements. This Transitional Regulation was issued with retrospective application to 1 July 2006, with only three months to go before the municipal 2006/07 financial year end. The so-called 'transition' period was defined in section 1 of the Transitional Regulation as the period between 1 July 2006 and 30 June 2007.

The Draft Value Added Tax Guide for municipalities, which sets out SARS's understanding and application of the VAT amendments is in its draft format as at 23 June 2008, almost 2 years after the financial year to which the Regulation and the amendments first applied (South African Revenue Service. n.d:1).

According to Van Zyl and Heydenrych (2006:15) “changes in tax laws invariably leads [sic] to difficulties in application”. …municipalities should… ensure that they have adopted policies and procedures to ensure that the change in [VAT] legislation has been implemented correctly”.

In light of the above, it is considered necessary to perform a critical analysis of the VAT amendments and by means of exploratory research, determine whether there could be any potential problems the implementation of these amendments in practice.

1.3 RESEARCH OBJECTIVES

The research objectives of this study are two-fold. Firstly, to perform a critical analysis of the VAT amendments to determine whether there could be potential problems or administrative challenges in their implementation. Secondly, to perform exploratory practical research into the matter by means of a limited case study on selected municipalities to assess whether or not the potential problems identified by this study may be prevalent in practice.

1.4 RESEARCH STRATEGY

The research strategy of this study consists of a review of the existing literature, a detailed critical analysis of the VAT amendments as legislated and an analysis of the responses to the specially-developed questionnaire.

There are a total of 283 municipalities in the Republic of South Africa. For the purposes of the questionnaire distribution, ten per cent of the municipalities were selected, resulting in a total of 28 municipalities. The participants were selected randomly whilst ensuring that all of the nine geographical provinces of South Africa are included in the sample.

The questionnaire was distributed to potential participants by means of electronic mail (email) and addressed to the Chief Financial Officers and Financial Managers of the municipalities in the selected sample. The questionnaire contains specific statements and questions as per categories stated above. The respondents were required to indicate their agreement with the statements. The possible responses can range from “strongly disagree”, “disagree”, “neither agree nor disagree” to “agree”, “strongly agree” and “I am not aware/do not know”.

The responses received are analysed in order to establish the overall perception of the municipalities regarding the VAT amendments.

Given the voluntary nature of participation in the questionnaire survey as well as possible sensitivity involved in providing critical responses, the expected response rate is estimated at 15-20%.

1.4.1 Sampling method

The sampling method used in this study is the non-statistical approach of specific identification, on a judgemental basis, also known as ‘haphazard’ sampling technique, taking into account practical considerations.

The disadvantage is that not every item in the population had an equal chance of being included in the sample due to potential bias in the selection process. However, it is envisaged that this is unlikely to affect the validity of the study findings as the respondent municipalities in one province are expected to be comparable to those in other provinces due to the same legislative and administrative requirements within they operate.

Other methods of sampling, such random, systematic or block sampling, being statistical sampling methods, are not considered appropriate given the nature of this study.

1.4.2 <u>Pre-testing</u>

In order to ensure the validity and relevance of the contents of the questionnaire as well as to determine whether these adequately address the main issues identified by this study, several tax practitioners and academics were requested to review its contents. Their inputs have been incorporated in the questionnaire prior to the distribution to municipalities.

1.5 LIMITATIONS OF THE STUDY

This study does not include the following:

- Comprehensive proposals on restructuring of the South African taxation system
- Mathematical assessment of the effect of the VAT amendments on the macro-economy of South Africa
- Performance evaluation of any particular municipality
- Recommendations for the resolution of any administrative challenges experienced by municipalities
- Challenging of the existing legislation beyond the scope of 'critical analysis'
- Comparative study of other countries' VAT legislation
- Forecasts/speculation regarding the future amendments to the VAT Act
- Provision of any consulting or advisory services to those municipalities that responded to the questionnaire
- Extrapolation of the responses received in the sample being statistically identical to all South African municipalities

- Quality control of the current and draft guidance and legislation (such as Interpretation Notes) issued by the South African Revenue Services (SARS).

CHAPTER 2

HISTORICAL BACKGROUND TO MUNICIPALITIES AND LITERATURE REVIEW

2. 1 INTRODUCTION

This chapter aims to provide historical background regarding the functioning of municipalities, their role in the South African economy and their contribution to the fiscus. The VAT amendments as relevant to municipalities have been necessitated by a number of reasons, stemming mostly from the unique challenges present in municipal environment. Therefore, in order to critically analyse the VAT amendments, it is imperative to examine the situation which existed prior to the promulgation of the amendments.

To this end, an overview of the historical background of the VAT system of taxation and legal framework within which municipalities operate, is presented below.

2.2 HISTORICAL BACKGROUND OF THE VAT SYSTEM OF TAXATION

Governments all around the world use a variety of tax instruments to raise the funds needed to achieve their strategic objectives. One of the most commonly used taxes is the Value-added tax, also known as VAT.

As the name implies, VAT is a tax on the value added at each stage of a product's production, distribution or retail sale. In South Africa, VAT is currently levied at a flat rate of 14 per cent in the entities’ sales, less VAT paid on the entity’s purchases, subject to certain exemptions and adjustments.

Prior to 30 September 1991, the general sales tax was in effect at 13 percent, which excluded exports, professional services and basic foods and services which served as intermediate goods in a goods production process. In essence, the sales tax was a single-stage tax, only levied once the goods or services reached the final consumer.

Administration of this tax proved to be burdensome, particularly with regard to counter-acting tax evasion and the distortional effect it had on the prices of certain goods (Lachman & Bercuson, 1992:[20]).

Similarly, the 'tax net' of the sales tax was not wide enough to bring in the required revenue, and therefore, with effect from 30 September 1991, general sales tax was replaced by VAT at a flat rate of 10%, with a lenient provision which exempted businesses from paying VAT on capital items, such as property, plant and equipment. This measure was aimed at encouraging business development. Subsequent to 1995, the rate of VAT was increased to 14% in 1995 (Photius, 1996).

One of the aspects of the old general sales tax that VAT did not manage to redress is that of 'regressivity'. According to Jac Laubscher, the Group Economist of Sanlam Limited (2007:[3]) a regressive tax is 'a tax where its impact will be proportionately greater the lower one's income", usually applied at a uniform rate.

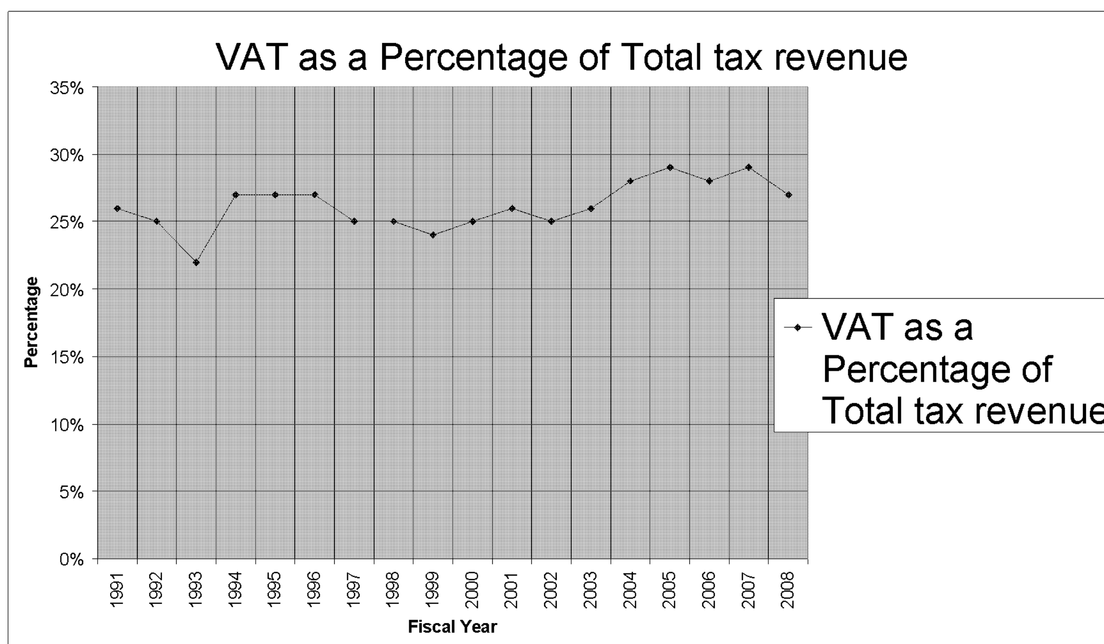
In effect, both the general sales tax and VAT are taxes that take a larger percentage from low-income people than from high-income people. According to COSATU (1999), this means that it hits lower-income individuals harder, which is particularly anomalous given the historic level of poverty in South Africa.

It is in this context that the introduction of VAT in 1991 was not welcomed by the lower-income groups. These sentiments have manifested in a national strike

organized by the African National Congress (ANC) and its ally, the Congress of South African Trade Unions (COSATU). The strike was supported by the lower-income groups, who demanded that, inter alia, electric and water utilities be exempted from VAT (Wren, 1991:[2]).

Regardless of its apparent drawbacks, since its inception, VAT has been one of the key contributors to the total fiscus. According to the South African Reserve Bank, VAT has been contributing to the total tax revenue receipts at a constant rate of approximately 26%. As per the table below, the VAT collections for the 2007/8 fiscal year were R150.4bn, which constitutes 27% of the total tax revenue of R548,028bn.

Table 1



*Compiled from SA Reserve Bank Time series KBP4578F and KBP4595F

SARB. Not dated. *Time series data.*

Moreover, VAT is an important consideration in the budgeting process of any entity, as it also has a significant/substantial impact on the cash flow of the entity. Correct application of the VAT Act should maximize the deductions (VAT input

entitlements) and correctly manage the output VAT and the net vat payable to SARS.

Factors that play a role in achieving this objective include the correct re-configuration of financial accounting systems, accounting for VAT in the correct time periods and ensuring timely payments to avoid interest and penalties.

Section 58 of the VAT Act (89/1991) deems any non-compliance with the provisions in the Act as a criminal offence, which may render the Chief Financial Officer, in his or her capacity the accounting authority of a municipality, liable to a conviction of a fine or imprisonment. Municipalities should therefore strive be fully compliant with the VAT amendments.

With the above understanding in mind, it is now possible to proceed to the overview of the historical and legal framework for the municipalities, as discussed below, in order to understand the history of functioning of municipalities both as government entities and important VAT vendors.

2.3 LEGAL FRAMEWORK FOR THE MUNICIPALITIES

Since the dawn of the new South Africa, as symbolised by a new political dispensation in 1993, municipalities, being the local government, have faced a variety of challenges related to the transition process necessary to address the inequalities of the past and to re-structure the framework in which municipalities operate.

The demarcation of 283 new local government entities was completed in 2000 through the Municipal Structures Act 17 of 1998. According to the United Nations Commission for Sustainable Development (2004:5), this action

consolidated fragmented local service delivery entities into consolidated local authorities and established the foundation for structured local government.

Additionally, a number of important amendments related to, inter alia, municipal administration and finance model have been implemented since, such as the amendments made to the Value Added Tax Act in 2006, which are aimed at streamlining the functioning and the operations of municipalities, and improving their efficiency.

The legal framework of municipalities consists of the Constitution, the Municipal Structures Act, the Municipal Finance Management Act, the Municipal Systems Act, the Municipal Fiscal Powers and Functions Act and the Division of Revenue Act, which are briefly discussed below.

2.3.1 The Constitution

The Constitution (108/1996) recognises local government as a distinctive sphere of government, interrelated with national and provincial spheres of Government.

Specifically, section 151 of the Constitution provides for the establishment of municipalities as the local government for the whole of the territory of the Republic of South Africa. The objectives of local government are defined in section 152 as follows:

152(1) *The objects of local government are:*

(a) to provide democratic and accountable government for local communities;

(b) to ensure the provision of services to communities in a sustainable manner;

(c) to promote social and economic development;

(d) to promote a safe and healthy environment; and

> *(e) to encourage the involvement of communities and community organisations in the matters of local government*
>
> *(2) A municipality must strive, within its financial and administrative capacity, to achieve the objects set out in subsection (1).*

Section 153(a) - A municipality must structure and manage its administration and budgeting and planning processes to give priority to the basic needs of the community, and to promote the social and economic development of the community.

Therefore, the types of goods and services which municipalities provide and which are therefore potentially subject to VAT are stemming directly from their constitutional mandate.

2.3.2 Municipal Structures Act

The Local Government: Municipal Structures Act (117/1998) regulates the establishment of municipalities in accordance with the requirements relating to categories and types of municipality. The Act also aims to regulate the municipalities' internal systems and structures.

The Preamble to the Municipal Structures Act sets out the strategic objectives of municipalities, most notable/important of which include ensuring sustainable, effective and efficient municipal services and transformation "…in line with the vision of democratic and developmental local government". It may therefore be argued that favourable tax treatment (such as input VAT deductions) of the costs associated with provision of the services plays a role in their sustainability.

2.3.3 Municipal Finance Management Act

Local Government: Municipal Finance Management Act (MFMA) (56/2003) places emphasises the importance of the municipalities' role as taxpayers, as section 65(2)(f) of the above Act requires municipalities to comply with its tax commitments. Therefore, any non-compliance with the VAT Act also constitutes non-compliance with the MFMA.

2.3.4 Municipal Systems Act

The Preamble to the Local Government: Municipal Systems Act (32/2000), accentuates the need for "an efficient, effective and transparent local administration that conforms to constitutional principles". This echoes the principles contained in the Constitution. It may be reasoned that complex taxation principles may jeopardise the efficiency of municipal administration.

2.3.5 Municipal Fiscal Powers and Functions Act

The above Act (12/2002) regulates the manner in which a municipality imposes surcharges on fees for services provided by the municipality. In turn, the type of service and goods provided by municipalities to the communities which they serve has direct implications on whether such services and goods fall within the net of the VAT Act.

2.3.6 Sources of funds for municipalities

Municipalities derive their revenue from three main sources, namely property rates, revenue from trading accounts (e.g. sale of water and electricity), annual equitable share, which is a parliamentary allocation of grants. Additionally category A and C municipalities were receiving income from Regional Service

Council (RSC) levies (up until 30 June 2006). Details of these sources of revenue are:

a) Property rates

Property rates refer to the monthly charges which homeowners and proprietors of immovable property pay to municipality as the tax on land within the particular municipality's borders. Municipalities utilise the raised revenue to fund services such as, inter alia, the supply of fire fighting services, street lighting, road infrastructure and public amenities.

b) Revenue from trading accounts

Municipalities also generate their own revenue earned by providing billable goods and services to the communities in their respective demarcated areas. Prior to the VAT amendments, there were special rules applicable to determining of the taxable/non-taxable nature of the goods and services

c) Annual equitable share

The Division of Revenue Act (DoRA) (2/2008) is an annually promulgated Act which sets out the allocation of the equitable division of revenue raised nationally among the national, provincial and local spheres of government for each financial year. The DoRA also sets out the responsibilities of all three spheres regarding the utilisation of these funds.

d) Regional Services Councils levies

The apparent inefficiency of the tax called the Regional Services Councils levy (RSC), played a role in the promulgation of the VAT amendments. According to Barnett (2001:4), municipalities are intended to be largely self-financing, as on average own revenues account for 93 percent of total revenues, with a negligible annual income stream of equitable share

distribution from Parliament of 1-2 percent and conditional grants of approximately 7 percent.

As per section 12(6)(d) of the RSC Act (109/1985), the RSC levies were originally introduced in 1985 for, inter alia, the purposes of funding the extension of basic services of water, electricity, sewage and waste to certain non-serviced areas and were applicable only to categories A (metro) and C (district) municipalities.

Barnett (2000:14) argued that this situation is not in line with the current government goals of economic and administrative efficiency and local autonomy, as discussed below:

- Inappropriate economic signals
    - By levying an additional tax on employment, the RSC levies were adding to the cost of employment and production
    - The employers with labour-intensive business models are penalized with higher RSC levies. This implies that the RSC levies caused horizontal inequity.
- Inappropriate administrative signals
    - The RSC levy Act entitled category A and C municipalities to the RSC levy income, without providing the corresponding means of enforcement.

- Inappropriate intergovernmental signals
    - The rate of the RSC levies applicable in each of the nine provinces is determined on the national level, which did not support local fiscal autonomy.

In addition, there also appeared to be an anomaly in the sense that section 229(1)(b) of the Constitution prohibits the municipalities from levying any sales or income-related taxes, but, notwithstanding the Constitutional provisions, the RSC levies were based on payroll and turnover. This may be attributed to historic reasons, as the RSC Act came into existence in 1985, while the Constitution was promulgated in 1996.

According to Bahl and Solomon (2000:40), "…the RSC levy is a poor choice to support South African decentralization" as it '…accentuates fiscal disparities and provides little autonomy for local governments".

The combination of the factors described above have prompted the National Treasury to consider various options for replacement of RSC levies in 2005, with the intention of determining which tax instrument, or combination of tax instruments, whether currently existing or not, would be able to raise the equivalent or greater funds than the RSC while addressing or minimizing the shortcomings of the RSC levies.

The RSC levies were abolished with effect from 1 July 2006 and coincided with the VAT amendments, which aimed to free up funds previously tied up in non-claimable VAT inputs, so as, in combination with the increased government grant allocation, to counter-act the loss of the RSC levy revenue (Budget speech 2006:15,20)

2.4 CURRENT STATUS OF THE TOPIC AND LITERATURE REVIEW

As the first year of implementation of the VAT amendments is the 2006/7 financial year, ended on 30 June 2007, limited literature has been published on this topic to date.

In 2007, Chris Eagar (2007a:14) raised concerns regarding the potentially adverse implications of the VAT amendments, including the unfair prejudice which may be caused by the new prescribed method of apportionment of input tax when a municipality acquires goods and services for the purposes of making partially taxable supplies.

However, the research into the first-hand experiences of the municipalities themselves as to the actual challenges, obstacles and successes they experienced in the implementation of the VAT amendments, as well as whether they have experienced any relief of administrative burden, has not yet been undertaken and/or published. Therefore, this study constitutes exploratory research on this subject.

2.5 SUMMARY

The historic background of VAT as a tax instrument and municipalities as VAT vendors is fundamental to the understanding of the VAT environment in which municipalities operate. The objective of Chapter 3 is to build upon this understanding and perform a detailed analysis of the VAT Act amendments, clearly distinguishing between the functioning of the VAT Act both pre and post the 2006 amendments. This analysis will be aimed at identifying any potential problems which may present in the practical implementation and functioning of the VAT amendments.

CHAPTER 3

CRITICAL ANALYSIS OF THE VAT AMENDMENTS

3.1 INTRODUCTION

The purpose of this chapter is to provide a critical analysis of the VAT amendments relating to municipalities and the transitional provisions in order to identify any possible problem areas that could arise in municipalities.

As discussed in chapters 1 and 2, the VAT amendments were promulgated by the Small Business Tax Amnesty and Amendment of Taxation Laws Act (9/2006), which came into effect retrospectively from 1 July 2006.

The amendments relate to, inter alia, the changes made to the definition of ‘enterprise’ in section 1 of the VAT Act, which brought activities of municipalities within the wide scope of the Act.

Charles de Wet (Lee 2006:20), a tax partner at PricewaterhouseCoopers, is of the opinion that the VAT amendments are the measures which the government is taking as part of its drive to improve the financial position of municipalities. This would enable SARS to collect more VAT and other taxes as many municipalities would be in a better position to comply with the VAT Act.

The VAT amendments were supplemented with certain transitional provisions contained in Regulation R.270 (29741/2007).

3.2 VAT AMENDMENTS RELATED TO THE DEFINITION OF 'ENTEPRISE'

Prior to 1 July 2006, the definition of 'enterprise' contained a separate paragraph with specific requirements applicable to municipalities. This resulted in a number of special 'enterprise rules' which applied to municipalities. With the promulgation of the VAT amendments effective 1 July 2006, subsection (c) to definition of the 'enterprise' in section 1 of the VAT Act was deleted. This eliminated the distinction between 'vendors other than local authorities' and 'vendors which are local authorities', thus effectively bringing municipalities under the normal provisions of the VAT Act applicable to all types of vendors.

This amendment is of fundamental significance, as one of the main pre-requisites for the application of the VAT Act is compliance with the definition of 'enterprise', in other words, in order for the provisions of the VAT Act to apply, a person or a body needs to comply with the requirements of carrying on of an enterprise.

Prior to 1 July 2006, the taxable supplies of municipalities, previously known as 'local authorities', were limited to those listed in subsections (i)-(iii) to paragraph (c) of the definition of 'enterprise' in section 1 of the VAT Act. Any other municipal activities, including provision of any other goods or services not mentioned in either the above subsections or the categories of business per the Ministerial Regulation, as was envisaged in subsection (iv), subparagraph (aa), were not subject to standard rate of 14% VAT.

The 'Ministerial regulation' in question, which supplemented the VAT Act is Regulation 2570 of 21 October 1991. The categories of municipal business were subject to VAT provided the particular generated sufficient revenue for the municipality to 'break-even' and therefore be regarded as a business comparable to the private sector, and therefore a true VAT vendor only in so far as these activities were concerned.

This implied that prior to including VAT into the fees charged to the public and prior to claiming input VAT on expenditure, associated with the provision of these goods and services, municipalities had to perform financial analyses in order to establish whether a certain activity would be reasonably expected to break-even or not. Franck (2008) states that the VAT status of an activity is determined with this 'budgetary' analysis, regardless of whether this activity actually breaks-even during the upcoming financial year. Examples of such activities are listed below:

- Abattoirs
- Farming
- Parking grounds and garages
- Produce markets
- Township development
- Letting of commercial and industrial buildings
- Airports
- Quarries and sale of sand
- Cement-making
- Caravan parks, pleasure and holiday resorts
- Nurseries
- Hiking trails
- Brickyards
- Liquor sales
- Provision of computer services
- Game farms
- Cattle pens and auction facilities

In an interview conducted with Mr. Peter Franck, former Head of VAT Law interpretation at South African Revenue Services (SARS) on 3 September 2008, it became apparent that the Regulation did not cover all municipal activities and it had created uncertainty regarding the VAT status of a number of activities, for

example, services provided at municipal crematoriums and vehicle testing centres which were in competition with similar enterprises in the private sector.

The reason for this shortcoming is at the core of the rationale of the Regulation, which meant that if a municipal activity had a profit motive and was expected to breakeven on its costs with the income received, it would be seen to be in possible competition with the private sector, and therefore, it would be fair to subject it to VAT at standard rate of 14%, so that the municipality would not be seen to have an unfair advantage over other vendors.

However, if the fees and prices charged by municipalities were significantly lower than those charged by the private sector to begin with, it would be inevitable that the municipality would not break-even on its costs. To aggravate the price difference further, the Regulation would not subject such activities to VAT, and the price charged by the municipality would remain significantly lower. Franck (2008) argues that the proportions of this dilemma have even prompted an enquiry into the matter by the Competition Commission.

Initially, there was also some degree of uncertainty regarding the falling away of the Regulation and some tax professionals expressed concern regarding the potential misunderstanding of whether the income from the Regulation activities would now attract VAT at 14% or at 0% or not at all (Van Zyl & Heydenrych, 2006:15).

Fortunately, subsequent to the promulgation of the VAT amendments, which deleted the above subsection (c) of the ‘enterprise definition’, these activities constituted carrying of an enterprise as per the amended definition in section 1 of the VAT Act and automatically became subject to VAT at the standard rate, thus eliminating the burden of special rules and treatment to be applied to municipal goods and services.

Franck (2008) puts it quite plainly: "Instead of trying to regulate the myriad of municipal activities which were subject to VAT, the new definition of 'enterprise' makes it straightforward – whatever the municipality does, constitutes the making of taxable supplies at the standard rate, unless specifically exempted or zero-rated elsewhere in the VAT Act, no need for any Ministerial Regulations or complicated VAT rulings. The amended definition of 'enterprise' is a welcome development".

The difference between the old and the new definitions of 'enterprise' are best illustrated by means of a comparative table.

Comparative table 1

The table below illustrates the application of the amended 'enterprise definition' if applied to the various activities of municipalities. As discussed above, the breakeven assumption was a requirement for those activities regulated in the Regulation 2570 which had to be met for the activity to be charged with VAT for all periods prior to 1 July 2006.

Type of activity	**Enterprise prior to 1 July 2006?**	**Enterprise post 1 July 2006?**
Farming	Yes, but only if assumed that it is expected to break even	Yes, regardless of profitability
Public parkades	Yes, but only if assumed that it is expected to break even	Yes, regardless of profitability
Abattoirs	Yes, but only if assumed that it is expected to break even	Yes
Hiking trails	Yes, but only if assumed that it is expected to break even	Yes, regardless of profitability
Sewerage	Yes, part of definition of enterprise (section 1, para c(ii)	Yes, no change to the definition of enterprise , section 1, para c(ii)
Airport facilities	Yes, but only if assumed that it is expected to break even	Yes
Plant nurseries	Yes, but only if assumed that it is expected to break even	Yes, regardless of profitability
Municipal pool	No, not part of the Regulation 2570	Yes

3.3 VAT AMENDMENTS RELATED TO THE ZERO-RATING OF PROPERTY RATES

Prior to the 1 July VAT amendments, property rates, also known as assessment rates or municipal rates were not part of the definition of the enterprise and were also not included in the categories of business in the Regulation 2570. Therefore, the rates were effectively out-of-scope for VAT purposes.

By virtue of the amended 'enterprise' definition, property rates form part of the taxable supplies of municipalities. However, as a new section 11(2)(w) has been inserted into the VAT Act, the property rates are zero-rated, in other words, subject to output VAT at zero percent, while VAT paid on expenditure funded from these rates, is claimable as input VAT.

Property rates refer to the monthly charges which homeowners and proprietors of immovable property pay to municipality as the tax on land within the particular municipality's borders. Historically, this constituted a significant and reliable source of revenue for municipalities. There is no direct relationship between the rates paid by residents and goods and services received in return by that particular person. Municipalities utilise the raised revenue to fund services such as, inter alia, the supply of fire fighting services, street lighting, road infrastructure, traffic department, clinics and public amenities.

Franck (2008) believes that the previously 'exempt' or 'out-of-scope' VAT status of the municipal rates was a result of a misconception at the time when the VAT Act was first introduced in 1991, as certain political role-players erroneously believed that the VAT exempt status meant that there was 'no tax on tax' and therefore more acceptable to the general public.

However, as exempt supplies are wholly exempt from both output and input VAT, it follows that any expenditure funded from the VAT-exempt revenue received would be denied, thus actually making the associated costs higher, not lower. It may therefore be argued that it would have been better if the legislature zero-rated the municipal rates from the inception of the VAT Act back in 1991.

Therefore, due to its 'exempt' status, prior to the VAT amendments, the input VAT credit was denied on expenditure funded from property rates, which meant that the municipality had to absorb the VAT component as part of its costs. Whenever municipalities purchased capital assets and consumables for these activities and paid contractors for services rendered, the municipality was charged the cost plus VAT at 14%, without being able to claim it back from SARS.

It follows that as the VAT portion in the associated expenditure was non-claimable, this had a negative impact on the financial resources of municipalities, increasing their project costs and limiting their service delivery to the communities due to sub-optimal use of the funds. In turn, this had an adverse effect on the amount of funds at the disposal of municipalities.

In order to address this anomaly, the VAT amendments, through the zero-rating of the municipal property rates, aimed at 'unlocking of input tax and shifting of revenue back to municipalities (The Preamble to the Regulation No. R.270 on transitional provisions). This, to an extent, also off-set the loss of revenue from the abolishment of the RSC levies on the same day as the VAT amendments became effective.

However, given the clear wording of the new section 11(2)(w) and the absence of any complicated proviso thereto, it is envisaged that no confusion would arise in its interpretation and any administrative interventions required by municipalities in order to implement it are insignificant in terms of time, cost and effort.

The zero-rating of property rates has an impact on the operation of Section 17 of the VAT Act, which deals with apportionment of input VAT when expenditure is incurred for the purposes of making partly taxable and party exempt supplies.

Franck (2008) is of the opinion that the decision taken in 1991 by the South African Revenue Services (previously Inland Revenue) to let many of the activities of municipalities to fall into the exempt category was a disaster for all concerned, as municipalities were unable to deal with the complications of apportioning input VAT for the various activities of the municipalities which were conducted with a dual purpose of earning both taxable (i.e. subject to VAT) and non-taxable income, the so-called 'mixed supplies'.

Examples of municipal activities falling into this category are the mayor's office personnel services, and departments which handle the administration for both commercial accommodation and residential accommodation. Other examples include capital assets acquired for use in both taxable and exempt divisions of the municipality (Van Zyl & Heydenrych, 2006:15).

For the purposes of claiming input VAT, section 17 of the VAT Act requires vendors to calculate a ratio as the intended use of such goods and services in the course of making taxable supplies bears to the total intended use of such goods and services. The only method acceptable to SARS is the 'turnover-based method', which uses the information from the financial statements of the vendor's enterprise. This method applies by default in absence of a specific ruling obtained by the municipality from SARS (SARS n.d:29).

Franck (2008) is of the opinion that accounting systems of many municipalities were inadequate to readily apply this apportionment method, thus requiring extensive effort, including the undue and costly reliance on VAT consultants in order to establish the apportionment ratio.

There is however a way to escape this apportionment 'trap'. Section 17(1)(i) of the VAT Act contains a relief provision whereby a vendor need not apportion his input VAT provided that his actual apportionment ratio calculation is equal to at least 95%, being the ratio that the taxable supplies made by that vendor relate to the total supplies made. Unfortunately, very few municipalities were able benefit from this relief provision as most did not actually achieve an apportionment ratio of equal or greater than 95%, which would have exempted the municipality from the need to apportion their input vat on mixed supplies. As a result, many municipalities have expended significant funds on enlisting the services of tax advisors who attempted to calculate the best possible apportionment ratio for the municipality (Franck, 2008).

With the introduction of zero-rating for property rates, the apportionment percentage of municipalities is expected to increase as zero-rated supplies are considered taxable supplies and thus it is expected that municipalities will be able to enjoy higher claims for input tax deductions.

3.4 AMENDMENTS RELATED TO TRANSITIONAL PROVISIONS

In order to ensure that municipalities put the necessary mechanisms in place to comply with the VAT amendments, the Minister of Finance has published transitional provisions, effective for the period of 1 July 2006 – 30 June 2007. The preamble to the Regulation R.270 (29741/2007), acknowledges that many municipalities already lack administrative capacity and need time to make changes to their accounting and financial systems.

The transitional arrangements deal with matters such as output tax on supplies which became taxable for the first time during the transition period, and issues regarding the payments made and received by municipalities pre and post 1 July

2006 and special rules for apportionment of input tax as per paragraphs 2-4 of the Regulation.

a. Output tax on supplies which became taxable for the first time during the transition period

Paragraph 2 of the Regulation, allows municipalities to correct any errors related to output tax which occurred during period of 1 July 2006 – 30 June 2007, in the any other VAT returns, provided that it is done prior or on 25 July 2007, in other words, no later than the June 2007 VAT return. As an act of grace, SARS would not penalise such municipalities with additional tax, penalties or interest.

b. Special rules for the payments basis of accounting

Paragraph 4 of the Regulation on transitional arrangements contains certain special rules that municipalities need to apply to payments received or made on or after 1 July 2006.

This transitional arrangement has been necessitated by the fact that most municipalities account for VAT on a “payments” basis as envisaged in sections 15(2)(a)(v) and 16(3)(b). The payments basis implies that VAT is only accounted for when expenses are incurred (i.e. paid in cash) and when income is physically received. Due to the changes brought about by the VAT amendments, the legislature deemed it necessary to create a transitional mechanism for accounting for VAT on transactions on or after 1 July 2006. This is best illustrated by means of a simplistic example.

Example 1

Assume that the Municipality receives a payment in cash from one of its customers on 1 July 2006. This payment relates to a belated payment of an entry fee to a caravan park resort run by the municipality. The municipality has determined that this resort does not meet the profitability requirements as envisaged in section 1 of the VAT Act, definition of enterprise, paragraph (c(bb)). The customer used the resort on 30 June 2006. The amount charged by the municipality is R1, 000.

According to paragraph 4.1 of the Regulation on transitional arrangements, the municipality must deem this payment to have been received before that date, i.e. before 1 July 2006. This implies that this amount is not subject to output VAT.

Similarly, according to paragraph 4.2 of the Regulation, the municipality is required to treat payments made by it on or after 1 July 2006 in respect of the supply of goods and services acquire by that municipality before that date as if that payment had been made before that date.

It may be argued that although these special arrangements may be beneficial to the municipality, the efforts involved in manually adjusting the accounting entries for these transactions may be onerous. This is supported by the fact that many municipalities are already under pressure due to lack of administrative capacities (Franck, 2008).

c. Special rules for apportionment of input tax

Section 17 of the VAT Act requires that those VAT vendors, who in the course of their enterprises, incur expenditure in respect of making both taxable and non-taxable supplies, to determine the apportionment ratio for the purposes of

claiming input VAT incurred on such expenditure, also referred to as expenditure with regard to 'mixed supplies'.

Regardless of whether SARS has previously issued a VAT ruling to a particular municipality permitting it to use an apportionment method other than the turnover based method, all municipalities are required to apply the turnover based method with effect from 1 July 2006, unless a new ruling was given to it by SARS subsequent to that date.

A number of adjustments had to be made to the classic 'turnover-based method 'to account for the value of supplies of goods and services which were not taxable prior to 1 July 2006, but which became taxable on that date, as well as grants received by the municipality.

Below is an extract from the Regulation which sets out the mechanism of the apportionment ratio calculation process applicable during the transitional period.

Paragraph 3.2

In order to determine the amount of input tax during the transition period, a municipality must use the information pertaining to the value of the supply of goods and services made during the previous 12 months as per its financial statements as at 30 June 2006 and apply the following formula:

Y = A/B x 100

where

"Y" = the percentage of input tax which may be claimed on goods and services acquired on or after 1 July 2006 that are partly attributable to making taxable supplies.

"A" = the aggregate value of all taxable supplies made during the previous 12 month period.

"B" = the aggregate value of all supplies made during the previous 12 month period (including the value of any other amounts received (e.g. statutory fines and penalties) during that period which are not in respect of any supply.

Paragraph 3.3.

The following adjustments must be made to the financial statements for the purposes of applying the apportionment formula, during the transition period:

3.3.1 The value of supplies of goods and services which were not taxable prior to 1 July 2006, but which become taxable on that date must be included for purposes of A and B of the formula.

3.3.2 The amounts received from punitive statutory fines and penalties such as those levied for the infringement of municipal by-laws, or traffic offences, must be included for purposes of B of the formula.

3.3.3 Grants (including capital grants) made to a municipality for purposes of financing the taxable supplies of goods and services made by that municipality must be included in the value of supplies for purposes of A and B of the formula.

3.3.4 Grants (including capital grants) made to a municipality for the purposes of financing supplies of goods and services made by that municipality which are exempt in terms of section 12 of the Act, which are out of scope for VAT purposes, must be included in the value of supplies for purposes of B of the formula.

However, the Regulation only came into effect on 28 March 2007, three months short of the end of the proposed transition period, with retrospective effect to 1

July 2006. This may be viewed as possible lack of pro-active planning by the relevant authorities and may have posed additional administrative burden on municipalities to comply with these transitional provisions, which is directly the opposite of the intended purpose of the provisions.

Another contentious issue is calculation of a revised apportionment percentage at the end of the transition period. According to paragraph 3.6, municipalities have to recalculate the apportionment percentage based on the actual value of supplies of goods and services made during the transition period, by using the financial statements for the financial year ending on 30 June 2007.

This is impractical as section 126(1)(a) of the Local Government: Municipal Finance Management Act (MFMA) (56/2003), states that municipalities have a period of two months after the financial year end, which is 30 June 2007, to prepare their annual financial statements. This brings the timeline to 30 August 2007.

At this stage, the financial statements are as yet unaudited, and only become finalised and publishable once the Auditor-General has completed the regularity audit and expressed the appropriate audit opinion thereupon. In terms of section 126(3)(b), the Auditor-General has three months after receipt of the financial statements to audit them. The end of this process is set to be 30 November 2007.

The following question arises: how can a municipality calculate the correct ‘revised’ input VAT apportionment percentage in time for its September 2007 VAT return if, according to the statutory deadlines, the underlying financial statements are only finalised at the end of November? It may be argued the calculations performed based on the preliminary amounts may lead to a material misstatement of the ‘revised’ apportionment percentage.

The complexities of the mechanics of the special 'estimated' apportionment formula are best explained by means of a practical example. The purpose of this example is to illustrate the high-level specialist taxation and financial knowledge which is required from municipalities in order to comply with the provisions of the Regulation. It may be argued that many municipalities may be unable to perform such calculation without enlisting the costly expertise of private consultants.

For the purposes of this example. the past tense ('was/were/did) is used when referring to the time period(s) prior to the VAT amendments becoming effective on 1 July 2006, while present tense ('is/are) is used for the time periods subsequent to the amendments.

Example 2

Assume that Municipality had the following financial information as at 30 June 2006.

<u>Income statement of the Municipality for the year ended 30 June 2006 (Excluding VAT)</u>

1. Revenue from hiking trails	R 0.4 mil
2. Revenue from caravan parks	R1.2 mil
3. Revenue from provision of water and electricity	R40 mil
4. Revenue from city parking meters	R2.1 mil
5. Fines from traffic violations	R1.5 mil
6. Agency fee received from Department of Transport for vehicle licenses issued	R1 mil
7. Revenue from operation of municipal buses	R3 mil
8. Receipts from municipal property rates	R1 mil
9. Grants received for provision of water	R10 mil
10. Grants received to subsidise municipal buses operating costs	R 3 mil

10. Interest income on overdue water and electricity accounts	R 1.4 mil
Total income `	R 64.6 mil
Total revenue not subject to VAT up to 30 June 2006	R 14.6 mil
Total revenue which was subject to VAT (14% or 0%) pre 1 July 2006	R 50 mil
Total revenue which becomes subject to VAT from 1 July 2006	R 55.7

The above financial information can be analysed as follows:

1. Revenue from hiking trails of R 0.4 mil, prior to the promulgation of the VAT amendments, has formed part of the 'special enterprise activities' as per the VAT 2570 Regulation. In order to determine whether this amount was inclusive of VAT, one would have to give regard to whether it was expected to be profitable. This was the requirement of the enterprise definition in section 1 of the VAT Act, subsection (c(bb)). For the purposes of this discussion it is assumed that the hiking trails operated by the Municipality were in the remote area of the demarcated territory and did not attract sufficient hikers in order to break even on the operating costs.

2. Same principle as per point 1 above applied to the revenue of R1.2 mil received from operating caravan parks, as caravan parks and holiday resorts were specifically included within the ambit of the Regulation.

3. Revenue from provision of water and electricity of R40 mil has been subject to VAT at the standard rate of 14% since the inception of the VAT Act, by virtue of subsection (c)(i) to the definition of 'enterprise' in section 1 of the Act. Therefore receipts of R40 mil were and remain to be subject to VAT at the standard rate.

4. Revenue from city parking meters amounting to R2.1 mil were not subject to VAT because this type of income was not included in the definition of 'enterprise' nor was it part of the activities listed in the Regulation. Therefore, no VAT was charged on the parking payments made by motorists and no input VAT was claimable on any expenditure funded from such revenue. In other words, revenue from parking was out-of-scope for VAT purposes and the VAT Act did not apply to it.

5. Same principle as per point 4 (above) applied to fines from traffic violations amounting to R1.5 mil.

6. Same principle as per point 4 (above) applied to agency fee amounting to R 1 mil received from Department of Transport for vehicle licenses issued. However, subsequent to the VAT amendments, the agency fees became part of the definition of enterprise and were not specifically zero-rated nor exempt, and therefore standard rate of 14% applies to all agency fees received from 1 July 2006 onwards.

7. Revenue from operation of municipal buses amounting to R3 mil constitutes exempt activity per section 12(g) of the VAT Act and therefore no output VAT is chargeable on the bus tickets. Consequentially, no input VAT was claimable on any expenditure associated with provision of the bus transport services. Section 12(g) did not undergo any amendment for fiscal years subsequent to 30 June 2006 and therefore this type of revenue remains exempt for VAT purposes.

8. Receipts from municipal property rates of R1 mil was not subject to VAT, in other words, neither taxable (at the standard rate or zero-rate) nor exempt, prior to 1 July 2006. Subsequent to 1 July 2006, the municipal property rates have become zero-rated.

9. Grants received for provision of water of R10 mil relate to a taxable activity of the municipality, and therefore zero-rated in terms of section 11(2)(p) of the VAT Act. This particular principle remains unchanged subsequent to the implementation of VAT amendments

10. Grants of R 3mil received to subsidise municipal buses operating costs constitute grants received for the purposes of making non-taxable supplies (road passenger transport). These grants are not subject to VAT in neither the financial year ended on 30 June 2006 nor subsequent to that.

11. Interest income on overdue water and electricity accounts amounting to R 1.4 mil constitutes a 'financial service' as defined in section 2 of the VAT Act and is exempt for VAT purposes by virtue of section 12(a). This particular principle remains unchanged subsequent to the implementation of VAT amendments

Shown below is the information for the subsequent financial year, ended on 30 June 2007.

Balance Sheet of the Municipality as at 30 June 2007
(VAT inclusive)

Assets

Municipal buses	Note 1	R3.6 mil
Office equipment	Note 2	R3 mil
Computer software	Note 3	R2 mil
Repairs vehicle	Note 4	R 0.5 mil

Fittings	Note 5	R 0.2 mil

Notes:

1 – Municipal buses include new purchases of buses amounting to R1.2 mil which are used solely for fare-paying passenger transportation. The new buses were acquired on 5 August 2006.

#2 – Office equipment includes new purchases of desks and chairs amounting to R1 mil for the sole use at the bus management division of the municipality. These were acquired on 2 July 2007 from a supplier who is a registered VAT Vendor

#3 – Computer software includes R1.5 mil which relates to new software acquired to run the municipality's procurement system. All departments within the municipality use this software. The software was developed for the municipality by IT Program Pty Ltd, a VAT vendor. The software was put into use on 1 September 2006.

#4 – Repairs vehicle is used for carrying out maintenance and repairs to the municipal buses as well as the local rail line, which transports passengers via commuter trains. The repair vehicle was acquired on 1 August 2006.

5 – Fittings relate to curtain railings and blinds installed in all departments at the municipality. The fittings were acquired on 3 May 2007.

In order to comply with the transitional provisions, the Municipality would need to calculate the transitional apportionment percentage for the purposes of claiming input VAT on expenditure incurred in making of mixed supplies. All the values in the formula would need to be calculated from the accounting records of the preceeding financial year, i.e. 1 July 2005 – 30 June 2006. The end result of the

formula represents the ‘estimated’ apportionment percentage which should be applied during the financial year 1 July 2006 – 30 June 2007.

It should be noted that if this percentage equals or exceeds the 95% non-apportionment threshold, as envisaged in the first proviso to section 17(1), the Municipality would not be required to apportion its input VAT and instead, it would be allowed to claim the full input VAT paid.

The next step is to apply this percentage to the asset information for the subsequent year ended on 30 June 2007. Thereafter, paragraph 3.6 of the Transitional Regulation requires the municipality to recalculate a ‘revised’ apportionment with reference to the actual value of supplies of goods and services made during the transition period according to the financial statements for the financial year ending on 30 June 2007.

The municipality should account for any difference in input tax for the transition period between the revised apportionment percentage and the percentage determined previously as the ‘estimated’ apportionment percentage in the September 2007 VAT return, due by 25 October 2007.

It may be argued that the municipalities may be unable to comply with this specific requirement as their actual final financial statements will only be available on 30 November 2007, after the sign-off by the Auditor-General.

Regardless of whether provisional or final figures are used, the above example demonstrates the practical complexities of the transitional provisions which municipalities need to comply with. Although the time needed to prepare these calculations may be extensive, the actual methodology of the calculation as set out in the Transitional Regulation is unlikely to cause confusion among municipalities, as it is clearly worded.

3.5 SECTION 40(B) LIABILITY OF MUNICIPALITIES AND LIMITATION OF REFUNDS

Historically, there has been a degree of uncertainty and confusion regarding the VAT treatment of grants, transfer payments and government subsidies. Section 11(2)(p) of the VAT Act zero-rated certain of these payments, provided that the payment in question complied with the requirements of the 'transfer payment' definition. This section has unfortunately been misunderstood by many government entities and resulted in inconsistent application (SARS 2007:6).

In order to address these anomalies, with effect from 1 April 2005, a number of important changes have been made to the VAT Act. These amendments are contained in the Revenue Laws Amendment Act, 2003 (45/2003), the Revenue Laws Amendment Act, 2004 (32/2004), the Taxation Laws Amendment Act, 2005 (9/2005), the Taxation Laws Second Amendment Act, 2005 (10/2005), and the Revenue Laws Amendment Act, 2005 (31/2005).

Although the detailed provisions contained in the above acts are beyond the scope of this study, however, it is important to note that certain confusion still persisted notwithstanding the provisions therein.

This had prompted the legislature to promulgate of a new section, namely section 40(B), which was inserted into the VAT Act by section 51(1) of The Small Business Tax Amnesty and Amendment of Taxation Laws Act 2006 (9/2006). Section 40(B) attempts to clarify the VAT consequences of previously incorrect application of VAT on grants and government assistance received by municipalities. This section came into effect on 1 July 2006. The section reads as follows:

40B. Liability of municipalities for tax and limitation of refunds.—

(1) This section applies in respect of the supply of goods or services on or before 31 March 2005 by any entity which at the time of that supply qualified as a "local authority" as defined prior to the deletion of that definition by the Small Business Amnesty and Amendment of Taxation Laws Act, 2006.

(2) Where the Commissioner on or before 31 March 2005 issued an assessment for an amount of tax or additional tax in respect of any supply of goods or services contemplated in subsection (1) to correct a prior incorrect application of the zero rate of tax in terms of section 11 (2) (p) as it read on 31 March 2005 in respect of that supply, the Commissioner must, on written application, reduce that assessment to the extent that the amount of tax, additional tax, penalty or interest arose as a result of that correction and was not yet paid on that date as long as the reduced assessment will not result in a refund to that entity.

(3) The Commissioner may not after 31 March 2005 make any assessment to correct a prior incorrect application of the zero per cent rate of tax in terms of section 11 (2) (p) as it read on 31 March 2005 in respect of any supply of goods or services contemplated in subsection (1).

(4) If a local authority incorrectly charged tax at the rate referred to in section 7 (1) instead of the zero per cent rate of tax in terms of section 11 (2) (p) as it read on 31 March 2005 in respect of any supply contemplated in subsection (1), the Commissioner may not refund any such tax or any penalty or interest that arose as a result of the late payment of such tax, paid by that local authority to the Commissioner.

At first glance, section 40(B) is a lenient provision as it compels the Commissioner of SARS to reduce the assessment of tax, additional tax, penalty or interest which arose due an error on municipality's part, when it erroneously

declared output VAT at the standard rate on grants which were actually zero-rated.

However, this section only applies if the assessment remains unpaid on that date. This means that in order for the municipality to benefit from this relief, the municipality should have defaulted in paying this assessment.

Franck (2008) argues that such provisions may be sending an undesirable message to the taxpayers regarding the benefits of diligent compliance with the VAT Act in future. However, it may be expected that the municipalities would not misconstrue or abuse this section.

3.6 AMENDMENTS RELATING TO CAPITAL ASSETS

Municipalities own a variety of assets which they use to engage in a diverse range of activities. The VAT treatment of such assets may be problematic if such assets are originally used for making of non-taxable supplies, and subsequently used for making of taxable supplies.

To address any uncertainties that may have previously existed in this regard, VAT amendments were introduced a new section into the VAT Act, namely section 16(3)(h)(iii), which was inserted in the VAT Act by section 47(1)(b) of the Small Business tax amnesty and Amendment of Taxation Laws Act.

This section prohibits municipalities from claiming input tax on an asset on which a VAT adjustment was not previously allowed in terms of proviso (v) to section 18(4). The section reads as follows:

Section 16(3) - Calculation of tax payable

(3) Subject to the provisions of subsection (2) of this section and the provisions of sections 15 and 17, the amount of tax payable in respect of a tax period shall be calculated by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period, as determined under subsection (4), and the amounts (if any) received by the vendor during that period by way of refunds of tax charged under section 7 (1) (b) and (c) and 7 (3) (a), the following amounts, namely—

(h)

in the case of a vendor who has supplied goods or services during that tax period otherwise than in terms of section 18 (2), an amount determined in accordance with the formula

$$A \times B \times C,$$

(iii) this subsection does not apply where such goods or services were acquired by a municipality before 1 July 2006, or an input tax deduction in respect of that acquisition was denied in terms of paragraph (v) of the proviso to section 18 (4);

In the past, where the municipality acquired capital goods and services prior to 1 July 2006 with the intention of making non-taxable supplies, the municipality was prohibited from claiming input VAT on the costs thereof.

This scenario has changed with the amendments of section 16(3)(h)(iii) and now the following two possibilities exist.

The municipality may, after 30 June 2006, decide to apply these capital goods and services for the making of taxable supplies. Unfortunately, section 16(3)(h)(iii) now prohibits municipalities from claiming input tax on an asset on

which a VAT adjustment was not previously allowed in terms of proviso (v) to section 18(4).

If the municipality decides to vary the extent to which these goods and services (acquired before 1 July 2006) are applied in the making of taxable versus non-taxable supplies, the municipality will not be required to account for an output or input VAT adjustment due to this annual variation in the extent of the taxable use of the capital assets (section 18(2) and 18(5) of the VAT Act).

Where a capital asset purchased prior to 1 July 2006 is subsequently used to provide taxable supplies and it is later sold, donated or exchanged, the municipality will need to account for output VAT liability at the standard rate of 14%, on the proceeds of the sale, regardless of whether any input VAT has been allowed on this asset.

Where the municipality acquires capital assets and services after 1 July 2006 for mixed purposes (both taxable and non-taxable supplies), the normal rules for annual input and output apply, i.e. input VAT may be claimed on such assets and services in proportion to the extent to which those assets are applied for taxable purposes over their lifetime. This claim is based on an annual estimation of their use for taxable versus non-taxable supplies for the previous financial year.

Section 18 of the VAT Act requires that any change in use of goods and services is accounted for as an input or output VAT adjustment, if the VAT apportionment percentage during the year varies by more than 10% from the percentage applied in the previous year.

It may be argued that the amended section 16(3)(h)(iii) reads clearly and although it may appear complicated, it would be unlikely to cause confusion among municipalities.

CHAPTER 4
ANALYSIS OF QUESTIONNAIRE

4.1 INTRODUCTION

A questionnaire consisting of 28 questions was compiled will all the possible issues and problem matters relevant to the VAT amendments, as well as certain matters concerning the pre-consultation process and abolishment of the RSC levies, which were integral to the process of promulgating the VAT amendments.

The questionnaire aims to establish, by means of practical perspective, whether any practical problems were encountered by municipalities in complying with VAT amendments, their views on the pre-consultation, information sharing in the amendment process and whether VAT amendments have achieved their multiple strategic objectives of simplifying taxation and administration of the municipalities.

In order to ensure the validity and relevance of the contents of the questionnaire as well as to determine whether these adequately address the main issues identified by this study, several tax practitioners were requested to review its contents. Their independent inputs have been incorporated in the questionnaire prior to its distribution to municipalities.

As there are a total of 283 municipalities in South Africa, it was considered appropriate for the purposes of this exploratory research to select ten per cent of municipalities for inclusion in the sample. This questionnaire was sent for comment to these 28 respondents. The respondents were selected randomly from a listing of metropolitan as well as medium capacity municipalities in all nine provinces.

Given the voluntary nature of participation in the survey as well as possible sensitivity involved in providing critical responses, out of the 28 questionnaires sent out, six responses were received, five of which were submitted by metropolitan municipalities, and one by a district (medium capacity) municipality. Nevertheless, this number of responses is in line with the expected response rate, which was estimated to be 15-20% (5 or 6 municipalities). Moreover, all the metropolitan municipalities in South Africa have provided their comments on the questionnaire. This is of particular significance as these metropolitan municipalities are the largest and most influential municipalities in South Africa

Due to the sensitive and confidential nature of responses, the names of the municipalities and their officials are not disclosed in this chapter.

The responses not received are therefore excluded from the analysis below. As the purpose of this questionnaire is to determine whether the potential problem areas as discussed in Chapter 3 are prevalent in practice, the six responses received are considered to be adequate to conclude on this exploratory research as well as to enable identification of possible problem areas that may require further research.

The respondents were required to indicate their agreement/disagreement with the statements contained in the questionnaire, as follows:

- ***Strongly disagree***: The respondent objects strongly to the validity of the statement as it is fundamentally misleading/flawed
- ***Disagree***: The respondent feels that the statement does not hold true
- ***Neither agree nor disagree*** (no opinion) or not applicable – The respondent feels neutral regarding the statement and does not have any particular opinion thereupon
- ***Agree***: The respondent agrees with the statement
- ***Strongly agree***: The respondent strongly agrees with the statement as it is ‘spot on’

The respondents were also required to indicate their consent to provide responses to this questionnaire, with the understanding that the responses provided will not be linked to the identity of the municipality or the person providing the responses. The numbers shown below indicate the number of municipalities which gave the particular response.

4.2 ANALYSIS

4.2.1 Pre-consultation on VAT amendments and RSC abolishment

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	There was wide consultation regarding proposed abolishment of the RSC levies and the resultant VAT amendments		3		2	1	
2.	The abolishment of the RSC levies, as effective from 1 July 2006, did not present severe administrative or financial burdens.	1	1		3	1	

1. The respondents were divided as to whether the consultation regarding proposed abolishment of the RSC levies and the resultant VAT amendments was adequate. Half of the respondents disagreed that it

was adequate, while the other 50% were satisfied with the extent of the consultation process.

2. Sixty-six percent of the respondents did not encounter negative consequences from the abolishment of the RSC levies, while the remaining respondents maintained that the abolishment of the levies presented severe administrative and/or financial burdens.

4.2.2 Information and consultants

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	The municipality was adequately informed and received sufficient appropriate information regarding the proposed VAT amendments prior to them becoming effective on the 1 July 2006.	1	3	1	1		
2.	The municipality received adequate assistance from the relevant authorities when challenges arose in the subsequent implementation of the VAT amendments.		1	3	2		
3.	Substantial effort and costs had to be incurred by the municipality, including the appointment of consultants (both tax and IT), to implement that VAT amendments.		1		3	2	

1. According to the majority of the respondents (66%), the training and information which they received was inadequate to enable them to fully understand the proposed VAT amendments prior to their implementation. Only 1 out of 6 respondents felt that they received sufficient training. This is unfortunate given the current indication of a shortage of skills facing municipalities.

2. There is no clarity on whether the relevant authorities have provided appropriate assistance to municipalities during the implementation of the amendments, as half of the respondents did not have any specific opinions on this issue, and the rest of the respondents were divided in their opinions (33% satisfied and 16% unsatisfied).

3. There appears that an almost unanimous consent among the respondents (83%) that the implementation of the VAT amendments required substantial effort and costs within their municipalities.

4.2.3 RSC levies

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	The income received from RSC levies was a significant source of revenue for the municipality.	1			1	4	
2.	The RSC levy income was successfully used to develop and maintain infrastructure which benefited the communities.				3	3	

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
3.	The increase in government grants has adequately compensated the municipality for the lose RSC levy income.		2	1	2	1	

1. The RSC income was a significant source of income for most municipalities (84%) in the survey.

2. All the respondents agree that the development and maintenance of infrastructure benefited from the income generated from RSC levies.

3. Notwithstanding the abolishment of the RSC levies, majority of the respondents feel satisfied with the increase in grant allocation, while the remaining respondents are either dissatisfied (34%) or neutral (16%). Therefore it may be argued that the abolishment of the RSC levies did not have a detrimental effect on the majority of the respondents.

4.2.4 Transitional provisions per Regulation R.270 (March 2007)

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	The transitional provisions as contained in Regulation No. R.270 on 28 March 2008		2	1	3		

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
	(Government Gazette No. 29741) were well communicated and publicised.						
2.	These transitional provisions within the transitional period of 1 year (1 July 2006-30 June 2007) provided sufficient time and mechanisms to enable the municipality to implement the VAT Act amendments.	1	1	1	2	1	
3.	The fact that the VAT rulings for apportionment of VAT granted by SARS prior to 1 June 2006 have been withdrawn with effect from 1 July 2006 was well communicated and publicised.			2	3	1	
4.	No significant problems were experienced in the implementation of the new method/formula of calculating 'estimated' and 'revised' apportionment percentages for the purposes of calculating input VAT to claimed on making of the taxable supplies (as per the Transitional arrangements in the		1	1	3	1	

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
	Regulation).						
5.	The special rules for VAT treatment of receipts and payments which relate to pre 1 July 2006 supplies, have been clearly explained in the paragraph 4 of the Regulation and are practical (e.g. timing effect when an invoice from a contractor was received prior to 1 July 2006, but paid after 1 July 2006 – applicable to municipalities on the payments basis of VAT).			1	5		
6.	The mechanism for rectification of errors in VAT returns as well as the possibility of waiving of additional tax, interest and penalties for late payment of output tax on supplies which became taxable for the first time on or after 1 July 2006, is clear in its application and does not cause preferential treatment between municipalities. (*Note: Extension was granted until 25 July 2007 to account*			1	1	4	

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
	for any omitted output VAT on supplies which became taxable for the first time on or after 1 July 2006).						
7.	The extension/window period of until June 2007 (due 25 July 2007) was sufficient/reasonable to account for any previously omitted output VAT.		3		2	1	

1. Half of the respondents believe that the transitional provisions were well communicated, while the rest is either undecided (16%) or of the opinion that the legislature failed to adequately publicise the provisions.

2. Furthermore, half of the respondents felt that a transitional period of 1 year and the transitional provisions have enabled the municipality to implement the VAT amendments, while 34% disagreed that the transitional arrangements assisted the implementation of the VAT amendments. The remaining sixteen percent of the respondents did not have an opinion on this issue.

3. Majority of the respondents (66%) were aware that VAT rulings were withdrawn.

4. Majority of the respondents (66%) did not encounter difficulties in implementing the new apportionment formulas for ‘estimated’ and ‘revised’ apportionment percentages.

5. None of the respondents struggled with applying the special rules for VAT treatment of receipts and payments which relate to pre-1 July 2006 supplies.

6. It continues to be a trend that most of the respondents (84%) reacted positively to the introduction of a mechanism for rectification of errors in VAT returns during the transitional period.

7. However, surprisingly, there was a strong difference of opinion on whether the extension period of until June 2007 was reasonable or not. Half of the respondents thought it was indeed sufficient, while the other half disagreed.

4.2.5 VAT amendments

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	Prior to 1 July 2006, the municipality was significantly disadvantaged due to not being able to claim input VAT on expenses incurred in connection with the services which were funded from the municipal rates income (e.g. streets and storm water, upgrading of parks etc.)		1	1	1	3	
2.	The zero-rating of municipal rates and taxes with effect from				2	4	

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
	1 July 2006 (VAT output levied at 0%, input VAT claimable on expenses funded from the rates) has freed up substantial amount of claimable input VAT on expenses funded from the rates						
3.	The municipality was able to understand and implement the necessary changes to the accounting and record-keeping system (e.g. re-coding) to comply with the VAT Act, as amended.			1	3	2	
4.	The goods and services which are subject to VAT at 14% with effect from 1 July 2006 are readily identifiable.			1	3	2	
5.	The application of the new VAT rules to progressive supplies, where there are price increases, does not pose significant difficulties.		1	1	4		
6.	The new rules are clear regarding when VAT output must be declared on grants received and when VAT input may be claimed on the		2		4		

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
	associated expenses						
7.	The new rules are clear regarding the new VAT treatment to be applied to capital assets acquired before and after 1 July 2006		1	1	4		
8.	The municipality understands the VAT treatment to be applied to supplies outside of the VAT net, such as statutory fines and licence fees.			1	3	1	1
9.	The provisions of the new section 40(B) in the VAT Act regarding the potential relief from tax where transfer payments were treated incorrectly for VAT purposes prior to 1 April 2005, are beneficial.		1	1	4		

1. Majority of the respondents (68%) feel that prior to the introduction of the VAT amendments, their municipality has been adversely impacted due to its inability to claim input VAT on expenses funded from municipal (property) rates income.

2. All of the respondents welcomed the zero-rating of the property rates as it made available for use the previously 'lost' funds which were tied up in 'non-claimable' input VAT.

3. The re-coding of the accounting systems in line with the VAT amendments did not present challenges to any of the respondents (84% positive and 16% neutral)

4. None of the respondents encountered difficulties in identifying the goods and services which are subject to VAT from 1 July 2006.

5. The majority of the respondents (68%) did not struggle with applying the new VAT rules on progressive supplies.

6. There is a difference of opinion regarding the clarity of the new VAT rules on grants, with 68% of the respondents believing that the rules are clear, while the remaining 32% disagree.

7. Majority of the respondents understand the VAT treatment to be applied to capital assets acquired before and after 1 July 2006.

8. Treatment of out-of-scope supplies is clear to 66% of the respondents, while 2 municipalities (32%) are either not aware of the rules or do not have an opinion regarding the treatment of supplies such as statutory fines and license fees.

9. Majority of the respondents (64%) agree that the provisions of relief section 40(B) are beneficial, while the remaining respondents either disagree or do not have an opinion on this issue.

4.2.6 General

No.	Questions	Strongly disagree	Disagree	Neither agree nor disagree	Agree	Strongly agree	Not aware/do not know
1.	The input VAT claimed by the municipality on the VAT returns since 1 July 2006 has increased significantly.	1			2	3	
2.	The increase in input VAT deductions has lead to a substantial decrease in net VAT paid to SARS and therefore has provided noticeable financial relief and improved the cash flow position of the municipality	1		1	2	2	
3.	The VAT amendments have achieved their aim of simplifying the accounting and administration processes at the municipality.	1	1	1	2	1	
4.	The Small Business Amnesty and Taxation Laws Amendment Acts (Acts 9 and 10 of 2006) are clear on the changes made to the VAT Act.			2	2	1	1

1. The majority of municipalities in the survey (84%) are experiencing increased claims of input VAT, while the remaining 16% do not relate this situation to their municipalities.

2. Again, the majority (68%) are enjoying lower net VAT payments to SARS and are benefiting from improved cash flow while the remaining respondents disagree or have no opinion.

3. Interesting to note here, that there is no consensus among the respondents regarding whether or not the VAT amendments have achieved their aim of simplifying the accounting and administration processes at municipalities. Half of the respondents agree that simplification has taken place, while the other half either disagree (32%) or have no opinion (16%).

4. Overall, half of the respondents believe that the Small business amnesty and Taxation laws amendment Acts are clear on the changes made to the VAT Act, while the rest either does not have an opinion (34%) or are not aware/unable to express an opinion (16%).

4.3 CONCLUSION

Overall, it may appear that the consultation process regarding the proposed VAT amendments and RSC levy abolishment was not deemed satisfactory by all the respondents in the survey.

It appears that the respondents had to incur substantial effort and costs to implement the VAT Amendments.

Not all municipalities surveyed believe that they have been adequately compensated for the abolishment of the RSC levy income by the increase in the government grants.

Transitional provisions as per Regulation R.270 were generally well received and understood.

Most municipalities have welcomed the zero-rating of municipal property rates and other VAT amendments.

However, there is no clear indication on whether the respondents deem that the VAT amendments have achieved their strategic objective of simplifying the municipal financial administration and related processes.

CHAPTER 5

EXECUTIVE SUMMARY

The purpose of the study was two-fold: firstly to perform a critical analysis of the VAT amendments, relevant to municipalities as introduced by the Small Business Amnesty and Amendment of Taxation Laws Act No. 9 of 2006 with effect from 1 July 2006. Secondly, to perform exploratory practical research by means of a custom-designed questionnaire. The questionnaire contained a list of potential problem areas and it was used to obtain an indication of the practical perspective of the matters identified by the critical analysis. Six municipalities provided their responses to this questionnaire.

A literature review, including brief historical and legal framework of municipalities was performed in Chapter 2. Chapter 3 focused on the critical analysis of the VAT amendments, which where necessary, were supplemented with illustrative examples.

The responses from the questionnaire have indicated that VAT amendments and transitional provisions were generally well received by the survey participants, while there is an indication that the information related to the VAT amendments was not entirely satisfactory. This may be an area for consideration for future taxation laws amendment and implementation process. Also, the initial cost, effort and time required by the respondents to implement the VAT amendments has shown to be substantial.

This survey represents exploratory research and although is useful in identifying possible problem areas, it is therefore subject to a number of limitations due to a small sample size used. Further comprehensive research is needed in order to establish whether the conclusions reached within the sample of six municipalities are indeed applicable to all municipalities in South Africa.

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