

# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

Mini dissertation by

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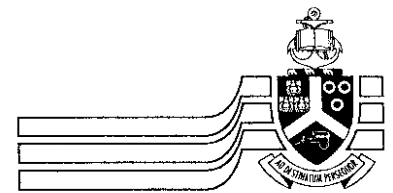


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April 2009



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## ABSTRACT

# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

by

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The general mindset of most vendors is that if they have a valid tax invoice, they can claim all their input VAT. They are, however, not aware of the requirements of section 17(1) of the Value-Added Tax Act. Section 17(1) explains that vendors cannot claim all their input tax if their expense relates to both taxable and non-taxable supplies and that, consequently, input tax need to be apportioned in some or other way.

There are several methods of apportionment available to vendors of which the turnover-based method is the only approved method by the South African Revenue Service (SARS) for which no ruling is necessary. This study investigates the most common methods used by vendors, how these methods function and also under which circumstances these methods are recommended.

The sectors that are influenced the most by this provision in the Value-Added Tax Act are banks, universities and municipalities. These sectors have large amounts of exempt supplies but also taxable supplies with expenses incurred that cannot be allocated specifically to a certain income. Therefore, a method of apportionment should be used to allocate the input VAT. Information was obtained through financial reports and questionnaires from 29 entities in South Africa. The information was used to calculate an average percentage of apportionment in each sector and also to establish which method of apportionment is the most commonly used method of apportionment in each sector. The conclusion was drawn that there might, under

certain circumstances, be uncertainty on whether some income should be included or excluded in the apportionment calculation. Under these circumstances, it is recommended that a ruling should be obtained from SARS to avoid problems in the future.

## OPSOMMING

# 'N OMVATTENDE STUDIE VAN TOEDELINGSMETODES VIR INSETBELASTING VIR BELASTING OP TOEGEVOEGDE WAARDE IN SUID AFRIKA

deur

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GRAAD: M COM BELASTING

Verskaffers verkeer onder die algemene indruk dat, indien hulle in besit is van 'n geldige belastingfaktuur, hulle alle insetbelasting vir -BTW-doeleindes kan eis. Hulle is egter nie altyd bewus van die vereistes van artikel 17(1) van die Wet op Belasting op Toegevoegde Waarde nie. Artikel 17(1) van die wet verduidelik dat, wanneer verskaffers belasbare, sowel as nie-belasbare, lewerings maak en 'n uitgawe aangegaan word wat op albei soorte lewerings betrekking het is, hulle nie al die insetbelasting kan eis nie en dat die BTW met behulp van een of ander metode toegedeel moet word.

Daar is verskeie metodes wat verskaffers kan gebruik, maar slegs die omset-gebaseerde metode word deur die Suide Afrikaanse Inkomstediens (SAID) aanvaar. Indien 'n verskaffer 'n ander metode wil gebruik, moet hulle toestemming van SAID deur middel van 'n aanwysing ontvang. Hierdie studie ondersoek die mees algemene metodes, asook hoe hierdie metodes werk en onder watter omstandighede die metodes die mees bruikbare is.

Die sektore wat die meeste deur die bepaling in die BTW-wet beïnvloed word, is banke, universiteite en munisipaliteite. Hierdie sektore het groot hoeveelhede vrygestelde lewerings, maar maak ook belasbare lewerings. Gevolglik kan 'n uitgawe nie altyd aan 'n spesifieke inkomste toegedeel word nie en moet die uitgawe se insetbelasting toegedeel word. Inligting is ingewin deur middel van finansiële inligting

en vraelyste van 29 entiteite in Suid-Afrika. Die inligting is gebruik om 'n gemiddelde persentasie van toedeling vir elke sektor te bereken, asook om vas te stel watter metode die meeste deur 'n sektor gebruik word. Die gevolgtrekking is gemaak dat daar steeds onsekerheid kan heers oor watter inkomstes ingesluit of uitgesluit moet wees. In so 'n geval word daar aanbeveel dat 'n aanwysing van SAID verkry word om onsekerheid uit die weg te ruim en te verhoed dat daar later probleme opduik.

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# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

## CHAPTER 1 : INTRODUCTION

### 1.1 BACKGROUND

“This product is not so expensive because I can claim back all the VAT”. This is the general mindset of most VAT vendors. However, are they aware of the provisions of section 17(1) of the Act?

In terms of section 17(1)(i) of the Value-Added Tax Act No. 89 of 1991 (“the Act”) expenses can be deducted for VAT purposes *“where the intended use of goods or services in the course of making taxable supplies is equal to not less than 95 per cent of the total intended use of such goods or services, the goods or services concerned may for the purposes of this Act be regarded as having been acquired wholly for the purpose of making taxable supplies”*.

From this extract it is clear that the full input tax paid cannot be claimed back where taxable and non-taxable goods/services are supplied by the same entity and the non-taxable goods/services exceeds the taxable supplies by 5%. Therefore, when goods and services are not obtained exclusively relating to taxable supplies, the entity should determine which portion relates to taxable supplies.

Input tax claimable is then calculated according to the apportionment percentage by using an approved method of SARS. The only approved method which may be used to apportion input tax in terms of section 17(1) of the Act read with general binding ruling 30 of the Act without prior written approval from the Commissioner is the turnover-based method (SARS, 2007a:36).

Currently, most of the text books only provide guidance on how the turnover-based method should be applied namely taxable supplies divided by the total supplies (taxable plus non-taxable supplies). However, uncertainty exists on which income/revenue amounts include in the calculation of total goods/services. The financial services sector for example

uses the net interest received in the turnover-based method which is not a method generally known. By including different bases of taxable and non-taxable amounts in the calculations, different results will be obtained and the amount of input tax that can be claimed back will differ. The question then arises whether this is acceptable, as a more favourable percentage does not necessarily means it is an acceptable method of calculating the apportionment percentage.

This research study focuses on the different methods available to calculate the apportionment percentage in South Africa and to establish an acceptable percentage for a specific industry.

## **1.2 PROBLEM STATEMENT**

What methods are available to calculate the percentage of input tax that is claimable when an expense relates to both taxable and non-taxable goods/services, and which methods are used by entities in South Africa? This specifically relates to methods used by the banking sector, universities and municipalities as these sectors deliver both taxable and non-taxable goods/services. The study also investigates what an acceptable percentage would be.

## **1.3 RESEARCH OBJECTIVES**

The objectives of the research study are as follows:

- to consider the apportionment methods used by South African entities especially in the banking, university and municipal sectors and to gain insight into why these methods are used; and
- to investigate what an acceptable percentage would be.

## **1.4 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY**

The Act only states that the input tax should be apportioned when non-taxable goods/services are more than 5% of the total supplies of a business. Section 17(1)(iii) of

the Act also indicates that several methods are available to calculate the apportionment percentage, but no specific guidance is given on how the calculations should be done. The South African Revenue Service (SARS) issued the *VAT 404 - Guide for Vendors* which set out more detail on what apportionment is. A basic example is also provided on how this apportionment calculation should be done. However, no further guidance is available on other methods to calculate the apportionment percentage. Most of the text books follow the same reasoning.

Because of the lack of previous research on this topic, there is high academic value in conducting this research. The research will elaborate on the information provided by the SARS Guides and text books. The study also gives an indication of what percentage an apportionment percentage should be in a specific sector – something that has not been done to the researcher's knowledge to date.

## **1.5 DELIMITATIONS AND ASSUMPTIONS**

### **1.5.1 Delimitations**

The aim of this study is to determine the effect of different methods on the apportionment percentage and not to find the ideal method or a method that is the most beneficial to a business.

The study will not deal with adjustments as described in section 18 of the Act.

### **1.5.2 Assumptions**

The research was started with the assumption that the information received from the different entities would be accurate and complete and that it would be received on time.

## 1.6 DEFINITION OF KEY TERMS

**Enterprise:** The *VAT 404 - Guide for Vendors* (SARS, 2007a:86) indicates that an enterprise is any business activity in the broadest sense. It includes activities carried on:

- continuously or regularly;
- by any person;
- in or partly in the RSA;
- in the course of which goods or services are supplied for a consideration, i.e. some form of payment; and
- whether or not for profit

Special inclusions:

- public authorities – certain government departments and provincial authorities;
- municipalities – include municipalities, joint services and the Regional Services Council (RSC);
- welfare organisations and foreign donor funded projects; and
- share block companies.

**Exempt supply:** The *VAT 404 - Guide for Vendors* (SARS, 2007a:87) defines an exempt supply as a supply on which no VAT may be charged (even if the supplier is registered for VAT). Persons making only exempt supplies may not register for VAT and may not recover input tax on purchases to make exempt supplies. Section 12 of the Act contains a list of exempt supplies.

Examples:

- certain financial services;
- supplies by any “association not for gain” of certain donated goods or services;
- rental of accommodation in any “dwelling” including employee housing;
- certain educational services;
- services of employee organisations, e.g. trade unions;

- certain services to members of a sectional title, share block or old age scheme funded out of levies (not applicable to timeshare schemes);
- public road and railway transport of fare-paying passengers and their luggage; and
- childcare services in a crèche or after school care centre.

**Input tax:**

This is the tax paid by the recipient to the supplier of goods or services. Input tax may only be deducted by the recipient vendor if the goods or services are acquired for making taxable supplies and if the vendor is in possession of a valid tax invoice for the supply as per the requirements of section 20 of the Act. Where goods or services are acquired only partly for taxable supplies, an apportionment of input tax must be made. In the case of an importation, the vendor must be in possession of a valid bill of entry and proof that the VAT has been paid to Customs. In certain instances, input tax may also be claimed on non-taxable supplies of second-hand goods acquired by the vendor, but the vendor must retain a proper record of the details of the transaction. Where the second-hand goods acquired constitute fixed property, the input tax is limited to the stamp duty or transfer duty payable and may only be deducted after the transfer duty or stamp duty has been paid actually.

According to the *VAT 404 – Guide for Vendors* (SARS, 2007a:88) input tax may not be claimed on supplies of “entertainment”, motor cars and club subscriptions as a general rule. Input tax may also not be claimed where goods or services are acquired for making exempt supplies or other non-taxable activities or for private use.

**Taxable supply:**

This refers to any supply of goods or services which is chargeable with tax in terms of the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent in terms of section 11 of the Act.



## 1.7 ABBREVIATIONS USED IN THIS DOCUMENT

**Table 1: Abbreviations**

Abbreviation	Meaning
Income Tax Act	Income Tax Act 58 of 1962
The Act	Value-Added Tax Act 89 of 1991
SARS	South African Revenue Service
VAT	Value-Added Tax

## 1.8 LITERATURE REVIEW

Theoretically it is easy to account for input tax when a vendor only makes taxable supplies or exempt supplies. De Koker and Kruger (2008:131) indicate that in practice a vendor will make purely taxable supplies or purely exempt supplies only in exceptional circumstances. Such a mixture of supplies gives rise to one of the most problematic areas in any VAT system, namely the question of apportionment of input tax. Apportionment refers to the fact that only a portion of input tax that was paid is claimable – the portion not claimable will be added to the expense and will be deductible for income tax purposes when the enterprise is assessed for income tax.

Section 17(1) of the Act indicates that input tax should be apportioned when the intended use of goods and services in the course of making taxable supplies is less than 95% of the total intended use of such goods and services.

Botes and De Wet (2003:17-5) summarise the tax consequences as follows:

**Table 2: Tax consequences**

Intended use	Amount of VAT which is input tax	VAT consequences
Taxable supplies	Full amount of VAT incurred is input tax	Deduction under s 16(3), unless denied by s 17(2).
Exempt supplies	VAT incurred is NOT input tax	No deduction under s 16(3)
Other non-taxable supplies (e.g. s 8(14))	VAT incurred is NOT input tax	No deduction under s 16(3)

Intended use	Amount of VAT which is input tax	VAT consequences
Private (non-business) purposes	VAT incurred is NOT input tax	No deduction under s 16(3)
Mixed use/purposes: taxable supplies AND exempt supplies, or private purposes	VAT incurred is input tax to the extend of taxable intended use – as determined under s 17(1)	Amount of VAT which is input tax may be deducted under s 16(3), unless deduction is denied under s 17(2).

From the above we can see clearly that it is easy to treat taxable and exempt supplies but it is difficult to claim the input tax when the supply is a mixture of exempt and taxable supplies because the vendor is clearly not entitled to the full input tax. The question, however, is what portion of input tax is claimable and how this should be calculated. Most of the text books give general information on apportionment but very few give an indication of how this should be calculated and what the effect would be when using different methods.

De Koker and Kruger (2008:132) indicate that where mixed supplies are made, the vendor is clearly entitled to only a partial deduction of input tax, namely, on the portion that relates to his taxable supplies. To determine an appropriate basis of apportionment in these circumstances may cause uncertainty and may be a controversial exercise.

The starting point according to Botes and De Wet (2003:17-6) is the following formula:

$$\frac{\text{Input tax}}{\text{Full VAT or notional VAT}} = \frac{\text{Intended taxable use}}{\text{Total intended use}}$$

This can also be explained as follows:

$$\text{Input tax claimable} = \frac{\text{Intended taxable use}}{\text{Total intended use}} \times \text{full VAT or notional VAT}$$

## **1.9 COMMON METHODS OF APPORTIONMENT**

The *VAT 404 - Guide for Vendors* (SARS, 2007a:37) provides the following examples of special apportionment methods which may be applied:

- turnover-based method;
- varied input-based method, based on the ratio of VAT wholly attributable to taxable supplies, to the total VAT incurred for all supplies, excluding VAT incurred for mixed purposes;
- floor space method (see SARS ruling 172);
- transaction-based method; and
- employee time method

No guidance and no indication of whether these methods are appropriate are given by the literature studied till date. This research will investigate whether these methods are used.

## **1.10 RESEARCH DESIGN AND METHODS**

### **1.10.1 Description of overall research design**

The research that was conducted included questionnaires as set out in the applicable chapters of this document. They were sent out to the different sectors that are experiencing problems with VAT apportionment. The sectors that are experiencing the most problems and where there is no clear guidance on how to treat the issue are banks, municipalities and universities. This research is an empirical study of primary data and will include numeric and textual data.

### **1.10.2 Sampling**

Primary data was collected for every sector investigated and there was a sampling plan for every sector that was tested. The sectors included the financial sector, municipalities and universities located within the borders of South Africa. The data collected is based on the latest audited financial statements.

### 1.10.3 Banks

The data collection consists primarily of banks situated in South Africa. Because the Banking Council of South Africa is currently negotiating with SARS regarding VAT apportionment it is a very sensitive matter and no questionnaires were sent out as it was projected that no response would be received or the information would be very vague. Therefore information available in their published financial statements was used. A list of all the banks was obtained from the website of the SA Financial Sector Forum (Not dated:[1]). The sample selected consists of the following local banks:

**Table 3: Banks**

<b>Bank</b>	<b>Website</b>
ABSA Bank Limited	<a href="http://www.absa.co.za">www.absa.co.za</a>
African Bank Limited	<a href="http://www.africanbank.co.za">www.africanbank.co.za</a>
Capitec Bank Limited	<a href="http://www.capitecbank.co.za">www.capitecbank.co.za</a>
First Rand Bank Limited including First National Bank, Rand Merchant Bank, RMB Private Bank, Wesbank	<a href="http://www.firststrand.co.za">www.firststrand.co.za</a>
Investec Private Bank	<a href="http://www.investec.co.za">www.investec.co.za</a>
Marriott Corporate Property Bank Limited	<a href="http://www.marriott.co.za">www.marriott.co.za</a>
MEEG Bank Limited	<a href="http://www.meegbank.co.za">www.meegbank.co.za</a>
Rennies Bank Limited	<a href="http://www.renniesbank.co.za">www.renniesbank.co.za</a>
Sasfin Bank Limited	<a href="http://www.sasfin.co.za">www.sasfin.co.za</a>
Standard Bank of South Africa	<a href="http://www.standardbank.co.za">www.standardbank.co.za</a>
TEBA Bank Limited	<a href="http://www.tebabank.co.za">www.tebabank.co.za</a>
Nedbank Group Limited including Nedbank, Old Mutual Bank, Peoples Bank, Go Banking, BoE Private Clients, Fairbairn Private Bank, Imperial Bank Limited	<a href="http://www.nedbankgroup.co.za">www.nedbankgroup.co.za</a>

### 1.10.4 Universities

The data collection consists of traditional universities situated in South Africa. The required information was collected via a questionnaire sent to the Financial Directors directly.

The list of traditional universities was obtained from Wikipedia (Anon2:[1]).



**Table 4: Universities**

<b>University</b>	<b>Contact details</b>
University of Cape Town	www.uct.ac.za fnd-director@uct.ac.za
University of Fort Hare	www.ufh.ac.za Director Finance Tel: 040 602 2299
University of the Free State	www.uovs.ac.za Mr Chris Liebenberg ficr.fin@ufs.ac.za
University of KwaZulu-Natal	www.ukzn.ac.za Mr Hollie Clarkson haripersads1@ukzn.ac.za
University of Limpopo	www.ul.ac.za Mr H. Rhode Tel: 015 268 9111 Fax: 015 267 0152
North-West University	www.nwu.ac.za Mr B. van der Westhuizen Tel. 018 299 1777 Jeanette.vnderheever@nwu.ac.za
University of Pretoria	www.up.ac.za Mr T. Kruger Tel. 012 420 2144 tom.kruger@up.ac.za
Rhodes University	www.ru.ac.za Tel. 046 603 8124 Mr Anton Vorster a.m.vorster@ru.ac.za
University of Stellenbosch	www.sun.ac.za Tel. 021 808 4517 alj@sun.ac.za
University of the Western Cape	www.uwc.ac.za Mr M. Khan Tel. 021 959 2911
University of the Witwatersrand	www.wits.ac.za Mr Hendrik van der Westhuizen hendrik.vanderwesthuizen@wits.ac.za

### 1.10.5 Municipalities

The data collection consists primarily of metropolitan municipalities in South Africa as it was expected that the information provided by these municipalities would be the most accurate because of their size. The list of municipalities was obtained from the website of the Municipal Demarcation Board (Anon1:[1]). The municipalities are as follows:

**Table 5: Municipalities**

Municipality	Contact details
City of Cape Town Metropolitan Municipality (Cape Town)	Mr A Ebrahim achmat.ebrahim@capetown.gov.za
Ekurhuleni Metropolitan Municipality (East Rand)	Mr P. Flusk goosenk@ekurhuleni.com
eThekweni Metropolitan Municipality (Durban)	Dr M.O. Sutcliffe dovec@durban.gov.za
City of Johannesburg Metropolitan Municipality (Johannesburg)	Mr M.A. Dlamini citymanager@joburg.org.za
Nelson Mandela Bay Metropolitan Municipality (Port Elizabeth)	Adv. J.G. Richards grichards@mandelametro.co.za
City of Tshwane Metropolitan Municipality (Pretoria)	Mr Kiba Kelana citymanager@tshwane.gov.za

The required information was collected via a questionnaire sent to Chief Financial Officers of the municipalities selected. All correspondence was sent to the municipalities directly as their contact details are available on [www.demography.co.za](http://www.demography.co.za) (Anon3:[1]).

### 1.11 DATA COLLECTION

Data was collected via information from the websites of the entities selected or questionnaires. The questionnaires consist of a maximum of five questions to ensure that the questionnaire is completed since it was expected that a lengthy questionnaire would not be completed by participants due to time constraints. The questionnaires obtained the necessary information to conduct the research successfully. The questionnaires were sent to universities and municipalities and are discussed in Chapter 4 and Chapter 5 of this research study.

Because tax issues, which are usually sensitive in nature, were investigated it was expected that individuals would not participate if questionnaires are sent out which is not treated in a confidential manner. For this reason all information is confidential and anonymous – this was communicated to the participants. Also refer to Annexure A for the informed consent that was signed by the participants.

No special equipment or facilities were needed to collect the data. The information required was obtained via e-mail or fax and the ethical requirements regarding the use of internet and e-mail were adhered to.

The questionnaires were measured against the questions/uncertainties that arose from the literature review. Questions were formulated to address the uncertainties that were identified. Refer to Chapters 4.6 and 5.6 for the questionnaires that were sent out.

## **1.12 DATA ANALYSIS**

Because the questionnaires consist of only five questions and a total of 17 questionnaires were sent out, no specific techniques or methods were used to analyse the data. Microsoft Excel was used to analyse the data. Every sector was treated on its own by capturing the data in separate Excel files.

Microsoft Excel was used to analyse the data, calculate average totals on the feedback given and will be used to compile graphs where necessary. The data that was analysed was used in the final research report.

## **1.13 ASSESSING AND DEMONSTRATING THE QUALITY AND RIGOUR OF THE PROPOSED RESEARCH DESIGN**

The quality of the information was of a high standard as it was obtained from capable financial persons. The risk, however, remained that the questionnaires were not completed accurately because of the sensitive nature of the data.

On receipt, questionnaires were evaluated to ensure that they were completed in full and to ensure that the participant understood the questionnaire. All the questionnaires sent back were of a high standard and none had to be returned to the participant.

## 1.14 RESEARCH ETHICS

Research ethics were treated as the highest priority during the research. The teleological approach was not followed under any circumstances. The guidance given by the Ethics Committee of the University of Pretoria was also adhered to and the application to conduct the research was submitted successfully.

Thought was given to the following key ethical issues as described in Saunders *et al.* (2007:178-195):

- privacy of possible and actual participants;
- voluntary nature of participation and the right to withdraw partially or completely from the process;
- consent and possible deception of participants;
- maintenance of the confidentiality of data provided by individuals or identifiable participants and their anonymity;
- reaction of participants to the way in which data is collected, including embarrassment, stress, discomfort, pain and harm;
- effects on participants of the way in which data is used, analysed and reported, in particular the avoidance of embarrassment, stress, discomfort, pain and harm; and
- behaviour and objectivity of the researcher.

The avoidance of harm was the cornerstone of the research. Because the medium of e-mail was used to gather information, care was taken on information received. The privacy of participants was ensured and treated as high priority. A consent form was signed by the participants as set out in Annexure A.

There was no monetary or non-monetary incentive for participants. They could also withdraw from the study at any time should there be reasons why they could not participate any more.



Confidentiality and anonymity were important factors during the research process.

Objectivity was also high on the priority list, especially when data was obtained and evaluated for the research project.

## **1.15 CONCLUSION**

It is clear that there are many theories available on apportionment methods. However, there is little theory available on which method is the most appropriate for different sectors/businesses and on what the average percentage is for a certain sector. Therefore this research focuses on the methods available and a study was conducted to establish which method is used by which sector and what the acceptable percentage is which would be acceptable. In Chapter 2, the most used apportionment methods will be discussed and in Chapter 3 to Chapter 5 the banking industry, universities and municipalities will be investigated to determine how these industries are treating their VAT apportionment.

# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

## CHAPTER 2 : THE BASIC RULES AND METHODS OF APPORTIONMENT OF INPUT TAX

### 2.1 INTRODUCTION

In this chapter the basic rules and the working of apportionment of input tax will be discussed. The different methods available to apportion input tax will also be investigated.

### 2.2 APPORTIONMENT OF INPUT TAX – BASIS OF APPORTIONMENT

The starting point when claiming input tax is the application of the *de minimus* rule. De Koker and Kruger (2008:132) explain the *de minimus* rule as follows: “Once the proportion of taxable and non-taxable consumption or use of goods or services has been determined, the total amount of VAT incurred on the acquisition of the relevant goods or services must be apportioned between the making of taxable supplies and other supplies”.

The above is clearly the starting point. Once this is done, input VAT on taxable supplies can be claimed and input VAT on exempt supplies cannot be claimed. There are however expenses that cannot be linked to a taxable or an exempt supply directly.

De Koker and Kruger (2008:132) further explains that to relieve the compliance burden of businesses in apportioning inputs, the legislation provides for a special rule, referred to as the *de minimus* rule (s 17(1) proviso (i)). This rule provides that, where the intended use of the goods or services in the course of making taxable supplies is equal to not less than 95% of the total intended use of the goods or services, the goods or services concerned may be regarded as having been acquired wholly for the purpose of making taxable supplies. The implication of this provision is that no apportionment needs to be made by the vendor and that the total amount of VAT payable is treated as input tax in the hands of the vendor concerned.

De Koker and Kruger (2008:132) explain this concept with the following example:

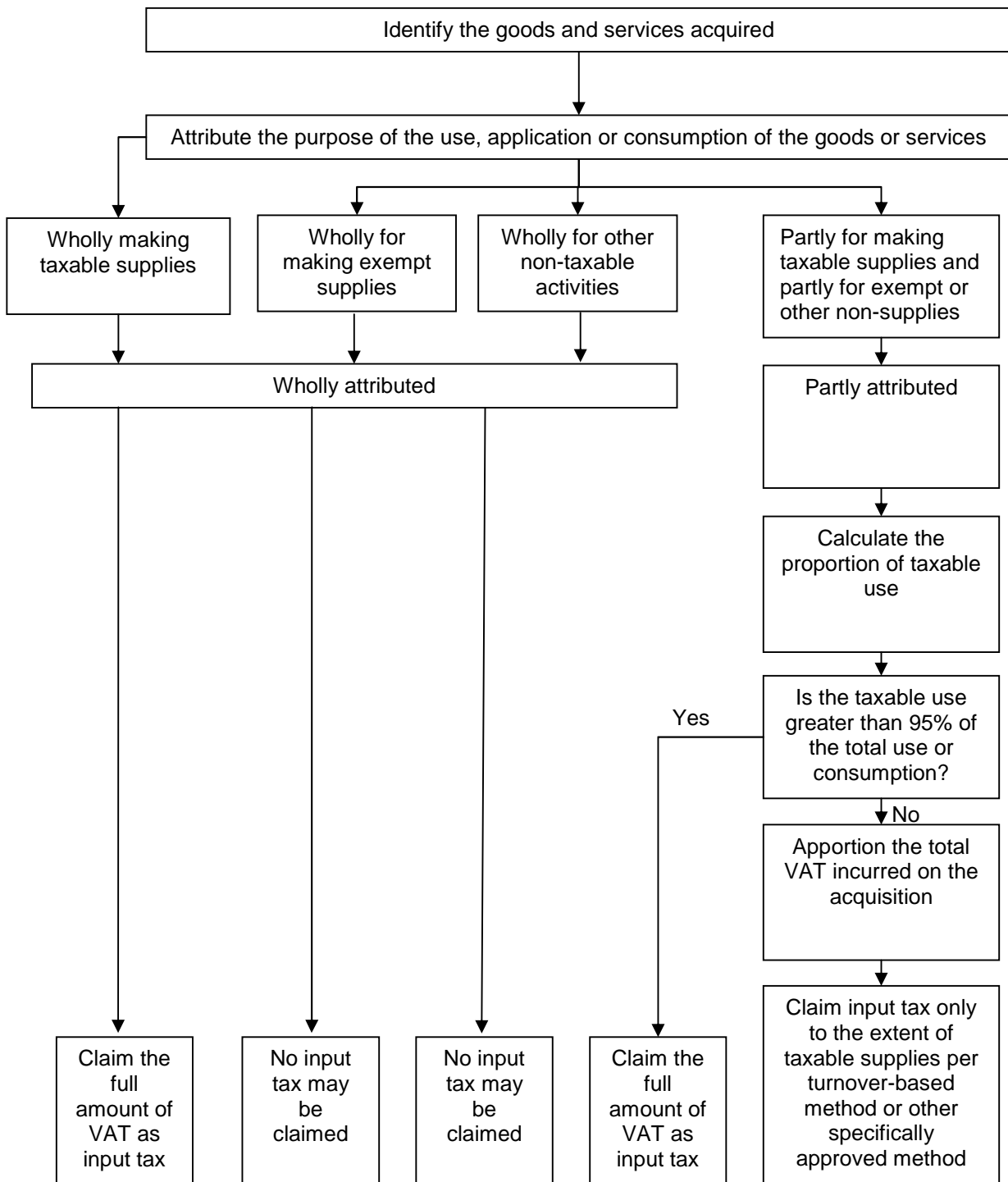
*“A vendor purchases a computer which he intends to use partly in the course of making taxable supplies. He determines the partial use of the computer for the purpose of making taxable supplies as being 95% of his total use of the computer, the other 5% of the computer’s total usage being for the purpose of making exempt supplies”.*

From this example it is clear that only 5% of the computer is used for exempt supplies. This means that not all the input VAT is claimable because 95% is used for taxable supplies. Because of the *de minimus* rule the vendor can claim 100% of the input tax and not only 95%. If the use for taxable purposes is 94%, the vendor can only claim 94% of the input VAT and the 6% relating to exempt supplies cannot be claimed.

Now that the background of apportionment was explained in the literature above, the main methods of apportionment and how they are applied will be explained to obtain a more clear view on them.

The *VAT 404 - Guide for Vendors* (SARS 2007a:38) explains the apportionment by way of a flow diagram:

*Apportionment flow diagram:*



## 2.3 DIRECT-ATTRIBUTION METHOD

The starting point of claiming input tax is the direct-attribution method:

De Koker and Kruger (2008:133) explain the direct-attribution method as follows:

*“No practical guidelines are prescribed for the calculation of the ratio of intended taxable use to total use. Section 17(1) does, however, imply an approach that was specifically endorsed by Vatcom Report (1991) namely, the use, at least in the first instance, of the direct-attribution method”.*

The direct-attribution method takes every transaction and attribute input VAT to a taxable or exempt income. When this is done, no input is claimable when the expense relates directly to an exempt income and the full input tax is claimable when the expense relates directly to a taxable supply. However a problem arises when an expense cannot be linked directly to an exempt or taxable supply. The only way to overcome this burden is to apportion the input tax between the taxable and exempt supply, but this is easier said than done as there should be some kind of method to do this apportionment.

The direct-attribution method is straight forward. It is based on the following question: Has the VAT in issue been incurred wholly for the purpose of making a standard-rated (or zero-rated) supply of goods or services? If the answer is “Yes”, the tax concerned may be deducted in full. If the answer is “No”, a further question must be answered: Has the VAT been incurred wholly for the purpose of making exempt supplies only? If so, none of that tax is deductible. In this case any tax remaining should be apportioned in some other way. This is where the problem and debates start because of the lack of guidance in this regard.

Although the Act does not prescribe any method of apportionment, and did not give SARS any discretionary powers in this regard prior to 29 June 1998, SARS nevertheless prescribed two so-called standard methods of apportionment – the input-base method and the turnover-base method. It does not only prescribe how apportionment should be done, but stipulates that the method selected by the vendor must be applied consistently to all goods and services which are partially attributable to the making of taxable supplies according to section 17(1) of the Act. Furthermore, a vendor was only allowed to change from one standard method to the other after approval from SARS.

With effect from 29 June 1998 a vendor is required to adopt a method of apportionment prescribed by SARS in accordance with a ruling envisaged in s 41A or 41B of the Act. Since April 2000, SARS has prescribed one standard method of apportionment in the *VAT 404 - Guide for Vendors* (SARS, 2007a:36) to be used with effect from 1 November 2000. This method is known as the turnover-based method of apportionment. Where a vendor finds it difficult to apply the turnover-based method of apportionment, he may approach SARS requesting permission to use another method (for example, the input-based method). The vendor will be required to prove that it is a fair and reasonable approximation of the VAT that should be claimed. An entity that uses another method than the turnover-based method must obtain written approval from SARS to continue to apply that method as mentioned earlier in the literature review (SARS, 2007a:37).

## **2.4 SPECIAL OUTPUT METHODS**

Zacharopoulos (2001:110) describes three special methods of apportionment under the output principle namely the standard method or turnover-based method, the method based on the number of taxable and exempt transactions and the method based on the number of staff attributable to taxable and exempt transactions.

### **2.4.1 Standard method or turnover-based method**

The turnover-based method implies that there is a necessary correlation between amounts of costs incurred and amounts of turnover generated, directly or indirectly. The turnover-based method is the only method allowed by SARS without a ruling and is the most used method by VAT vendors.

Botes and De Wet (2006:17-7) explains the formula for calculating a vendor's apportionment percentage in accordance with the turnover-based method as follows:

$$\frac{\text{Total value of taxable supplies}}{\text{Total value of all supplies}} \times 100 = \text{input tax apportionment percentage}$$

Botes and De Wet (2006:17-7) further use the *VAT 404 - Guide for Vendors* as guidance to explain the turnover-based method.

The formula set out below in respect of the turnover-based method of apportionment constitutes a binding general ruling issued in accordance with section 41A of the Act. This binding general ruling was effective from 1 April 2007 and will remain in force until withdrawn or replaced. The formula is as follows:

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

Where:

y = the apportionment percentage

a = the value of all taxable supplies (including deemed taxable supplies) made during the period

b = the value of all exempt supplies made during the period and;

c = the sum of any other amounts not included in “a” or “b” in the formula, which were received or which accrued during the period (whether in respect of a supply or not)

In this formula:

- the term “value” excludes any VAT component;
- “c” will typically include items such as dividends and statutory fines (if any);
- the value of any capital goods or services supplied, is excluded unless supplied under a rental agreement/operating lease (i.e. not a financial lease or instalment sale agreement);
- the calculation of the value of any goods or services supplied is excluded where input tax on those goods or services was denied specifically;
- the apportionment percentage should be rounded off to 2 decimal places; and
- the full amount of VAT incurred on mixed expenses may be claimed where the formula yields a result of 95% or more (referred to as the *de minimus* rule).

Zacharopoulos (2001:110) explains that this method is a version of the current output method in the sense that the provisional deductible pro rata proportion is calculated on the basis of the value of the taxable and exempt outputs in the preceding year. He further explains that this proportion applies to the total input tax in each tax period of the current year. The amount deducted must in every case be subject to adjustment by the trader when the percentage based on the current year’s outputs is determined.

From the above information it is clear that the basic formulae are given in the text books and in the SARS guides, but it is still unclear which turnover amounts should be included in the formula. For instance, should bad debt recovered be included in the formula or not? And which amounts should be included under “c” in the second formula? It is also unclear what is meant by statutory fines under “c” in the formula. Furthermore the same formula is used in the *VAT 404 - Guide for Vendors* and the *VAT 419 - Guide for Municipalities*. These formulae cannot be compared because the income streams are totally different for a normal business and a municipality.

There is also no guidance given for the banking sector and for universities – two sectors that will apportion most of their input tax.

#### **2.4.2 Method based on the number of taxable and exempt transactions (or transactions formula)**

The method based on the number of taxable and exempt transactions involves indirect input attribution with reference to outputs. It is suitable for traders, particularly in the finance sector, who have exempt outputs with a high value in comparison with the cost of related positive-rated inputs (Zacharopoulos, 2001:112). According to Zacharopoulos (2001:112) *“when a trader sells securities as a principal and cannot disregard these transactions, the value of the exempt output is the price of the securities, but the input tax attributable to that output may be relatively very small”*. A trader in this situation, who uses the turnover based method to calculate his deductible input tax, would only be able to deduct an unreasonably small proportion of his total tax because of the high value of his exempt outputs. For this reason, a trader who prefers the simplicity of a proportional method should be allowed to propose a method that is not based on the value of his outputs.

According to Zacharopoulos (2001:111) the number of taxable and exempt transactions provides an acceptable basis for apportioning a block of input tax. This is fair and reasonable only if roughly the same amount of input tax is incurred in connection with each transaction, irrespective of the value and whether it is taxable or exempt. This basis could be approved for use alone or for different sectors of a trader’s business, or to apportion residual input tax in cases where the trader proposes to use a method



that consists partly of the direct attribution with reference to inputs method described below, provided that his accounting system can be relied upon.

Zacharopoulos (2001:111) mentions that when a trader calculates deductible input tax for each tax period with reference to the numbers of transactions occurring in that period, he should adjust his deductions in the light of the appropriate figures for the year as a whole. Alternatively, when the calculation is based on figures for the preceding year, the trader must make an adjustment at the end of the first year using this method on the basis of that year's actual percentage as soon as it has been determined.

Zacharopoulos (2001:112) explains that this method would be particularly suitable for stockbrokers who make exempt and taxable supplies. Stockbrokers normally act as agents in stock exchanges buying and selling securities on behalf of clients and charging them a commission, which is taxable at a positive rate. However, a stockbroker may be partially exempt because he also makes exempt supplies by selling securities as a principal. Other activities of stockbrokers also give rise to exempt supplies for example, if they enter into option transactions (receive option money, whether in respect of a buying or a selling transaction), act as money brokers, negotiate loans of money in an agency capacity, receive interest on bank deposits, or rent property. In this case, when the stockbroker sells securities as a principal, their value will usually be very high compared with the value of his taxable outputs. He cannot disregard these sales for the purpose of his partial exemption calculations, his loan transactions or bank deposits. If, therefore, he uses the pure or the standard output method to calculate his deductible input tax, the high value of his exempt outputs would enable him to deduct only an unreasonably small proportion of his total input tax. In calculating the number of exempt transactions, he should include both his sales of securities as a principal and all other exempt transactions since they cannot be considered strictly incidental and hence be disregarded exempt supplies. At the end of each tax period, the company should make an adjustment based on these figures for the year as a whole as for all the other apportionment methods used.

### **2.4.3 Method based on the number of staff attributable to taxable and exempt transactions**

According to Zacharopoulos (2001:112) the number of employed staff engaged in taxable and exempt activities respectively can be the basis, but only if there is a direct and constant relationship between the positive-rated inputs concerned and the staff members who use them. Provided that the proportion of the total staff employed in each activity does not vary significantly, the number of staff members on an agreed date in each tax period or each year can be used. Otherwise, average numbers are to be used. The United Kingdom *Partial Exemption Guidance* manual (2008:[7]) indicates that this method is only appropriate where the staff members record their time accurately which can often be a major problem. According to Zacharopoulos (2001:113) this is also a method of indirect input attribution with reference to outputs, similar to the method based on the number of taxable and exempt transactions.

## **2.5 METHOD OF APPORTIONMENT BY REFERENCE TO INPUTS**

### **2.5.1 The input-based method**

According to the *VAT 404 – Guide for Vendors* (SARS, 2007a:36) the input-based method can no longer be applied without the permission of SARS. This method apportions the input tax claimable which cannot be related directly to either a taxable or non-taxable (the non-attributable input tax). The United Kingdom *Partial Exemption Guidance* manual (2008:[7]) explains that this method is used most commonly where cost involved in making supplies are incurred normally in a different tax year than the year the supplies are made. De Koker and Kruger (2008:136-137) explain that since the non-attributable input tax is included in the denominator in determining the applicable ratio, this method will almost always prejudice the vendor. Not only is this method mathematically unsound, but patently unfair, as is illustrated in the following example.

Suppose a vendor incurs the following amounts of input tax on goods or services acquired during a tax period, and determines its usage as follows:

Total VAT incurred	R1 000 000
--------------------	------------

Attributable as follows:

- wholly for the purposes of making taxable supplies R400 000
- wholly for the purposes of making non-taxable (including exempt) supplies R100 000
- non-attributable use R500 000

The proportion of non-attributable input tax, which relates to the making of taxable supplies, using the input method “prescribed” by SARS, would be as follows:

$$R400\ 000\ (\text{taxable supplies}) / R1\ 000\ 000\ (\text{total supplies}) = 40\%$$

From the calculation above it is evident that 40% is attributable to the making of taxable supplies, therefore the deductible part is =  $40\% \times R500\ 000 = R200\ 000$  (deductible out of R500 000).

However, by applying the same logic one could argue that the proportion of non-attributable input tax relating to the making of non-taxable supplies should be determined by applying the ratio of input tax incurred wholly for the purpose of making non-taxable supplies to the total input tax incurred. The result would be as follows:

$$R100\ 000\ (\text{exempt supplies}) / R1\ 000\ 000\ (\text{total supplies}) = 10\%$$

From the calculation above it is evident that 10% could be attributable to the making of non-taxable supplies and therefore the input VAT is non-deductible. The calculation is as follows:

$$10\% \times R500\ 000 = R50\ 000\ \text{non-deductible out of R500\ 000}$$

The study will show that this alternative approach gives a completely different result, which is more favourable to the vendor. It appears that the more correct and equitable method would be to apply the ratio of input tax wholly attributable to the making of taxable supplies to the total input tax wholly attributable to the making of taxable and non-taxable supplies.

In the example this would result in the non-deductible portion of the non-attributable input tax being determined as follows:

$$\begin{aligned} & \frac{\text{Input tax wholly attributable to making taxable supplies}}{\text{Total input tax attributable supplies and non taxable supplies}} \times \frac{100}{1} \\ = & \frac{400\,000}{500\,000} \times \frac{100}{1} \\ = & 80\% \text{ allowable to the making of taxable supplies} \end{aligned}$$

Should the input tax wholly attributable to the making of exempt supplies be adopted as the numerator, the result remains the same.

$$\begin{aligned} = & \frac{100\,000}{500\,000} \times \frac{100}{1} \\ = & 20\% \text{ attributable to the making of non-taxable supplies} \end{aligned}$$

Botes and De Wet (2003:17-11) on the other hand explains the input based method as follows:

The proportion of the taxable use of goods or services is calculated by determining the ratio of VAT incurred on goods or services which is wholly attributable to taxable supplies is the total VAT incurred on all goods and services during the tax period and expressing that ratio as a percentage. The resultant percentage reflects the proportion of the taxable use of the goods or services which were partially attributable to making taxable supplies. The following amounts should be excluded in the calculation of the ratio:

- VAT incurred on goods supplied in the same state under an instalment credit agreement;
- VAT incurred on capital goods or services (other than goods acquired for supply under a rental agreement) acquired for use in the enterprise (including any exempt activity); and
- VAT incurred on goods or services for which an input tax credit is denied.

The United Kingdom *Partial Exemption Guidance* manual (2008:[12]) gives the following guidance to produce a fair and reasonable result:

- there must be directly attributable cost incurred relating to both taxable and exempt supplies;
- a significant portion of the cost must be directly attributable; and
- the directly attributable cost must be incurred in about the same proportion in which the residual input tax is used to make taxable and exempt supplies.

From the above it can be argued that the proposed method may be controversial. It is also unknown whether there are entities that use this method. The input-based method is an appropriate method preferred to the transaction method used by stockbrokers.

### **2.5.2 Quasi inputs method**

According to Zacharopoulos (2001:114) the *quasi* inputs method is used by traders who acquire positive-rated goods for onward taxable supply without processing or alteration and who can identify them in their records (such as wholesaler's or retailer's purchases of goods for resale). The input tax on such goods may be deducted in full, and the rest of the trader's input tax apportioned by the methods described above. The value of "same state" taxable outputs is to be included in the pro rata calculation to ensure that a fair proportion of the input tax on overhead expenses is deducted. The total amount of deductible input tax is to be claimed in the trader's tax return. "In the same state" means that the goods supplied are essentially the same as when they were acquired and have not been transformed into different goods by applying a treatment or process that may require inputs used both for the exempt and the taxable side of a business. Zacharopoulos (2001:115) further explains that the periodical apportionment of the residual input tax (for example, on overhead expenses) under this method should be provisional and subject to annual adjustment as with the standard outputs method.

The *quasi* inputs method requires more record keeping than the turnover-based method, because the trader must distinguish between "same state" and other inputs (Zacharopoulos, 2001:115). However, this method will always give a more favourable result than the other methods because any possible unfairness of the pro

*pro rata* rule is restricted to a residual amount of input tax (which, referring to inputs not acquired for onward taxable or exempt supply, cannot be attributed directly to either of these supplies). The outcome of the method will depend on the nature of the taxable and exempt activities of the business and the inputs related to each of these activities (Zacharopoulos, 2001:115). The method will definitely be unfair to a trader if the trader has exempt outputs of disproportionately high value. In any case, the *quasi* inputs method is less fair than any other method using the inputs principle because the trader cannot claim a full deduction of input tax in respect of capital goods (such as a cash register) and overhead expenses, even though they relate solely to his taxable business. These disadvantages should be weighed against the fact that according to this method the trader is able to claim a proportion of the tax on inputs related to his exempt business.

### **2.5.3 Indirect input attribution method**

Zacharopoulos (2001:117) explains that in some cases, it will not be possible to relate actual inputs directly to taxable or exempt outputs at the time of receipt. However, the trader may propose a formula by which inputs over a period are related to particular taxable and exempt activities, and the tax on them is attributed accordingly. For example, some traders, for their own purposes, periodically allocate expenditure to various branches or departments of their business in order to keep the profitability of each activity under review. Such traders may find it practicable to adapt their accounting systems so that a percentage of their own input tax, based on the previous year's allocation, is attributed to taxable or exempt outputs. Even if the trader does not already allocate expenditure in this way, he may wish to do so for partial exemption purposes so that he can apportion his input tax more accurately than by using the *pro rata* rule. This method is explicitly provided for in the United Kingdom and is applied in practice in many member states (such as Sweden, Ireland and Germany).

When this course is practical and reliable figures are available, or can be produced specially to show the percentage of input tax that would have been deductible or non-deductible in the preceding year, a special method may be approved by which the trader uses this percentage provisionally to calculate his deductible input tax for

the current year, subject to adjustment at the end of the year (Zacharopoulos, 2001:117). Therefore, a fresh percentage is to be calculated at the end of each year, and this is to be used to calculate deductions in the following year.

#### **2.5.4 Other methods available to apportion**

The *VAT 404 – Guide for Vendors* (SARS, 2007a:37) further provides for the floor space method. The floor space method takes the basis of floor space occupied by taxable supplies in relation to exempt supplies (see SARS Ruling 172 for further guidance) into consideration

With the different apportionment methods discussed above, it will be interesting to discover which methods are used by the different sectors.

The United Kingdom *Partial Exemption Guidance* manual (2008:[1] – [14]) gives the following guidance on which method to use:

- input-based calculations are often more appropriate than output-based calculations where the output occurs at a much earlier time than the related input tax, as for example in many land and property projects;
- net input-based calculations are often more appropriate than input tax based calculations where a trader received large amounts of zero-rated supplies;
- if a transaction-based method is used, care should be taken on the definition of a transaction;
- when considering floor space methods bear in mind whether the tax was incurred on a building itself used to make mixed supplies, where, for example some floors are sublet while others are used for taxable purposes or whether the building is used as an overhead, for example a head office supporting other supplies made elsewhere; and
- staff time-based methods are only appropriate where the staff members record their time for purposes other than partial exemption calculations.

## 2.6 APPORTIONMENT ADJUSTMENTS

As stated in the *VAT 404 – Guide for Vendors* (SARS, 2007a:36), it is difficult to determine accurately the apportionment percentage according to the turnover-based method in each tax period. SARS allows vendors to calculate the estimated percentage using the turnover figures from the previous year’s financial statements. This percentage is then applied for claiming input tax in each tax period during the following year. An adjustment must be made within three months after the vendor’s financial year end, to account for any shortfall or overestimation in the apportionment percentage used. This will be done when the audited financial statements for the current financial year are available and when the correct percentage can be calculated. If the audited financial statements have not been completed within the three month period, the year-end trial balance figures should be used. A final adjustment must then be made when the final figures are available (SARS, 2007a:36).

The adjustment can be explained by way of an example:

In year Y1 the apportionment percentage based on the turnover was 85%.

During year Y2 the input tax was claimed as follows:

**Table 6: Annual adjustment to input tax**

Expenses relating to taxable supplies (including VAT)	Expenses relating to exempt supplies (including VAT)	Expenses relating to both taxable and exempt supplies (including VAT)	Apportionment percentage	Input relating to taxable supplies (valid invoices available for all expenses)	Input relating to both taxable and exempt supplies (valid invoices available for all expenses)
R120 000	R35 000	R50 000	85%	R14 736.82	R5 219.30

Based on the audited financial statements the apportionment percentage on the turnover based method is 90.123%. Because the percentage is higher, additional input tax is claimable on the R 50 000 expenses. The adjustment is R314.57 (R5 533.87 [based on the 90.123%] less R5 219.30) which will be claimable on the month following the adjustment month’s VAT 201 return.



## 2.7 CONCLUSION

The explanation of the different methods in this chapter laid a solid foundation for the study that follows. The methods used by banks will be investigated in the next chapter.

## AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

### CHAPTER 3 : BANKS

#### 3.1 INTRODUCTION

With the background of the most commonly used apportionment methods discussed in Chapter 2, the apportionment methods used by banks will be discussed in Chapter 3. As no questionnaires were sent out to the banks in South Africa, the annual reports which were available from the banks were used. A bank must be registered as a financial services provider in South Africa. Gendron (2007:1) states that the VAT treatment of financial services is a complex issue in the best of circumstances.

#### 3.2 DEFINITION

The Collins Cobuild Advanced Learner's English dictionary (2005:97) defines a bank as an: "*institution where people or businesses can keep their money and a building where a bank offer its services*".

The Oxford dictionary (1996: 107) defines a bank as a "*financial establishment which uses money deposited by customers for investment, pays it out when required, makes loans at interest, exchanges currencies etc*".

#### 3.3 INCOME THAT A BANK RECEIVES

The main income that is received by a bank is:

- interest from customers;
- asset finance which include rental income and instalment credit agreements;
- fee and commission income;
- insurance premiums;
- gains and losses from investment activities;
- gains and losses from equity and foreign exchange trading;
- proceeds on sale of assets; and
- sundry income.

### 3.4 CURRENT LAW APPLICABLE TO A BANK

Section 2 of the Act lists the activities that are included under financial services.

The activities that are applicable to banks are:

- the exchange of currency which could be bank notes, coins, crediting and debiting of accounts, etc.;
- the issue or payment of a cheque;
- all activities relating to debt securities;
- provision of credit, under an agreement that needs to be repaid in future periods;
- buying and selling of derivatives; and
- the issuing of long-term insurance policies.

There is a provision listed at the end of section 2(1) to the Act which excludes consideration paid for the activities listed above from the exemption of section 12 which makes it a taxable supply. The provision explains that any fee, commission, merchant's discount or similar charge, excluding discounting cost, is a taxable supply. The effect is that this consideration is not a consideration for an exempt supply, but it is a standard rated supply and it is subjected to VAT and output VAT is payable by the vendor.

Further in the section, definitions are given to explain some of the terms mentioned above.

The explanations and definitions of financial services are important because they will determine whether a service rendered is exempt in terms of section 12(a) of the Act or not.

Section 12 (a) of the Act, explains exempt supplies as: *"[t]he supply of any of the following goods or services shall be exempt from the tax imposed under section 7(1)(a):*

- (a) *The supply of any financial services, but excluding the supply of financial services which, but for this paragraph, would be charged with tax at the rate of zero per cent under section 11".*

This means that the receiver of the financial service does not pay any VAT and the supplier does not account for any output VAT because it is an exempt supply.

### 3.5 APPORTIONMENT METHODS AVAILABLE

From the information above it is evident that banks usually make exempt supplies because they are rendering financial services to their customers. Banks however also make taxable supplies in the form of commission and fees earned. The apportionment methods as described in Chapters 2.4 and 2.5 are available for all the banks although there is a specific method available for them. This method is called the net interest method.

SARS issued a ruling on 13 May 1998 to the Banking Council of South Africa. This ruling is still applicable but from discussions with the Banking Council of South Africa it seems that this method is currently under review with SARS and a new ruling in the foreseeable future is a possibility. SARS issued this ruling to ensure that the method applied in every case, is appropriate to the circumstances of the vendor and that it provides a fair and reasonable approximation of the vendor's actual use or consumption (of goods) to make taxable supplies (Commissioner SARS Ruling, 1998:1). A bank may however still approach SARS for an alternative method should the standard method be materially inappropriate and not be fair and reasonable.

According to the Commissioner: SARS (Commissioner SARS Ruling, 1998:1) *“[t]he objective behind the ruling was to standardise the turnover apportionment method. Further the objective was to provide a consistent, equitable and measurable basis for the recovery of input tax that complies with the framework of the Act for all banks”*.

The following standard method was introduced (Commissioner SARS Ruling, 1998:2):

$$\frac{A}{B} \times \frac{100}{1} = \% \text{ input tax recovery rate}$$

Where:

- A = total value of taxable supplies (standard and zero-rated) – excluding VAT;
- B = total value of all supplies excluding VAT; and
- Supply = all supplies as defined in terms of the Act except the supplies listed below specifically included or excluded for the purpose of this calculation

The ruling (Commissioner SARS Ruling, 1998:3) further explains the inclusions of income in either “A” or “B” and is explained as:

**Table 7: Inclusions and exclusions of income in the formula for banks**

<b>Specific inclusion</b>	<b>Included in "A"</b>	<b>Included in "B"</b>
Net interest i.e. interest receipts (excluding the interest received in respect of rental agreements) less interest paid (excluding any interest paid/cost of funds in respect of rental agreements)	N/A(1)	Yes
Gross rentals receipts (including cash value of rental agreements) less interest paid/cost of funds in respect of rental agreements	Yes	Yes
Gross profit/loss dealing in financial assets	N/A (1)	Yes
Proceeds on sale of properties in possession	Yes	Yes
Proceeds on sale of repossessions	Yes	Yes
Non-interest income (fee, commission, merchant discount)	Yes	Yes
Directly attributable taxable income	Yes	Yes
Directly attributable exempt income	N/A (1)	Yes
Insurance proceeds – taxable supplies and taxable portion of mixed supplies	Yes	Yes
Insurance proceeds – fully exempt supplies and exempt portion of mixed supplies	N/A (1)	Yes
Zero-rated supplies	Yes	Yes
Proceeds on sale of movable assets	Yes	Yes
<b>Specific exclusions</b>	<b>Excluded in A</b>	<b>Excluded in B</b>
Cash value of instalment credit agreements	Yes	Yes
Bad debt	Yes	Yes
Capital value of loans	Yes	Yes
The deemed value of the supply of fringe benefits	Yes	Yes
Dividends (received from investments)	Yes	Yes
Imported services	Yes	Yes
Abnormal items in terms of General Accepted Accounting Practice (GAAP)	Yes	Yes

(1) Included in A is the zero-rated component.

Some of the inclusions or exclusions to the apportionment formula are explained below:

Inclusions in the apportionment formula:

- Net interest:

The net interest margin derived from lending and borrowing represents consideration for the services of intermediation, and as such, should be included in total supplies. The reason behind this principle is:

- a financier takes the role of intermediary between lenders and borrowers – the main objective is the borrowing and lending of money which constitutes a single activity. Consequently the receipt of interest cannot be separated from the payment of interest;
- a financier is also under a contractual obligation to lenders for the payment of interest. The Bank's Act requires that a minimum capital and unimpaired reserve fund is maintained, to ensure that the financier's obligation to lenders is met. The fact that he cannot employ funds held as he wishes clearly highlights that he is merely bringing borrowers and lenders together;
- one of the most important activities of a financier is the management of the net interest margin. All accounting and expenditure incurred in this process is geared towards managing the movement of the net interest margin; and
- the final reason for using the net interest method is that interest is exempt from VAT because the value added component of an interest charge cannot be isolated from its other components, namely the compensation of inflation, the premiums to risk intermediation and the required return on capital. These components render gross interest and are an unsuitable measure of the value of a financier's output.

- Gross profit/loss from dealing in financial assets

The trading in derivative margin equals the consideration for the supply. The gross profit/loss should thus be included in the calculation.

- Properties in possession

The proceeds of properties in possession sold should be included on the basis of the industry being forced to trade in these properties in order to recover underlying capital loans.

- Repossessions  
The proceeds of repossessions should be included as the industry is forced to trade in these assets in an attempt to recover outstanding debt.
- Non-interest income  
Non-interest income incorporates service fees, commissions, trade and ancillary income
- Directly attributable income  
Directly attributable income/supplies is income against which directly attributable input tax is claimed. It is included in the formula since the infrastructure (which is used to maintain both taxable and exempt supplies) is used to generate the income, for example, the rental of electronic payment devices to merchants, where the input tax is claimable fully.
- Insurance proceeds  
Insurance proceeds are included in the calculation in terms of section 8(8) of the Act.
- Value of the supply of fringe benefits  
A fringe benefit is a deemed supply in terms of section 18(3) of the Act and is included in the calculation.
- Zero-rated supplies  
All zero-rated supplies should be included in the formula.
- The sale of assets (excluding extraordinary items)  
The sale of assets is inherent to a business and is part of trading. For this reason proceeds should be included.

## Exclusions to the apportionment formula:

- The cash value of instalment credit agreements  
Cash values of instalment credit agreements are excluded because it is not seen as trading. The assets are producing income.
- The capital portion of rentals  
The capital portion of rentals is excluded seeing that only the finance charges should be included in the formula. This would result in an unfair outcome should the capital portion be included in the calculation of apportionment.
- The capital value of loans  
The underlying capital values of loans, advances and other financial and money market instruments normally traded by a bank must be excluded from the calculation as it does not represent trading income.
- Dividends  
All dividends, except dividends in terms of section 8E of the Income Tax Act which are regarded as interest and dividends on preference shares, are excluded from the calculation of the apportionment percentage.
- Imported services  
Imported services represent a cost to the relevant industries involved and not income. Therefore imported services should be excluded from the calculation.
- Extraordinary items  
Transactions of an extraordinary nature are to be excluded as these would distort the percentage.

Taking the above into account it is also important to establish the different income streams that a bank receives as well as the VAT treatment of these income streams.



**Table 8: Income received by banks**

<b>Income</b>	<b>VAT treatment</b>
Interest income	Exempt supply – s 12(1) of the Act
Rental income from asset finance <ul style="list-style-type: none"> <li>• rental agreement</li> <li>• instalment credit agreement</li> </ul>	Rental agreement is a taxable supply and instalment credit agreement is an exempt supply in terms of s 12(1)
Fee and commission income	Taxable supply
Insurance premiums	Depend on the nature of the premium (short term or long term)
Gains and losses from investment activities	Exempt supply – s 12(1) of the Act
Gains and losses from trading activities (equity trading and foreign exchange trading)	Taxable supply
Proceeds on sale of assets (own assets and assets in possession)	Depends on whether the assets were used for taxable or exempt supplies

Other available methods in addition to the net-interest method:

- turnover-based method;
- method based on the ratio between the number of taxable and exempt transactions;
- method based on the ratio between the number of all staff attributable to taxable and exempt transactions;
- the input-based method;
- the *quasi* inputs method;
- the varied input-based method; and
- the floor space method.

### **3.6 STUDY CONDUCTED ON BANKS IN SOUTH AFRICA**

As mentioned in Chapter 1, a list of banks in South Africa was obtained from the SA Financial Sector Forum. Because of the sensitive discussions between the Banking Council of South Africa and SARS, no questionnaires were sent out to the various banks as no response was expected. The annual reports of the various banks were obtained as far as possible and the outcome was as follows:

**Table 9: Outcome of study on banks**

<b>Bank</b>	<b>Annual report received</b>
ABSA Bank Limited	Yes
African Bank Investments Limited	Yes
Capitec Bank Limited	Yes
First Rand Bank Limited including First National Bank, Rand Merchant Bank, RMB Private Bank and Wesbank	Yes
Investec Private Bank	Yes
Marriott Corporate Property Bank Limited	No
MEEG Bank Limited	Yes
Rennies Bank Limited / Bidvest Bank	Yes
Sasfin Bank Limited	Yes
Standard Bank of South Africa	Yes
TEBA Bank Limited	No
Nedbank Group Limited including Nedbank, Old Mutual Bank, Peoples Bank, Go Banking, BoE Private Clients, Fairbairn Private Bank, Imperial Bank Limited	Yes

As discussed previously, a ruling (Commissioner SARS Ruling, 1998) was issued by SARS to the Banking Council of South Africa. This ruling is very favourable because the interest paid is deducted from the interest received before it is included in the formula. Because the ruling is very favourable, the research was based on the assumption that all banks are using the net interest method to calculate the VAT apportionment percentage. Some of the banks also disclose the input tax that could not be claimed due to the apportionment of input tax in their financial statements. The effect of this will be calculated where applicable.

A few assumptions need to be made before the effect of the net interest method is illustrated. These assumptions are that:

- the annual reports are consolidated figures which include business income from subsidiaries other than banking. It is most likely that the income is taxable income and consequently the recoverable part would be higher as for a bank only;

- zero-rated income from services/goods rendered to foreign customers cannot be obtained from the information in the financial statements which result in the percentage being lower than it is suppose to be;
- no information is available for gross rental receipts less interest paid/cost of funds in respect of rental agreements as described in the specific inclusions above. Only gross rental receipt is disclosed in the financial statements, and not the interest paid. This will result in a slightly higher recoverable percentage; and
- the figure for bad debts written off, which should be excluded from the calculation, is not available in the annual reports and was thus excluded from the calculations performed below.

Taking the above into consideration, it is expected that the exact apportionment percentage will not be calculated below, but the effect of the net interest method and turnover-based method will be illustrated accurately. The information was obtained from the income statements and notes to the income statements of the various banks. By using the guidance given above regarding the net interest method and turnover-based method, the recoverable percentage was calculated as illustrated in the table below.

**Table 10: Effect of net interest method and turnover-based method on apportionment percentage**

	<b>Net interest method</b>	<b>Turnover-based method</b>	<b>Difference</b>
<b>ABSA Bank Limited (2007:205-271)</b>			
Recoverable input VAT	42%	22%	20%
Non-recoverable input VAT	58%	78%	
<b>African Bank Investments Limited (2007:127-149)</b>			
Recoverable input VAT	21%	18%	3%
Non-recoverable input VAT	79%	82%	
<b>Capitec Bank Limited (2007:47-71)</b>			
Recoverable input VAT	25%	24%	1%
Non-recoverable input VAT	75%	76%	
<b>First Rand Bank Limited (2007:162-187)</b>			
Recoverable input VAT	44%	28%	16%
Non-recoverable input VAT	56%	72%	
<b>Investec Private Bank (2008:84-126)</b>			



	Net interest method	Turnover-based method	Difference
Recoverable input VAT	53%	26%	27%
Non-recoverable input VAT	47%	74%	
MEEG Bank Limited (2008:9-29)			
Recoverable input VAT	33%	24%	9%
Non-recoverable input VAT	67%	76%	
Rennies Bank / Bidvest Bank (2007:28-51)			
Recoverable input VAT	91%	88%	3%
Non-recoverable input VAT	9%	12%	
Sasfin Bank Limited (2007:39-68)			
Recoverable input VAT	71%	56%	15%
Non-recoverable input VAT	29%	44%	
Standard Bank Limited (2007:171-248)			
Recoverable input VAT	40%	22%	18%
Non-recoverable input VAT	60%	78%	
Nedbank Group Limited (2007:170-223)			
Recoverable input VAT	39%	18%	21%
Non-recoverable input VAT	61%	82%	

**Table 11: Effect of apportionment percentage on input VAT not claimable**

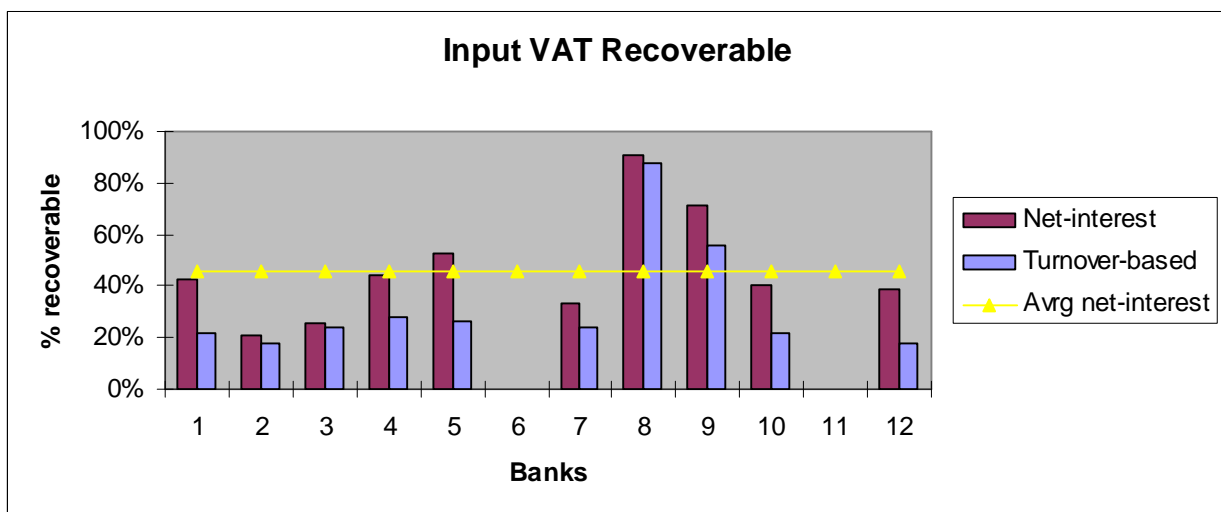
Input not claimed (net interest method) Million	Input not claimed Million	Difference Million
ABSA Bank Limited (2007:271)		
R595	R804	R209
African Bank Investments Limited (2007:149)		
R38	R40	R2
Capitec Bank Limited		
Information not disclosed in the financial statements.		
First Rand Bank Limited (2007:173)		
R625	R805	R180
Investec Private Bank Limited		
Information not disclosed in the financial statements.		
MEEG Bank Limited (2008:24)		
R3.6	R4	R0.4

Input not claimed (net interest method) Million	Input not claimed Million	Difference Million
Rennies Bank / Bidvest Bank (2007:51)		
R4.4	R6.1	R1.7
Sasfin Bank Limited		
Information not disclosed in the financial statements.		
Standard Bank Limited (2007:248)		
R965	R1 258	R293
Nedbank Group Limited (2007:208)		
R258	R346	R88

From the above tables it is evident that the net interest method is a very favourable method to use. It is also evident that millions of rands are involved in using the net interest method. Should the use of this method not be allowed, it will have a major impact on the cash flow of the bank, as well as the physical cost incurred by the bank.

Below is a summary of the recoverable apportionment percentages per bank calculated according to the net interest method and turnover-based method. The average of 46% is also inserted into the graph which is a good indication of what the average recoverable percentage would be given the information received.

**Figure 1: Input VAT recoverable for different methods for banks**



**Table 12: Key to Figure 1**

<b>Number</b>	<b>Bank</b>
1	ABSA Bank Limited
2	African Bank Limited
3	Capitec Bank Limited
4	First Rand Bank Limited
5	Investec Private Bank
6	Marriott Corporate Property Bank Limited
7	MEEG Bank Limited
8	Rennies Bank Limited / Bidvest Bank
9	Sasfin Bank Limited
10	Standard Bank Limited
11	TEBA Bank Limited
12	Nedbank Group Limited

### **3.7 CONCLUSION**

From the literature above and the information obtained from the banks' annual reports, it is evident that the net interest method is a more advantageous method than the other available methods.

It will be interesting to see the outcome from the discussions between the South African Banking Council and SARS and what the impact would be on the recoverable percentage.

In Chapter 4 the apportionment methods used by universities and the outcome of the questionnaire sent to universities will be discussed.

## AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

### CHAPTER 4 : UNIVERSITIES

#### 4.1 INTRODUCTION

In the previous chapter, banks and the methods they use were discussed. In this chapter the methods used by universities will be discussed. Questionnaires were sent out to all the traditional universities in South Africa to gain the information needed for the research conducted. A university or college is the next step for some Grade 12 students to obtain the necessary knowledge to fulfil their dreams. To understand the purpose of a university the definition of the concept are discussed below.

#### 4.2 DEFINITION

The Collins Cobuild Advanced Learner's English dictionary (2005:1589) defines a university as "*an institution where students study for degrees and where academic research is done*".

The Oxford dictionary (1996:1714) defines a university as "*an educational institution designed for instruction, examination, or both, of students in many branches of advanced learning, conferring degrees in various faculties, and often embodying colleges and similar institutions*".

Two important elements are mentioned in the definitions namely education and research. There is no definition of education found in the Act or for that matter in any act. For this reason it is difficult to draw the line between what is educational in nature and what is not. This is important because education is exempt from VAT although other activities might not be exempt from VAT, for example certain research activities.

### 4.3 INCOME THAT AN EDUCATIONAL INSTITUTION RECEIVES

The main income that an educational institution receives is as follows:

- grants and subsidies based on the amount of students at the university received from national government;
- tuition income from the students (including boarding income);
- donations;
- funding for research of an educational nature;
- contract income/research done for commercial organisations;
- interest and dividend income from investments;
- gains on investments; and
- other income, for example rental income, investment from associates, etc.

### 4.4 CURRENT LAW APPLICABLE TO EDUCATIONAL INSTITUTIONS

Section 1 of the Act reads:

“***association not for gain***’ means—

- (a) ...
- (c) *any educational institution of a public character, whether incorporated or not*”.

The term “educational institution” is not defined in section 1 which sometimes makes it difficult to classify a service as educational or not. The definition of an educational institution indicates further that this service is rendered not with the sole purpose of making a gain for its proprietor, member or shareholder. It is also mentioned specifically that any property or income should be used to the furtherance of its objective. No person can make a profit from this institution except if the payment made to the specific person is a payment in good faith of reasonable remuneration for services rendered.

From the definition in section 1 of the Act it is clear that an educational institution is an association not for gain and its main goal should be to promote education.



Section 12(h) of the Act defines exempt supplies as: “[t]he supply of any of the following goods or services shall be exempt from the tax imposed under section 7(1)(a)

(a)...

(h) (i) *the supply of educational services”.*

Section 12(h) of the Act has some provisions on educational services. In house training by an employee is not an educational service and is thus not exempt from VAT in terms of section 12(h) of the Act.

The exemption from VAT is not limited to full-time academic courses over a long period of time alone. If the courses are presented by the institutions listed below even for a seminar or day course, it could be exempt from VAT. It is, however important to note that the Act refers to educational service and not educational institutions. Services rendered by an educational institution for example the leasing of facilities for a function, could be a taxable supply and not exempt from VAT.

The institutions and activities listed in section 12(h), which entails education services that are exempt from VAT are:

- institutions registered under the South African Schools Act 84 of 1996, established by the State or registered under the Further Education and Training Act 98 of 1998;
- an institution that provides higher education on a full-time, part-time or distance basis established under the Higher Education Act 101 of 1997;
- any public benefit organisation registered in terms of section 30(1) of the Income Tax Act which was formed for adult basic education and training, education and training of religious or social workers, training or education of persons with physical or mental impairment and the provision of bridging courses to enable indigent persons to enter a higher education institutions;
- supply of goods and services by a school, university, technikon or college solely or mainly for the benefit of its learners; and
- a supply of services by the Joint Matriculation Board to students.

The above gives good guidance to an organisation that is rendering educational services to establish which income is exempt from VAT and which income are taxable income so that output VAT can be accounted for.

#### 4.5 APPORTIONMENT METHODS AVAILABLE

Clearly from the legislation mentioned above, it is evident that educational and related activities are exempt from VAT. Universities, however, may have other taxable supplies. A guide was issued by SARS, namely the *VAT 414 - Guide for Associations not for Gain and Welfare Organisations*. An association not for gain is defined as:

*“.. [a]n educational institution or a public charter. The constitution of the institution must require that any asset or income of the institution must be used to further its aims and objectives. Assets or income cannot be used to profit any person unless it is for reasonable payment for goods and / or services actually received”* (SARS, 2007b:4).

Therefore this guide can be used for assistance to the VAT apportionment percentage.

The guide indicates (SARS, 2007b:12) that in some instances both taxable and exempt supplies are made. In such cases, VAT may be incurred on expenses that relate to both types of activities. Input tax that can be attributed to both activities should be apportioned. The VAT 414 Guide does not have a specific formula and refer to the turnover-based method of the VAT 404 Guide issued by SARS. This formula was discussed in detail in Chapter 2.4.1.

It is also important to distinguish which income is taxable and which income is not taxable. By taking the income listed above, the following classification can be made:

**Table 13: Income received by universities and the tax treatment**

Income	Taxable / exempt from VAT
Grants and subsidies received from national government	Exempt in terms of s 12(h) of the Act
Tuition income from students	Exempt in terms of s 12(h) of the Act
Donations	Exempt in terms of s 1 of the Act as this is not consideration
Contract income – educational	Exempt in terms of s 12(h) of the Act
Contract/research income done for commercial organisations	Subject to VAT
Interest and dividends	Exempt in terms of s 12(a) of the Act
Gains on investments	Exempt in terms of s 12(a) of the Act

Income	Taxable / exempt from VAT
Sundry income	Could be subject to VAT or not depending on the nature of the income.

From the above it is evident that there are some taxable supplies, but the majority of the income is exempt. Depending on the number of research programmes for commercial activities, which is not educational in nature, and sundry taxable income, the recoverable amount of VAT would be minimal.

Other apportionment methods available in addition to the turnover-based method are:

- based on the ratio between the number of taxable and exempt transactions;
- based on the ratio between the number of all staff attributable to taxable and exempt transactions;
- the input-based method;
- the *quasi* inputs method;
- the varied input-based method; and
- the floor space method.

#### 4.6 STUDY CONDUCTED ON UNIVERSITIES IN SOUTH AFRICA

As mentioned in Chapter 1, all the traditional universities in South Africa were selected. Questionnaires were sent out to all the Financial Directors of the various universities. The table below indicates the response that was received.

**Table 14: Outcome of study conducted on universities**

	University	Questionnaire received
1	University of Cape Town	Yes
2	University of Ford Hare	Yes
3	University of the Free State	Yes
4	University of KwaZulu-Natal	No
5	University of Limpopo	No
6	North-West University	Did not participate
7	University of Pretoria	Yes
8	Rhodes University	No

	<b>University</b>	<b>Questionnaire received</b>
9	University of Stellenbosch	Yes
10	University of the Western Cape	Yes
11	University of Witwatersrand	Yes

A percentage of 73% responded positively to the questionnaire which is discussed below.

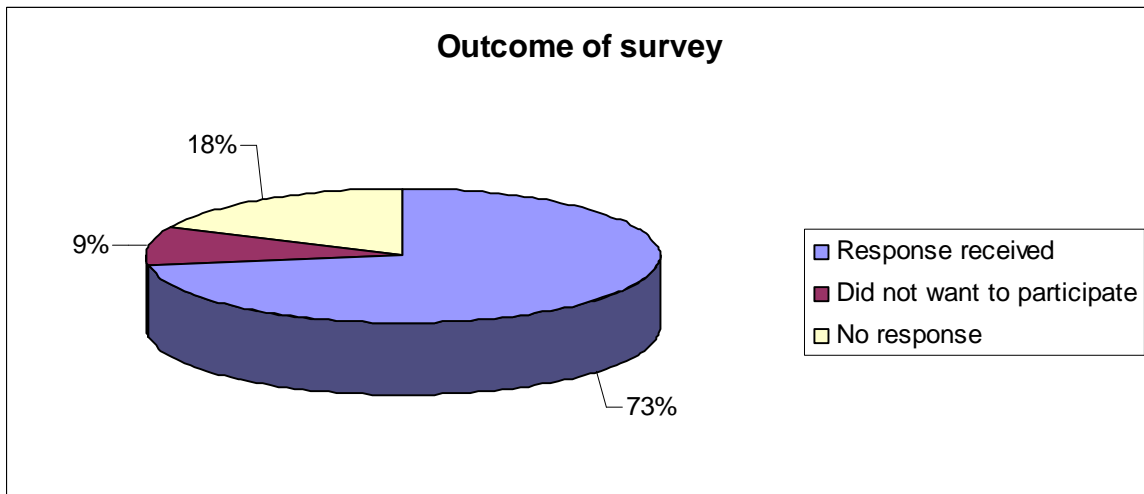
The questionnaire consisted out of the following five questions:

1. How did you become aware of the requirements of section 17(1) – VAT apportionment? Four options were given, namely
  - Auditor
  - SARS
  - Own knowledge
  - Other, which should be specified
  
2. Which apportionment method do you use currently? Six options were given for this question:
  - Turnover-based method
  - Net interest method
  - Employee time method
  - Transaction-based method
  - Floor space method
  - Other, which should be specified
  
3. Are any expenses taken into account when calculating the apportionment percentage? Three options were given:
  - Bad debt
  - Interest
  - Other, which should be specified
  
4. What is the current apportionment percentage based on the latest audited figures?  
A range from 0% to 95% was given.

5. Did the entity obtain a written ruling from SARS to apply the apportionment percentage? The options given were “Yes” or “No”.

As mentioned, 73% of the participants responded positively. Nine per cent did not want to participate in the survey and 18% of the participants did not respond at all.

**Figure 2: Outcome from the survey conducted on universities**

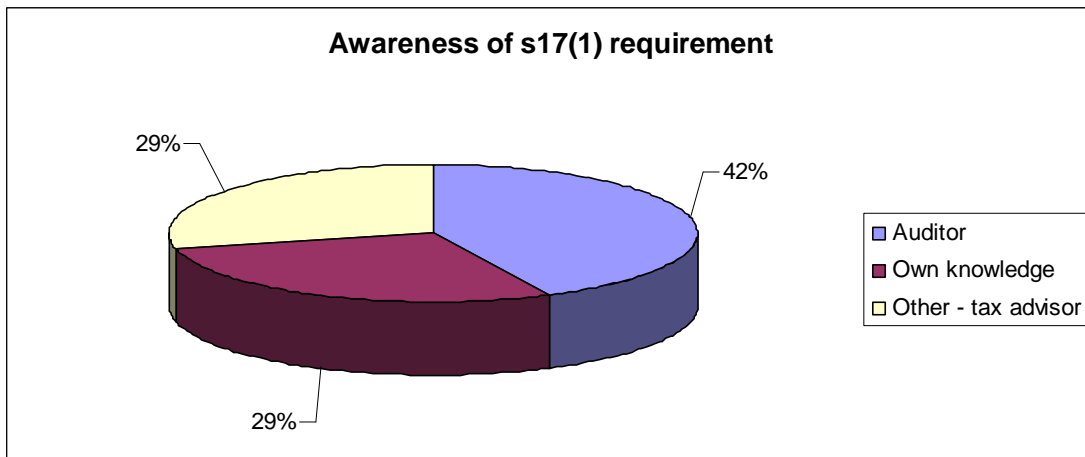


The outcome of the questionnaire was as follows:

*How did you become aware of the requirements of section 17(1) – VAT apportionment?*

Of all the participants, 43% responded that their auditor made them aware of this requirement and 29% responded that their tax advisors made them aware of this. A further 29% said that it was through their own knowledge that they knew that section 17(1) is applicable to their business and that they need to apportion their input tax relating to certain expenses. The fact that auditors and tax advisors had to make them aware of the requirements indicates that this section is not common knowledge and that the vendors do not know this through own knowledge. It is also a good indication that the owner of a VAT registered small business would not know that this is applicable and this could mean that the vendor is not compliant with the Act.

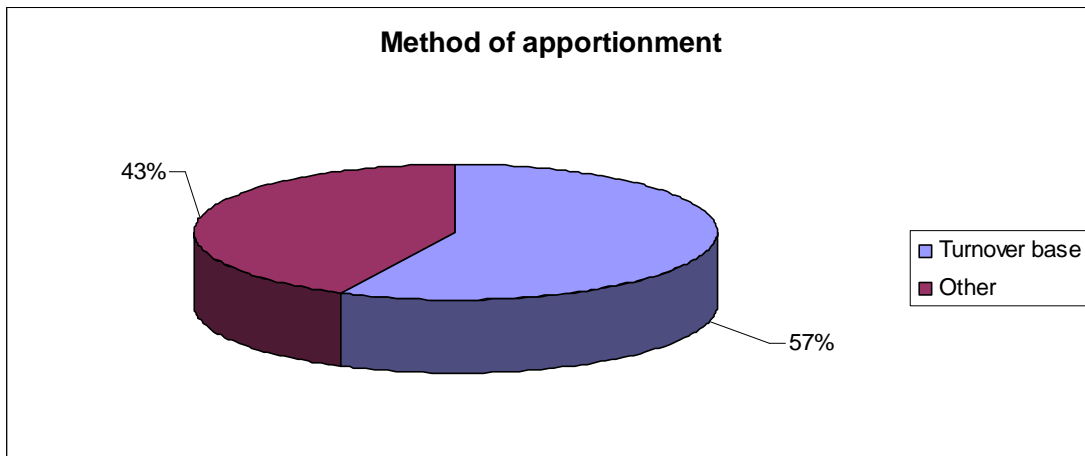
**Figure 3: Awareness of section 17(1) requirements at universities**



*Which apportionment method do you use currently?*

From the information gathered it was evident that 57% of the participants use the turnover-based method, and 43% of the participants used the varied input-base method. No other method was used by the participants.

**Figure 4: Method of apportionment used by universities**



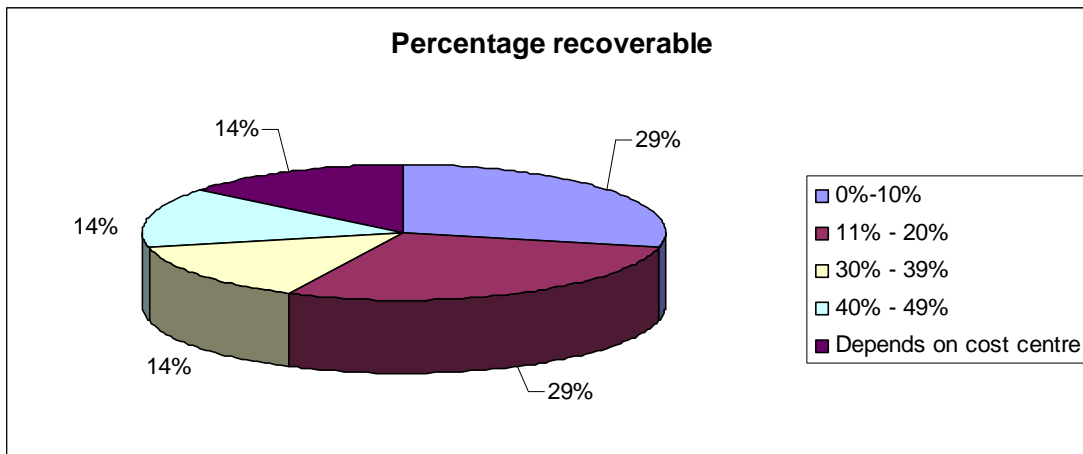
*Are any expenses taken into account when calculating the apportionment percentage?*

All the participants indicated that no expenses were used in their calculation of their apportionment percentage.

*What is the current apportionment percentage based on the latest audited figures?*

There was a variety of percentages with 29% on the lowest margin of 0% to 10% and 14% on the highest margin of 40% to 49%. The universities at the lowest percentage would traditionally be the universities that focus more on education. The universities in the 40% to 49% margin would be the universities that do more commercial research and still focus on their main objective namely education. It would be a cause for concern if some of the universities had a recoverable rate of more than 60%. This would cast doubt on whether the main objective of the university is still education. Of the respondents 14% indicated that the recoverable amount depends on the cost centre. This means that every cost centre has its own recoverable rate and that a micro turnover-based method was followed (every department has its own recoverable rate). The average from apportionment percentage of this study would be in the range of 20% to 30% which is considerably low.

**Figure 5: Percentage recoverable from universities**



*Did the entity obtain a written ruling from SARS to apply the apportionment percentage?*

All of the participants indicated that they obtained a written ruling from SARS. As indicated previously, it is not necessary to obtain a written ruling from SARS if the turnover-based method is used. Fifty seven per cent uses the turnover-based method but still obtained the ruling from SARS. The reason for this could be that the universities needed clarifications on the inclusion or exclusion of certain income.

## 4.7 CONCLUSION

From the research conducted it is evident that the recoverable input tax percentage of universities in South Africa is fairly low with a recoverable percentage between 0% and 49%. Based on this study the average recoverable percentage is between 20% and 30%. The most popular method used, remains the turnover-based method with the second most popular method the varied input base method. To use the latter, the university needs a refined financial system to obtain the necessary information for the calculation.

In Chapter 5 the apportionment methods used by municipalities will be investigated.



# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED TAX IN SOUTH AFRICA

## CHAPTER 5 : MUNICIPALITIES

### 5.1 INTRODUCTION

The VAT apportionment methods of banks and universities were discussed in Chapters 3 and 4. In Chapter 5 the VAT apportionment used by municipalities will be discussed. Municipalities were previously considered as public authorities. The information needed to conduct this research was obtained through questionnaires that were sent out to all the metropolitan municipalities in South Africa. Almost every city/town in South Africa has a municipality with the responsibility to provide basic services to its residents. According to Wikipedia (Anon1:[1]) there are almost 250 municipalities in South Africa. This includes metropolitan municipalities, district municipalities and local municipalities. The services that must be provided includes the building and maintenance of streets in the city/town, providing libraries to the community, fire protection, clinics and providing basic services, for example water, electricity. Municipalities receive certain grants from the national and provincial government to help them fulfil their purpose in society.

### 5.2 DEFINITION

According to the Income Tax Act a municipality falls “*within a category listed in section 155(1) of the Constitution of the Republic of South Africa, 1996, and which is an organ of state within the local sphere of government exercising legislative and executive authority within an area determined in terms of the Local Government: Municipal Demarcation Act, 1998*”.

The Collins Cobuild Advanced Learner’s English dictionary (2005:941) defines a municipality as “*a city or town which is governed by its own locally appointed official. You can also refer to a city’s or town’s local government as a municipality*”.

The Oxford dictionary (1996: 1000) defines a municipality as “*a town or district having local government*”.

From the definitions above it is evident that a municipality operates as part of the local government and because local government has certain social responsibilities, the municipality needs to fulfil this task and should ensure that this basic responsibility is adhered to.

### **5.3 INCOME THAT A MUNICIPALITY RECEIVES**

The main income received by a municipality is:

- grants and equitable share received from local and national government;
- interest received from investments and debtor accounts;
- fines;
- rates and taxes;
- water and electricity sold to residents;
- parking meters, rental of facilities, cemeteries, zoo's; and
- sundry income.

### **5.4 CURRENT LAW APPLICABLE TO MUNICIPALITIES**

Until 30 June 2006 certain income that a municipality received was exempt from VAT (for example, property rates and taxes). Input VAT could only be claimed under circumstances mentioned in regulation 2570. The implication of the above is that the recoverable percentage became very low as the majority of income was VAT exempt. After 1 July 2006 the picture changed dramatically. Paragraph (c) of the definition of enterprise of section 1 of the Act was deleted. Property rates and taxes are zero-rated income in terms of section 11(2) of the Act and therefore a taxable supply. Other income is taxed similar to other normal enterprises and certain income is VAT exempt as like other normal enterprises. On the other hand input VAT can now be claimed as a normal business and regulation 2570 is not applicable anymore.

As mentioned in the definitions above, municipalities are part of the local government sphere and for that matter need to enforce certain laws. Section 1 of the Act has the following provision under enterprise

**“enterprise means—**

(a) ...

(x) *where the Minister is satisfied that an activity of the municipal entity as defined in section 1 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000), is of a regulatory nature and if the Commissioner, in pursuance of a decision of the Minister, has notified that “municipal entity” of that decision, the supply of goods or services in respect of that activity by the municipal entity **shall be deemed not to be the carrying on of an enterprise”.***

From the above extract it is clear that fines and penalties imposed by the municipality are VAT exempt and form part of the VAT exempt pot.

Income from investments (interest and dividends) is also VAT exempt as for normal businesses.

A municipality is allowed to be registered on the payments basis in terms of section 15(2) of the Act which has a very positive impact on the cash flow of the municipality.

## 5.5 APPORTIONMENT METHODS AVAILABLE

From the *VAT 419 - Guide for Municipalities* (SARS, 2008:30), guidance is given regarding the turnover-based method of apportionment.

The formula set out below in respect of the turnover-based method of apportionment constitutes a binding general ruling issued in accordance with section 76P of the Income Tax Act, read with section 41A of the Act. This binding general ruling is effective from 1 April 2007 and will remain in force until withdrawn or replaced.

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

Where:

y = the apportionment ratio/percentage;

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

In this formula:

- the term “value” excludes any VAT component;
- “c” in the formula will typically include items such as dividends and statutory fines (if any);
- the value of any capital goods or services supplied, unless supplied under a rental agreement/operating lease (that is, not a financial lease or instalment sale agreement);
- the value of any goods or services supplied where input tax on those goods or services was denied specifically; is excluded from the definition;
- the apportionment ratio/percentage should be rounded off to two decimal places; and
- where the formula yields an apportionment ratio/percentage of 95% or more, the full amount of VAT incurred on mixed expenses may be claimed (referred to as the *de minimus* rule).

The income that a municipality receives is set out below as well as the VAT treatment of this income. This is important because it determines where the income should be included in the apportionment formula.

**Table 15: Income received by a municipality**

Income	VAT treatment
Grants and equitable share received from local and national government	Taxable supply but normally zero rated
Interest received from investments and debtor accounts	Financial service
Fine income	Exempt income s 1 of the Act (refer above)
Income from rates and taxes	Zero-rated income
Income from water and electricity sold to customers	Taxable supply at the standard rate

Income	VAT treatment
Income from parking meters, rentals of facilities, cemeteries, zoo's, etc.	Taxable supply at the standard rate
Sundry income	Taxable / exempt supply depending on the nature of the supply

From the above it is evident that a municipality receives great amounts of zero-rated income which would put the municipality in a refund position with SARS seeing that input VAT is claimable on expenses incurred, but no output VAT is payable.

Other apportionment methods available to municipalities in addition to the turnover-based method are:

- based on the ratio between the number of taxable and exempt transactions;
- based on the ratio between the number of all staff attributable to taxable and exempt transactions;
- the input-based method;
- the *quasi* inputs method;
- the varied-input based method; and
- the floor space method.

## 5.6 STUDY CONDUCTED ON METROPOLITAN MUNICIPALITIES IN SOUTH AFRICA

In Chapter 1 it was mentioned that all the metropolitan municipalities in South Africa were selected. Questionnaires were sent out to all the Municipal Managers of the various metropolitan municipalities. The table below indicates the response that was received.

**Table 16: Outcome of study conducted on municipalities**

	Municipality	Questionnaire received
1	City of Cape Town Metropolitan Municipality (Cape Town)	Yes
2	Ekurhuleni Metropolitan Municipality (East Rand)	No
3	eThekweni Metropolitan Municipality (Durban)	Yes
4	City of Johannesburg Metropolitan Municipality (Johannesburg)	Yes
5	Nelson Mandela Bay Metropolitan Municipality	Yes

	<b>Municipality</b>	<b>Questionnaire received</b>
6	City of Tshwane Metropolitan Municipality (Pretoria)	Yes

A percentage of 83% responded positively to the questionnaire which is discussed below.

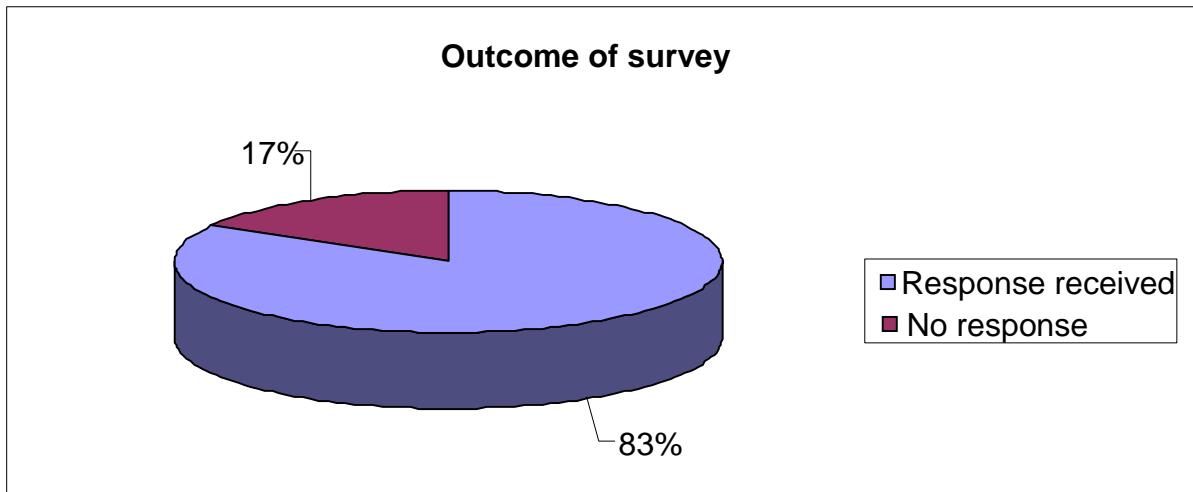
The questionnaire consists of the following five questions which were as follow:

1. How did you become aware of the requirements of section 17(1) – VAT apportionment? Four options were given, namely
  - Auditor
  - SARS
  - Own knowledge
  - Other which should be specified
  
2. Which apportionment method do you use currently? Six options were given for this question:
  - Turnover-based method
  - Net-interest method
  - Employee time method
  - Transaction-based method
  - Floor space method
  - Other, which should be specified
  
3. Are any expenses taken into account when calculating the apportionment percentage? Three options were given:
  - Bad debt
  - Interest
  - Other, which should be specified
  
4. What is the current apportionment percentage based on the latest audited figures? A range from 0% to 95% was given.

5. Did the entity obtain a written ruling from SARS to apply the apportionment percentage? The options given were “Yes” or “No”.

As mentioned, 83% of the participants responded positively and 17% of the participants did not respond at all.

**Figure 6: Outcome of the survey conducted on municipalities**

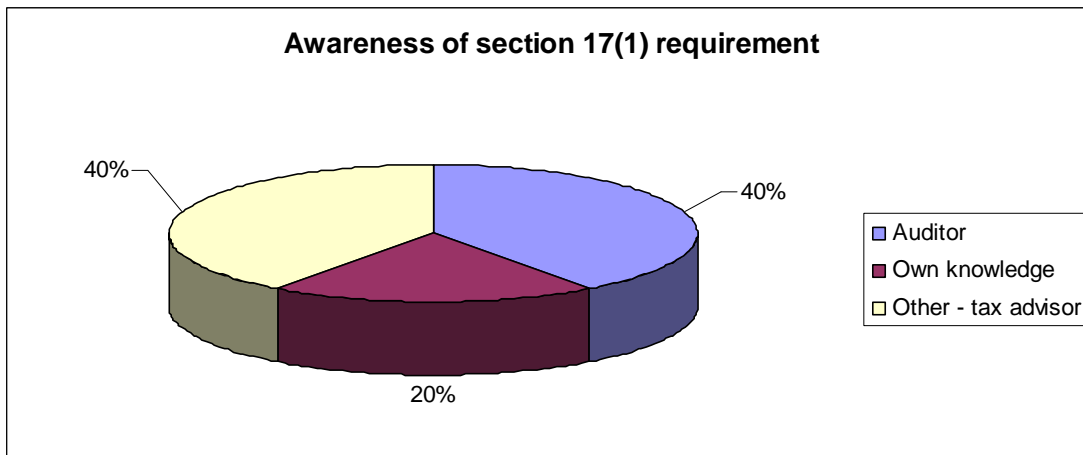


The outcome of the questionnaire is explained below:

*How did you become aware of the requirements of section 17(1) – VAT apportionment?*

Of all the participants, 40% responded that their auditor made them aware of this requirement and 40% responded that their tax advisors made them aware of it. A further 20% said that it was through their own knowledge that they knew that section 17(1) is applicable to their business and that they need to apportion. If the auditors and tax advisors are regarded as one source, it is evident that the requirements are not common knowledge and that the municipalities are not aware of them in all instances. This evidence once again proves that municipalities are not aware in all instances of what is applicable to their situation which could mean that they are not compliant with the Act.

**Figure 7: Awareness of section 17(1) requirements at municipalities**



*Which apportionment method do you use currently?*

From the information gathered it was established that all the municipalities are using the turnover-based method. No other method is used and because 80% of the questionnaires indicated that auditors and the tax advisors made them aware of the section 17(1) requirement, it could be concluded that this is the best method to use in the case of a municipality.

*Are any expenses taken into account when calculating the apportionment percentage?*

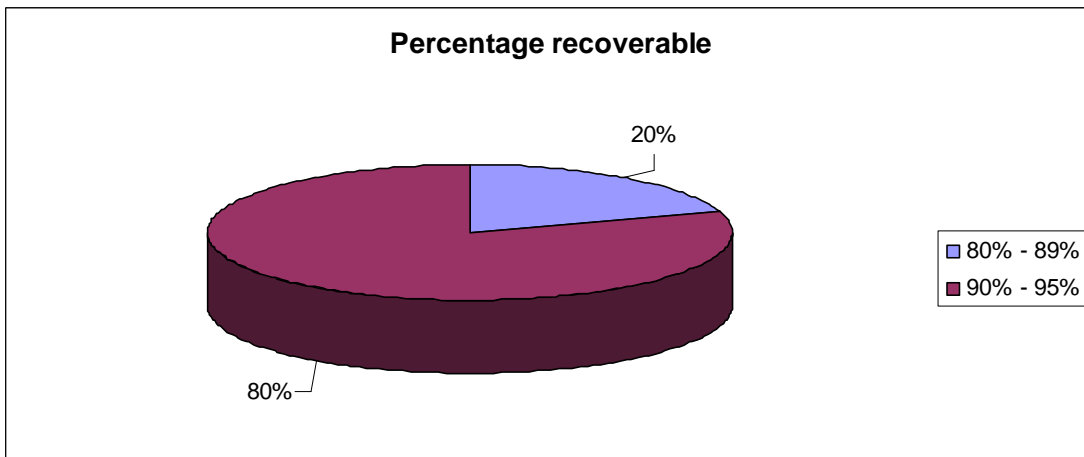
All the participants indicated that no expenses were used in their calculation of the apportionment percentage.

*What is the current apportionment percentage based on the latest audited figures?*

It was evident from the results that the recoverable rate is high in the case of municipalities. Twenty per cent had a recoverable rate of between 85% and 90% and 80% had a recoverable rate between 90% and 95%. All the municipalities, however, need to apportion. From the recoverable percentage it can also be concluded that there is not a high amount of interest and fines in comparison to other taxable income received. The average recoverable percentage for the purposes of this study would be between 90% and 95%.



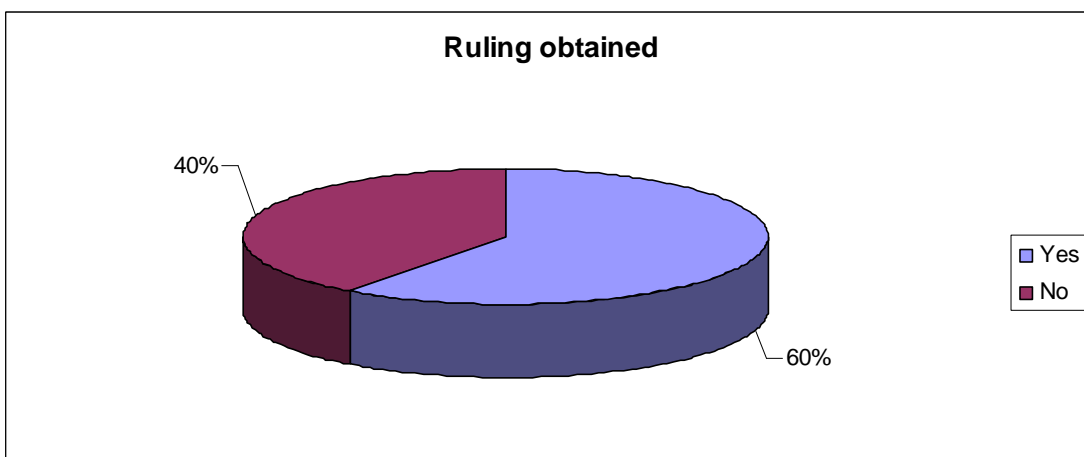
**Figure 8: Percentage input VAT recoverable from municipalities**



*Did the entity obtain a written ruling from SARS to apply the apportionment percentage?*

Sixty per cent indicated that they did obtain a written ruling from SARS and 40% indicated that they did not obtain a written ruling. Because all the participants are using the turnover-based method, it is not necessary to obtain a written ruling. It might be possible that the municipalities simply needed clarifications on certain income included or excluded in the apportionment percentage and whether it should be included or not in the calculation.

**Figure 9: Ruling obtained by municipality**



## 5.7 CONCLUSION

From the information obtained, it is clear that after the Act changed in 2006, the recoverable rate of input tax became high in the case of municipalities. Registered on the cash basis together with the zero rating of property rates and grants the refund of VAT has a very positive influence on the cash flow position of the municipalities. It can also be concluded that a municipality which does not look after its investments well and does not care about the enforcement of laws, will not earn great amounts of interest and fine income. Therefore it would not need to apportion its input tax as the recoverable percentage would be more than 95% seeing that most of its income would be from taxable income.

From the study the conclusion can be drawn that the turnover based method is once again the most popular method used by municipalities. The varied input-base method is probably not used, as municipalities have very complicated financial systems which could make it difficult to obtain the necessary information to calculate the recoverable percentage.

In Chapter 6 a conclusion will be given on all the research conducted in this study.

# AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE-ADDED-TAX IN SOUTH AFRICA

## CHAPTER 6 : CONCLUSION

### 6.1 INTRODUCTION

The aim of an apportionment method is to be fair and reasonable and to find a method that suits a certain industry or entity the best. In Chapter 1 the following goals were set for this study:

- the apportionment methods available should be investigated;
- it should be established which methods are used by entities in South Africa especially methods used by banks, universities and municipalities; and
- the acceptable percentage for the industries mentioned should also be established.

### 6.2 METHODS THAT COULD BE USED BY SOUTH AFRICAN ENTITIES

In Chapter 2 of the research study the different apportionment methods were discussed in detail. It is important to remember that the starting point is the direct attribution method. Through direct attribution, expenses are linked directly to a specific income. No input VAT can be claimed when the expense is linked directly to an exempt income. On the other hand, all the input tax can be claimed when the income is taxable income. The problem, however, arises with expenses that cannot be linked directly to an exempt or taxable supply and the input tax on these expenses should be apportioned.

The apportionment methods available are:

- methods with reference to outputs:
  - turnover-based method;
  - based on the number of taxable and exempt transactions;
  - based on the number of staff attributable to taxable and exempt transactions;
  - floor space method; and
- methods by reference to inputs:
  - input-based method;
  - *quasi* inputs method; and
  - indirect input attribution method.

There could be other methods used by entities as well but the above methods are the most commonly used methods.

The conclusion drawn from the study of these different methods is that there is not a “one size fits all” method. The method that will suit the entity best will depend on the nature of the entity and the type of income that the entity receives. Another factor to consider when deciding which method to use, is how refined the financial system of the entity is. Some of the methods can only be used when there is a refined financial system in place which can deliver the accurate information to calculate the apportionment percentage.

### **6.3 BANKS**

From Chapter 3 it is evident that banks have a very favourable method that can be used, namely the net interest method. In essence the net interest method is the turnover based method, but interest paid is deducted from interest received which results in a higher recoverable percentage for input tax purposes. The other methods are available to banks but the outcome is not as favourable as the net interest method.

Because the apportionment matter is very sensitive to the Banking Council of South Africa, no questionnaires were sent out and the annual reports of the banks in South Africa were obtained and analysed. Of all the banks in South Africa 83% of the annual reports could be obtained and were analysed. By using the net interest method, an average of 46% recoverable input VAT was calculated. This would be the industry norm given the assumptions of the study. This percentage would be acceptable as most of the income that a bank receives is exempt income.

The research conducted also illustrates that a different method than the net interest method has a very negative impact on the amount of input VAT recoverable. Different methods than the net interest method have a cash flow and actual cost impact on the banks.

## 6.4 UNIVERSITIES

The study conducted on universities was performed by means of a questionnaire that was sent to every traditional university. Seventy three per cent of the universities responded positively to the questionnaire. The research was discussed in Chapter 4 of the study.

There is some guidance in the *VAT 414 Guide for Associations not for Gain and Welfare Organisations* given by SARS regarding an apportionment method that can be used. The proposed method of SARS for a university is the turnover-based method. From the study, 57% of the participants indicated that the turnover-based method is used to apportion their input tax, and 43% of the participants are using the varied input base. Thus it is evident that the turnover-based method is the preferred method.

The information received also indicates that the average percentage of input tax recoverable would fall in the region of 20% to 30%. A university can measure itself against this norm but depending on the amount of taxable supplies incurred, it will vary from the norm.

## 6.5 MUNICIPALITIES

The study conducted on municipalities was also performed by means of a questionnaire that was sent to every metropolitan municipality in South Africa. Eighty three per cent of the municipalities responded positively to the questionnaire. The study conducted was discussed in Chapter 5.

SARS issued a guide which indicates the turnover based method as the preferred method to use. This guide is called the *VAT 419 - Guide for Municipalities*. It was clear from the response received that the turnover-based method is the preferred method. As indicated in 5.6 all the municipalities that participated are using this method.

The average recoverable percentage was between 90% and 95%. This norm is a good indication that after the changes in the Act in 2006 almost all of the income that is received is taxable income. It is also clear that a municipality that does not receive great amounts of

finance income (interest and dividends) and fine income from enforcing certain laws does not need to apportion as the exempt portion will be less than 5%, which is the *de minimus*.

## 6.6 CONCLUSION

From the research study conducted and as mentioned above it is clear that there is not a correct or incorrect method to apportion input VAT. The golden rule is to ensure that the method that is used is a fair and reasonable method for the given circumstances of the vendor apportioning its input VAT. It is important that SARS should be convinced that this is the case. However, this study indicates clearly that the turnover based method is the preferred method to be used by universities and municipalities. Banks would be using the net interest method as this is a very favourable method that they can use.

It is also evident from this study as discussed in Chapters 2.4 and 2.5 that the calculation of this percentage could be very difficult and technical and consequently is not a task that should be given to lower levels of staff. The calculation is difficult and requires some judgement. The preferred way would be for this task to be performed by the management of the entity or even by the entities' auditor or tax advisor who has the necessary knowledge to do these calculations.

The inclusion or exclusion of certain income in the formula, for example bad debt recovered, can be a grey area for certain entities. Therefore, it is recommended that a binding ruling from SARS is obtained. This will ensure that the percentage calculated is correct and that SARS agree with the calculation. By obtaining this ruling possible penalties and interest could be avoided.

It is also important to note that all binding rulings prior to 1 January 2007 were repealed. This was announced in the VAT News 29 of February 2007. Entities which had a ruling on calculating its apportionment percentage should be aware of this, because that ruling is not binding and acceptable any more. Should this pre January 2007 ruling still be used by an entity, it should have been confirmed with SARS before 30 June 2007. If not, the entity should re-apply for a ruling according to VAT News 29 (SARS, 2007c:1).

## ANNEXURE A

### Informed consent for participation in an academic research study

Dept. of Taxation

### AN IN-DEPTH STUDY OF INPUT TAX APPORTIONMENT METHODS FOR VALUE- ADDED TAX IN SOUTH AFRICA

Research conducted by:

Mr H.J.A. Smit (26431263)  
Cell: 083 445 2333

Dear Respondent

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

The purpose of the study is to establish which Value-Added-Tax apportionment methods are used by entities in South Africa. An apportionment method is compulsory when exempt supplies are more than five percent in comparison to total supplies.

Please note the following:

- This study involves an anonymous survey. Your name will not appear on the questionnaire and the answers you give will be treated as strictly confidential. You cannot be identified in person 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 in the attached questionnaire as completely and honestly as possible. This should not take more than 15 minutes 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, Mr X 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.

HJA Smit

August 2008

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**Respondent's signature**

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**Date**

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