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A CRITICAL ANALYSIS OF THE VAT IMPLICATIONS OF OVER-ALLOWANCES IN THE SOUTH AFRICAN MOTOR RETAIL INDUSTRY

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ABSTRACT

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by

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The VAT treatment of over-allowances in the motor retail industry has proved contentious for South African Revenue Services ("SARS"). VAT legislation dictates that notional VAT may be claimed on the lower of the open market value and the consideration paid. The industry, however, claims notional VAT on the actual consideration paid for a used vehicle on the basis that a higher output VAT will be declared on the consequent sale of the new vehicle. This is because the over-allowance is offset against the lower discount granted. SARS allows this practice on account of SARS' own issuance of a binding general ruling, provided certain criteria are met. This ruling is contained in the VAT Guide to Motor Dealers.

This study performs an analysis of the current practice by South African motor retailers pertaining to over-allowances. The aim of the study is to determine the impact on the industry of the issuance of the Guide, both practically and from the perspective of compliance, focussing on VAT legislation and Competition Commission legislation.

The study discusses the requirements contained in the *Guide* in the light of the Competitions Act and the practical benefits, and concludes that the industry is satisfied with the issuance of the *Guide*, despite its silence on the interpretation of certain key criteria. The industry has chosen to assume that, as SARS has acted reasonably in the issuance of the *Guide*, it would not expect the industry to deviate from any other legislation, including the Competitions Act. If SARS is not satisfied with this interpretation,

the *Guide* will have to be amended to include definitions of terms such as “permissible discount”.

Keywords:
Over-allowance
Permissible discount
Competition Commission
Open market value
Motor retail industry
Guide for Motor Dealers
South African Revenue Services

OPSOMMING

‘n KRITIESE ONTLEDING VAN DIE IMPLIKASIES VAN OORMATIGE AFTREKKINGS VAN BTW OP DIE SUID-AFRIKAANSE MOTORVOERTUIGINDUSTRIE

deur

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Die hantering van die toelating van oormatige BTW in die motorvoertuig-kleinhandelsindustrie is, insover dit die Suid-Afrikaanse Inkomstediens (“SAID”) betref, omstrede. BTW-wetgewing bepaal dat geagte BTW gehef mag word op die laagste van ope markwaarde en die werklike bedrag betaal. In die motorvoertuigindustrie word BTW egter altyd gehef op die werklike bedrag betaal vir ‘n gebruikte voertuig met die veronderstelling dat hoër uitset BTW verklaar gaan word met die verkoop van ‘n nuwe voertuig wat die inruiltransaksie tot gevolg gaan hê. Daar word geredeneer dat die oortoelating van BTW uitgekanselleer gaan word deur ‘n laer afslag op die nuwe verkope.

As gevolg van bindende bepalings in die BTW Handleiding vir Motorhandelaars, wat uitgereik is deur die SAID en die nakoming van sekere voorwaardes deur die motorhandelaars, laat die SAID hierdie praktyk toe.

In hierdie mini-verhandeling word die vereistes wat in die Handleiding vervat is teen die agtergrond van die Wet op Mededinging en die praktiese voordele daarvan bespreek. Die gevolgtrekking is dat die motorvoertuigindustrie tevrede is met die uitreiking van die Handleiding vir motorhandelaars ongeag die feit dat sekere sleutel aspekte nie in die Handleiding voldoende toegelig word nie.

Die motorindustrie het die aanname gemaak dat SAID redelikerwys opgetree het deur die Handleiding uit te reik en sal daarom nie verwag dat die industrie van enige ander

wetgewing sal afwyk nie, insluitende die Wet op Mededinging. As die SAID nie tevrede is met hierdie interpretasie nie sal dit beteken dat die Handleiding aangepas sal moet word om ander relevante terminologieë soos “toelaatbare afslag” beter te omskryf en te verduidelik.

Sleutelwoorde:
Oormatige verminderings
Toelaatbare afslag
Mededingingskommissie
Ope markwaarde
Motorvoertuigkleinhandelsindustrie
Handleiding vir motorhandelaars
Suid-Afrikaanse Inkomstediens

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A CRITICAL ANALYSIS OF THE VAT IMPLICATIONS OF OVER-ALLOWANCES IN THE SOUTH AFRICAN MOTOR RETAIL INDUSTRY

1 INTRODUCTION

1.1 BACKGROUND

The Motor Retail Industry of South Africa (the "industry") has been under close scrutiny by the South African Revenue Service ("SARS") for the past few years. With the controversy that has arisen around making exempt supplies and the notional input claim on second-hand goods from the perspective of value added tax ("VAT"), SARS has shamelessly attacked a very common practice in the industry that of "over-allowances" derived from the trade-in of second-hand vehicles.

An over-allowance (also known as an over-trade) occurs when an individual sells his/ her motor vehicle to a dealership. In most instances, the customers do so when they intend purchasing a new vehicle from the dealership. Often the motor dealer will agree to pay the customer a value higher than the accepted trade-in value (i.e. open market value) for the traded-in vehicle. When a new vehicle is purchased, the discount given on the price of the new vehicle is reduced by the value of the over-allowance given on the trade-in.

In terms of legislation in South Africa ("SA"), dealers can claim notional input tax on the purchase of a second-hand motor vehicle. This is calculated by multiplying the tax fraction by the lesser of the consideration paid and the open market value ("OMV"). The question arises as to what the OMV is and how it is determined. According to the *VAT 420: Guide for Motor Dealers* ("the *Guide*") (SARS, 2009: 12), the OMV is the value stated in the Auto Dealers' Guide ("M&M Book"). The M&M book is published monthly by Mead and McGrouther, Trans-union, and serves as a guide to valuing second-hand motor vehicles. There are, however, two problems arising from the treatment prescribed in the *Guide*.

First, the specification of pricing could be considered to be price-fixing in terms of section 41(b) of the Competition Act 89 of 1998 ("Competition Act"). According to Moodaliyar and

Weeks (2008, 337-353), there are no apparent advantages to price-fixing by competitors. It is, in fact, potentially so destructive that it should be considered intolerable and unlawful. In 2005, the industry was found to be guilty of price-fixing and was fined heavily as a result. In specifying that the price indicated in the M&M book is the OMV, and should therefore be the price given for trade-ins, the industry could be seen to have been price-fixing.

Secondly, the M&M book is merely a guide and cannot take into account every possible condition or eventuality relating to vehicles that may be brought into the dealership. In most instances, dealerships have a valuation expert who is able to evaluate any vehicle brought in. This is surely more reliable than a theoretical textbook. Furthermore, the Value-Added Tax Act 89 of 1991 ("VAT Act") states in section 3 that, "[f]or the purposes of this Act, the OMV of any supply of goods or services at any date shall be the consideration in money which the supply of those goods or services would generally fetch if supplied in similar circumstances at that date in the Republic, being a supply freely offered and made between persons who are not connected persons". These values cannot be confined to one book, which is openly viewed by the industry as a mere guideline.

Despite questions arising with regard to the determination of the OMV, SARS (2009: 44) has stated in the *Guide* that "it is not the intention of the VAT Act to deny an input tax credit on an arm's length transaction between parties that are not connected persons", and has therefore issued a binding general ruling. The ruling allows for the motor dealers to continue the current practice, which allows for input VAT to be claimed on the full consideration paid. This is because the price obtained for the new vehicle is higher on account of the reduced discount, so that the dealer would pay increased output VAT on the sale of the new vehicle. However, this treatment is acceptable only if certain conditions are fulfilled. The most problematic condition is that "the over-allowance given by the vendor shall not exceed the discount that is permissible of the vehicle being sold [referring to the discount on the purchase of the new vehicle]". SARS (2009:43-44) remains silent on what and how the permissible discount is obtained. And the industry would once again be at risk of price-fixing if they were to specify "permissible discounts".

1.2 PROBLEM STATEMENT

While SARS (2009:43-44) accepts the treatment that is currently used in the industry, it does so on condition that certain criteria are met. It is these criteria that have made the policy somewhat unclear. As a result, the industry may be forced to choose between complying with either the VAT legislation or the Competition Commission legislation. In other words, should the industry choose to comply with the *Guide*, it could be found to be in contravention of the Competition Act. This study aims to identify and investigate any practical difficulties encountered by a sample of dealers as a result of the treatment prescribed in the *Guide*. An extensive search into the South African motor retail industry on SABINET indicates that there is no formal study into practices commonly followed in the industry, and certainly none in respect of the treatment of over-allowances.

1.3 PURPOSE STATEMENT

SARS (2009: 43-44) stipulates the requirement of permissible discounts, which, in terms of the Competition Act, could be considered price-fixing, putting the industry at risk of being anti-competitive. This study aims to examine how a number of key members of the industry in SA treat over-allowances from the perspective of VAT.

1.4 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives:

- to identify how a fair OMV is determined in the industry;
- to identify the interpretation by the various participants in the industry of “permissible discount” as contained in the *Guide*;
- to determine whether or not “permissible discount”, as cited in the *Guide*, stands in contravention of the Competition Act;
- to identify whether or not the *Guide* succeeds as a practical solution in the industry when it comes to the VAT treatment of over-allowances in the South African industry; and

- to identify and investigate any practical difficulties that are currently experienced as a result of the prescribed treatment.

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This study will attempt to make a valuable, practical contribution to the accepted treatment of over-allowances in the context of the SA industry on a number of levels.

First, the industry finds itself in a complex and controversial environment in SA, whereby it is governed by a number of bodies, including the Competition Commission. Setting either maximum or minimum pricing can be seen as price-fixing and therefore as anti-competitive. Having already been found guilty of price-fixing, the industry would be foolish to implement maximum or minimum pricing rules. In the light of the *Guide*, which clearly stipulates that the most practical application of the VAT legislation can be used only if a maximum permissible discount is not exceeded, the industry is left with a conundrum, deciding whether to comply with the *Guide*, at the risk of being anti-competitive, or to comply with Competition legislation, at the risk of being in contravention of the *Guide*.

Further, the study aims to find the most acceptable treatment of over-allowances from the industry's perspective as well as from that of SARS, thus eliminating any confusion or controversy existing in the current practice.

1.6 DELIMITATIONS AND ASSUMPTIONS

1.6.1 Delimitations

The study has a number of delimitations that have to be considered. First, the study will be limited to the context of the SA industry and will not extend beyond this. In addition, the study is interested purely in understanding the treatment of over-allowances from the perspective of VAT and will therefore not be assessing any business-specific policies or trade secrets relating to accounting for the over-allowances.

1.6.2 Assumptions

Leedy and Ormrod (2005:5) define an assumption as “a condition that is taken for granted, without which the research project would be pointless”. The following basic assumptions underlie the proposed study:

- all motor retail dealers have a policy on the valuation of trade-in vehicles;
- all motor retail dealers have a policy on the treatment of over-allowances from the perspective of VAT;
- the selected motor retail dealers will be willing to participate in the study; and
- the pre-structured/ pre-determined questions will gather the required data in order to generate conclusions in line with the pre-defined objectives.

1.7 DEFINITION OF KEY TERMS

Competition Commission Act: An act established by the Competition Commission, establishing three institutions; to ensure open, clean and healthy competition in the SA economy. (Riordan, 2010:6)

Competition Commission: A statutory body constituted by the SA government, in terms of the Competition Act. This body is empowered to investigate, control and evaluate restrictive business practices, abuse of dominant positions and mergers in order to achieve equity and efficiency in the SA economy. (Competition Commission, 2004:1)

Input tax: As defined in section 1 of the VAT Act, input tax is a deduction allowed to the vendor when goods or services are acquired for consumption, use or supply in the ordinary course of making taxable supplies. (Beneke & Silver, 2009:120)

Motor retail industry of SA: The network of organisations (known as dealers) in SA, whose purpose is the retail of motor vehicles to consumers.

Open market value: An agreed-upon price, after negotiations have been entered into, between a willing buyer and a willing seller, who are not connected, in a free and open market (VAT Act, section 3(3))

Output tax: The tax which is levied when a vendor supplies goods or services in the course of conducting any ongoing business activity, as defined in section 1 of the VAT Act. (Beneke & Silver, 2009:14)

Over-allowances: An amount paid to a customer which is in excess of the generally accepted trade-in market value of a second-hand vehicle.

Permissible discount: The permissible discount has not been defined and as a result the industry is uncertain as to where to obtain any discount guidelines. It can be assumed that the discount refers to the discount on the price of the new vehicle against which the trade-in vehicle is being traded.

Price-fixing: The practice of minimum resale pricing through specifying maximum discounts or specifying minimum prices. (Competition Commission, 2004:1-2)

VAT: In terms of section 1 of the VAT Act, VAT is an indirect tax on the consumption of goods and services. It is, effectively, a sales tax, in that only the end consumer is taxed, as the buyer is entitled to claim input tax on the purchase price, and is required to declare output tax on the selling price. (Beneke & Silver, 2009:13-14).

Table 1: Abbreviations used in this document

Abbreviation	Meaning
Competition Act	Competition Act 89 of 1998
M&M Book	Auto Dealer's Guide
OMV	Open Market Value
SA	South Africa
SARS	South African Revenue Services
The Guide	VAT 420: Guide for Motor Dealers
The industry	Motor retail industry
VAT Act	Value-Added Tax Act 89 of 1991
VAT	Value-added tax

1.8 SUMMARY OF CHAPTERS

This study has been broken down into a number of chapters, each of which will be summarised briefly.

A search of related literature was conducted and the findings from the search have been discussed under chapter 2. Firstly, the search was conducted on the terms over-allowance and motor retail industry. The concept of over-allowances has been defined and discussed, including a discussion of the industry practice relating to the VAT treatment of over-allowances. The literature search was then extended to include notional input VAT and the basic principles thereof have been discussed. Finally, the search was extended to the principles of OMV and the impact of the Competition Act on the issuance of the Guide, including a discussion on the contraventions and what is considered to be a contravention to the Competition Act.

Chapter 3 defines the data collection methodology adopted in order to obtain the necessary data required to draw the relevant conclusions, in line with the predefined research objectives and documents the results of discussions held with selected participants in the industry.

Chapter 4 documents the summaries and conclusions of each of the questions contained in the predetermined interview schedule, based on the responses of the participants as documented in chapter 3. Furthermore, this chapter includes an e-mail discussion with a United Kingdom ("UK")-based motor retail company, as a point of comparison.

Chapter 5 draws the final conclusions in terms of the objectives raised as well as the proposition raised.

2 AN OVERVIEW OF OVER-ALLOWANCES IN LIGHT OF CURRENT VAT LEGISLATION AND COMPETITION COMMISSION LEGISLATION

2.1 INTRODUCTION

The problem of how over-allowances are treated by the industry from the perspective of VAT has been raised and it is important to examine the current literature available relating to the topic under consideration, in order to assess the problem statement raised against previous findings or related data (University of Pretoria, 2009:2-3).

The purpose of the *Guide* is certainly not to make life and business difficult for the motor dealers but is to attempt to find a solution to accommodate VAT-controversial, industry-specific issues, one of which is the issue of over-allowances. While the *Guide* attempts to find a common-ground solution for over-allowances, there remain many matters that have not been considered in prescribing such a solution. For one, if SARS were to perform an analytical review of the current treatment of over-allowances by the larger motor-dealer groups in South Africa, they would see that what it views as one transaction is what the industry, in fact, views as two separate transactions, and that the final result amounts to the same thing. To explain this a bit further, should an individual (assume non-vendor) in practice walk into a dealership with the intention of trading in his/her vehicle and purchasing a new one, the dealership may, in order to secure the business of the sale of the new vehicle, purchase the trade-in for a price that is slightly higher than the original valuation. The vehicle is therefore traded in with an over-allowance/over-trade. However, the transaction does not stop here. In order to complete the picture, the sale of the new vehicle must still be taken into account. While the customer may have secured a discount on the price of the new vehicle, the over-allowance will reduce the discount that may have been given, resulting in the customer paying a higher price on the new vehicle than would have been paid had no over-allowance been granted. In practice, therefore, the dealership would claim a notional input tax credit on a higher trade-in value, but, in turn, VAT output is declared on the higher selling price. SARS (2009:43-44) views these two legs as completely separate transactions that have no bearing on each other. Therefore, prior to the issuance of the *Guide*, SARS expected notional input tax to be claimed on the

lower value (i.e. the value excluding the over-allowance), and then output VAT to be declared on the higher selling price (Krause, 2005:14). According to the *Guide*, SARS (2009:43-44) has agreed to view one part of the greater transaction in the light of the other. However, this requires compliance with certain minimum requirements.

2.2 OVER-ALLOWANCES

2.2.1 Definitions

As a starting point, it is necessary to understand the various definitions of over-allowances held by the respective parties, in order to ascertain whether there are any ambiguities or double meanings for the term "over-allowances", and, furthermore, to arrive at a meaning for the purposes of this review.

SARS (2009:12) defines over-allowances as a situation in which motor dealers may agree to pay an amount to a customer which is higher than the market trade-in value of the second-hand vehicle. The over-allowance is the difference between the market value and the amount paid to the customer. This usually arises when the second-hand vehicle being traded in is a fundamental part of a further transaction, which involves the supply of a new vehicle to the same customer by the same motor dealer.

However, Krause (2005: 14) argues that over-allowances cannot really be confined to a definition but rather that a hands-on example is the best way to explain the nature of a transaction that is unique to the industry. He relates how "Mr Jones walks into a new car dealership to purchase that new vehicle he really needs". He explains how Mr Jones has a trade-in vehicle for which he believes he should receive R100 000, based on the excellent condition of the vehicle. The dealer, however, has a different view and believes that R80 000 is a "more than fair compensation" for the trade-in. As would happen in the real world, and as very insightfully noted by Krause (2005: 14), the car salesman is willing to 'lose' R20 000 on the deal in order to secure the sale of the new vehicle. The reality is that the car salesman will merely take the loss or will compensate for it by a decreased discount given on the price of the new vehicle in order to secure the additional business.

While the *Guide* tries to define the concept and really does try to view the transaction from all perspectives, Krause's example manages to encapsulate so much more than a concept. It clearly illustrates the business principles which are so definitely lost in the clear-cut definition. One of the large motor dealer groups (2009: 6) (who will remain unnamed for the purposes of confidentiality), in a letter to SARS stated that in the industry the system of paying over-allowances is not a means of reducing the dealer's VAT liability, but is, in fact, a business arrangement established in an attempt to obtain the best possible financing solution for the customer. This sets out the intention behind the over-allowances and provides a further definition. This definition concurs with the view indicated in Krause's illustration that it is a purely commercial or business decision to create business, and in no way is there an intention to see SARS out-of-pocket, as some may put it. This study will consider the view that over-allowances are not merely a scheme used by motor dealers to reduce their VAT liability.

In summary, while SARS (2009:12) does attempt to define the concept of over-allowances in the *Guide*, this multi-faceted and rather complex concept is certainly more readily understood when presented as an illustration.

2.2.2 Industry practice

While no formal study has been conducted on the actual transactional treatment of over-allowances in the industry, Krause (2005:14) has considered the treatment and has documented, at a very high level, what is done in practice, as well as what is expected by SARS. Continuing with the Mr Jones illustration introduced by Krause, once the car salesman has secured the deal, the question arises as to how the transaction should be recorded and how the VAT liability is calculated. Krause (2005:14) has assumed that one particular treatment is used by the entire industry. While his assumption may be correct, one of the aims of this study is to identify whether various treatments are used by the different dealer groups in South Africa in order to identify the practice that is most acceptable to the industry, SARS and the Competition Commission. Based on Krause's assumptions, though, and assuming that his view represents the general view of the industry, the form VAT 264, which is a declaration of the acquisition of second hand goods in which the owner states that the supply of goods is not a taxable supply, will reflect the

purchase of the trade-in vehicle at the agreed price of R100 000 and the dealership will, therefore, calculate a notional input claim based on this R100 000. The real value allocated to the vehicle, however, is R80 000, and the vehicle is therefore stocked at R80 000, in order to maintain the correct profit percentage on the subsequent sale of the second-hand vehicle. Krause (2005) then indicates SARS' view. It must be noted that this was prior to the issuance of the *Guide*. According to Krause (2005:14), SARS' view is that the notional tax should be calculated based on R80 000. Additional tax at 20% and penalties will therefore be levied with the issuance of an additional assessment. SARS' rationale is that the actual open-market value is lower than the amount actually paid by the dealership for the trade-in, so the dealership is permitted to claim notional tax only on the lower amount.

Having considered Krause's views, this would be a good place to stop and refer to the legislation before attempting to understand SARS' views.

2.2.3 Prescribed treatment

Ordinarily, motor vehicles do not attract VAT. Van Zyl (2008:392) noted that section 17(2) of the VAT Act prohibits the claiming of input tax credits in respect of certain goods and services, even though they may be used to render taxable supplies. More specifically, section 17(2)(c) prohibits the claim on motor cars, as defined. However, in terms of section 17(2)(c)(i), this prohibition does not apply when the vendor acquires the motor car in the ordinary course of making a taxable supply of that vehicle. Consequently, the provisions of section 16(3)(a)(ii)(aa) of the VAT Act, relating to notional input tax, apply in respect of motor dealers.

According to Beneke and Silver (2009:136), a vendor may purchase goods without incurring any VAT on the purchase, and still be entitled to claim an input tax deduction. This deduction is known as notional input tax. A prime example would be the acquisition of second-hand goods from non-vendors. No VAT is levied by the non-vendor, but the acquirer (and VAT vendor) is entitled, under certain circumstances, to claim an input tax deduction.

Vendors are allowed to claim an input tax deduction when second-hand goods are purchased from a non-VAT vendor (Grant Thornton, Howarth Zeller Karro, Deloitte, 2004). By definition, second-hand goods are “any goods that were previously owned and used” (Beneke & Silver, 2009:136). Second-hand goods would, therefore, include the purchase by a motor dealer of a used or pre-owned motor vehicle. Provided that the motor dealer is a VAT vendor, and the person from whom the dealer is acquiring the vehicle is a non-VAT vendor, the dealer is entitled to claim a notional input tax deduction (Beneke & Silver, 2009:136).

This is supported by the law. In terms of section 16(3)(a)(ii)(aa), read with paragraph (b) of the definition of input tax in section 1 of the VAT Act, in instances where a vendor acquires second-hand goods from a non-vendor who is resident in the Republic, the vendor is entitled to claim a notional input tax deduction. The input tax deduction is calculated as an amount equal to the tax fraction of the lesser of the consideration in money given by the vendor or the OMV of the supply.

The purpose of the notional input tax and the reason that the claim is permitted is to make sure that VAT is collected only on the value added by the vendor (Beneke & Silver, 2009:137). Beneke and Silver (2009:137) use an illustration to explain this. Effectively, if the dealer was not allowed the notional input tax deduction, she/he would have to account for output VAT on the sale of the vehicle. In some cases this may mean the VAT paid across to the fiscus exceeds the profit made on purchasing the used motor car and then selling it. In granting the dealer the input tax credit, the fiscus is collecting only 14% on the actual value added by the dealer.

There are certain requirements for claiming notional input tax. As pointed out above, Van Zyl (2008:392) noted that the dealer is entitled to claim the notional input tax deduction only if s/he has purchased the vehicle with the intention of making a taxable supply by selling the vehicle. Another requirement is documented in detail in SARS’ VAT NEWS (2002:1). A dealer may not claim the notional tax deduction unless she/he has complied with the requirements to obtain and keep certain information, including:

- a declaration by the seller that there has been no taxable supply (i.e.: that the seller is not a vendor);
- the seller's personal details and a copy of their ID document;
- the date on which the vehicle was acquired by the dealer;
- description of the vehicle;
- amount paid by the dealer; and
- proof that payment was affected by the dealer to the non-vendor.

Thus, in spite of the issuance of the *Guide*, onerous requirements are already imposed on the dealer prior to their being entitled to claim a notional tax credit.

Assuming all of the above requirements have been fulfilled, Beneke and Silver (2009:136) note that the "notional input tax deduction is equal to the tax fraction multiplied by the actual amount paid for the goods (or the market value of the goods if lesser than the amount paid)". Surprisingly, SARS (2002:1) states that the dealer is "entitled to claim a notional input tax by applying the tax fraction to either:

- the amount paid for the second-hand vehicle, or
- the amount given by way of a trade-in".

This implies that the trade-in value is, effectively, equal to the OMV.

However, if one were to look at the actual meaning of OMV as well as the manner in which it is determined, one would refer to section 3 of the VAT Act. Section 3(3) of the VAT Act states that "the OMV shall be the consideration in money which a similar supply would generally fetch if supplied in similar circumstances at that date in the Republic, being a supply freely offered and made between persons who are not connected persons". Using Krause's illustration of Mr Jones: although the dealer's view was that the vehicle was worth R80 000, the seller's view was that it was worth R100 000. In this situation, the parties agreed to settle on R100 000. Is this, then, not the OMV, being the value determined for a "supply freely offered and made between persons who are not connected persons" (VAT Act). As one of the motor dealer groups asks, who once again will remain unnamed to maintain confidentiality, is the best gauge of the OMV not the price finally agreed between

the willing buyer and seller, provided these persons are not connected, but are parties to an arm's-length transaction?

Interestingly enough, in a letter to the Australian Treasury Department written by Delaney, an executive director of the Motor Trades Association of Australia, dated April 2009, he states that "the notional input tax credit scheme has... generated substantial additional costs for small business and complicated compliance issues for the motor vehicle dealers, who are the largest single sector dealing in used goods". While Delaney's reference to "substantial additional costs" may not necessarily apply in South Africa, the reference to "complicated compliance issues" may certainly hold some truth, in the light of the already-existing compliance requirements mentioned above, over and above the additional requirements prescribed in the *Guide*. Delaney (2009:3) continues by saying that the current requirements are "unwieldy, time consuming and, most important, unnecessary for the efficient administration of the taxation system". Delaney (2009:3-4) goes so far as to state that any acquisitions of second-hand goods from non-vendors in the ordinary course of business should generate the actual input tax credit that would normally be generated if the purchase had been made from a vendor. Delaney (2009:3-4) states that the only instance where notional input tax credits should apply is in respect of connected party transactions. This is, indeed, an interesting stance and would certainly support the view noted above that the trade-in value would, in fact, be the OMV with an offer freely made between non-connected persons.

While SARS attempts to adopt a practical viewpoint, there is reason to believe that they have not considered the bigger picture when prescribing the treatment that must be adopted, or, more specifically, when prescribing the rules to be followed if the more practical approach is to be adopted. It is evident that SARS has considered the practicalities of the treatment in the *Guide*, in that under certain circumstances, it allows the current practice. The problem arises with the conditions SARS imposes on the dealers in order to allow this treatment. The first problem arises when the *Guide* stipulates that the OMV of a trade-in vehicle is the value specified in the M&M book. SARS makes the general assumption that all motor dealers base all their valuations on the value stipulated in the M&M book, and therefore value the vehicle at the OMV. "Motor dealers usually

determine the market value of second-hand vehicles according to a publication known as the 'Auto Dealer's Guide [M&M book]'" (SARS, 2009:12).

Before continuing, the question must be asked whether or not the dealers themselves have been consulted as to the way in which the M&M book is used in the industry. One of the large motor dealer groups says that the M&M book does not take into account the instances where the dealership is to sell another vehicle to the seller of the traded-in vehicle. Furthermore, although, the M&M book is published monthly, there is a lag between the date of the actual transaction and the date of the reporting of it in the M&M book. One also needs to take into consideration the market conditions that may fluctuate dramatically in the month following publication of the M&M book, which will only be reflected in later publications of the M&M book (Anon, 2009). This statement on market conditions could not have been made at a more appropriate time than now, with the world having faced an economic recession which Pretorius (2008:18) described in the words: "the world economy has indeed been hit by a 'perfect storm'". The word "hit" is most appropriate, considering the speed at which the markets declined. Given this, the M&M book would only have published market-adjusted trade values a good few months down the line. So, while the *Guide* seems to assume that the motor dealers "usually determine" the trade-in value with reference to the M&M book, the reality is that the M&M book is widely known in the industry as merely a guide and is hardly ever referred to when a vehicle is valued. In fact, the M&M book (2009) itself states that the trade value (being the value given in the book), as opposed to the trade-in value, takes into account the estimates of the respective dealer of the cost of refurbishing the traded in vehicle into showroom condition. It also includes a warranty and roadworthy certificate. The trade value will not only be affected by the physical condition of the vehicle, but also the degree of refurbishment required and trading conditions.

The trade value is then used as the base upon which the trade-in value is calculated. The trade-in value starts with the trade value and applies the following to the trade value:

- adds the value of any additional optional extras fitted to the vehicle;
- this total value is then multiplied by the adjustment percentage, which is determined according to the number of kilometres travelled, as well as the condition of the

vehicle, and is obtained from the kilometre and condition chart found at the back of the M&M book;

- then, the estimated costs of refurbishment are subtracted from this sub-total in order to obtain the estimated trade-in price.

SARS (2009:12) stipulates that the value noted in the M&M book is the OMV, which means that any vehicle traded-in for a value higher than the trade value given in the book must be written down to the value in the book for VAT purposes. One refers back to the statement that the best gauge of an open-market price is the trade-in price that is finally agreed upon between a willing buyer and a willing seller in an arm's-length transaction (Anon, 2009). Furthermore, by dictating a specific value for trade-in vehicles, the *Guide* appears to be negating Mr Jones's ability to negotiate discounts and his ability to seek better deals (Konyana, 2005:*3-4*), something for which the industry could be penalised in terms of the Competition Act.

Although the method of valuing a trade-in vehicle appears to have been prescribed, this study will attempt to understand the various methods used by dealers when determining a value for a trade-in vehicle, and in so doing, will understand whether or not the prescribed method is appropriate to the industry.

2.3 CONSIDERING THE COMPETITION COMMISSION

Given the matter of the Competition Act in the previous paragraph, the prescribed pricing of both new vehicles and trade-in vehicles set out in the *Guide* (SARS, 2009:43-44) should be considered against previous findings by the Competition Commission. The most competition-controversial rule or condition in the *Guide* is contained in condition (c), namely that "[t]he consideration paid shall be regarded as the value of the trade-in plus the over-allowance given by the vendor. However, this allowance given by the vendor shall not exceed the discount that is permissible on the vehicle being sold" (SARS, 2009:43-44).

As noted above, permissible discount has not been defined in the *Guide*, resulting in a high degree of uncertainty in the industry:

- how is this permissible discount determined?
- is it a percentage of the value of the new vehicle?
- who determines the discount?
- is it specified by the manufacturer or by the dealer group? and
- if the dealer group specifies the discount, is it sufficient for the group policy to be that there is no "discount that is permissible" but that each transaction is viewed independently and treated in whatever manner is best for the business of the group as a whole?

The mere fact that SARS (2009:43-44) stipulates pricing conditions demands the question to be asked: "Is SARS "threatening" the industry so that it complies with discount limits?" This was referred to in the Competition Commission South Africa Press Statement (2005:3), in which it was stated that the Competition Commission had obtained evidence relating to certain limits on discounts being suggested to dealers. Not only this, but certain dealers had been reported for not complying with these limits and had ultimately been threatened for not complying.

As previously noted, this study aims to identify and investigate any practical difficulties encountered as a result of the treatment prescribed in the *Guide.* This includes whether or not the matter of price fixing is, in fact, a concern, in the light of both the Competition Act and a previous investigation into the industry price and sales practices, which have been explained below.

The Competition Commission (2004:1) announced the investigation into the prices and sales practices of new vehicles. The investigation was based on the minimum resale prices being imposed on dealers which limited or even excluded a dealer's freedom to offer discounts. Simelane (2004:1), the Competition Commissioner, reasoned that if this sort of practice really does exist, it is a matter for extreme concern that the normal practice in the industry is so anti-competitive and so harmful to customers, especially as it goes against the principles of the Competition Act. The Competition Commission (2004:1) stated that they were in possession of information that "indicates possible collusion amongst dealers as well as price coordination by manufacturers and we are determined to uncover these practices and eradicate them if we prove their existence in this industry".

The findings of this investigation were noted by the Competition Commission (2005:1-5) and the outcome was finalised in a press statement dated 7 December 2005.

In summary of the Competition Commission's findings (2005:1-5), it was found, *inter alia*, that "dealers have entered into agreements that impose restrictions that have the effect of substantially preventing or lessening competition in contravention of Section 5(1) of the Competition Act" and "…manufacturers/ importers/ distributors and dealers agree on minimum resale price in contravention of Section 5(2) of the Act…. The evidence gathered during this investigation indicates that most of the motor vehicle manufacturers and their franchised dealers have contravened sections…5(1) and 5(2) of the Act".

Lepaka (not dated) states that agreements between/among competitors undercut the essential principles of competition law, namely; to defend competition in the SA economy.

As a background to the Competition Act, Riordan (2010:6), in summary, said that in 1998, after a period of discussion, the SA parliament passed the Competition Act. The Competition Act established three institutions that are designed to ensure open, clean and healthy competition in the SA economy, as noted in chapter 4 of the Competition Act.

The Consumer Guide to the Competition Act (2004:1) identifies the aims of the Competition Commission as being "to investigate, control and evaluate restrictive practices, abuse of a dominant position and mergers, with the overall objective of promoting and maintaining competition in the market. The ultimate goal is to achieve a competitive environment that will, *inter alia*, provide consumers with competitive prices and product choice". Furthermore, it notes that historically, in instances where competition is not controlled, organisations have participated in anti-competitive behaviour, such as setting pre-determined prices in order to avoid competition (namely, price fixing). Ultimately, the role of the commission is to protect consumers and to ensure that they have the freedom to choose from the best available prices (2004:1).

The Consumer Guide (2004:1) also noted that anti-competitive behaviour includes competing companies agreeing on what prices and when to charge customers. Is this

what is meant by a maximum allowable discount? Is SARS intending the entire industry to unite to determine a maximum discount? If not, who defines this discount?

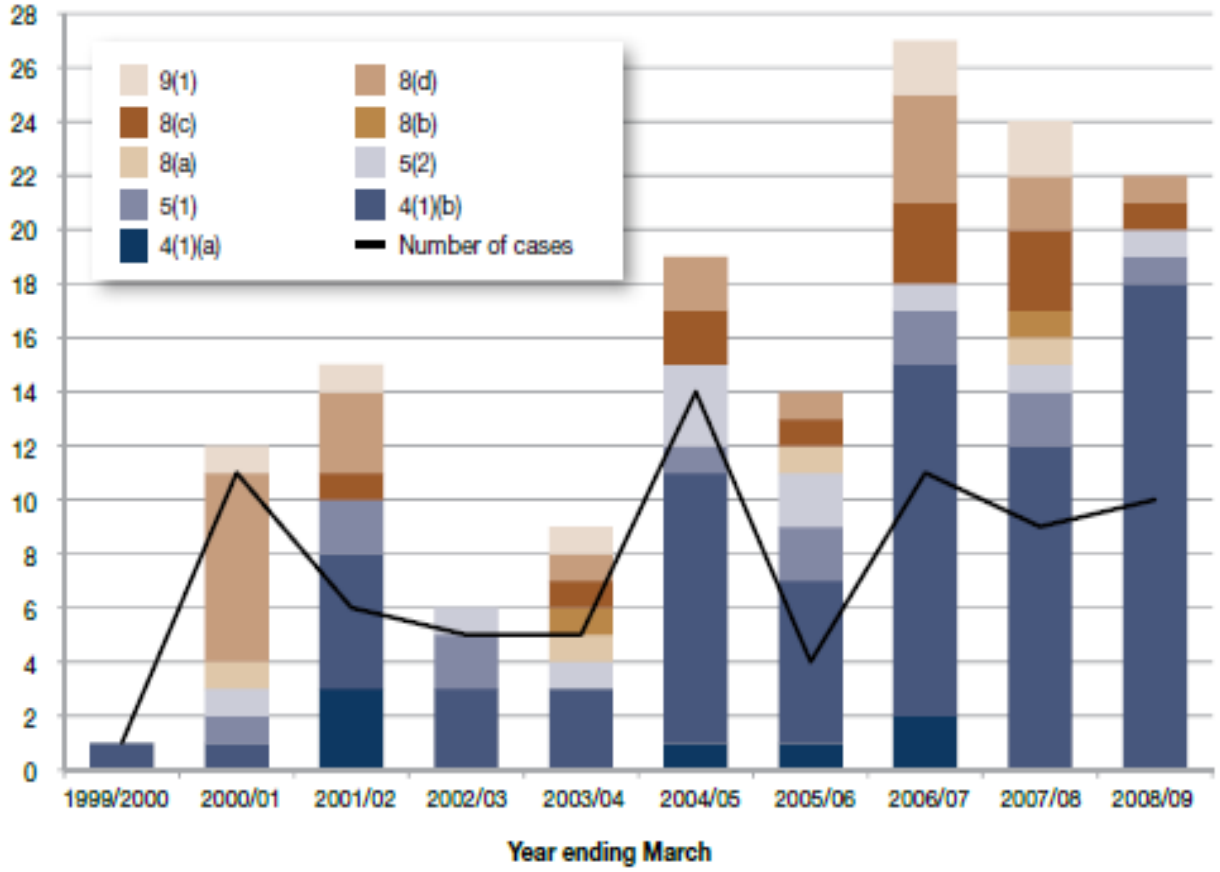
Prior to delving into the application of the Competition Act to the topic under discussion, a review of the history of the Competition Commission's activity would be useful in identifying what are deemed to be prohibited practices.

Riordon (2010:6) encourages the public to visit the COMPCOMM website in order to view the 10 Year Review document, found under publications. This document highlights the activity of the Competition Commission over the past ten years. While the document makes for interesting reading, only the section relevant to this study will be referred to; namely that of prohibited practices. As noted in the review document, Sections 4, 5, 8 and 9 of the Competitions Act deal with prohibited practices, and are summarised as follows:

- Section 4: Horizontal behaviour among competitors (i.e.: collusion);
- Section 5: Restrictive vertical practices, including minimum resale price maintenance. (As noted by the Competition Commission (2009:1): "this is the sole restrictive practice which is a *per se* violation and so does not require any weighing up of pro- and anti-competitive effects");
- Section 8: Unilateral anti-competitive abuse by dominant firms;
- Section 9: Price discrimination.

Sections 4 and 5 will be reviewed further, as they are relevant to this study. It is interesting that they seem to be the most contravened sections of the Competitions Act, in respect of prohibited practices, based on the Competition Commission review over the past ten years, and as depicted in the tables extracted from Competition Commission (2010:41-42), below:

Table 2: Referrals by the Competition Commission to the Tribunal of complaints, consent orders and settlements



Source: Competition Commission and Tribunal, 2009

Note: Each sub-section referred is counted separately, so, for example, where a cartel case is referred under price fixing and market allocation, it is reflected as two counts

The graph above reflects the matters that were referred to or reported to the Competition Tribunal that were considered to be potential contraventions to the Competition Act. These matters have been detailed by sections and extend over the 10 year period March 1999 to March 2009. The graph very clearly depicts that section 4(1)(b) has had the highest number of matters reported as being contravened over the last 10 years, than any other section. Section 4(1)(b) refers to the matter of price fixing or the setting of minimum prices in a specific market. These findings are further supported by table 3 below.

Table 3: Prohibited practices contraventions 2002-2009

Reporting year ending 31 March	Respondent	Penalty	Contravention
2002/03	Federal Mogul	R3 million	5(2)
	Hibiscus Coast Municipality	No penalty	5(1)
	Patensie Sitrus Beherend Beperk	No penalty	8(d)(i)
2003/04	The Association of Pretoria Attorneys	R223 000	4(1)(b)(i)
2004/05	SA Medical Association	R900 000	4(1)(b)(i)
	Hospitals Association of South Africa	R4.5 million	4(1)(b)(i)
	United SA Pharmacies	R250 000	4 (1)(b)
	The Institute of Estate Agents of South Africa	R522 400	4(1)(b)
	The Board of Healthcare Funders	R500 000	4(1)(b)
	Toyota South Africa	R12million	5(2)
	J Melnick & Co	R200 000	5(2)
2005/06	USA Citrus Alliance	R400 000	4(1)(b)(i)
	Subaru SA	R500 000	4(1)(b)(i)
	Nissan SA	R6 million	5(2)
	South African Airways	R45million	8(d)(i)
	DaimlerChrysler SA	R8 million	5(2)
	Volkswagen SA	R5 million	5(2) & 4(1)(b)(i)
	Citroen SA	R150 000	5(2)
	BMW SA	R8 million	5(2)
	General Motors SA	R12million	5(2)
	GlaxoSmith and BI	No penalty	8(a) and (b)
	Italtile Franchising	R2million	5(2)
2006/07	Oakley	R212 100	5(2)
	South African Airways	R15 million	8(d)(i) and(c)
	South African Airways, SA Airlink, SA Express Airways	R20 million	4(1)(b)(i)
	South African Airways, SA Express Airways	R20 million	4(1)(b)(i)
	Deutsche Lufthansa AG	R8.5 million	4(1)(b)(i)
	Zip Heaters	R78 500	4(1)(b)(ii)/(i)
	SA Orthotic and Prosthetic Association	No penalty	4(1)(b)(i)
2007/08	Tiger Consumer Brands	R98 million	4(1)(b)(i) & (ii)
	Nedschroef Jhb	R200 000	4(1)(b)(i) & (ii)
	CBC Fasteners	R300 000	4(1)(b)(i) & (ii)
	Uitenhage & Dispatch Independent Practitioners Association and Members	No penalty	4(1)(a)
2008/09	Aveng (Africa)	R46 million	4(1)(b)
	Lancewood	R100 000	4(1)(b)(i)
	Food Corp	R45.4 million	4(1)(b)(i)
	ANSAC	R10 million	4(1)(b)(i)
	Adcock Ingram	R54 million	4(1)(b)(iii)
	Dismed Criticare	R1.2 million	4(1)(b)(iii)
	Thusanong Healthcare	R287 415	4(1)(b)(iii)
	Reclam Group	R146 million	4(i)(b)(i) & (ii)
	Netcare and Community Hospital Group	R6 million	4(1)(b)(i)
2009/10	Sasol Chemical Industries	R250 million	4(1)(b)
	Senwes	Pending	8(c)

Source: Competition Tribunal, 2009

Note: The Tribunal's largest administrative penalty to date, an order of R692 million to Mittal Steel South Africa in 2007, for contravention of section 8(a), was remitted to the Tribunal by the Competition Appeal Court, and the Tribunal is yet to issue its amended decision.

Table 3 indicates actual contraventions to the Competition Act and the sections that have been contravened over the period 2002 – 2009. What is evident is that section 4(1)(b) and section 5(2) appear to be the most contravened sections, indicating that collusion between parties resulting in price-fixing is rife and is being penalised, under the Competition Act. This is of some concern if the *Guide* is suggesting the industry need to impose a maximum permissible discount (SARS, 2009:43-44).

2.3.1 Horizontal restrictive practices (section4(1))

Section 4(1)(b) refers to/ prohibits agreements between parties in a horizontal relationship setting prices (both purchase and selling prices) and/or trading conditions in a specific market. Furthermore, collusion would be seen to be in contravention of the Competition Act when two or more parties agree to pre-setting/ fixing prices. (Competition Commission, 2010:43).

The cartel arrangements involve competitors agreeing on prices and conditions (eg discounts) as opposed to offering consumers better products and prices (Competition Commission, 2010:43). In terms of section 4(1)(b) noted above, agreements to "fix prices or other trading conditions... are all illegal, per se, meaning that no anti-competitive effect has to be demonstrated to prove a contravention". The Competition Act allows, in terms of section 59, for penalties of as much as 10% of one year of affected turnover, to be levied from offenders. It also allows for penalties to be imposed on both first-time and repeat offenders of section 4(1)(b), while first-time offenders of section 4(1)(a) do not have penalties levied against them.

2.3.2 Vertical restrictive practices (section 5)

The Competition Act, in section 5(1), provides that agreements between parties in a vertical relationship are forbidden, should the agreement result in prevention or reduction of competition in any specific market, unless it can be proved that there is some pro-competitive benefit achieved as a result of the agreement that outweighs any negative impact.

Further, section 5(2) specifically prohibits the practice of minimum resale pricing. These sorts of arrangements that limit discounting restrict competition between distributors and retailers and have therefore often also been referred under section 5(1) (Competition Commission, 2010:52-53)). As noted above, this is the only prohibited practice that is a "*per se violation"*.

Thus, on a review of the Competition Act, and in terms of the findings of the Competition Commission press release, maximum discounts are “a per se violation for which no justification can be provided” (2005:3). The Competition Commission (2005:4-5) makes it clear that the ultimate situation is one in which consumers can negotiate discounts and have an opportunity to seek better prices. This is expected to motivate price competition in the industry. The press release also cautioned dealers to “refrain from fixing prices, discounts and/or trading conditions”.

Before applying these findings to the stipulations on pricing that SARS has set out in the *Guide*, it is both interesting and important to note the outcome of the abovementioned investigation. The Competition Commission (2005:1) states that “the manufacturers and/or their dealers will, in terms of the consent agreements, pay administrative penalties amounting collectively to R31 650 000. The manufacturers and dealers have agreed to implement compliance programmes to ensure that their businesses comply with the Competition Act, in particular to eradicate the practices of minimum resale price maintenance by manufacturers and collusion between dealers”. Acting Commissioner Ramburuth said: “[a]s a result of the Commission’s intervention, dealers **will no longer have the excuse that they are bound to a maximum discount**. This will give consumers greater power to negotiate better discounts with dealers” (author’s emphasis).

While the abovementioned investigation refers to price-fixing forced on dealers by the manufacturers, importers or distributors, no investigation has been undertaken with regard to the conditions put in place by SARS in respect of the treatment of over-allowances. Part of this study aims to compare the requirements stipulated by SARS in respect of pricing with the nature of what was declared in 2005 to be price-fixing in principle (2005:1-5). This would ascertain whether or not SARS is, in fact, forcing the dealers to be locked into a maximum price discount in the case of new vehicle pricing, as well as in respect of valuing the trade-in vehicles, setting prescribed values that will effectively prevent/ decrease competition significantly and thus contravene section 5(1) of the Act (Commission’s Motor Vehicle Investigation, 2005).

2.4 CONCLUSION

Based on the literature reviewed, it is evident that the Guide issued by SARS to assist motor dealers with industry specific VAT matters, has some flaws which may result in misunderstanding from either SARS' perspective or the motor dealer's perspective. The flaw of most concern is the interpretation of the term "permissible discount", which when viewed in light of the Competition Commission legislation, and the transgressions that have been noted as being penalised, raises some level of concern. In order to fully understand the full impact of the issuance of the Guide and how matters such as this have been addressed in the industry by the relevant motor dealer groups, representatives from the industry will need to be consulted.

3 AN OVERVIEW OF THE PERCEPTIONS AND OPINIONS OF A SELECTION OF PARTICIPANTS IN THE INDUSTRY

3.1 INTRODUCTION

Having identified a potential concern in the industry and having looked at the available literature relating to the topic under study, a potential conflict between the requirements stipulated in the *Guide* and the requirements of the Competition Act emerges. In order to fully understand the extent to which the concern raised is, in fact, a reality, the industry will need to be consulted in order to obtain the relevant qualitative data required to draw conclusions.

The various data collection methods available that specifically relate to the collection of qualitative data include participant observation; interviews or questionnaires.

The participant observation would not be appropriate to this study as it involves the observation and analysis of people's behaviour. Whilst a questionnaire could be administered to the sample selected, an interview process would be far more beneficial, particularly if the interview schedule is pre-determined according to the data required. The self-administered questionnaire may result in a distortion of understanding of the background to the study, which may result in an unwillingness to participate, or a delay in receiving responses. The interview process poses the benefit of timely responses and allows the interviewer an opportunity to explain the purpose of the study clearly. Furthermore, it gives the participant an opportunity to raise any concerns and to discuss any other related matters. The importance and benefits of the personal contact cannot be ignored, in that the interviewer generally establishes a rapport and a level of trust with the participant resulting in better co-operation or participation.

While participant bias may be problematic when one is trying to obtain reliable and valid data from the selected participants, another major problem is the idea that the questionnaire may not be treated as confidential, particularly as the study involves understanding company policies and opinions. The advantage of a personal interview is

that it reassures the participants that the study will be written completely anonymously, that they will be allocated an individual number and that no names will be mentioned in the final results. Thus, the industry has been consulted utilising an interview process with a pre-determined interview schedule.

"The internal validity of a research study is the extent to which its design and the data it yields allow the researcher to draw accurate conclusions" (Leedy & Ormrod, 2005:97). The aim of this study is to understand the difficulties and impracticalities experienced by the industry because of the treatment prescribed in the *Guide*. It is therefore important to obtain an accurate reflection of the treatment used by the various organisations in order to draw accurate conclusions. This study aims to achieve the internal validity of the data by collecting it from multiple organisations rather than testing just one. In addition, triangulation will be used to a certain extent. The other sources of data will be the prescribed treatment in the *Guide* and what the law itself prescribes.

To ensure that the most useful information on the VAT treatment of over-allowances in the industry is obtained, adopting a non-probability sampling technique would appear to be the most suitable option. In non-probability sampling, the sample size is not necessarily calculated but rather is dependent upon the research questions and objectives, and therefore what the researcher intends to find out from the sample selected, so it is predominantly used when obtaining qualitative information (Saunders *et al*, 2007:227). In essence, the size of the sample is not what is important; it is the quality of the information extracted.

Once the sample was selected according to the purposive, homogeneous, typical case-sampling technique, the participants were contacted telephonically and directly by the researcher. The Financial Director was addressed first in order to obtain the necessary authority to conduct the interview in the organisation. The telephonic discussion gave the researcher the opportunity to introduce the topic being researched and explain, at a high level, the background to the study. Based on this, the participants were able to make an informed decision as to whether or not they would have liked their organisation to participate in the study. It was emphasised, in the introductory conversation, that confidentiality would be maintained and that the name of the organisation would be

withheld from the study so as to ensure complete anonymity. The purpose of the study was explained as being purely research-related.

The type of interview technique utilised was that of in-depth, personal interviews. As the study aims to obtain an understanding of a very specific aspect of the industry, being the VAT treatment of over-allowances, a pre-defined schedule of questions would be appropriate as this study should not allow for too much deviation. The interviews needed to maintain focus on the topic.

There are various types of interviews defined, being that of highly formalised/ structured; semi-structured or completely unstructured conversations. The highly formal interview would not be appropriate as it allows for absolutely no deviation from the pre-determined questions and makes use of a standardised response schedule. The nature of the responses anticipated from the type of questions raised in respect of this study are not conducive to standard responses. Rather, they include opinions and may result in further discussions. The discussions did, however, require some form of guidance and therefore, a completely unstructured technique was also not appropriate, resulting in a semi-structured technique being the technique of choice. Semi-structured interviews allow for some structure, whilst still allowing for a level of discussion and deviation from the pre-determined order of questions.

Prior to selecting the sample, the pre-determined interview schedule was established in order to ensure that the interviews maintained a level of structure and to ensure that the required data was obtained.

Each dealership has been given a unique code for identification purposes, which will ensure confidentiality is maintained. Each question will be stated and will be followed by the responses of each dealership group. In certain instances, the questions contained in the Interview Schedule have been combined, as the answers given by the dealerships covered two questions in one. The interviews were conducted and, with the permission of the participants, a Dictaphone was used to record the responses. Responses have, therefore, been transcribed verbatim under the respective participant's dealership unique code. Alterations have been made only to the name of the organisation, for purposes of

confidentiality. Following on from the responses recorded below, each question will be summarised and concluded, based on the responses given in the following chapter.

The responses have been set out according to the three dealership groups interviewed

3.2 QUESTION 1

HOW WOULD YOUR ORGANISATION DEFINE THE TERM "OVER-ALLOWANCE"? UNDER WHAT CIRCUMSTANCES DOES YOUR ORGANISATION ISSUE AN OVER-ALLOWANCE?

3.2.1 JC001

Basically, it is offering a higher trade-in value on the vehicle traded in and a lower discount on the subsequent vehicle sold.

3.2.2 KC001

Well, I think if we go back in history, over-allowances were invented, if that's the word, in the days of the previous Credit Act when there was a deposit requirement. There were the various customers that didn't have the deposit or the cash, as it were, and so some ingenious traders came up with the idea of creating that deposit via the trade-in. In essence, I think, the banks are aware of it and obviously they need to be aware of it to sign it off and make it a valid deal under the old legislation and they seemed to be happy to the extent that it wasn't abused- so that there was a sort of a relationship between the value of the vehicle and the value with the over-allowance. I think "OMV" is obviously a very subjective issue and I think if you gave the same vehicle to a number of different traders, they would come up with a variety of values; really depending on how comfortable they are with that particular product and how familiar they are with it; particularly a Ford franchise dealer, for example, would give a higher price to trade in a Ford and a lower price for a Nissan and vice versa.

I think that's, in essence, how it was born. And with the advent of the National Credit Act, there is no deposit requirement, in theory. But, in practice, obviously, the banks are still looking at some sort of equity. They are saying we are valuing or financing a car worth 100, how much does the customer stand to lose, if the deal goes south. So over-allowances have continued. And the dispute then obviously arose with the VAT man. He was pitching up at some dealerships.... coming back to OMV. They say it's a very difficult concept. If I trade in your vehicle for 100 and spend 10 on it and sell it for 120, what is the OMV? So, it is a very nebulous concept.

[Participant continues]
Yes. Yes, that's right. So, yes, it is difficult. As I say, many traders will put different values on these vehicles, but the banks have taken the attitude that as long as those over-allowances are not abused, that there is some argument or some defence for the value that has been placed on the vehicle; that they are, basically, happy to agree.

So, then the VAT issue arrived with applying the strict letter of the law. But, in essence, the tax ruling presents a compromise. Basically it says that, in essence, if the over-allowance is equal to the discount, there is no revenue lost and they are happy with that approach.

3.2.3 AC001

Well, pretty much, we would value a vehicle- we can either get a price from the trade as to what they would pay for the vehicle, if we don't intend to purchase it and to retail it. Or if we intend to retail it, we would put a value on that vehicle ourselves.

Then, we would then, obviously in the process, you would, if there's an over-allowance, you would look at/ there is obviously a new vehicle or another vehicle that is being sold, involved in the process. And then you may pay more for the vehicle for a couple of reasons:

- the trade-in value, sorry, the settlement value might be higher than you are prepared to pay for it, is the first thing. And then,
- you may pay a bit more for it in lieu of the discount on the new vehicle that you are selling.

Obviously, in that whole deal process, if the settlement value is higher than what you are prepared to carry it in your books, then you'd have to weigh up what that difference is and make that equate to... does it still make your new vehicle deal profitable?!

So, at the end of the day, if you look at the complete wash-out between the trading the vehicle in and selling the other vehicle, it must be a profitable deal to make it worthwhile.

3.3 QUESTION 2
ARE YOU AWARE OF THE TREATMENT PRESCRIBED IN THE NEW VAT GUIDE FOR MOTOR DEALERS?

This question was broken down into 5 sub-sections.

3.3.1 How does your organisation value a trade-in?

3.3.1.1. JC001

Currently, it has changed from how we used to do it, but currently, all trade-ins are loaded on the Auto-bid system. We'll have to explain to you the Auto-bid system... Auto-bid is an electronic auction house that we use for used vehicles today. Every used vehicle that comes into stock gets valued by the second hand manager and they use a hand held terminal. They scan, take a photo of the car, scan the licence and the VIN number and all that stuff. As it gets uploaded on a web-based system, we've got a whole lot of traders- what we call club members. You can only buy a used, wholesale vehicle from our organisation if you are a club member

going forward. They [the club members] will all bid electronically, done on a bidding basis. So Auto-bid will give us a low, guaranteed price, so within 15 minutes we can give the customer a price. It's a low number but it's a guaranteed price. Thereafter, all the bidders will bid and then we can either choose to sell to the highest bidder or we can roll it into our stock and then sell at retail. So, it will be brought into stock at either the value of the highest bid or at the price agreed with the person trading it in.

You need to understand that there are two values for used vehicles- there is a wholesale price and there is a retail price because there is always a willing buyer and seller in any transaction, but if you are buying a car wholesale to retail, that's a different market price from whether you are going to retail it to an individual or company. So, we believe in bringing it in at a market related rate but at a wholesale rate, not at a retail rate.

With a normal trade in, where a customer brings the vehicle in and you [the dealership] want to buy the vehicle, we still put the vehicle onto Auto-bid but you get a price from Auto-bid and Auto-bid will, within 15 minutes, send you a price back. So you've got a price in front of you and you can tell the customer. If he brings a vehicle in and wants R10 000, you can tell him "I can give you R10 000" 'cos you've already got an Auto-bid price. And you keep that vehicle for stock.

3.3.1.2 KC001

There are no rules, as such. But then in our organisation, we have an on-time valuation system, which enables our guys to enter the details of the vehicle and the proposed value of that vehicle onto an intranet and all dealers throughout the country can then make bids on that particular vehicle. And so that enables us, obviously, to get the best price that is possible for that vehicle, which gives the customer the best price and then, obviously, hopefully, leads to a more competitive deal because customers will obviously take their vehicles to a variety of franchise outlets and try to get the best price. We try and avoid that [for the customer] by putting it open, across... and we even include a variety of outside

traders, that we give access to that intranet, so that they can also bid on those vehicles. Then, we find out who the highest bidder is and that's the price we can offer the customer.

3.3.1.3 AC001

In a lot of dealerships, the pre-owned manager would do the job of valuating the vehicle, but in our case, we've got valuators, whose job it is, to valuate.

It's all relative to the market value. It all comes down to market value. You would obviously trade the vehicle in at a price that you believe to be either what the trade might have [traded it in at], or a price that you feel. If it's your own product, for example, if you're a Mercedes dealer, then you would obviously feel comfortable about what price you would pay for a Mercedes and what you believe that a correct price would be to carry it in your stock at.

Obviously, the guys refer to the M&M book as a guide. It's not the gospel because the M&M book is obviously issued at a point in time, which is obviously part of their condition. It's a little out of date, but it is a guide and a reference point for people to use. But they would always either pay more or less than book, but it's not necessarily, if the M&M trade-in price is R100k, that you are going to pay R100k. It depends on market conditions. It all comes down to what is believed to be the market value.

3.3.2 Does your organisation make use of any rules when valuing a trade-in? If so, please explain?

3.3.2.1 JC001

The answer above in part 3.3.1 has answered this question, but the following was added by the participant:
We cannot bring in a single vehicle wholesale that is not on Auto-bid. It's a new thing. Only been implemented in the last two months.

Interviewer: Is that organisation specific or industry specific?

Organisation specific but quite a few of our competitors are on Auto-bid but each one runs their own club and so it is confidential just to the organisation. So, we can have some club members that only belong to a few dealerships, per se. But there are competitors that use Auto-bid.

3.5.2.2 KC001

[Answered in part (3.3.1) above]

3.5.3.3 AC001

[Answered in part (3.3.1) above]

3.3.3 In your view, does the ascertained trade-in value represent a fair market value?

3.3.3.1 JC001

[Answered in part (3.4.1) above].

3.3.3.2 KC001

[Answered in part (3.3.1) above].

3.3.3.3 AC001

[Answered in part (3.3.1) above as well as (3.5) below].
Extract from answer 3.5:

You see, the way I read it, is what they basically said here, "where a motor dealer pays an amount in excess...", OK, you see, they were just speaking about the law. They're saying that the motor dealer guide [referring to the M&M book] is the "generally accepted value" and where you have a difference between that and the amount you pay, that's the over-allowance. So, I don't think they're saying that it is/ I don't think they are limiting... But they use the word "generally". It is "**generally** accepted that the value in the Auto Dealer Guide...". Well, they're not 100% right because at the end of the day, it is a **guide**.

3.3.4 Does your organisation make use of the Auto Dealer Guide (aka M&M book)? If yes, to what extent do you place reliance on this Guide?

3.3.4.1 JC001

We do. Although what we are finding; certainly in today's climate, which would be different to 2 or 3 years ago, where your market- there is a strong demand for used vehicles and there is an increase in prices. Then M&M probably reflects reality a lot closer than what it does today because there is a decline in prices and the lag is probably 1 to 2 months. Just too slow for us. So, we do use it, but depending on the circumstances, the economy and the market, the relevance changes.

3.3.4.2 KC001

Ah, we do, to an extent, but it's not the bible, as such. We prefer our internal bid system. There can be up to a four month lag between the date on which the data is captured onto the system and the date on which the book is actually released.

If prices are stable over a relatively long period, then it's fine. If you're in a rising market or a declining market, then they're out of date. So, our guys would refer to the book, as such, and will say they are "over-book" or "under-book". And so it is a reference point but it doesn't always give the value.

3.3.4.3 AC001

[Answered in part (3.3.1) above and (3.5) below].

3.3.5 Does your organisation refer to specified maximum permissible price discounts when valuing trade-ins? If yes, please explain from where you, as an organisation, obtain the maximum permissible discounts.

3.3.5.1 JC001

I can't answer per dealership... do they not set a criteria, but certainly not across the group. There is no standard across the group. My guess is at certain dealerships there will be certain levels where they are given free reign.

3.3.5.2 KC001

No. We don't specify.
Interviewer: It just would be dependent on the over-allowance given, as alluded to previously?

Yes, that's right. It really is market forces that are going to determine that. You can offer whatever discount you like, but the downside of offering too much discount is that you are actually downgrading the product. That's the problem. So, if you are offering a big discount on a particular motor vehicle, each customer likes to believe that either he or she has negotiated this special discount and then is horrified to find that when trade-in comes, that that was the genuine selling price. So, people think they have negotiated down and when the time comes for trade-in, they should be working off a higher figure. But they'll find if they've got a good discount, every other customer has got the same discount. And then it means that the resale value of the product just deteriorates and that product then gets known in the market as being not a good re-seller.

So, as I say, you'd like to believe you have a one-off special deal. You've got to be careful. The factory is not allowed to dictate prices. They can only give recommended prices. If you started selling their product at below recommended price or you go below cost price, you're soon going to see a problem.

3.3.5.3 AC001

Well, there is a permissible discount but that would obviously vary. I mean, it's not really a set permissible discount given by the manufacturer. The manufacturer would say that this is the recommended retail price and this is your cost. So, I mean, the manufacturer... like your concern was from an anti-competitive point of view... it's not really relevant because **nobody** can tell you what the permissible discount is/ should be. In any case, the VAT guide refers to a permissible discount. But, set by who? We would obviously, from time to time, we would have internally... maybe, we'd give say 7% on a deal and then obviously, then, your over-allowance or rather the discount would guide is as to how much the over-allowance we would give etc. But in terms of saying that there is a permissible discount, there is **NO** manufacturer, I don't think, well, they cannot specify!

So, yes, if you want to say, I mean we don't exceed the permissible discount, but it's not clear, in the Guide, who sets the permissible discount.

It's difficult to envision exactly what they mean by that. Look, I suppose, a concern is, just in general, that you don't claim too much input VAT, whereas, you're actually not. I mean, you could sell a vehicle below cost, if you wanted to, or if the market demands it. I mean, if that's what you've got to do, that's what you've got to do. It's still a market related deal. And I think that's what they also, sort of, just in general, envisioned.

So, we don't necessarily have a problem with them saying it shouldn't be more than the permissible discount because, you know, whatever discount you give, at the end of the day, is permissible! Permissible by the manufacturer and is permissible by the organisation. So, to say that it's not permissible, well, it is permissible. So, it's not really a problem. It's really not clear what else they could mean by that.

3.4 QUESTION 3

IN LIGHT OF THE COMPETITION COMMISISON RULING, IN 2005, REGARDING PRICE FIXING IN THE INDUSTRY, DOES YOUR ORGANISATION HAVE ANY CONCERNS REGARDING THE SETTING OF A MAXIMUM PERMISSABLE PRICE DISCOUNT IN RESPECT OF CALCULATING THE OVER-ALLOWANCE?

3.4.1 JC001

It certainly doesn't seem to be an issue today; in terms of our trade. So I suppose, if I were to answer the question, I certainly wouldn't say it is a major concern. Certainly, not our hit list as a primary concern.

3.4.2 KC001

We don't see it as a problem. Because there is and there cannot be a maximum specified discount. If you kept on giving high discounts, then you'd soon go out of business.

Interviewer: It points to being a business decision at the end of the day?

Yes. That's right.

3.4.3 AC001

Answered in part 3.3.4 above.

3.5 QUESTION 4

PRACTICALLY, HAS THE ISSUING OF THIS RULING IMPACTED YOUR ORGANISATION IN ANYWAY?

3.5.1 JC001

No. Definitely not at this moment. *This was followed up later with an e-mail stating that "*there are still system changes to be made, but they have not yet been made on the system".

3.5.2 KC001

Practically? No. The mission from our side has been making sure that that VAT form [VAT 264] is completed. Our internal audits cover that issue and it's obvious often that that is a point of break-down. That is an area, obviously, where revenue is trying to cotton onto... Doing inspections and all sorts of things. And the problem is that they can pick up one or two forms in a sample, so then they just extrapolate. They can go back five years and in our case, many of our dealerships are all branches of a particular company, so you can have a guy in Cape Town that is picked up for one or two and it's spread across the country because it's all the same (Pty). That's just housekeeping from our side. Not anything that will hold us back. Just got to be done and the boxes ticked or crossed, as the case may be, and signed by the customer. Our case, very often, the customer signs, but they don't fill in. So, the customer signs it blank, as it were, and the salesmen promise themselves that they'll get the paperwork sorted out later, but it never gets done.

But, we stress, obviously, the importance of it and threaten them with their lives.

3.5.3 AC001

In terms of the documentation requirements, we'd have to think a bit more carefully about that. But, basically, at the end of the day, with our computer systems, it is all there and if you need to, you can just print what you want. So, no, I don't think that that is a major issue.

The VAT 264, obviously, that's always been around... for a while. We've got a VAT 264 form, same format, which has got a bit more detail, but I mean, basically, needing the VAT 264.

Then, I think your next question, well; you mentioned the fair market value. But, I mean, that was what the Act says. But, then, they've now put these rules into place where it's not their intention to disallow the VAT on the consideration, provided it's the / they allude to the permissible discount and.... what else do they refer to *[looking through **the Guide**]...*what are the other conditions... it's just documentation requirements... there was something...

[Interviewer: "They do refer to the fact that the OMV is the price specified in the Auto Dealer Guide/ M&M book]

Well, yes, yes. You see, the way I read it, is what they basically said here, "where a motor dealer pays an amount in excess...", OK, you see, they were just speaking about the law. They're saying that the motor dealer guide [referring to the M&M book] is the "generally accepted value" and where you have a difference between that and the amount you pay, that's the over-allowance. So, I don't think they're saying that it is/ I don't think they are limiting... But they use the word "generally". It is "**generally** accepted that the value in the Auto Dealer Guide...". Well, they're not 100% right because at the end of the day, it is a **guide**.

3.6 QUESTION 5

HAS YOUR ORGANISATION EXPERIENCED ANY PRACTICAL DIFFICULTIES IN COMPLYING WITH THE RULING OR DOES YOUR ORGANISATION HAVE ANY CONCERNS REGARDING THE APPLICATION OF THIS RULING?

3.6.1 JC001

Answered above.

It is all about supply and demand. If you look at amount of over-allowance will depend on, well, like on the more expensive models, you make a higher GP so it will depend on the GP you make on the new car, the over-allowance you will be willing to give

And it also depends on your circumstances; it depends on how close you are to your volume incentives etc. More volume driven businesses will give a bigger over-allowance because their business model is a volume driven model. Push numbers and quantity. Some dealers actually sell below cost in order to get the volumes. So, their over-allowance will be significantly more. It's a business decision at the end of the day.

How close you are to quarter end targets is going to change your pricing. From a used [vehicle] point of view, we've certainly had a mixed year in terms of the price gap between new and used; has narrowed so significantly that it has put the used market under serious pressure. But on top of that, we've got a serious shortage of them. So, as the economy... as people have less and less disposable income, they are holding onto their cars for longer so our supply has been drastically reduced, offset by an over-supply of single brands from the rentals... from the world cup, all the rental fleets. So, it's been a really mixed year. You are getting excess cars of one model, but then the ones you want, you've for no stock. As previously stated, it's about supply and demand.

3.6.2 KC001

No. No practical difficulties other than the form.

3.6.3 AC001

No, we haven't, because we don't think that it has made a difference, because the very fact that the deal has got to be feasible and possible would make sure that you're not stepping outside of the law. The reality is, is that if you take the wash out of the two deals and the Receiver of Revenue would still get a greater portion of VAT, because, in general, well, in 99.9% of the cases, there is a profit on the net of the two, so he would get value add, net value add tax, so we don't see that as a major issue.

At the end of the day, maybe it was a good thing that they did this. So, yes, it's a good thing. There were one or two things that I looked at again on the documentation, but we went through that with our computer systems and all the details are there on the system.

3.7 QUESTION 6

HAS YOUR ORGANISATION FOUND THE VAT 420 TO BE A SOLUTION TO THE PROBLEM EXPERIENCED BETWEEN THE PRACTICAL APPLICATION OF THE VAT TREATMENT OF OVER-ALLOWANCES AND THE SARS LETTER OF THE LAW?

3.7.1 JC001

Overall we are satisfied with the ruling. SARS have taken a practical view.

3.7.2 KC001

Yes, I think it has. It is the ultimate proof that the customer is not a vendor and it is the final requirement for your entitlement to that notional input. Rather than trying to argue every single case on an Open Market Value basis, much easier to accept the ruling and comply. I mean, practically, in terms of the Open Market Value, our view had been that if you, no matter what over-allowance you put on the vehicle, if you ultimately sell it at a profit, then you've covered your bases. I mean, we're not going to do deals where we continue to make losses.

3.7.3 AC001

Answered in 3.6 above.

4 FINDINGS

4.1 INTRODUCTION

Whilst the discussions held during the interviews, and therefore the actual answers have been included in the previous chapter, conclusions must be drawn, based on the data collected from the responses obtained through the interviews conducted. Thus, conclusions have been drawn for each of the questions contained in the interview schedule and have been included in this chapter.

Furthermore, included in this chapter is a chapter entitled "ITL001". In conducting research and investigating various avenues relating to the topic under study, contact was made with one of the largest motor dealer groups in the United Kingdom ("UK"). By way of interest, communication commenced in order to understand, from an international perspective, whether or not other countries hold similar concepts and, if so, whether or not they face similar conflicts with their respective Revenue Collection Services. Although the pre-defined interview schedule was not used in its actual form, the vital concepts were discussed. All communication was conducted via e-mail. The results of the communication have been recorded under this section.

4.2 QUESTION 1

HOW WOULD YOUR ORGANISATION DEFINE THE TERM "OVER-ALLOWANCE"? UNDER WHAT CIRCUMSTANCES DOES YOUR ORGANISATION ISSUE AN OVER-ALLOWANCE?

The term over-allowance is a complicated concept. As noted in the literature review, Krause (2005) was reluctant to confine the concept of over-allowances to a simple definition. The findings noted above seem to confirm this, in that, on the surface, over-allowances can be broadly defined as a negotiation between a willing buyer and a willing seller, resulting in a vehicle being traded in at a higher

value, which is offset by a lower discount on the subsequent sale of the new vehicle.

However, when referring to the historical background to the concept of over-allowance, its origin is rather important. The concept originated as a result of deposit requirements governed by the previous Credit Act. It was essentially related to the financing of the new vehicle. A deposit was required to finance the new vehicle, which the customer may not have had. The trade-in of the customer's previous vehicle was a way of creating this deposit. Interestingly enough, the banks appear to be relatively satisfied with the set-up, provided the privilege is not abused and there is some correlation between the OMV and the final agreed price.

Although the rules of the new National Credit Act no longer require a deposit, the practice of over-allowances has continued, as the banks continue to some extent to require a deposit.

KC001 indicated that the difficulty with the concept arises from the term OMV. As stated, one dealership's valuation on a vehicle can differ completely from another's. The concept is therefore objective. What may be considered by one dealership to be an over-allowance may, in fact, be considered an undervaluation against OMV by another.

In concluding, therefore, there are essentially two reasons for the issuance of an over-allowance, the first a financial reason and the second a business decision. While the definition may exist, the over-allowance concept becomes extremely dealership-specific and in practice the ultimate conclusion of the transaction as a whole will need to be reviewed if the impact from a VAT perspective is to be understood. As noted by AC001, one needs to look at the complete washout of the trade-in offset against the sale of the new vehicle.

4.3 QUESTION 2

ARE YOU AWARE OF THE TREATMENT PRESCRIBED IN THE NEW VAT GUIDE FOR MOTOR DEALERS?

4.3.1 How does your organisation value a trade-in?

It would appear that a common trend in the valuation of trade-in vehicles is an on-line bidding system. The details of the vehicle are uploaded onto an intranet. In some cases, only internal bidders have access to bid or name a price for the vehicle, while in other instances both internal and external bidders are permitted.

The highest bid for that vehicle is then used as the price offered to the customer for that vehicle. Negotiations may then take place between the customer and the dealer, but, essentially, the highest bid is considered to be a fair OMV for that particular vehicle.

Alternatively, specialised valuators, who have the necessary skill and expertise, are asked to value vehicles. With their knowledge and skill and possibly contacts in the trade, a price is determined which is deemed to be a fair OMV.

Consequently no actual rules govern the process.

4.3.2 Does your organisation make use of any rules when valuing a trade-in? If so, please explain?

It would appear that no actual rules govern the process, other than making use of either an on-line bidding system or a specialised valuator to determine the OMV.

4.3.3 In your view, does the ascertained trade-in value represent a fair market value?

Yes. In respect of instances of the on-line bidding system being used, the highest bid granted is considered to be a fair OMV. Alternatively, where a specialised

valuator is used, the valuators have the necessary knowledge, skill and contacts in the trade to establish a price that is deemed to be a fair OMV.

4.3.4 Does your organisation make use of the Auto Dealer Guide (aka M&M book)? If yes, to what extent do you place reliance on this Guide?

It is very clear that the industry views the M&M book merely as a point of reference. There is evidently a time-lag between the dates when the data is captured and when it is actually released, resulting in fairly unreliable data, particularly in fluctuating markets.

While the industry does make use of the M&M book, it is certainly not relied upon to identify a fair OMV of a vehicle. Thus, SARS' statement in the *Guide* is certainly flawed. It is quite evident that the M&M book cannot be relied upon to reflect a fair OMV, but the method currently used by the dealer groups is far more reliable and is a far better reflection of OMV.

4.3.5 Does your organisation refer to specified maximum permissible price discounts when valuing trade-ins? If yes, please explain from where you, as an organisation, obtain the maximum permissible discounts.

It would appear that the industry does not use a specified maximum permissible discount. Discounts granted are a business-related decision and a number of factors contribute to the amount granted, including market conditions, profitability/ profit targets, manufacturer concerns and product reputation, to name but a few.

4.4 QUESTION 3

IN LIGHT OF THE COMPETITION COMMISISON RULING, IN 2005, REGARDING PRICE FIXING IN THE INDUSTRY, DOES YOUR ORGANISATION HAVE ANY CONCERNS REGARDING THE SETTING OF A MAXIMUM PERMISSABLE PRICE DISCOUNT IN RESPECT OF CALCULATING THE OVER-ALLOWANCE?

Given the reference to permissible discount in the *Guide,* the industry does not appear to be concerned about price-fixing. It seems instead to have made an interpretation based on the fact that, legally, a maximum price discount cannot be specified. This also suggests that SARS cannot possibly mean that the industry should impose one. The literature reviewed confirms that the imposition of a maximum allowable discount is a "per se violation for which no justification can be provided". It would therefore be unreasonable and unlawful for SARS to expect the industry to impose a maximum permissible discount. Without being provided with a definition, the industry has continued its regular practice, assuming that the permissible discount referred to in the *Guide* is a dealer-specific and business-specific decision.

The general consensus appears to be that SARS envisages a market-related deal as opposed to the industry setting or the imposition of a maximum permissible discount. An imposition could not possibly have been envisaged, as this would be anti-competitive.

4.5 QUESTION 4

PRACTICALLY, HAS THE ISSUING OF THIS RULING IMPACTED YOUR ORGANISATION IN ANYWAY?

The *Guide* itself does not seem to have made any practical impact other than possibly that of documentation requirements. However, the systems and system integration available make it very easy to access the requisite information and documentation. All the detail is on the system and can be pulled off in report format.

4.6 QUESTION 5

HAS YOUR ORGANISATION EXPERIENCED ANY PRACTICAL DIFFICULTIES IN COMPLYING WITH THE RULING OR DOES YOUR ORGANISATION HAVE ANY CONCERNS REGARDING THE APPLICATION OF THIS RULING?

The only practical difficulties experienced relate to the VAT 264 forms. These were required prior to the issuance of the *Guide*. What AC001 says is extremely important, which is that the *Guide* has not really made much difference.

4.7 QUESTION 6

HAS YOUR ORGANISATION FOUND THE VAT 420 TO BE A SOLUTION TO THE PROBLEM EXPERIENCED BETWEEN THE PRACTICAL APPLICATION OF THE VAT TREATMENT OF OVER-ALLOWANCES AND THE SARS LETTER OF THE LAW?

It would appear that the *Guide* has been welcomed and has had positive results in the SA industry.

AC001 said that it hadn't made a difference, but also noted that, provided the deal was feasible and possible, one could not step outside of the law. This seems to be the general interpretation. SARS is willing to accept current practice, provided that feasible and possible deals are entered into.

4.8 ITL001

4.8.1 Correspondence with ITL001

As mentioned above, e-mail contact was made with one of the largest motor dealer groups in the UK (unique code "ITL001"). The following responses have been extracted directly from this e-mail communication. The name of the organisation has been altered for purposes of confidentiality. After explaining the research topic and the background to the study, the following questions were posed:

- Do you have the same/ similar concept of over-allowances in the UK?
- What are the requirements from a UK VAT legislation perspective, regarding the treatment of these over-allowances?

The response was as follows:

> There exists a very similar problem in VAT in the motor trade which centres around values of the exchange and new vehicle, and of course HMRC [Her Majesty's Revenue and Customs, the UK equivalent of SARS] is just as eager to take the most favourable values from each side of the transaction!
>
> Just as some context to the UK situation that I will come onto I have included a brief description of how VAT is charged on the sale of vehicles by motor dealers, and how that status is important when looking at the UK system, and also an extract on the HMRC Guidance (V1-37 Motor Dealers s3.6 Bumping) on problems caused similar to the topic you have queried:
>
> **Extract from HMRC Guidance (V1-37 Motor Dealers)**
>
> ***3.6 Value manipulation (Bumping)***
>
> *Dealers manipulate vehicle values on their paperwork for a wide range of reasons, but often do not realise that there can be a side-effect on their VAT liability. Value manipulation can take many forms, below are two specific issues to demonstrate what is and is not acceptable.*

3.6.1 Vehicle sales on finance

Finance Companies often set minimum deposit requirements, which can be stretching if the customer has a low value or no part-exchange vehicle to put towards the deposit.

Some dealers will inflate the value of the car that is being sold, and the value of the part exchange, by an equal amount to accommodate the minimum percentage deposit requirements set by the Finance Company. A fictitious cash deposit may even be introduced where there is no part exchanged vehicle. The "bottom line" figure, which is what most customers are interested in, will remain the same.

This practice is commonly referred to as "bumping", "stacking" or "up-jarring" and has probably been in existence in the ***motor*** *trade since before VAT was first introduced 1973.*

From an HMRC viewpoint, consideration must be given to who is actually buying the car. In the case of a typical HP agreement the line of supply is to the Finance Company and not the ultimate purchaser of the vehicle. For VAT purposes the values shown on any documentation raised to the Finance Company ***must*** *be the same as the values declared to HMRC in the businesses books and records.* ***There are no exceptions to this rule.***

The issue that arises in the UK is generally only relevant when we are selling to a VAT registered business (In most cases this will be a finance company, where the sale is a Hire purchase agreement and in these cases the finance company will be the owner of the vehicle, and have the potential right to Input VAT recovery) - A customer will approach our dealerships with a part exchange vehicle which is currently on finance, and in some cases the finance settlement is actually higher than the value of the vehicle (e.g. Vehicle is worth £3K, finance settlement is £5K) so what the salesman will be tempted to do

is over allow for the part exchange against the value of the newer vehicle (New vehicle for sale at £20K, will be inflated to £22K to cover the negative equity) - The problem arises where we have charged VAT to the finance company (In this example £22K inc VAT) and an invoice will be raised and sent to them, and the finance company will finance the difference - £17K; However, some motor dealerships will adjust the values in their records back to the lower 'True' values of £3K Part Exchange value and £20K New car value.

As you can imagine, HMRC want to take the values at their higher agreed value when selling - £22K, and normally at the lower value for the part exchange - £3K as this forms the basis for calculating VAT on the profit. I hasten to add that this does not happen at our dealer group as we have many report etc to guard against this happening, but it certainly is a risk in many motor dealers.

In the UK however, there is no conflicting legislation, in the UK we can also sell at whatever price is agreed, with any amount of discount or added value that is agreed upon [between the customer and the seller]. The problem comes in the UK where values are artificially increased for the benefit of obtaining finance, and then a second set of figures is used to calculate the VAT - Which I agree, is not what a legitimate business should be doing.

Following the above response, the following matters were identified and questions posed:

- After reading the first attachment, I am very comfortable with the treatment in the UK, on a vehicle that is purchased by a dealer from a non-VAT vendor. In effect, where you would declare VAT on the profit element only, SA just goes about it in a more round about way. We claim notional input on the purchase of the used vehicle and then declare output on the selling price of the vehicle (ie: the

net effect being a declaration of output VAT on the profit). I suppose the only difference is cash flow and timing!

- Where I would like some clarity: - From reading the second attachment [being the extract from the HMRC Guidance quoted above], it would appear that the practice of over-allowances in SA is much the same as the practice of "bumping" in the UK, but the intentions are slightly different. Over-allowances can occur regardless of how the vehicle is financed. In effect, Mr X walks into a dealership wanting to sell his current vehicle to the dealership and purchase a new vehicle from that same dealership. Mr X feels his vehicle is in immaculate condition and is therefore worth R5k. The dealership valuator, however, does not have the same view. He feels it is only worth R3k. In order to secure the business of the sale of a new vehicle to Mr X, the dealership agree to a trade in value of R5k, resulting in an over-allowance of R2k (R5k less R3k). The value of the new vehicle is R25k, but the dealership normally allows for a discount (again, to secure customers) up to R5k (for example). Because Mr X has been given a higher trade in on his vehicle, the loss to the dealership is compensated for by giving Mr X a lower discount. Mr X will probably only get a discount up to a maximum of R3k (being the normal max of R5k less the over-allowance of R2k). Assume Mr X purchases the new vehicle for R22k, when, in fact, he could have purchased it for R20k, had he accepted the trade in value as being R3k. Under a separate transaction, Mr X's previous vehicle (a non-qualifying vehicle) is sold at an amount of R8k. My question to you, is this:
    - Would HMRC see the Margin of Profit on the sale of the non-qualifying vehicle as R3k (ie: R8k selling price less R5k purchase price) or R5k (ie: R8k selling price less R3k "market value" according to the dealership valuator)?

The response was as follows:

> The only figure that would be of concern to HMRC in the example that you have given would be the agreed purchase price of the trade in vehicle, in the UK there is this same facade that the customer values their vehicle more than the dealer, especially in cases where there is finance to repay on the customers trade in.
>
> However, in the UK after all of the back and forth we are obliged to settle on a figure and one of the conditions of the margin scheme is to provide a purchase invoice for the customers trade in with an agreed figure, in the example you have given we would settle on the £5K, and as you say this forms the basis for the next calculation of profit on the onward sale of this vehicle, profit in your example being £3K.
>
> Whichever example we use in the UK, HMRC will get approximately the same amount of tax from the deal - so there is no concern as long as the agreed values remain (And are not changed or altered after the fact as in the example of Bumping), so in the UK, lets say we give the customer more than he was expecting for his vehicle - £8K, and no discount on the new car, £25K @ 20% VAT HMRC would get £4166.00 VAT in total (No VAT on the part exchange re-sale)
>
> In the example of giving market value £3K for the trade in, and the customer getting the full discount on the new car, £20K, in the UK HMRC would get £3333.33 VAT from the new car, and £833.33 from the sale of the trade in on the margin scheme (£5K profit when sold at £8K) - In total, £4166.66 VAT in total!

4.8.2 Conclusion

The UK has a very similar concept to over-allowances, called “bumping” or “stacking”. The origin of the concept arose as a result of financing deposit requirements, much the same as described by KC001. In essence the value of the trade-in, as well as the value of the new vehicle being sold, is inflated in order to accommodate the minimum percentage deposit requirements. Furthermore, in many instances, the finance settlement amount is actually higher than the value of the vehicle.

In the UK, once a value for the trade-in is agreed upon, a purchase invoice is required to be made out to the customer with the final agreed value. This is much the same as the VAT 264 form required in SA, in instances where a vehicle is purchased from a non-vendor and the same as the invoice required when a purchase is made from a VAT vendor. The value that is used to claim input VAT upon, is the amount stated in the purchase invoice. Evidently, the UK tax authorities would only be interested in this value and would not be concerned with the lower value.

ITL001 explained that VAT is always paid on the margin of profit. Effectively, SA works the same except that in SA, the vendor can claim input VAT on the purchase of a supply and must declare output VAT on the sale separately. The UK appears to work on a net basis. Therefore, the VAT on the trade-in will only be paid once the traded-in vehicle is then sold on.

In concluding, the comment was made that it really does not make a difference whether or not the trade-in vehicle is bumped up in value or not. This was explained in a further example:

Firstly, assume a vehicle is traded in at the actual value of R3 000 plus an over-allowance of R5 000, being R8 000 in total. The vehicle is then on sold at R8 000. As a result of the over-allowance being granted, no discount is allowed on the value of the new vehicle, being R25 000 (including VAT). The total VAT to be paid to the UK tax authorities at a rate

of 20% is R4 166.67 (R25000 x 20/120). The margin of profit on the sale of the traded-in vehicle is nil (R8 000 less R8 000) resulting in VAT of nil. Thus, total VAT payable on the two transactions is R4 166.67.

Secondly, assume the same details as above except that the vehicle was traded in with no over-allowance and as a result a discount of R5 000 was granted on the purchase price of the new vehicle. The margin of profit on the on sale of the trade-in vehicle is R5 000 (R8 000 less R3 000) resulting in VAT payable of R833.33 (R5 000 x 20/120). The VAT payable on the sale of the new vehicle is R3 333.33 (R20 000 x 20/120). The total VAT payable on the two transactions is R4 166.66 (R833.33 plus R3 333.33).

This final point made by ITL001 above confirms the point made in the introduction to this study - that, in actual fact, regardless of whether or not the strict letter of the law is complied with, the answer amounts to the same thing and SARS is not in the least out of pocket. AC001 confirmed this in their response to question 5, summarised in chapter 3.6 above. The net of the two transactions has to be taken into account to see that SARS ultimately earns VAT on the value added, or the margin, of the transaction, as a whole. This indicates that the new treatment adopted by SARS and outlined in the *Guide*, is certainly in line with other international tax authorities

4.9 CONCLUSION

The perceptions of the SA industry were determined based on interviews conducted with three prominent groups in the industry. In summary, the industry appears to be satisfied with the issuance of the guide and the treatment prescribed by SARS. Conclusions in respect of the individual objectives raised have been determined based on the responses given and have been documented in chapter 5.

An additional, international source was interviewed via e-mail to determine whether or not the VAT treatment prescribed by SARS is reasonable in relation to international tax authorities and therefore to ascertain whether or not the Guide has posed a practical solution. Based on the e-mail correspondence, it would appear that SARS are aligned

with international tax authorities with respect to the VAT treatment prescribed for over-allowances in the *Guide*, indicating that it is, in fact, a reasonable and fair solution.

5 DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1 CONCLUSION

Having collected the relevant data by conducting interviews and documenting the discussions, as well as drawing conclusions based on the discussions, focussing particularly on the objectives identified, it is necessary to summarise the individual conclusions and to draw a final conclusion on the research conducted.

For a start, it is necessary to conclude in terms of the proposition raised: in the light of the Competition Commission rulings and in terms of practicality, the prescribed treatment for over-allowances, as defined in the *Guide*, is at risk of being both anti-competitive and impractical in the SA industry.

It is quite evident, as shown in the responses, findings and conclusions above, that the industry feels that the *Guide* has been very positive. However, the issues identified in the introduction, along with the proposition, remain the same. The *Guide* is not clear as to the permissible discount. Moreover, the reference to the Auto Dealer Guide as being "generally accepted" as the source for OMV is also somewhat unclear.

5.2 RESEARCH OBJECTIVES

In order to be able to draw any final conclusions, each objective has been addressed and concluded below:

5.2.1 Identifying how a fair OMV is determined in the industry

It is very clear that the M&M book cannot be used as gospel, as was pointed out, when valuing the OMV of a trade-in vehicle. The book is used purely as a guide because it is outdated. The dealer groups have their own methods of valuing trade-in vehicles which results, as far as they are concerned, in a fair OMV. Although none of the groups interviewed has undergone a SARS audit subsequent to the issuance of the *Guide*, the

methods of valuation are completely justifiable and, as AC001 put it, “feasible and possible”.

5.2.2 Identifying the interpretation by the various participants in the industry of “permissible discount” as contained in the *Guide* and determining whether or not “permissible discount”, as cited in the *Guide*, stands in contravention of the Competition Act

The general view is that SARS could certainly not have envisioned the imposition of a maximum permissible discount, as this is prohibited in terms of Competition legislation. The industry has thus continued with business as usual. The interpretation has been that the permissible discount is the discount permitted in terms of a business decision. Once again, it boils down to what is “feasible and possible”. The decision on discounts is driven by what is best for business, from the perspective of both profitability and product reputation, which have always been the deciding factors.

5.2.3 Identifying whether or not the Guide succeeds as a practical solution in the industry when it comes to the.VAT treatment of over-allowances in the South African industry how a fair OMV is determined in the industry

The *Guide* has offered a solution and a compromise which the industry has welcomed. The industry has chosen to make an interpretation where the *Guide* is silent, which could be dangerous. However, taking into account the alternative interpretation and the ramifications that it could have on the industry from a Competition Commission perspective, the industry has no other choice. As noted by KC001, the practical requirements do not pose a problem because choosing to not comply would result in the onerous and costly task of having to defend every transaction on an OMV basis.

5.2.4 Identifying and investigating any practical difficulties that are currently experienced as a result of the prescribed treatment

The practical issues do not seem to be a problem at all. None of the dealer groups interviewed has experienced any practical difficulties. In fact, all the dealer groups indicated that the issuing of the *Guide* has made little or no impact on their business.

5.3 FINAL CONCLUSION AND RECOMMENDATIONS

The assumption made by the industry is that SARS has chosen to take a reasonable, fair and practical stance in issuing the *Guide*, particularly owing to the comment in this publication: “It is not the intention of the VAT Act to deny an input tax credit on an arm’s-length transaction between parties that are not connected persons”. Thus, business has continued as normal and, provided transactions are “feasible and possible”, the industry cannot step outside of the law. If SARS were not happy with this interpretation, the *Guide* would have to be amended to clarify what is meant by such terms as “permissible discount”.

5.4 FURTHER RESEARCH

While a thorough review of the participants’ responses has been conducted, in the light of the literature review contained here, it must be borne in mind that this study has focussed on the limited sample selected, while the scope was limited to the issues identified. The findings are therefore not absolute and further research need to be conducted, which extends beyond the scope of this study.

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APPENDIX A

- Interview Schedule -

INTERVIEW SCHEDULE

1) How would your organisation define the term “over-allowance”? Under what circumstances does your organisation issue an over-allowance?
2) Are you aware of the treatment prescribed in the new VAT Guide for Motor Dealers? (If no, please see Attachment 1 for an extract from ***the Guide***).
    a. How does your organisation value a trade-in?
    b. Does your organisation make use of any rules when valuing a trade-in? If so, please explain?
    c. In your view, does the ascertained trade-in value represent a fair market value?
    d. Does your organisation make use of the Auto Dealer Guide? If yes, to what extent do you place reliance on this Guide?
    e. Does your organisation refer to specified maximum permissible price discounts when valuing trade-ins? If yes, please explain from where you, as an organisation, obtain the maximum permissible price discounts.
3) In light of the Competition Commission ruling, in 2005, regarding price fixing in the industry, does your organisation have any concerns regarding the setting of a maximum permissible price discount in respect of calculating the over-allowance?
4) Practically, has the issuing of this ruling impacted your organisation in anyway?
5) Has your organisation experienced any practical difficulties in complying with the ruling or does your organisation have any concerns regarding the application of this ruling?
6) Has your organisation found the VAT 420 to be a solution to the problem experienced between the practical application of the VAT treatment of over-allowances and the SARS letter of the law?

7.3 SECOND-HAND GOODS

When a motor dealer purchases a second-hand motor vehicle (including a "motor car") from another motor dealer, the supply will usually constitute a taxable supply and the supplier will be required to issue a tax invoice as discussed in ***paragraphs 7.1*** and ***7.2*** above. The same will apply if a motor vehicle is purchased from any other vendor which has used the motor vehicle in an enterprise and claimed input tax thereon.[68] However, motor dealers often purchase second-hand motor vehicles from private owners (non-vendors) or accept these as trade-ins.

If a second-hand motor vehicle purchased or accepted as a trade-in is not a taxable supply by that person, the motor dealer will be entitled to claim a notional input tax deduction on the motor vehicle acquired, subject to the following conditions:

- The motor vehicle must qualify as "second-hand goods" as defined.[69]
- The supply may not be a taxable supply.[70]
- The supplier must be a South African resident.
- The goods supplied must be situated in South Africa.
- The motor dealer must have paid[71] for the motor vehicle or at least made part payment, as input tax is only allowed to the extent that payment has been made.
- The prescribed records[72] must be kept (form VAT 264 and attachments – *refer to* ***Annexure A***).

The notional input tax is calculated by multiplying the tax fraction (presently 14/114) by the lesser of the consideration paid or the open market value (OMV). Where the OMV is less than the consideration paid, the OMV will be used to calculate the notional input tax claim.[73]

No input tax may be claimed by a motor dealer on any second-hand motor vehicles acquired under a non-taxable supply unless a form VAT 264 has been completed, signed by the seller and retained as part of the motor dealer's records. Form VAT 264 is a declaration in respect of the acquisition of moveable second-hand or repossessed goods in which the owner of the goods or the person representing the owner declares that the supply of the goods is not a taxable supply.

Motor dealers may not claim input tax on the acquisition of second-hand motor vehicles from diplomats or consular or diplomatic missions if relief was granted to the owner on the acquisition of that motor vehicle in the form of a refund of VAT.[74]

As mentioned in ***paragraph 2.11***, motor dealers sometimes agree to pay an amount to a customer which is in excess of the generally accepted trade-in value of a second-hand motor vehicle in cases where the trade-in is an integral part of another transaction involving the supply of a new vehicle to the same customer by the motor dealer. The difference between this value and the amount credited or paid to the customer is referred to as an "over-allowance". The issue which arises in this regard is that the notional input tax which the dealer seeks to claim on the vehicle traded in is limited to the tax fraction of the **lesser** of:

- any consideration in money given by the dealer; or
- the OMV of the vehicle.

It is generally accepted that the values mentioned in the Auto Dealer's Guide represent the OMV. As a result, when any so-called "over-allowance" is paid to the customer, the OMV will be the lesser amount, and the notional input tax credit will be limited accordingly.

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[68] Motor cars acquired from vendors that do not supply motor cars in the ordinary course of their business are usually not taxable supplies.

[69] Section 1 of the VAT Act.

[70] This will occur when the supplier is not a registered vendor, or if the supply is made by a vendor, but is not a taxable supply in the circumstances (for example, the supply of a motor car by a vendor that has been denied input tax on the acquisition thereof).

[71] A set-off, or granting of credit to the customer for the trade-in value of a second-hand motor vehicle against the selling price of another motor vehicle will constitute payment of the consideration for the second-hand motor vehicle traded in.

[72] In addition to form VAT 264, a copy of the green bar-coded ID of the supplier (or the supplier's representative) must be attached as well as a copy of the business letterhead or other similar document if the supplier is a juristic person.

[73] However, refer to the binding general ruling in this regard on page 44.

[74] *Refer to section 68 of the VAT Act - Tax relief allowable to certain diplomats and diplomatic and consular missions.*

As it is not the intention of the VAT Act to deny an input tax credit on an arm's-length transaction between parties that are not connected persons in such circumstances, a binding general ruling has been issued in this regard (refer to the following page).

OVER-ALLOWANCES: NOTIONAL INPUT TAX AND OPEN MARKET VALUE

The statement below regarding the application of the VAT law in regard to over-allowances for the purposes of paragraph (*b*) of the definition of "*input tax*" and "*open market value*" as defined in section 1 of the VAT Act constitutes a binding general ruling issued in accordance with section 76P of the Income Tax Act, 1962 (Act No. 58 of 1962), read with section 41A of the VAT Act. This binding general ruling applies **with effect from 1 March 2009** and will remain in force until withdrawn or replaced.

Where a motor dealer pays an amount to a customer in excess of the generally accepted trade-in market value reflected in the Auto Dealer's Guide of a second-hand motor vehicle, the difference between this value and the amount credited or paid to the customer is referred to as an "over-allowance". The effect of paying an "over-allowance" is that in terms of paragraph (*b*) of "*input tax*" and "*open market value*" as defined in section 1 of the VAT Act, the open market value is less than the consideration paid to the customer. Consequently, the notional input tax to which the dealer is entitled is limited to the tax fraction of the open market value of the vehicle traded-in.

In cases where the trade-in is an integral part of another transaction involving the supply of a new vehicle to the same customer by the same motor dealer, the overall position for the motor dealer is the same with regard to the VAT payable if –

- the generally accepted trade-in open market value of the second-hand motor vehicle is paid and a discount is granted to the customer on the new vehicle; or
- a so-called "over-allowance" is paid to the customer on the second-hand motor vehicle traded-in, and no discount (or a very small discount) is granted to the customer on the new vehicle purchased.

As it is not the intention of the VAT Act to deny an input tax credit on an arm's-length transaction between parties that are not connected persons in such circumstances, an arrangement is hereby made in terms of section 72 of the VAT Act, to allow motor dealers to deduct input tax in terms of paragraph (*b*) of "*input tax*" as defined in section 1 of the VAT Act, read with section 16(3)(*a*)(ii)(*aa*) and 16(3)(*b*)(i) on the full consideration (including any over-allowance amount) paid or credited to the supplier for a second-hand vehicle traded-in under a non-taxable supply.

This ruling is made under the following conditions:

(a) The trade-in transaction is dependent on the conclusion of a transaction for the purchase of another motor vehicle by that customer from the same motor dealer.
(b) The parties to the transaction are trading at arm's-length and are not "*connected persons*" as defined in section 1 of the VAT Act.
(c) The consideration paid shall be regarded as the value of the trade-in plus the over-allowance given by the vendor. However, this allowance given by the vendor shall not exceed the discount that is permissible on the vehicle being sold.
(d) The required records as prescribed in section 20(8) of the VAT Act must be held, as well as the following:

- A detailed list of the second-hand vehicles traded in, and the subsequent sale thereof.
- A statement containing the details of the allowance/discount allowable on the vehicles to be sold.
- A statement showing the net accounting effect of the combined transactions involved (that is, the trade-in and sale).

(e) Failure on the part of the motor dealer to comply with the aforementioned conditions and the provisions of the VAT Act will result in the arrangement not being allowed or withdrawn. Furthermore, SARS reserves the right to withdraw this arrangement, should it be found that such dispensation is being misused or causing verification problems for SARS. In these instances the normal rules as set out in the VAT Act will apply.

APPENDIX B

- Informed consent form -

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA
Faculty of Economic and
Management Sciences

Informed consent for participation in an academic research study

Dept. of M.Com Taxation

A CRITICAL ANALYSIS OF THE VAT IMPLICATIONS OF OVER-ALLOWANCES IN THE SOUTH AFRICAN MOTOR RETAIL INDUSTRY

Research conducted by:
Mrs. M.A. Coventry (2503288)
Cell: 084 494 4044

Dear Respondent

You are invited to participate in an academic research study conducted by Michelle Anne Coventry, a Masters student from the Department of Taxation at the University of Pretoria.

The purpose of the study is to obtain clarity with regard to the VAT treatment of over-allowances in the South African motor retail industry, bearing in mind the recent issuance of the VAT 420: Guide for Motor Dealers and in light of Competition Commission rulings in respect of price-fixing in the motor retail industry. The study aims to understand current practice utilised by the dealer groups and to try to ascertain a treatment that will be practical as well as legally complying with both VAT legislation as well as Competition Commission legislation.

Please note the following:

- This study involves personal, structured interviews based on pre-determined questions. Your name will not appear on the questionnaire/ in the results of the study and the answers you give will be treated as strictly confidential. You cannot be identified based on the answers you give.
- Your participation in this study is very important to us. You may, however, choose not to participate and you may also stop participating at any time without any negative consequences.
- Please answer the questions presented in the interview as completely and honestly as possible. This should not take more than 1 hour of your time
- The results of the study will be used for academic purposes only and may be published in an academic journal. We will provide you with a summary of our findings on request.
- Please contact my supervisor if you have any questions or comments regarding the study.

Please sign the form to indicate that:

- You have read and understand the information provided above.
- You give your consent to participate in the study on a voluntary basis.

Respondent's signature **Date**