

THE VAT TREATMENT OF FINANCIAL SERVICES LINKED TO CREDIT CARDS

by

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SUMMARY

THE VAT TREATMENT OF FINANCIAL SERVICES LINKED TO CREDIT CARDS

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The treatment of financial services under the VAT has been one of the most contentious VAT issues since the origin of the VAT. Due to theoretical and measurement complexities, most countries opt to exempt financial services under the VAT. Exemption is the cause of all the controversy. Exempting supplies under the VAT compromises one of the cornerstones of the VAT – neutrality.

South Africa is one of many countries that exempts most financial services under VAT. Credit card suppliers in South Africa offer a bundle of financial services comprising fee-based-charges and interest earned. The credit card user is usually only charged for the interest. Interest is an exempt supply under VAT. This gives rise to many distortions for South African credit card users and financial intermediaries.

Exhaustive research has been conducted on the treatment of financial services under the VAT around the world. This study only focusses on the VAT treatment of interest margins of credit cards in South Africa. Firstly, it was determined that credit card offerings in South Africa include bundled offerings which is impractical to separate on a transaction-for-for transaction-basis due to valuation complexities and market conditions. Secondly, it was determined that VAT doesn't play a major role in credit card suppliers' decision on how

offerings are structured. It is mostly guided by the competition and legislation. Thirdly, it was determined that administrative burden and compliance cost caused by apportionment in South Africa is highly underplayed in the literature. Lastly, it was proposed that full taxation of all financial services with implicit charges at a lower rate or full taxation of fee-based charges with exemption of financial services with a partial input recovery, to be the best alternatives for South Africa to consider to tax financial services under VAT.

Keywords:

VAT

Financial services

Credit cards

Exemptions

Distortions

Bundling

OPSOMMING

DIE BTW-HANTERING VAN FINANSIËLE DIENSTE WAT AAN KREDIETKAARTE GEKOPPEL IS deur

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Die hantering van finansiële dienste onder BTW is een van die mees kontroversiële probleme sedert die ontstaan van BTW. As gevolg van komplikasies met betrekking tot teorie en waardasie word finansiële dienste in meeste lande van BTW vrygestel. Vrygestelde lewerings onder BTW is die oorsaak van al die kontroversie. Die vrystelling van lewerings onder BTW vernietig een van hoeksteunpilare van BTW – neutraliteit.

Suid-Afrika is een van die lande wat die meeste finansiële dienste onder BTW vrystel. Kredietkaartverskaffers in Suid-Afrika bied 'n bondel finansiële dienste aan, bestaande uit fooi gebaseerde heffings en rente ontvang. Die gebruiker van die kredietkaart word gewoonlik net vir die rente gedebiteer. Rente ontvang is 'n vrygestelde lewering onder BTW. Dit veroorsaak baie komplikasies vir Suid-Afrikaanse kredietkaartgebruikers en finansiële tussengangers.

Baie navorsing is gedoen oor die hantering van finansiële dienste onder BTW regoor die wêreld. Die fokus van hierdie studie is alleenlik op die BTW-hantering van rentemarges van kredietkaarte in Suid-Afrika. Eerstens, was dit bepaal dat kredietkaartaanbiedinge in Suid-Afrika gebondelde aanbiedinge insluit, wat onprakties is om op n transaksie-vir-transaksie-grondslag te skei as gevolg van waardasie probleme en markkondisies. Twedens was bepaal dat BTW nie n groot rol speel in hoe kredietkaartverskaffers hul aanbiedinge struktureer nie. Dit word hoofsaaklik gelei deur die kompetisie en wetgewing.

Derdens, was bepaal dat die adminastriewe las en nakoming koste wat veroorsaak word deur toedeling in Suid-Afrika onderskat word in die literatuur. Laastens, was voorgestel dat finansiële dienste ten volle onder BTW belas word met implisiete heffings teen n laer koers of volle belasting van fooi-gebaseerde finansiële dienste met vrystelling van finansiële dienste met n gedeeltelike-inset-terugeis, die beste alternatiewe vir Suid-Afrika is om te oorweeg om finansiële dienste onder BTW te belas.

Sleutelwoorde:

BTW

Finansiële dienste

Kredietkaarte

Vrygestelde lewerings

Komplikasies

Bondeling

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THE VAT TREATMENT OF FINANCIAL SERVICES LINKED TO CREDIT CARDS.

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

“The taxation of financial services is the major remaining frontier for the VAT (Gendron, 2008:494). Despite significant efforts by prominent VAT thinkers over a significant period of time, no convincing, conceptually correct and practical solutions for capturing the bulk of the financial services under the VAT have been found.”

The levying of Value-added Tax (hereafter VAT) on the consumption of financial services has been one of the most contentious issues relating to the VAT since its origin (Poddar & English, 1997:89; De la Feira & Wadpole, 2009:897). The main reason for this to be such a debated issue is that most countries opt to exempt financial services under the VAT due to valuation problems and its theoretical problems. The main valuation problem is that many financial services are usually bundled up in the net interest margin and it is difficult to separate and attach a value to it individually (Benedict, 2011:175). The main theoretical problem is that most of these types of products include savings and by nature saving is not consumption (Benedict, 2011:175). Most countries either apply the fully taxable method, zero rating or exemption to tax financial services under the VAT.

The fully taxable method taxes the total value added by financial services as a standard supply and allows input credits on goods and services procured. Under zero rating the total value added is taxed at 0% and input credits are allowed on goods and services procured. Exemption, on the other hand, means that the value added by financial services is exempted and input credits on the goods and services procured is denied. Exemption remains the most popular among countries due to simplified administration and low cost to

administer (Ebrill, Keen, Bodin & Summers, 2001:91). Exemption is the source of the distortions caused and the most important distortion exemptions are the following:

- Tax income leakage due to non-levying of the VAT at the final stage of supply for governments (Ebrill *et al.*, 2001:85).
- Increased cost to suppliers of exempt supplies due to the apportionment or denial of input tax credit, which causes an increase in price for financial services (Benedict, 2011:190).
- Financial services companies will rather self-supply than outsource to avoid incurring the cost of the input VAT (Ebrill *et al.*, 2001:86).
- Exemption of financial services under the VAT also creates extra and difficult administration of apportionment of input tax (Ebrill *et al.*, 2001:88).
- A theory also exists that it might set the stage for more exemptions as precedents are set (Ebrill *et al.*, 2001:89).

The majority of studies conducted are comparisons between the treatment in different countries (De la Feria & Walpole, 2009) and proposed revised treatment with special reference to the proposed cash flow method (Poddar & English, 1997). No specific research has been done in a South African context in terms of Section 2(1)(f) of the Value-Added Tax Act (89/1991) (hereafter the Act) with a specific focus on credit cards and all the financial services included in the interest rate margin. Ideally the taxing of financial services under VAT in South Africa should be an exact science, but due to the structure of the offerings of the financial services sector, this is a vexing issue that is creating a lot of contention.

1.2 PROBLEM STATEMENT

The offerings by credit card companies are constantly changing. The credit card companies have to adapt to increased competition among each other and the current method of retaining clients is by offering them a bundle of financial services included in the interest rate margin. These services typically include reward programmes, discounts at business partners and insurance-related services, to name but a few. Typically the only charge that the client will receive is the interest charge on credit utilised, except for a few

explicit fee-based charges. In South Africa, interest is a financial service as stated in Section 2(1)(f) of the Act, and an exempt supply. No studies have been conducted on the possibility of unbundling these financial services to separate components or comparisons of treatment in other countries that might lead to less distortions and improve the neutrality of the VAT.

This study aims to explore the option of unbundling the different financial services included in the interest margins of credit cards and to compare the South African taxing of financial services under VAT with that of other countries under the VAT. This comparison will be done to evaluate if there are alternatives available that will lead to fewer distortions for the consumer and the financial intermediaries.

This is a very contentious issue. Firstly, it could be argued that South African credit card users are paying too much for the financial services included in the interest rate margin due to being input-taxed. Secondly, there is VAT leakage for the government not being able to levy the tax at the final stage, and thirdly, the financial services industry receives preferential tax treatment in comparison to other industries. The root of the problem is that governments use exemption due to a lack of workable alternatives (De la Feria & Walpole, 2009:898). It is thus done almost by force. This is where research and academics have a huge role to play in formulating theories that can be converted into working solutions that will limit and eliminate these distortions.

The research done on the general issue of financial services and the VAT is exhaustive, but a more focused approach, focusing on the financial services, loans and interest as per Section 2(1)(f) of the Act relating to credit cards, is more likely to yield workable solutions that will limit and eliminate these distortions.

1.3 PURPOSE STATEMENT

The main goal of the proposed study will be to determine whether there are other options available that will limit or eliminate the distortions caused by exempting all the financial and other services included in interest margin of credit card companies under VAT. The units

of analysis of the proposed study present the alternatives that are available regarding exemption of the financial services included in the interest margins of credit cards.

1.4 RESEARCH OBJECTIVES

The study will be guided by the following research objectives:

- To explore the methods used by other countries to tax financial services under the VAT. This will be done to identify alternatives to the exemption of financial services under the VAT.
- To identify the different (separate) financial- and other services included in the interest margin of credit cards for the four big South African banks. This will be done to determine whether the different services can be separated and whether it will be feasible, and to emphasise the difficulties that arise as a result of the exemption of these financial services in South Africa.
- To evaluate whether the treatment of financial services-linked credit cards under VAT complies with Section 8(15) and 10(22) of the Act.
- To critically analyse the different alternatives for the treatment of financial services under the VAT identified for practicality and feasibility in a South African context. This will be done to determine whether other alternatives to exemption might alleviate the distortions caused by it.

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This study is unique as it will be done in a South African context, focused on specific financial services as per Section 2(1)(f) of the Act limited to the interest margins earned on credit cards and not in a broad sense that is applicable to financial services as a whole, as done by previous research. A detailed analysis of bundled credit card offerings may provide benefits for both academia and tax professionals.

This study may benefit various stakeholders, like the South African government, financial services companies and consumers as it might highlight workable alternative methods of levying VAT on financial services. One of the cornerstones of the VAT is that it should be

neutral and not affect any other decisions of business. It is in the interest of all that the levying of VAT does not influence price and operational decisions.

1.6 CHAPTER LAYOUT

This mini-dissertation comprises eight chapters:

- **Chapter 1** – Introduction to proposed study stating the problem to be researched
- **Chapter 2** – Discussion of the delimitations and assumptions of the proposed study
- **Chapter 3** – Definition of the key terms and abbreviations used in the mini-dissertation
- **Chapter 4** – A review of the literature that is available on financial services and the VAT
- **Chapter 5** – A short description of the research design of the mini-dissertation
- **Chapter 6** – The South African landscape in terms of financial services linked to credit cards and their treatment under VAT
- **Chapter 7** – Proposals for treating financial services linked to credit cards under VAT
- **Chapter 8** – Findings, summary and value of the study

CHAPTER 2

DELIMITATIONS AND ASSUMPTIONS

2.1 DELIMITATIONS

The proposed study does have delimitations. In terms of context, the study will be conducted within a South African context, with reference to the treatment of financial services regarding VAT under South African legislation . There are many types of financial services, but this study will be limited to those as per Section 2(1)(f) of the Act. The study will further be limited to the interest margins when providing credit cards and the interest thereon. This effectively excludes all borrowings and interest that do not relate to credit cards. Taxes other than the VAT will not be evaluated as an alternative to exemption of financial services under the VAT. The study will be classified as a non-empirical study and the theories and findings will have to be tested empirically.

2.2 ASSUMPTIONS

The proposed study is based on the assumption that financial intermediaries would like to participate interactively in this study and would grant access to information. Furthermore, the information provided is correct.

CHAPTER 3

DEFINITION OF KEY TERMS

This study contains key terms such as: bundling, direct taxes, distortions, exemption creep, explicit fees, financial intermediaries, implicit fees, indirect taxes, input taxed, tax cascading and the VAT. These key terms are defined below.

Bundling: Bundling is defined as a single charge that is passed on to the customer, but various services are rendered to customers, which could have been rendered separately (Stitt, 2011:194) (see Section 4.8.3).

Direct taxes: Direct taxes are defined as tax that is assessed according to the characteristics of transactions (Flesher & Wells: 1999:117) (see Section 4.3.1).

Distortions: Distortions are defined as misrepresentations; giving a false account of something. (*South African Oxford School Dictionary*) (see Section 4.7.1).

Exemption creep: Exemption creep can be defined as the phenomenon of exempting an item which paves the way for more exemptions to follow, as each exemption creates pressure for more exemptions to follow. (Ebrill *et al.*, 2001:89) (see Section 4.7.7).

Explicit fees: Explicit fees are fees that are charged separately from other fees (Gendron, 2008:497) (see Section 4.8.3).

Financial intermediaries: Financial intermediaries bring depositors and lenders together and in the process manage the risks involved in investment and financing cycles, and render various services. Financial intermediaries include but are not limited to: banks, insurance companies, mortgage companies, investment and pension funds and stock brokers (IMF & OECD, 2009:1) (see Section 4.8.3).

Indirect taxes: Indirect taxes are defined as taxes on the income of taxpayers (Flesher & Wells, 1999:117) (see Section 4.3.1).

Implicit fees: Implicit fees are fees charged that are included in the interest margin: also referred to as financial intermediary services (Gendron, 2008:497) (see Section 4.8.3).

Input taxed: Input taxed effectively means that the financial intermediary is the final consumer and input VAT that was paid on goods and services procured are denied as an input credits against the output and becomes an expense to the financial intermediary (Gendron, 2008:495) (see Section 4.6.3).

Tax cascading: Tax cascading is defined as double taxation in that both the input and the output side are taxed (Ebrill *et al.*, 2001:16) (see Section 4.7.4).

The VAT: The VAT is defined as follows: “A broad-based tax levied on commodity sales up to and including at least the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs – except perhaps on capital goods – against that due on outputs” (Ebrill *et al.*, 2001:2) (see Section 4.5.1).

The following recognised abbreviations are used in this research mini-dissertation:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
ACT	Value-added Tax Act (89/1991)
ATM	Automatic Teller Machine
B2B	Business-to-Business
B2C	Business-to-Consumer
B.C.	Before Christ
EU	European Union
FTT	Financial Transaction Tax
GST	Goods and Sales Tax
HST	Harmonised Sales Tax
NCA	National Credit Act
OECD	Organisation for Economic Co-operation and Development
QST	Quebec Sales Tax
RST	Retail Sales Tax
SARS	South African Revenue Services

Abbreviation	Meaning
VAT	Value-added Tax

CHAPTER 4

LITERATURE REVIEW

4.1 INTRODUCTION

The literature available on the treatment of financial services under the VAT is exhaustive. It was intended to limit the critical review of literature to the most recent sources, but since this issue has been such a contentious issue for so long it was appropriate to include some older sources as they are as relevant today as they were many years ago. An inductive approach was followed as the purpose of the study is to better understand the problems associated with taxing financial services under the VAT and to identify alternatives to the exemption of financial services under the VAT. The critical review of literature focuses on: taxation, indirect taxes, consumption taxes, the VAT, the workings of the VAT, treatment of financial services under the VAT – a worldwide perspective, treatment of financial services under VAT in South Africa and bundled credit card services as a financial service in South Africa.

4.2 TAXATION

4.2.1 Defining taxation

The *South African Oxford School Dictionary* defines tax as “money that people or business firms have to pay to the government, to be used for public purposes”.

4.2.2 The history of taxation

One of the most famous quotes of all time is by Benjamin Franklin: “In this world nothing is certain but death and taxes.” This is so true if referring to the state of taxation today, but it doesn’t seem to have been any different in the past. According to Sharlach, Silverman and White (2002:4), evidence was found of governments and civilisations implementing taxes as far back as 3000 B.C. in ancient Egypt and 2500 B.C. in ancient Mesopotamia.

The Mesopotamian tax was called Burden. The name of this tax is actually a very accurate description of the tax as everything was basically taxed in ancient times. Livestock, boat trade, fishing and funerals, to name but a few, were taxed in ancient Mesopotamia. In ancient times, taxes weren't paid with gold, silver or currency. They were mostly paid in kind. This means that taxes were paid with livestock, commodities and by labouring for the government. The ancient Egyptians typically raised taxes for the tombs of the pharaohs and for military action. These taxes took the form of something physical (commodities) and labour (Sharlach, Silverman & White, 2002:4)

It is clear that the old saying "back in the day" doesn't apply to taxation. Tax seems to have been there from the start and will be there in the future. Today taxation is a complex field, brought about by globalisation and advances in technology. It evolves according to the social needs of countries, plays a major part in politics and can affect the outcome of elections. It is important that taxes are calculated fairly, as it affects everyone. Most countries, although having different taxes, have similar principles to determine taxes due.

4.2.3 Taxation principles

Smith (1776:454) listed four principles that legislatures should consider when drafting tax legislation:

- Each taxpayer should pay tax according to their abilities and in proportion to the revenue they generate under the protection of the state.
- Their calculation of tax payable must be an exact science, governed by legislation and without any uncertainties included in the calculation.
- Taxation must be levied at a time and in a manner that is most convenient to the taxpayer.
- A tax should be as little as possible, with special reference to the avoidance of expensive collection methods that increase the effective rate.

Although these principles were formulated 300 years ago by Adam Smith, they are still applicable today and most countries consider them when drafting tax legislation.

Taxes comprise either direct or indirect taxes. Most countries levy a combination of direct and indirect taxes to generate the required revenue for government.

4.3 INDIRECT TAXES

4.3.1 Defining indirect taxes

Flesher and Wells (1999:117) define indirect taxes as tax assessed according to the characteristics of transactions – thus a tax on a transaction as opposed to direct taxes that are taxes on the income of taxpayers. It is levied on transactions and goods, as opposed to direct taxes that are levied on individuals and entities. Duties on foreign transactions, excise on certain goods, toll fees, donations tax, estate duties, fuel levies, sales tax, turnover tax and the VAT are examples of indirect taxes.

4.3.2 History of indirect taxes

As discussed in Section 4.2.2, governments and civilisations have been implementing taxes since 3000 B.C. These ancient taxes are more indirect than direct in nature as they were mostly levied on transactions. The evidence is clear that indirect taxes have been with us since taxation originated.

4.3.3 Consumption taxes as an indirect tax

According to Smith (1776:479), the difficulty of taxing individuals directly led to consumption taxes: “The impossibility of taxing people, in proportion to their revenue, by any capitation, seems to have given occasion to the invention of taxes upon consumable commodities. The state not knowing how to tax directly and proportionately the revenue of its subjects, endeavours to tax it indirectly by taxing their expense, which, it is supposed, will, in most cases, be nearly in proportion to their revenue. Their expense is taxed by taxing the consumable commodities upon which it is laid out.”

4.4 CONSUMPTION TAXES

4.4.1 Retail Sales Tax

Retail Sales Tax (hereafter referred to as RST) is a consumption tax levied on the sale of goods and services by registered businesses to consumers and unregistered businesses (Cnossen, 2011:25). It is a single-stage consumption tax levied only at the final stage of the supply of goods or services (Ebrill *et al.*, 2001:23).

4.4.2 Direct Subtraction Method Tax

The Direct Subtraction Method Tax is a consumption tax that is levied at an account level. (Gendron 2008:500). The tax is calculated on the ledgers of an entity as opposed to being levied on a transaction-for-transaction basis. Cnossen (2011:25) states that with this method, consumption tax is levied on the registered business's revenue less goods and services procured from registered businesses.

4.4.3 Addition Method Tax

The Addition Method Tax is a consumption tax levied at an account level on the sum of the aggregated wages (referring to the broader meaning of wages which will include salaries) and business profits (Cnossen 2011:25; Gendron 2008:499).

4.4.4 Flat Tax

Flat Tax is a consumption tax levied on the amount calculated as per the Direct Subtraction method (refer to Section 4.4.2) less wages. This amount is taxed without exemptions and the wages are taxed after taking into consideration exemptions that are applicable on individuals at the same rate (Cnossen: 2011:25-26). In America, a Flat Tax is considered to be a bit different than in the rest of the world as it is seen as a cash flow tax on business income and tax wages. (Keen, Kim & Versano, 2008: 713-714).

4.4.5 Personal Expenditure Tax

Personal Expenditure Tax is a consumption tax levied at the level of the taxpayer. It is calculated by taking the aggregated earnings less the savings of a taxpayer on a cash flow basis (Cnossen: 2011:26). It is based on the theory that a taxpayer's earnings less savings will be equal to the goods and the services consumed by the taxpayer.

4.4.6 Credit Invoice Method of Tax

Credit Invoice Method of Tax is a consumption tax whereby the tax levied is recorded on the invoices issued by the seller to the buyer. The tax on the invoices raised to clients less the tax paid as per invoices for goods and services procured equals the tax liability (Ebrill *et al.*, 2001:2). With this method the calculation isn't done at an account level, but at a transaction-for-transaction level with invoices, with the tax recorded on them as supporting documents.

4.4.7 Similarities and differences between consumption taxes

The common denominator between the different consumption taxes is that in theory they all should collect the same amount of revenue for governments (Cnossen: 2011:28). The end result is the same, but it is the workings of the consumption taxes that differ. The main differences are:

- Some consumption taxes are collected in a single stage and others in multiple stages; levied throughout the whole process as opposed to only at the final stage.
- Some consumption taxes are calculated on account balances and others on a transaction-by-transaction base and are supported by invoices with the consumption tax recorded on them.
- Some consumption taxes that are levied only at the final stage require less registered taxpayers and should be less expensive and easier to administrate (Ebrill *et al.*, 2001:23).

Consumption taxes come in all shapes and sizes. This allows for a very flexible design for legislators to assist them to meet their tax objectives when drafting consumption tax legislation. According to Cnossen (2011:28), the following should be considered when drafting consumption tax legislation:

- There should be fair distribution of the tax burden among taxpayers.
- The tax should remain neutral and not influence any business decisions.
- The tax ought to be destination based. The tax revenue should be allocated to the country where it is consumed.
- Administrative and compliance cost to both government and taxpayer should be considered.
- The tax should be able to withstand erosion caused by political favouritism.

The Credit Invoice Method of Tax is currently the dominant consumption tax levied in the world (Ebrill *et al.*, 2001:2).

4.5 THE VAT

4.5.1 Defining the VAT

The VAT is defined as follows: “A broad-based tax levied on commodity sales up to and including, at least the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs – except perhaps on capital goods – against that due on outputs” (Ebrill *et al.*, 2001:2). Flesher and Wells (1999:114) provide an alternative definition: “The VAT is conceptually a tax on GNP (gross national product), the market value of all final products produced in the economy.”

The VAT doesn’t include taxes that only allow input credits in particular sectors, only allows input credits for items physically incorporated in the sales or taxes which suspend the tax if it has to be charged to a specific individual or entity (also known as “Ring systems”) (Ebrill *et al.*, 2001:2).

The Credit Invoice Method of Tax, which is described clearly in Section 4.4.6, will be incorporated with regard to this definition since it complies with it in all aspects, but there is a debate whether the other consumption taxes, described in Section 4.4, comply with this definition in all aspects (Ebrill *et al.*, 2001:2).

Goods and Sales Tax (hereafter GST) is a synonym for the VAT. The VAT or GST is however implemented with different designs due to the flexibility it offers.

4.5.2 The History of the VAT

The VAT can be traced back to the 1920s, as advocated by the German, Von Siemens, and the American, Adams (Ebrill *et al.*, 2001:4). Indirect taxes mainly consisted of: tolls, excise, duties and turnover (sales) taxes in those days, but the cascading effect (discussed in detail in Section 4.7.4) of turnover/sales taxes was one of the main motivations behind the engineering of the VAT (Flesher & Wells, 1999:116). France adopted the first VAT in 1948 and in 1953, Michigan adopted an accounts-based form of the VAT (Ebrill *et al.*, 2001:4). Thereafter the VAT spread to Western Europe, European communities, Brazil and Latin America (Ebrill *et al.*, 2001:4).

4.5.3 The principles of VAT by OECD

The Organisation for Economic Co-operation and Development (hereafter OECD) (2013:14) emphasises that the following principles are essential in the design of the VAT:

- **Neutrality** – The VAT ought to be neutral between all forms of commerce. Similar businesses and transactions should be taxed under VAT in a similar fashion. It further ought not to discriminate between domestic and international trade.
- **Efficiency** – Compliance and administrative cost ought to be as low as possible for businesses and government.
- **Certainty and simplicity** – The VAT ought to be easy to understand and to apply. The consequences of transactions ought to be certain, with special reference to the amount of tax due and when it is due.

- **Effectiveness and fairness** – The correct amount of VAT ought to be collected at the correct time. Tax avoidance and evasion ought to be limited.
- **Flexible** - The VAT's design ought to allow for flexibility to cater for industry and technological advancements.

The principles advocated by the OECD are in essence the same as those advocated by Adam Smith 300 years ago (refer to Section 4.2.3). At the core of the principles relating to VAT as advocated by the OECD are neutrality and the destination principle.

4.5.4 Current state of the VAT

Crossen (2011:34) refers to the advance of the VAT as follows: “Viewed globally, the advance of the VAT is the most significant development in the field of taxation in the past 50 years.” Crossen (2011:48) lists the reasons for the VAT being the preferred consumption tax:

- The VAT is a multistage tax collected throughout the whole process.
- The VAT is neutral for businesses – it doesn't affect business decisions and is not a cost to a business.
- The VAT is easy to understand and administrate.
- The VAT has an effective design to deal with cross-border transactions (exports and imports).
- The VAT is less likely to be applied differently for certain groups of individuals and businesses due to favouritism.
- The VAT is less vulnerable to evasion and avoidance than the other forms of consumption taxes.

OECD statistics reflect that 31% of all tax revenue of OECD members is levied via consumption taxes, of which the VAT comprises 66%. The OECD has 34 members, of which 33 have implemented the VAT, with America being the only exception that has implemented RST as their consumption tax of choice (OECD, 2012:8) The VAT has been

implemented by more than 150 countries and currently raises 20% of the world's tax revenue (OECD, 2012:44)

Currently the VAT is levied on the supply of goods and services to more than 150 countries. Typically, the supply of goods and services under the VAT is classified as either standard supplies, zero-rated supplies or exempted supplies.

4.6 STANDARD SUPPLIES, ZERO RATING AND EXEMPTIONS

4.6.1 Standard supplies

According to the definition of the VAT (refer to Section 4.5.1), the VAT was designed as a broad-based tax levied on goods and services supplied by a registered entity with the offset of input credits on the tax levied on goods and services procured by the registered entity. Most of the supply of services and goods will be standard supplies, as is noted by the definition. This effectively means that the entity will levy the VAT at a single or at multiple rates, depending on the country's design, on most goods and services supplied. Since standard supplies are taxable supplies, the entity will be allowed input credits on the goods and services procured. The net of the two will either be remitted to the government or remitted by the government to the entity.

4.6.2 Zero rating

Zero rating is a supply of which the standard rate is 0%. A zero-rated supply is still a taxable supply, although tax is levied at 0%, and the entity is allowed to deduct input credits on the goods and services procured (Stiglingh, Van Schalkwyk, Koekemoer, Wilcocks & De Swart, 2012:1035). Previously zero-rated transactions were also referred to as "GST-free" (Ebrill *et al.*, 2001:3). Most countries zero rate exports only (in order to tax consumption where it takes place), but some countries zero rate basic foods and fuel products as well in order to relieve the burden of the VAT on the poor.

4.6.3 Exemptions

To exempt goods and services under the VAT is different than a zero-rated supply. Although the VAT payable on both equals zero – the zero-rated supply is still a taxable supply and the exempt supply is not a taxable supply. This affects the tax paid on goods and services procured, as the entity is not allowed to claim these taxes paid. Previously, exempt supplies were referred to as “input taxed” (Ebrill *et al.*, 2001:3). The following items are typically exempted by governments (Ebrill *et al.*, 2001:85-87):

- agricultural products
- fuel products
- passenger transport
- financial services
- cultural and religious activities
- aid-financed activities
- capital expenditure

The term exemption is a misnomer (Grubert & Krever, 2012:203). Entities making exempt supplies are input-taxed (Freebairn, 2011; Gendron 2008: 495). This effectively means that the entity is the final consumer and input VAT that was paid on goods and services is denied as an input credit against the output and becomes an expense to the entity (Gendron, 2008:495). This gives rise to many distortions.

4.7 DISTORTIONS CAUSED BY THE EXEMPTION SUPPLIES UNDER THE VAT

4.7.1 Distortions defined

The *South African Oxford School Dictionary* defines distortions as follows: “misrepresent; give a false account of something.” Clearly the word has a negative connotation. It is the word used in most of the literature for the negative consequences caused by exempting financial services under the VAT. The word distortion in this context clearly refers to the word exemption being a misrepresentation as it has many other negative consequences

that affect decisions and lead to taxation, only in another way (input-taxed). A discussion on some of the more important distortions that are exempting supplies under the VAT follows.

4.7.2 Tax revenue leakage for tax authorities

By exempting supplies, less tax revenue is generated by governments (De la Feira & Walpole, 2009:912; Gendron, 2008:498). Since taxation does not take place at final place of consumption, it is effectively levied at a rate lower than the standard rate (Edmiston & Fox, not dated; Freebairn, 2011). This is also referred to as “breaking the VAT chain” (De la Feira & Walpole, 2009:910). The authorities are not necessarily worse off, for non-recoverable input VAT has become an important source of tax revenue for many authorities (Kerrigan, 2010:2).

4.7.3 Distorted input choices

One of the most significant results of exempting supplies under the VAT is that it distorts input choices. Entities making exempt supplies will typically rather self-supply than outsource to avoid the non-recoverable input VAT, and many operational efficiencies and synergies are lost (De la Feira & Walpole, 2009:911; Ebrill *et al.*, 2001:86; Gendron, 2008:498). This also advantages larger entities as they will be in a better position to self-supply than smaller entities that might not have a choice but to outsource due to lack of skills and additional financing (Stitt, 2011:195).

4.7.4 Tax cascading and the neutrality of the VAT

One of the cornerstones of the VAT is that it should be neutral. Neutrality means that the VAT should not influence any business decisions – thus decisions should be taken as if there is no VAT applicable (IMF & OECD, 2009:4). Jack (2000) supports this view that it is extremely important that the VAT has zero influence on the price of the product. The denial of input VAT paid on goods and services procured in making exempt supplies has a tax-cascading effect. (Benedict, 2011:191; De la Feira & Walpole, 2009:910; Firth & McKenzie, 2012:19). Tax cascading is defined as double taxation in that both the input and the output

side is taxed (Ebrill *et al.*, 2001:16). Tax cascading or being input-taxed causes the input-VAT paid on goods and services procured in the rendering of services to be non-deductible input VAT, thus effectively becoming an expense for the entity. Due to the VAT becoming an expense, it affects the price of exempt supplies. The input VAT becomes an expense and entities making exempt supplies will include this in the price to the consumer, thus increasing the price. Financial services are typically exempted under the VAT by most countries. Jack (2000) refers to a study done by PriceWaterhouseCoopers that indicated that it could increase the price of financial services as much as 4%. Exemption of the VAT on financial services is effectively passed on to the end user included in the interest margin (Benedict, 2011:191).

4.7.5 Bias towards foreign suppliers

Exemption under the VAT of certain supplies can also lead to foreign company supply bias. (De la Feira & Walpole, 2009:912; Firth & Mckenzie, 2012:19). Foreign companies can zero-rate their supply to local companies. Since these foreign companies can zero-rate the service for the VAT they can claim the input VAT on goods and services procured, the VAT is thus neutral and not an expense for them. This will allow foreign companies to have more competitive pricing than local companies and companies will be tempted to be bias towards the foreign companies. Ever-increasing globalisation makes it easier for companies to trade cross-border, making trade with foreign companies attractive (Firth & Mckenzie, 2012:19).

4.7.6 Apportionment problems

As soon as taxable and exempt supplies are generated by the same entity, the basic principle is that the input VAT must be apportioned in the ratio of taxable to exempt supplies. Thus input VAT can only be claimed for the portion that relates to taxable supplies, and the portion that relates to exempt supplies becomes input-taxed and effectively an expense. This leads to complex administration and compliance cost, especially for smaller, partially exempt traders (Ebrill *et al.*, 2001:88; Firth & Mckenzie, 2012:19; Gendron, 2008:499). Kerrigan (2010:11) expands on the neutrality of the VAT definition by adding that there should not be burdensome compliance with reference to the

administration. Apportionment also creates an opportunity for fraud as apportionment calculations are sometimes complicated and based on estimates (Gendron, 2008:499). Edmiston and Fox, (not dated:14) raise the concern that apportionment can motivate entities to substitute exempt supplies for taxable supplies to enable them to claim a higher ratio of input-VAT back against their outputs.

4.7.7 Exemption creep

Exempting supplies pave the way for more exemptions to follow as each exemption creates pressure for more exemptions (Ebrill *et al.*, 2001:89). This is referred to as the exemption creep (Ebrill *et al.*, 2001:89; Gendron, 2008:499).

4.8 THE REASON FOR EXEMPTING FINANCIAL SERVICES UNDER THE VAT ALTHOUGH IT CAUSES SO MANY DISTORTIONS

4.8.1 The general reason for exempting financial services under the VAT

The solution seems to be to zero-rate supplies instead of exempting them, but it is not so simple. The main reasons for the exemption of certain supplies, instead of zero-rating them, is for practicality and the revenue needs of the governments (Ebrill *et al.*, 2001:90).

Firstly, let's evaluate practicality. Output is sometimes hard to tax (Ebrill *et al.*, 2001:90). The example of a small trader refers. Output is extremely hard to tax in these circumstances as small retailers usually have very informal accounting records, the compliance cost is too high for them and zero-rating isn't practical as small traders will be making zero-rated supplies as opposed to the bigger traders that will be making standard supplies. It seems that the small traders will be unfairly advantaged by zero-rating their supplies.

Secondly let's evaluate the revenue needs of governments. The example used previously of the small trader refers, although the final supply to the consumer is not taxed under the VAT since the supplies by small vendors are typically exempt. The small trader is denied an input credit on goods and services procured. The small trader is input-taxed on these

items and the government raises VAT revenue, although not on the final supply to the consumer. Zero-rating causes a lot of refunds that need to be made by the governments to the taxpayers – this is very expensive to administer as it is usually accompanied with an audit process (Ebrill *et al.*, 2001:91).

Another alternative to exemption might be to tax certain supplies at lower rates, but exemption is a less costly and a more convenient option than dealing with the complex administration of multiple VAT rates (Ebrill *et al.*, 2001:91). (

As stated in Section 4.6.3, financial services are typical of supplies that are exempted.

4.8.2 Theoretical concerns regarding financial services

The VAT is a destination-based consumption tax (Ebrill *et al.*, 2001:15). This appears to be very simple, but the nature of financial services is different to goods supplied and services rendered. Interest charged on a savings account refers. The interest is received for a deferment in consumption and not consumption itself (Firth & McKenzie, 2012:10). Similarly, it is argued that interest paid on a loan is merely a means to an end to allow accelerated consumption (Firth & Mckenzie, 2012:8; Grubert & Krever, 2012:216). Benedict (2011:175) argues that since financial services relate more closely to savings than consumption, they should not be taxed under a consumption tax, but under a completely different regime. The opposite view also exists. Gendron (2008:497) argues that rendering financial services consumes goods and services in rendering the service and should be regarded as consumption. Firth and Mckenzie (2012:3) argue that the final consumption of all goods and services should be taxed under the VAT. There is also some that argue that some financial services should be taxed under the VAT and some not (Jack, 2000). Firth and McKenzie (2012:10) refer to the interest received for saving a deferment in consumption. Grubert and Krever (2012:215) raise the issue that assets are consumed over a long period, yet VAT is levied when the asset is purchased and not when the asset is consumed. Conflicting views exist on whether financial services should indeed be viewed as consumption or not.

4.8.3 Valuation and measurement complexities

Although the theoretical concerns on the nature of taxing financial services under the VAT contribute to this being such a contentious issue, the main problem with taxing financial services under the VAT is the valuation and measurement of transactions.

Financial intermediaries bring depositors and lenders together and in the process manage the risks involved in investment and financing cycles and render various services in the process. Financial intermediaries include but are not limited to: banks, insurance companies, mortgage companies, investment and pension funds and stock brokers (IMF & OECD, 2009:1). It is exactly here where the problem lies. Bundling takes place. Bundling is defined as a single charge that is passed on to the customer, but various services are rendered to the customer that could have been rendered separately (Stitt, 2011:194). Financial intermediaries bundle the services up in the interest margin. The only charge on a credit card is interest paid on funds advanced, but there are many services included: loyalty rewards, no interest grace period, sale-enhancing services and payment means (Grubert & Krever, 2012:225). Financial intermediaries currently generate the most of their revenue with interest margins (Kerrigan, 2010:2). Some fees are still charged separately, for example annual fees, but all the other services are charged as interest payable. Fees that are charged separately are usually referred to as explicit fees and fees that are included in the interest margin are referred to as implicit fees or financial intermediary services (Gendron, 2008:497).

Explicit fees are easily taxable under the VAT, but implicit fees tend to be problematic. Poddar (1997:97) attempts to separate the different components in a normal deposit-taking transaction by a financial intermediary into: the original deposit, also known as the capital amount, pure interest (remuneration for delayed consumption), pure risk premium and compensation for managing risks and taking the deposit. Poddar (1997:98) argues that only the compensation for managing risks and taking the deposit constitutes consumption and should be the only portion of the implicit fee to be taxed under the VAT. The total value added is easy to determine and equals the interest received from borrowers less the interest paid to depositors – the problem lies in separating them into the different services that were rendered (Gendron, 2008:497). To complicate matters even

further, different services that are bundled up in the interest margin are sometimes cross-subsidised by other services (Firth & Mckenzie, 2012:11; Mulineux, 2011:446). Another factor that also needs to be considered is that financial intermediaries are reluctant to disclose the details of their margins for confidentiality reasons (Bendict, 2011:176; Kerrigan, 2010:5). Auerbach and Gordan (2002) mention that taxing financial services under the VAT seems to be easy in theory, but is problematic in a real-life situation.

4.8.4 The problems and issues of exempting financial services under the VAT

Due to the concerns raised above, financial services are either fully taxed, zero-rated or exempted under the VAT (Gendron, 2008:495). Exemption is the most applied alternative. Most countries apply exemption to financial services in absence of other workable, practical and cost-effective alternatives (Barreix, Bes & Roza, 2011:16; De la Feira & Walpole, 2009:898). The exemption of financial services is the source of most of the controversy around taxing financial services under the VAT.

4.9 THE IMPORTANCE OF TAXING FINANCIAL SERVICES UNDER THE VAT

The importance of taxing the financial sector (of which most revenue is contributed by the rendering of financial services) cannot be understated. According to the IMF and OECD (2009:1-2), the taxing of the financial sector is important due to the following reasons:

- Financial sectors form a significant part of economies. Not taxing them or not taxing them adequately relates to major revenue leakage to governments.
- There is strong evidence that there is a link between well-functioning financial sectors and economic, social and political stability. An ill-constructed tax system can impede on the workings of financial sectors, which can lead to economic, social and political instability.
- Financial sectors play an important role in developing economies, as they assist in widening the tax net in these informal economies.
- Taxing financial sectors can decrease the bias toward debt financing. The 2008 financial crisis could have been avoided if levels of debt were lower.

4.10 TAXATION OF FINANCIAL SERVICES UNDER THE VAT – A WORLDWIDE PERSPECTIVE

4.10.1 Taxation of financial services under GST in Australia

Australia implemented a VAT called Goods and Sales Tax. (Gendron, 2008:501). Australia uses a hybrid approach to taxing financial services under GST. This approach entails that all explicit fees are taxable under GST, but implicit fees are exempt from GST (Gendron, 2008:505). Short-term insurance is taxable under GST, but not long-term insurance (life insurance). Australian authorities acknowledged the distortions caused by exempting financial services under GST and implemented the partial-input GST recovery system in order to decrease self-supply bias and level the playing field between the smaller and larger financial intermediaries as it is easier for larger financial intermediaries to self-supply (Benedict, 2011:180). The partial-input GST recovery system allows Australian intermediaries to claim back 75% of GST paid on certain goods and services procured externally (Gendron, 2008:501). Australian intermediaries thus don't have the compliance burden of apportionment of input credits between taxable and exempt. A fixed apportionment rate of 75% is used. Singapore uses a similar approach. This method is viewed as a step in the right direction, but is criticised for reducing the distortions, but not removing them (Firth & McKenzie, 2012:27). Australian financial intermediaries and consumers are relieved of some of the distortions caused by implementing the GST input recovery system.

4.10.2 Taxation of financial services under GST in Canada

Canada levies GST on consumption. The Canadian scenario is unique in the sense that it has both provincial and federal GST. Some of the provinces have harmonised it into one tax called Harmonised Sales Tax (hereafter HST), while others separate them, like Quebec. Quebec's provincial GST is called Quebec Sales Tax (hereafter QST). (Purohit, 2001:311-312). Financial services are taxed differently under HST and QST, although they were originally exempt under GST (Purohit, 2011:312). Financial services are zero-rated under QST and exempted under HST (Gendron, 2008:496-497). This is an odd situation as financial intermediaries and consumers in the same country are not treated the same.

Firth and Mckenzie (2012:25) raise the issue that all types of financial services, all the financial intermediaries and all the consumers should be taxed under GST in the same consistent manner. Quebec levies other taxes that the other provinces do not levy to compensate for their loss of revenue due to zero-rating (Gendron, 2008:496). It is odd that a country does not elect to tax their citizens the same in its various provinces.

4.10.3 Taxing of financial services under the VAT in New Zealand

New Zealand is referred to as the world's best VAT model and countries are encouraged to adopt a similar model (Ebrill *et al.*, 2001:89). New Zealand's VAT model for financial services treats the business-to-business (hereafter B2B) and business-to-consumer (hereafter B2C) differently under VAT. B2B has the option to zero-rate, but it is the financial intermediary's responsibility to ensure that the other party is registered for VAT and that the other party's taxable supplies are at least 75% of the total supplies. (Gendron, 2008:501). The reason why it is optional might be so as to allow the taxpayer the option to weigh the burden of extra administration against access to input credit on services and goods procured (Benedict 2011:191). B2C financial services are exempt under VAT. (Gendron, 2008:501). Thus many distortions created by exempting financial services are eliminated for businesses in New Zealand by zero-rating B2B financial transactions under VAT.

4.10.4 Taxation of financial services under the VAT in Israel

Israel has a totally unique way of taxing financial intermediaries under the VAT. Israel levies VAT on the income/profit and payroll of the financial intermediary, with no credit for inputs on goods and services procured (Edmiston & Fox, not dated:17; Merrill & Edwards, 1996). The taxation payable is calculated on an accounts basis and not on a transaction-for-transaction basis. This is very simple to administer as interest margins do not have to be broken up into the separate services and inputs do not have to be apportioned, but the distortions that this creates is worse than exempting financial services under VAT (Merrill & Edwards, 1996). The benefits of this method are that it is easy to administer and compliance cost is less.

4.10.5 Taxation of financial services under the VAT in Japan and Italy

The subtraction method is used in both Japan and Italy. This method levies VAT on the gross income less allowable expenses. (Gendron, 2008:500; Grubert & Krever, 2012:228). The taxation payable is calculated on an accounts basis and not on a transaction-for-transaction basis. This is very simple to administer as interest margins do not have to be broken up into the separate services and inputs do not have to be apportioned

4.10.6 Taxation of financial services under the VAT in Mexico

The net operating method is used on a small scale in Mexico. The VAT is levied on net interest plus margin plus income received from other activities (Gendron, 2008:500). The VAT levied in Mexico is also different to most as it is calculated on a cash basis.

4.10.7 Taxation of financial services under the VAT in Argentina

The gross interest method is used in Argentina. VAT is levied on the gross interest. This method was introduced by the government with a dual purpose: to try to decrease debt and to raise revenue (Gendron, 2008:500). Different rates of VAT are however charged to bring some relief in certain institutions.

4.10.8 Taxation of financial services under the VAT in the European Union

The directive on VAT by the European Union (hereafter the EU) on their members exempts financial services under Article 135(1) (a) to (g) and doesn't allow input credits on goods and services procured for exempt supplies (De La Feira & Lockwood, 2010:2). Financial services rendered to an entity outside the EU are zero-rated. The directive has recently been amended to allow members of the EU the option to tax these financial services. The directive allows member to tax, but does not compel them to tax (De La Feira & Lockwood, 2010:2). The EU's VAT directive allows the member flexibility in the design of the option-to-tax-mechanism. Many of the EU members have incorporated this option in their legislation, but most only allow the option to tax financial services in B2B transactions.

4.11 ADVOCATED THEORETICAL ALTERNATIVES TO EXEMPTION OF FINANCIAL SERVICES UNDER THE VAT

4.11.1 A theory – taxation of financial services under the VAT using a cash flow method

The most advocated alternative method for the taxing of financial services under the VAT in the literature is the cash flow method. This method basically taxes all transfers of funds under the VAT. When a loan is made, VAT is levied on both the capital and the interest payment (Poddar & English, 1997:89-111; Merrill & Edwards, 1996). The VAT is basically levied on the gross cash flows. The cash flow method is only a theory at this point in time as no country has adopted it. The literature on the cash flow method dates back many years, but the theory that relates to its workings is still exactly the same.

The use of the cash flow method as originally theorised had the following advantages (Poddar & English, 1997:97-98):

- Time value of money can be ignored in the calculations. The interest margin does not need to be split in its different components.
- It fully removes the effect of tax cascading.
- The destination principle is not compromised by this method.
- It is fully compatible with the credit invoice method.

The use of the cash flow method as originally theorised had the following disadvantages (Poddar & English, 1997:98):

- It has an effective tax rate change when the method is adopted.
- Larger finance is required for loans as the VAT added to the capital of loan must also be financed.
- Compliance will be difficult and costly for small and medium businesses.

The disadvantage regarding the extra additional financing as mentioned above led to the theory being developed even more to cater for this unwanted complication. The cash flow method with tax calculation account was proposed where VAT on the capital portions are deferred to a suspense account and applied when the capital is repaid (Poddar & English, 1997:99).

The cash flow method with a taxation calculation account requires complicated calculation which places an unfair administrative burden on small businesses. This led to the theory being developed even further to address this complication, and the truncated cash flow method with calculation account was theorised. Using this method, it is envisaged that the financial intermediary will be responsible for doing all the calculations – relieving smaller companies of this administrative burden (Poddar & English, 1997:107). There is also a method called full invoicing, which predates the cash flow method, but is in essence exactly the same. (Gendron, 2008:500).

4.11.2 A theory – taxation of financial services under the VAT using a reverse charged method

The reverse charged method is another alternative where VAT is levied on the complete interest margin, but the financial intermediary is allowed to claim a notional input on the service rendered. Typically, the financial intermediary will invoice itself for notional input VAT (Grubert & Krever, 2012:228-229). This is very similar to the notional input that can be claimed on the purchase of second-hand goods in certain circumstances in South Africa. This method is only a theory at this point in time as no country has adopted it, but it is in essence very similar to the partial input recovery system.

4.11.3 Financial Transaction Tax as an alternative to taxing financial services under the VAT

Financial Transaction Tax (hereafter FTT) is a tax that is levied on a specific financial transaction. It dates back quite a long time and examples of it are security transaction tax and stamp duty (Shaviro, 2012:3). Quebec (a province in Canada) is an example that has zero-rated financial services under the VAT, but levies FTT to compensate for the loss in

revenue (Gendron, 2008:496). South Africa has adopted securities transfer tax as from July 2008, which will also constitute an FTT.

The main difference between VAT and FTT is the following: FTT levies tax on the gross amount as opposed to VAT, which effectively levies the tax on the net amount due to the working of the input VAT credit. One of the main disadvantages of FTT is that it causes double taxation. Consider the example of somebody buying a share, FTT being levied thereon and that person sells the FTT for the same price that it was bought. FTT will apply on the second sale as well, although no value was added (Shaviro, 2012:6). FTT also causes a cascading effect if levied in a B2B transaction as it is an irrecoverable expense (Shaviro, 2012:6). On the positive side, FTT may reduce short-term speculation as it will become expensive with the tax levied per transaction.

FTTs are outside the scope of this study, but can be considered as a simple and cost-effective method to tax financial services.

4.12 TAXATION OF FINANCIAL SERVICES UNDER VAT IN SOUTH AFRICA

4.12.1 Overview of the type of VAT implemented in South Africa

VAT has been levied in South Africa since 1991. Before 1991, sales tax was levied. VAT was originally levied at 10%, but has been levied at 14% since 1993 (Stigling *et al.*, 2012:1017). The VAT levied in South Africa is best described as a Credit Invoice Method tax, calculated on a transaction-by-transaction basis with invoices that reflect the VAT as supporting documents for the transaction and tax. The VAT in South Africa typically zero-rates exports, fuel and basic foods and exempts financial services, passenger transport, government activities and education (this just to highlight the main principles). The supply of services that are not zero-rated or exempt is taxed at the standard rate.

VAT is levied under the Value-Added Tax Act (89/1991) and administered by the South African Revenue Services (hereafter SARS)

4.12.2 The importance of VAT in South Africa and taxing the financial sector in South Africa

The importance of taxing the financial sector of South Africa appropriately is validated by the 2012 tax statistics on SARS's website. VAT comprised 25,7% of South Africa's total tax revenue collected, and 32,3% of VAT collected was collected from the financial sector.

4.12.3 Overview of the law applicable on VAT on financial services in South Africa

According to Section 12(a) of the ACT, financial services are exempt from VAT if not zero-rated as per Section 11. The items that are deemed financial services are listed in Section 2(1). The following are included in financial services as per Section 2(1):

- **Section 2(1)(a)** – Exchange of currency
- **Section 2(1)(b)** – Payment or transfer of ownership of a cheque or letter of credit
- **Section 2(1)(c)** – Transfer of ownership of equity
- **Section 2(1)(d)** – Issue of debt security
- **Section 2(1)(f)** – Provision of credit and the interest thereon
- **Section 2(1)(i)** – Transfer of ownership of a long-term insurance policy
- **Section 2(1)(j)** – Transfer of ownership in a superannuation scheme
- **Section 2(1)(k)** – Buying or selling derivatives

Section 2(1)(f) is the centre of this proposed study. Section 2(1) also has a proviso that states that the activities of paragraphs (a), (b), (c), (d) and (f) will not be deemed to be financial services to the extent that the consideration is payable in respect of any fee, commission, merchant's discount or similar charge. This proviso also indicates that discounted costs are indeed deemed to be a financial service.

4.12.4 Broad description of the taxation of financial services under VAT in South Africa

South Africa is one of few countries with a hybrid-type approach to taxing financial services under VAT (Gendron, 2008:501). This approach entails that all the services deemed to be financial services as per Section 2(1) of the ACT are exempt under VAT (unless zero-rated by Section 11) and all fee-based services are taxed under VAT as per Section 7(1)(a). These fee-based services that are referred to include the explicit fees that relate to deemed financial services. In South Africa, short-term insurance is taxable under VAT, but long-term insurance is exempt. The South African VAT system follows the practice applied internationally, whereby a vendor that supplies taxable and exempt supplies must apportion their input tax credits and can only claim an input tax credit as far as it relates to taxable supplies.

4.12.5 Other sections of the ACT having an effect on the taxation of financial services under VAT

Other sections of the ACT that also closely relate to financial services and VAT are sections 8(15) and 10(22). Section 8(15) deems a single supply, that if separate considerations had been payable would have been charged part under Section 7(1)(a) and part under Section 11, to be separate supplies. Section 10(22) relates to dual supplies – simply put, this is when a consideration consists of a taxable and exempt supply. According to Section 10(22), the consideration needs to be apportioned to each component it relates to.

4.12.6 Problems associated with taxing of financial services under VAT in South Africa

Due to many financial services being exempt under VAT, South African consumers and financial intermediaries suffer under the distortions as listed in Section 4.7.

Section 2(1)(f) of the Act and interest margins refer. Many South African financial intermediaries opt to charge a single interest margin for a bundle of financial services and thus effectively render one exempt supply, although there might have been services included in the interest margin that are taxable under Section 7(1)(a) of the Act. It could be argued that this contravenes Section 8(15) and Section 10(22) of the Act that clearly states

that with more than one supply (taxable, zero-rated and exempt) included in the consideration, the consideration must be apportioned. There have been instances of case law regarding this. In *SARS vs British Airways*, 2005 (4) SA 231 (SCA) (67 SATC 167), SARS tried to rely on Section 8(15) to tax components included in the consideration (which were zero-rated as it was an international flight) under Section 7(1)(a) since they were rendered in South Africa. In this case, it was held that the component that SARS attempted to tax under Section 7(1)(a) was merely the recovery of a cost that British Airways incurred. Since it was a recovery of a cost, the following was held: “A ‘single supply of services’ is only capable of notional separations into its component parts, as contemplated by this section, if the same vendor supplies more than one service, each of which had it been supplied separately, would have attracted a different tax rate.”

Since zero-rating takes preference over exemption according to Section 12(a), a service supplied in terms of Section 11(2)(l) (many zero-rated services only selected this one as an example) will be zero-rated even if it is deemed a financial service as listed in Section 2(1). This effectively gives the service provider access to the input VAT paid on the goods and services procured to render this service since although VAT is charged at 0%, it is still a taxable supply. It is just odd that a service provider will be taxed differently under VAT for rendering a service to a South African resident as opposed to a non-resident.

4.13 FINANCIAL SERVICES LINKED TO CREDIT CARDS IN SOUTH AFRICA AS A FINANCIAL SERVICE UNDER VAT

4.13.1 The South African credit card landscape

Credit cards in South Africa are mainly provided by the four big banks: ABSA, First National Bank, Nedbank and Standard Bank. Different credit cards are provided to suit each individual's needs. These include but are not limited to: student cards, affinity cards, garage cards and transaction cards. The credit cards offerings are also tailored specifically to suit the income level of the individual. Credit cards are a very popular payment method in South Africa as individuals don't have to take the risk of carrying cash on their person.

4.13.2 Taxation of financial services linked to credit cards under VAT in South Africa

Credit cards users in South Africa will typically be charged interest for credit granted and fees for sundry services rendered. Although the interest charged might include other services due to bundling, it is an exempt supply in terms of section 2(1)(f) of the Act. The fees charged for sundry services are considered a standard supply as per the proviso of Section 2(1) of the Act.

4.14 CONCLUSION

No literature could be found on the VAT on financial services relating to credit cards. This highlights the importance of this research problem as no study has specifically been conducted in this context. Although the literature review was based on the VAT and financial services in a more broad sense, the information is still very relevant to the taxation of financial services related to credit cards under the VAT. It is clear that no one method exists that will eliminate all the distortions caused by exempting financial services under VAT, but by eliminating them one by one, the distortions could be reduced to the point that they will not be significant anymore.

The authors all agree that the exemption of financial services under the VAT is currently a matter of necessity in the absence of other workable alternatives. These distortions caused by exemption of financial services under the VAT are a reality and influence financial intermediaries and consumers. Some alternatives exist and it might only be a case of altering them a bit or combining them to solve this problem and to ensure that the VAT remains neutral in the rendering of financial services and does not cause distortions.

As no literature is available on the treatment of financial services relating to credit cards in South Africa, the four big banks' websites were perused and an anonymous semi-structured interview with one of the four big banks in South Africa was conducted. This shed more light on the challenges facing financial intermediaries in a South African context with special reference to the distortions caused by exempting supplies under the VAT, compliance costs, and possible alternatives.

CHAPTER 5

RESEARCH DESIGN AND METHODS

This study is an extended review of literature. A review of literature is essential for gaining a good understanding of the subject. This is due to the study of current theories, definitions, debates and previous studies and their results. Literature reviews are considered as inductive reasoning (Mouton, 2001:179-180).

Although a lot of literature is available on the VAT and financial services in general – none could be found on the VAT and financial services specifically regarding credit cards. Additional information was collected via the websites of the four big banks in South Africa and via an anonymous semi-structured interview with one of the four big banks in South Africa. A semi-structured interview was appropriate as additional information was acquired and the flexible design allowed the researcher to explore questions as they arose, which may not have been included in the original data collection instrument.

This study is a non-empirical study since no new data has been collected or analysed. Information is collected via a review of literature, the Internet and via an anonymous semi-structured interview, although it should be noted that this information was not collected with any intention of providing statistical inferences.

CHAPTER 6

THE SOUTH AFRICAN LANDSCAPE IN TERMS OF FINANCIAL SERVICES LINKED TO CREDIT CARDS AND THEIR TREATMENT UNDER VAT

6.1 DIFFERENT FINANCIAL SERVICES RENDERED BY SOUTH AFRICAN BIG BANKS FOR CREDIT CARDS UNDER VAT

6.1.1 Collecting information on financial services rendered by credit card companies

Since there is no literature available on the financial services rendered by credit card companies in South Africa, it was decided to peruse the websites of its four big banks and explore their credit card offerings to identify their different financial services. The purpose of this is not to compare the different banks, in order to determine who has the best offerings, but to try and identify the different financial services rendered by them. It is acknowledged that these offering/financial services rendered might not be comprehensive, but it is believed that it will provide guidance on the different types of financial services rendered. The listed offerings/financial services will typically not be available for all the different credit cards for that bank. When a financial service is indicated as free, it is merely to illustrate that the financial services are bundled and not to indicate that the offering is better than that of another bank. Detailed descriptions of the services are not provided as most are familiar with banks' terminologies. The offerings of the different banks are listed in alphabetical order.

6.1.2 Credit card offerings – ABSA

The following service offerings were identified on ABSA's website:

- payment for petrol, oil, services and tollgates with a garage card
- linking of garage card to other cards

- secondary cards to family members
- free lost card protection
- detailed monthly statements
- free monthly e-statements
- 57 days interest free on qualifying purchases
- free monthly service fee
- free purchases with card
- interest on positive balances
- surplus funds may be deposited into cards
- accepted worldwide
- free basis travel insurance with option to top up cover
- credit protection plan – death, disability and retrenchment
- 24/7 Absa Online (Internet banking), cellphone banking and telephone banking.
- secure online shopping with SecureCode
- Automatic Teller Machine (hereafter ATM) functionality worldwide
- budget facility. functionality to set amount for revolving and budget
- combi facility (link credit card to other account)
- enhanced security with chip and pin technology
- fixed monthly payments facility
- choice between Master and Visa
- expert advice and assistance
- purchase protection
- extended retailers warranty
- ABSA rewards

6.1.3 Credit card offerings – First National Bank

The following service offerings were identified on First National Bank's website:

- eBucks rewards
- free unlimited swipes
- inContact (notification via emails and sms)
- Decline in Contact (notification for reason of decline)
- free online banking
- free cellphone banking
- free telephone banking
- automatic debt protection
- personalised interest rates
- 55 days interest free on qualifying purchases
- comprehensive global insurance
- auto payment option (to pay credit card automatically every month)
- balance transfer option (debt consolidation).o
- lost card protection
- budget facility
- free card delivery
- Automobile Association emergency roadside assistance
- free bank application
- promotions via Visa
- accident death plan
- access to slow lounges at airports to relax prior to flights
- wealth management to private clients
- access to financial specialists
- private clients life application

6.1.4 Credit card offerings – Nedbank

The following service offerings were identified on Nedbank's website:

- access to BIDAir's Premier Domestic Airport Lounges to relax prior to flights
- automatic travel insurance, local and international
- detailed monthly paper or electronic statements
- free SMS notification system
- balance protection plan for death, disability, critical illness or retrenchment
- 55 days interests free on qualifying purchases
- budget facility
- worldwide acceptance
- secondary cards
- face-to-face delivery
- Greenbacks rewards
- interest earned on positive balances
- balance transfer option (debt consolidation)
- no transaction fees on purchases
- ATM functionality, local and international
- automatic payment option (to pay credit card automatically every month)

6.1.5 Credit card offerings – Standard Bank

The following service offerings were identified on Standard Bank's website:

- free secure Internet shopping
- free secondary cards
- basic automatic travel insurance. additional insurance available at a fee
- free emergency replacement card outside South Africa
- ATM functionality
- 55 days interest free on qualifying purchases
- budget facility, revolving and budget facility flexibility
- Avios rewards

- free 24-hour lost card protection
- automatic payment options (pays credit card automatically every month)
- free Internet banking
- emergency services
- secondary garage cards
- access to promotions
- automatic bill payment (pays bills automatically every month)
- credit protection plan
- accident and health insurance

6.1.6 Summary

It is clear from the above that the banks in South Africa all provide very similar financial services. The words “free” and “no fees” appear often in sections 6.1.2 and 6.1.5. This confirms that many services are bundled and not all financial services are charged on a transaction-to-transaction basis. The bundling of transactions has lately been taken to a whole new level. Banks now offer bundles of services. With these offerings, a fixed fee per month is payable that includes a cheque account, credit card, savings account and investments. This usually also includes the transactions on these accounts/products. The client only receives one charge per month, unless a service was rendered that is not included in the bundle. These bundles however include most of the services and it’ is not often that a service is rendered that is not included in these bundles. Another feature of these bundles is that if you maintain a certain balance on your cheque account during the month, only 50% of the fee is charged. This is an example of substituting a fee-based charge (the 50% discount granted for maintaining a balance) by offsetting interest payable on a positive balance against it. The fee-based charge fee will be a taxable supply as opposed to interest that is an exempt supply.

The table below illustrate the different services rendered by credit card providers:

Table 2: Different financial services rendered by credit card providers

Service grouping	Financial services rendered
Granting credit	<ul style="list-style-type: none"> • Assessing creditworthiness of applicants

Service grouping	Financial services rendered
	and related administration <ul style="list-style-type: none"> • Making a credit facility available • Making an extended facility available in the form of a budget facility • Flexibility to allocate facility between revolving and budget facility • Debt consolidation products • Interest received on outstanding balances
Safekeeping	<ul style="list-style-type: none"> • Taking deposits and deposit fees • Safekeeping of liquid funds • Interest payable on positive balances
Card issuing	<ul style="list-style-type: none"> • Administration in signing on new clients • Providing primary and secondary cards • Card delivery • Enhanced security on cards (chip and pin)
General record keeping	<ul style="list-style-type: none"> • Notifications on transactions via SMS, email and fax • Detailed monthly statements, paper-based and in electronic format
Transacting	<ul style="list-style-type: none"> • Payments. local and international • extended warranty on purchases • Internet banking • cellphone banking • telephone banking • secure online shopping • Combi facilities, linking of accounts • fixed monthly payments • automatic payment options
Insurance	<ul style="list-style-type: none"> • outstanding balance protection • purchase protection • lost card protection • travel insurance, local and international • Accident and health insurance
Reward programmes	<ul style="list-style-type: none"> • Points awarded to convert into purchases • Cash back • Access to exclusive promotions
Leisure	<ul style="list-style-type: none"> • Access to luxury lounges at airports
Personalised services	<ul style="list-style-type: none"> • Access to expert advice • Wealth management

Source This table was compiled from the information gathered in sections 6.1.2 to 6.1.5.

6.2 ANONYMOUS SEMI-STRUCTURED INTERVIEW WITH ONE OF THE LARGE BANKS IN SOUTH AFRICA

6.2.1 Assessment of competence of the participant

An anonymous semi-structured interview was conducted with the head of indirect taxation of one of the large banks in South Africa. The purpose of the interview was to gain more information on the treatment of financial services relating to credit cards under VAT in a South African context.

General questions regarding VAT and financial services in South Africa were directed to the participant. The participant answered all the questions correctly. This is indicative of the participant being competent in terms of VAT and financial services in South Africa.

6.2.2 Current treatment of financial services linked to credit cards under VAT by this bank

The participant described his employer's treatment of the financial services relating to credit cards under VAT and it can be summarised as follows:

- Local interest received is considered to be exempt supplies, and foreign interest received zero-rated supplies.
- Fee-based charges are standard supplies.
- Inputs that are directly attributable to taxable supplies are claimed as input credits in full. Inputs not directly attributable to taxable supplies are allocated to one pot that is apportioned according to the ratio of taxable supplies to exempt supplies.
- The portion of the pot that relates to taxable supplies is claimed as an input credit, but the portion that relates to exempt supplies is debited to the income statement for expenses and added to property, plant and equipment for fixed assets.
- VAT is levied on imported services as far as they relate to exempt supplies.

The treatment of financial services linked to credit cards under VAT by the participant's employer is consistent with the general overview of the South African treatment as described in sections 4.12.3 and 4.12.4.

6.2.3 Participant's opinion on whether South Africa should tax interest under VAT

The participant indicated that he agrees with the current treatment of exempting interest under VAT in principle, but would welcome simplified administration (referring to apportionment). The idea of charging VAT on interest received is impractical to him as many individuals (especially pensioners) rely solely on interest income, and individuals are usually not registered for VAT.

6.2.4 The apportionment process in more detail

The participant explained the apportionment process in more detail. This process can be summarised as follows:

- The Banking Association of South Africa applies for a binding ruling on the apportionment percentage on behalf of all South African banks once a year.
- The apportionment percentage in this binding ruling is then applied by all banks for the year it pertains to.
- The binding ruling is usually issued in March. The previous year's apportionment percentage is used from January to March. In April, the input apportionment for the period January to March is recalculated, based on the new binding ruling's apportionment percentage, and an adjustment is made for the difference.

The calculations used in the binding ruling are extremely complicated and some of its core characteristics are:

- Total exempt supplies are calculated on a net basis. Interest paid is deducted from exempt interest received.
- Other exempt supplies comprise: certain dividends received, shares sold, debentures and profits and losses on financial instruments. The profits and losses on financial instruments are the biggest contributor to total exempt supplies next to net exempt interest received.
- Instalment sale agreements are excluded from these calculations. Instalment sale agreements are taxable supplies under VAT, but since the assets are purchased and sold (referring to the assets that are financed) at the same price, including instalment

sale agreements, they will only distort the ration between the taxable and exempt supplies.

According to the participant, apportionment leads to complicated calculations and an increased administrative burden on entities that are generating taxable and exempt supplies. This view is shared by the literature on this subject (Ebrill *et al.*, 2001:88; Firth & Mckenzie, 2012:19; Gendron, 2008:499).

On the subject of apportionment, the participant further stressed that the design of their accounting system is of the utmost importance. The reason for this is that the system must be able to compile the information in specific formats to enable the bank to do the necessary calculations.

6.2.5 Problems (distortions) caused by exemption of financial services under VAT highlighted by participant

According to the participant most of the problems caused by exemption relate to the additional compliance cost and the administrative burden that apportionment puts on entities generating both taxable and exempt supplies. These problems include:

- The compliance cost is high. The indirect tax department of which the participant is the head consists of six people. Four of these six (66.67%) employees are occupied full time, with administration and compliance relating to apportionment. The salaries and relating costs of these employees are a compliance cost to this bank.
- The design of the accounting system is of the utmost importance when compiling the information in specific formats as required (refer to Section 6.2.4). The apportionment calculation should preferably be done on an account-level basis, as opposed to a transaction-to-transaction basis.
- The recalculation of the apportioned input VAT, due to the difference between the previous year's apportionment percentage and that of the current year, is a major administrative burden (refer to Section 6.2.4). This matter is further complicated by the difference between the treatment of transactions for normal tax, VAT and accounting purposes. This results in the inability to do some of the recalculations on an account-level basis and they must be done on a transaction-to-transaction basis.

The trapped VAT has become a major source of revenue for the government. The participant stated: “Government will be reluctant to change the legislation as trapped VAT has become a major source of revenue for them. More than a billion Rand of VAT was trapped last year.” Kerigan (2012:2) shares this view of the participant.

The participant raised the concern that some of the smaller banks might not be in a position to have dedicated indirect tax departments and skills at their disposal. They will probably have to procure these services from tax consultants. This gives the smaller banks a slight disadvantage over the bigger ones. Stitt (2011:195) came to the same conclusion.

6.2.6 Response of participant on pricing decisions

The participant indicated that VAT does not play a major role in pricing decisions, except in the case of large corporate transactions, where it might be considered. Pricing decisions are mostly influenced by market trends and the offerings of the other banks. Pricing is a business decision. The competition among the four largest banks in South Africa is fierce. This is confirmed by the findings in Section 6.1.6. The offerings of the four largest banks are very similar. This is indicative of fierce competition among them. Competition is so fierce that certain fees will be sacrificed to be more competitive. If the margin on a product becomes too low due to competition, cost-saving strategies are implemented to make up for the fees that are sacrificed.

The participant explained that most of the costs that seem to be implicit charges (not specifically charged and included in the interest margin) are included in fees like the annual fee or monthly fee of the card. The possibility of substituting exempt supplies with taxable supplies to gain access to more input credits due to an improved apportionment rate was discussed. The participant explained that to do this, unbundling of all the different financial services must first take place. The treatment of different financial transactions on a transaction-to-transaction-basis is not considered practical by the participant. The different fees that are not charged explicitly are included in other taxable supplies, like the annual fees. It is not practice to substitute exempt supplies for taxable, or vice versa. The exempt supplies and the taxable supplies also typically do not cross-subsidise each other.

A taxable supply is replaced with another taxable supply and exempt supplies are replaced by other exempt supplies. Alternatively, the revenue is sacrificed and cost-saving strategies are implemented to make up for the revenue that is sacrificed.

The participant stated that although substituting exempt supplies for taxable supplies will make the VAT more neutral for his employer, it will increase prices for non-vendors as they will now pay VAT on the final-stage supply (and will not be allowed an input credit as they are not vendors), as opposed to the input tax denied at an earlier stage that will be included in the cost of the service. It seems that the concern that Edmiston and Fox, (not dated:14) raised that entities will be tempted to substitute exempt supplies with taxable to gain access to a larger portion of the inputs, will not materialise in a South African context specifically on credit cards as the fierce competition in the market will not allow increases in fees to the consumer. These increases will be in the form of non-recoverable VAT charged on the services rendered by credit card companies to consumers.

A major influence on pricing decisions is the National Credit Act (hereafter NCA). The NCA has very prescriptive rules on what can and what cannot be charged, as well as on some rules as to how it must be charged. Compliance to the NCA is enforced by the National Credit Advisor.

6.2.7 Financial services rendered by credit card division

The participant explained that the bulk of revenue generated from financial services on credit cards are from interest received, merchant discounts and interchange fees.

Interest is typically charged on purchases not paid within a certain period. Interest is an exempt supply as per Section 2(1)(f) of the act.

The majority of the revenue generated by credit cards are merchant discounts and interchange fees. Payment by credit card is usually free to the credit holder. The retailer settlement is however less a certain percentage. This percentage is negotiated between the bank and the retailer and is usually between 1% and 2%. This short settlement is kept by the bank as their merchant fee. A merchant fee is a taxable supply under VAT and is

considered to be inclusive of VAT. Merchant discounts are a taxable supply under the proviso of Section 2(1) of the Act.

The interchange fee is charged between banks if cards are accepted for payment from another bank than the one owing the point of sale. Thus if a purchase is done by a credit card, and the credit card company and the point of sale is the same company, then there are no interchange fees applicable. Interchange fees are taxable supplies under VAT and fall under the proviso of Section 2(1) of the Act.

6.2.8 Insurance transactions

There are options for insuring the outstanding balance on a credit card if certain events happen. The participant explained that these insurance fees usually have an agent and principle relation. The bank is the agent and the insurer the principle. These fees are collected on behalf of the insurer and the insurer is responsible for accounting for the output VAT on these fees. There are no VAT implications on the bank.

6.2.9 Alternative treatment suggested

The participant indicated that the current treatment of financial services under VAT exposes him and his employer to major risks. These risks include: fraud, manipulation and huge compliance costs (penalties and interest on non-compliance). He proposes a system similar to the partial GST input recovery of Australia. Using this method, a fixed apportionment percentage is applied on goods and services procured that are not directly attributed to taxable supplies. The participant suggested that instead of allowing a fixed percentage as input credit (75% in Australia) for all industries, an industry-specific rate can be legislated. This simplified apportionment method will relieve the companies in South Africa of huge administrative burdens and compliance costs. Apportionment rates will not need to be calculated anymore and no requirement for binding rulings and adjustments after binding rulings are granted will be necessary. This will also be beneficial to SARS as part of their compliance checks are audits and this simplified method should decrease the number of audits required. It should also decrease their administrative costs.

6.2.10 Conclusion

Herewith a summary of the most important findings of the semi-structured interview:

- **Current treatment** – Participant agrees with exemption, but calls for simplified administration.
- **Apportionment** – Most of the literature refers to the administrative burden that apportionment places on individuals and entities, but it is only when you discuss it with someone dealing with it on a daily basis that you really get an understanding of the huge burden this puts on individuals that are responsible for the relating administration.
- **Compliance cost** – The compliance cost relating to exempting supplies and the apportionment of input VAT credits that follows, is significant. 66.67% of the indirect tax employees are occupied with the administration relating to apportionment. Designing the accounting system to cater for the information required is also a significant compliance cost.
- **Input VAT denied as credits** – The VAT that is trapped and input-taxed is significant – it exceeds a billion Rand for the participant's employer per annum.
- **Pricing decisions and how financial transactions are bundled** – VAT does not play a significant part in pricing decisions. Market conditions and competition among banks are the main factors that are influencing pricing decisions. This is confirmed with the finding as per Section 6.1.6. The analysis of the banks' offerings on credit cards is very similar. Financial services are bundled, but fees (taxable supplies) are bundled together with other fees (taxable supplies) and interest (exempt supplies) with other interest (exempt supplies). Exempt supplies are not substituted with taxable supplies or vice versa.
- **Unbundling financial transactions** – Regarding the unbundling of the financial services rendered to credit card customers: billing them on a transaction-to-transaction basis is impractical. This is due to administrative challenges and current market conditions with reference to the fierce competition in this market.
- **Most significant revenues earned** – Interest received, merchant discounts and interchange fees comprise the major component of revenues earned for the credit card department.

- **Proposal** – The participant proposes a partial input credit system that is similar to Australia's, with legislated apportionment rates per industry. This is mainly due to the simplified administration that accompanies this method.

6.3 TREATMENT OF THE FINANCIAL SERVICES RENDERED ON CREDIT CARDS UNDER VAT IN TERMS OF SECTIONS 8(15) AND 10(22) OF THE ACT

6.3.1 Financial services rendered on credit cards and Section 8(15) of the Act

Section 8(15) of the Act relates to rendering a supply (consisting of more than one supply) and if separate considerations have been payable, a part would have been charged under Section 7(1)(a) and another part under Section 11. Sections 7(1)(a) and 11 are both taxable supplies, but Section 7(1)(a) levies VAT at 14%, whereas Section 11 levies VAT at 0%. It is unlikely that a financial intermediary would combine such a charge on a credit card. Zero-rating is applicable to the export of goods or rendering of services outside South Africa or rendering of services to non-residents. This situation is highly unlikely due to the fact that if a credit card is supplied to someone in another country and the annual fee and the interest payable is combined in one charge - it will not be problematic as the interest will be zero-rated as per Section 12(a) and the annual fee will be zero-rated as well. Interest will be zero-rated since zero-rating overrides exemption as per 12(a). This however provides some guidance in that the legislator guides vendors to separate a charge should it comprise different supplies that are charged at different rates under VAT.

6.3.2 Financial services rendered on credit cards and Section 10(22) of the Act

Section 10(22) is applicable to the taxing of financial services that are linked to credit cards under VAT. This section refers to dual supplies. A dual supply is a consideration that comprises both taxable and exempt supplies. Section 10(22) states that the consideration received must be properly attributed to taxable and exempt supplies. This refers to a situation where a credit card company will charge only interest to the customers and all the fee-based charges are included in the interest spread. The bank where the semi-structured interview was conducted, does not combine fee-based charges (explicit charges) with the interest received (implicit charges), nor does it substitute the one for the

other with reference to Section 6.2.6. It is clear from the law that should banks or financial intermediaries in South Africa render dual supplies, those vendors will be responsible for separating the components relating to taxable supplies and exempt supplies.

CHAPTER 7

PROPOSALS FOR TREATING FINANCIAL SERVICES LINKED TO CREDIT CARDS UNDER VAT

7.1 INTRODUCTION

Various alternative methods for the treatment of financial services linked to credit cards under VAT were identified. Although FTTs might be a viable option for taxing financial services, it is not a VAT and falls outside the scope of this study. The different methods all have their own advantages and disadvantages. It is clear that no perfect solution to this problem has been identified as many countries would have adopted it by now.

7.2 VARIOUS ALTERNATIVES FOR TAXING FINANCIAL SERVICES LINKED TO CREDIT CARDS UNDER VAT

The following alternative methods for the treatment of financial services linked to credit cards under VAT were identified:

Table 3: Various methods identified

Method	Theoretical/Implemented	Country implemented
Exemption	Implemented	Most countries with a VAT
Exempting implicit fees and taxing fee-based charges	Implemented	South Africa
Addition type VAT	Implemented	Israel
Subtraction type VAT	Implemented	Italy and Japan
Partial Input Recovery System	Implemented	Australia and Singapore
Zero-rating	Implemented	Canada
Option to zero-rate B2B transactions and exemption of B2C transactions	Implemented	New Zealand
Option to tax B2B transactions and exemption of B2C transactions	Implemented	Many of the EU members
Net operating method	Implemented	Mexico
Gross interest method	Implemented	Argentina
Cash flow method	Theoretical	Not applicable
Reverse charge method	Theoretical	Not applicable
Tax-explicit and -implicit fees. tax-implicit fees at a lower rate of VAT, full taxation	Theoretical	Not applicable

Source This table was compiled using the information gathered in sections 4.10 and 4.11.

7.3 ADVANTAGES AND DISADVANTAGES OF ALTERNATIVE METHODS OF TAXING FINANCIAL SERVICES UNDER VAT

The various alternatives all have advantages and disadvantages. The table below highlights some of them.

Table 4: Advantages and disadvantages of alternative methods

Method	Advantages	Disadvantages
Exemption	<ul style="list-style-type: none"> • Method useful to tax small traders, input-taxed • Preferred method around the world • Trapped input VAT major source of revenue to governments • No need to separate implicit charges on a transaction-to-transaction basis • Compatible with preferred invoice credit method of VAT 	<ul style="list-style-type: none"> • Tax cascading caused by denied input tax credits • Input tax trapped becomes expense to entity • Rendering taxable and exempt supplies causes apportionment burden to entity • Not neutral, entity rendering service taxed instead of final consumer • Refer to Section 4.7 for detail on distortions caused by exempting.
Exempting implicit fees and taxing fee-based charges	<ul style="list-style-type: none"> • Taxing fee-based charges remove some tax cascading and restore some neutrality. • The rest are the same as exemption. 	<ul style="list-style-type: none"> • Same as exemption, but less tax cascading and more neutrality due to fee-based charges that are taxed
Addition type VAT	<ul style="list-style-type: none"> • Calculation at account level • No need to try to separate implicit and explicit charges • Simplified calculation 	<ul style="list-style-type: none"> • Audit trail does not consist of invoices that reflect VAT charges. • Not suitable for multiple VAT rates. Zero-rated supplies can be charged at 0% under invoice credit method, but with the addition type it needs to be omitted. • Usually taxes consumption at origin as opposed to place of consumption
Subtraction-type VAT	<ul style="list-style-type: none"> • Calculation at an account level 	<ul style="list-style-type: none"> • Audit trail does not consist of invoices that

Method	Advantages	Disadvantages
	<ul style="list-style-type: none"> • No need to try to separate implicit and explicit charges • Simplified calculation 	<p>reflect VAT charges.</p> <ul style="list-style-type: none"> • Not suitable for multiple VAT rates. Zero-rated supplies can be charged at 0% under invoice credit method, but with the addition type it needs to be omitted. • Usually taxes consumption at origin as opposed to place of consumption
Partial Input Recovery System	<ul style="list-style-type: none"> • More simple to administer • Fixed apportionment rate – no complicated calculations that need to be performed to determine rate • Portion of VAT still remains trapped, source of revenue for governments • Removes a major part of tax cascading, depending on the applied rate • No need to try and separate implicit and explicit charges 	<ul style="list-style-type: none"> • Does not remove the full effect of tax cascading, depending on the applied rate • Although more simple to administer, direct attributions must still be performed, as well as apportionment of inputs not directly attributable to taxable supplies. The apportionment rate is fixed though.
Zero-rating	<ul style="list-style-type: none"> • Easy to administer • No apportionment required as only taxable supplies are rendered • Neutrality for intermediaries achieved 	<ul style="list-style-type: none"> • Less revenue generated for governments • Zero-rating can cause rising administration costs due to more refunds and the relating verification process. • Refunds may be delayed by governments that are short on financing.
Option to zero-rate B2B transactions and exemption of B2C transactions	<ul style="list-style-type: none"> • Removes tax cascading on B2B transactions • Improves neutrality • Access to VAT trapped on B2B transactions for intermediaries 	<ul style="list-style-type: none"> • B2C transactions still exempt and cause tax cascading • Still have apportionment burden and complicated administration • Zero-rating B2B transactions can cause

Method	Advantages	Disadvantages
		<p>rising administration costs due to more refunds and the relating verification process.</p> <ul style="list-style-type: none"> • Refunds may be delayed by governments that are short on financing. • Loss of revenue to governments as the VAT trapped on B2B transactions will now be allowed as input credits as zero-rated is still taxable
Option to tax B2B transactions and exemption of B2C transactions	<ul style="list-style-type: none"> • Removes tax cascading on B2B transactions • Improves neutrality • Access to VAT trapped on B2B transactions for intermediaries 	<ul style="list-style-type: none"> • B2C transactions still exempt and cause tax cascading • Still have apportionment burden and complicated administration • Loss of revenue for governments due to the VAT that is charged on B2B transactions that will be claimed back as input credits, but intermediaries' apportionment rates will improve and will be input-taxed on less inputs
Net operating method	<ul style="list-style-type: none"> • Calculation at an account level. • No need to try to separate implicit and explicit charges • Simplified calculation 	<ul style="list-style-type: none"> • Audit trail does not consist of invoices that reflect VAT charges • Not suitable for multiple VAT rates, zero-rated supplies can be charged at 0% under invoice credit method, but with the addition type it needs to be omitted
Gross interest method	<ul style="list-style-type: none"> • Simplified calculations • .Decrease demand for credit 	<ul style="list-style-type: none"> • Only applicable on interest and not all financial services
Cash flow method	<ul style="list-style-type: none"> • Removes tax cascading completely • Compatible with preferred credit-invoice-type VAT • Doesn't compromise 	<ul style="list-style-type: none"> • Complicated calculations • Huge administrative burden on either intermediaries or businesses, depending

Method	Advantages	Disadvantages
	destination principle. <ul style="list-style-type: none"> • Shortcomings can be combatted with the following variations of the cash flow method: cash flow method with tax account and truncated cash flow method with tax account • Intermediary will only remit VAT once received and not on an accrual basis 	on variation used <ul style="list-style-type: none"> • Cash flow method less harmonised with accounting and normal taxation rules, the latter is more accrual based
Reverse charge method.	<ul style="list-style-type: none"> • Removes tax cascading completely for intermediary • More simple to administer than apportionment 	<ul style="list-style-type: none"> • Decrease in revenues for government • Notional inputs difficult to understand as not used in VAT often • Financial services become more expensive to consumers, they cannot claim input credits as they are not registered for VAT, though the aim of VAT is to tax the final consumer
Tax-explicit and -implicit fees, tax-implicit fees at a lower rate of VAT, full taxation	<ul style="list-style-type: none"> • Removes tax cascading completely for intermediary • No apportionment required • Taxing of implicit fees on consumers (no input credits for consumers) might compensate for revenues lost by governments on items previously input-taxed. • It assists with the principle that VAT's base should be as broad as possible. 	<ul style="list-style-type: none"> • Decreased revenues for governments as intermediaries will now have access to their input credits • More than one VAT rate will complicate administration. • Consumers will be taxed at the final stage of the supply and financial services will be more expensive for them as they cannot claim input credits.

Source This table was compiled using the information gathered in sections 4.10 and 4.11.

7.4 PROPOSED TREATMENT OF FINANCIAL SERVICES RENDERED BY CREDIT CARD COMPANIES UNDER VAT IN SOUTH AFRICA

7.4.1 General comments

As mentioned previously, no perfect solution for this problem exists. At this point in time, alternatives that decrease the problems/distortions caused by exempting financial services under VAT should be considered.

7.4.2 Less feasible alternatives for treatment of financial services rendered by credit card companies under VAT in South Africa

The following methods for the treatment of financial services rendered by credit card companies in South Africa under VAT are not advised:

- **Full exemption of financial services under VAT and exemption of financial services with the exception of fee-based charges**

This is the method that is currently applied in South Africa. Although taxing fee-based services under VAT is a step in the right direction, many complications are still caused by exempting interest earned under Section 2(1)(f) of the Act. The findings of the semi-structured interview concluded that the administrative burden and compliance cost caused by exemption are hugely under-estimated. A further complication is that this puts the bigger banks in an advantaged position as they are better suited to self-supply than the smaller banks. Kerrigan (2012:2) and the participant of the semi-structured interview both raised this concern.

- **Addition-type VAT, subtraction-type VAT, net operating method and gross interest method**

These methods can be considered internationally to simplify calculations in countries that have not adopted a credit invoice method of VAT. This is mainly due to the method's design that performs calculations at an account-level or entity-level basis. There is no requirement to separate the implicit and explicit charges on a transaction-to-transaction basis. Although the gross interest method only focuses on interest and not on all financial services – it is already a step in the right direction as the VAT net is cast wider. These methods are not recommended for South Africa as these will not be compatible with the credit invoice method. The credit invoice method deals with

VAT at a transactional level and the reflection of the VAT on the invoices provides many benefits, including a proper audit trail. The credit invoice method is the preferred method that is adopted worldwide (Ebrill *et al.*, 2001:20). The adoption of a hybrid between the entity-based methods and credit invoice method in South Africa will not be practical. This will be a material change to the current VAT applied in South Africa.

- **Taxing or zero-rating B2B transactions and exempting B2C transactions**

These alternatives remove the tax cascading on B2B transactions. Taxing B2B financial services and zero-rating them will have the same effect. The zero-rated transaction will have access to input credits as well as the standard supply. Although the standard taxed transactions levy VAT at the applicable rate, the entity procuring the service will be allowed an input tax credit on VAT levied on the services. The design of South Africa's VAT already caters for standard supplies and zero-rated supplies, but both these methods will cause a major decrease in tax revenue to government due to the lost trapped VAT on B2B transactions. The complex administration of apportionment will still remain as the B2C transactions remain exempt under VAT. This method may cause many VAT refunds due to zero-rating B2B transactions. This in turn will put an extra administrative burden on government, with specific regard to the verification/audit costs on refunds.

- **Zero-rating financial services under VAT**

This method removes the tax cascading caused by exempting financial services under VAT. Since zero-rating is a taxable supply, the input VAT will not be trapped anymore. This will have a major impact on the revenues of governments as they will lose the input-taxed revenue and no revenues will be collected on financial services as 0% VAT will be charged on it. This method may cause many VAT refunds that would put an extra administrative burden on governments, with specific regard to the verification/audit costs on refunds.

- **Taxing financial services under VAT with the cash flow method**

This method completely removes the effects of tax cascading, but although simple in theory, it is anything but simple. Complicated variations of this method must be used to limit its shortcomings. The first variant is the cash flow method with the tax calculation account that defers the VAT on capital loan repayments to where it is repaid. The second variant is the truncated cash flow method with the tax calculation account that places the burden of performing complex calculations on financial institutions. The cash flow method is too complicated and will place a huge administration burden on especially financial institutions. The calculating of the VAT via a cash flow method will also decrease the harmony that exists between VAT, income tax and accounting rules. The latter two are designed on an accrual and not a cash flow basis. The South African VAT design caters for a cash flow VAT on smaller vendors, but the larger vendors account for VAT on the earlier of invoice date or cash received. This method is compliant with the credit invoice method of VAT as is the case with VAT in South Africa, but it seems to be too complicated and has no track record as it is only a theory.

- **Taxing financial services under VAT with the reverse charge method**

The reverse charge method will remove the tax cascading effect and should be quite simple to administer. Notional inputs are not very popular with regard to VAT and seem to be an odd concept to most as it is designed in such a way that the intermediary basically collects VAT on the revenues and inputs/expenses. The South African VAT design already caters for notional inputs as notional inputs may be claimed on the purchase of second-hand goods from a non-vendor. The notional inputs will counter the cascading effects of VAT, but tax revenue to government will decrease. This method will also increase the price of financial services to consumers. The consumers will be charged VAT that cannot be claimed as input as they are not registered businesses. Although notional inputs have been used by some countries, in terms of financial services it is only theory as it has not yet been adopted for the taxation of financial services under VAT.

7.4.3 Promising alternatives for treatment of financial services rendered by credit card companies under VAT in South Africa

The following alternative methods for the treatment of financial services rendered by credit card companies under VAT are very promising in a South African context:

- **Full taxation of financial services under VAT, with implicit fees at a lower rate**

This method will fully remove tax cascading as there will be no more exempt supplies. This will simplify administration a lot as no complex apportionment calculations will need to be performed. The tax will then comply with the ideal VAT that is a broad-based consumption tax on consumers. Explicit fees will be charged at the normal VAT rate and implicit fees at a lower VAT rate. The government will lose tax revenue with the input VAT that is not trapped anymore, but can balance the budget with VAT charged on implicit fees. The VAT charged on implicit charges in B2B will have no effect on the government tax revenue as it will be claimed as input credits, but the VAT charged on B2C transactions will be revenue for the government as the consumers cannot claim input credits. The trapped VAT lost will have to be balanced with the lower VAT on implicit charges for consumers. The administration of multiple rates is not ideal, but it is effectively already done as there are supplies at 14% and supplies at 0% in South Africa's VAT. The extra administration on multiple rates seems to be less daunting than the complex calculations caused by apportionment. To add another rate for implicit charges or interest should not be too difficult.

- **Exempting financial services using a partial input recovery**

The system is very similar to what is currently used in South Africa, but without the additional administration, complex calculations and compliance costs caused by apportionment. Using this method, fee-based charges/explicit fees will be taxed as standard supplies and implicit fees will be exempt. Since exempt supplies rendered are only a portion of total services rendered, the input VAT on goods and services procured as not directly attributed taxable supplies must be apportioned. This is where the big difference lies – a fixed apportionment rate is applied. This rate is legislated and there is no need for complex calculations and waiting for binding rulings. The countries that have adopted this method apply a single rate, but as the participant of the semi-structured interview proposed (refer to 6.2.9), a rate could be legislated per industry. This method removes most of the effects of tax cascading, but

not all since there is still input VAT that will remain trapped. This is extremely important because input taxation is a major source of revenue for the South African government and as a portion is still trapped, the government might not have to raise alternative taxes to make up for the lost tax revenue. The administration of this method is much less complicated than a traditional apportionment system. This method is fully compatible with the credit invoice method and minimal changes to legislation and accounting systems will be required to adopt it in South Africa. This simplified method will reduce compliance cost for vendors and government. The same amount of VAT will be raised as with the current method, but without the administrative burden and compliance cost of frequently changing apportionment percentages.

CHAPTER 8

FINDINGS, SUMMARY AND VALUE OF THE STUDY

8.1 INTRODUCTION

The findings of this study are summarised in this chapter and the research objectives are linked to these findings. The chapter concludes with a summary of this study, contributions made by this study and proposed future research.

8.2 RESEARCH OBJECTIVES

The following research objectives were set at the start of this study:

- To explore the methods used by other countries to tax financial services under the VAT. This will be done to identify alternatives to the exemption of financial services under the VAT.
- To identify the different (separate) financial and other services included in the interest margin of credit cards. This will be done to determine whether the different services can be separated and whether it will be feasible.
- To evaluate whether the treatment of financial services-linked credit cards under VAT complies with Section 8(15) and 10(22) of the Act.
- To critically analyse the different alternatives for the treatment of financial services under the VAT that were identified with regard to practicality and feasibility in a South African context. This will be done to determine whether other alternatives to exemption might alleviate the distortions caused by it.

These research objectives were met as follows:

- Alternative methods were identified with a critical review of available literature in Chapter 4 and a semi-structured interview in Chapter 6. The alternative methods for taxing financial services are summarised in Section 7.2.

- The websites of South Africa's four largest banks were perused to try and identify the different financial services that are rendered by credit card companies. A list was compiled from their different offerings as listed on the Internet. The financial services that are rendered by credit card companies are summarised in Section 6.1.6.
- Information was gathered on the different financial services that credit card companies render in South Africa. A list was compiled in Section 7.2 to summarise these services. In Section 6.3 (while keeping the list in Section 7.2. in mind), the effects of Section 8(15) and 10(22) on taxing financial services relating to credit cards under VAT were discussed.
- The different alternative methods that were identified in research objective one were critically analysed to determine which methods might decrease problems/distortions in South Africa, caused by exempting financial services linked to credit cards under VAT. The least feasible alternatives were discussed in Section 7.4.2 and the most promising alternatives were discussed in Section 7.4.3.

All research objectives were met.

8.3 FINDINGS

8.3.1 The South African credit card landscape

The South African banks all offer very similar products (refer to Section 6.1.6). This is indicative of the fierce competition among the four larger banks. This was confirmed by the participant of the interview (refer to Section 6.2.6). The financial services rendered by South African banks on credit cards can be grouped into the following categories (refer to 6.1.6):

- granting credit
- safekeeping of money
- card issuing
- general record-keeping and administrative services
- transacting

- insurance
- reward/loyalty programmes
- leisure products and services
- personalised services

Many of these services are quoted as free on their websites. This is indicative of services being bundled, as confirmed by available literature (Grubert & Krever, 2012:225, Stitt, 2011:194). According to the interview that was conducted, the participant's employer does not mix or substitute taxable and exempt supplies with each other, but this might not be the policy used by the rest of the industry (refer to Section 6.2.6). Section 8(15) of the Act is not applicable on the taxing of financial services linked to credit cards, but Section 10(22) of the Act is very applicable and at the heart of this issue. Section 10(22) of the Act compels the vendor to separate the taxable and exempt portion included in dual supplies even though it might be difficult or impractical. The participant of the interview shares the view that it is impractical to unbundle all the different financial services and charge them on a transaction-to-transaction basis (refer to Section 6.2.6).

According to the interview that was conducted, VAT plays virtually no role in the decision on how offers are priced. Market trends and the rules of the NCA mainly determine the structure of offerings and how they are charged (refer to Section 6.2.6).

Kerrigan (2010:2) states that financial intermediaries generate most of their revenue from interest margins. This is not necessary the case with credit cards in South Africa. Although interest is one of the major revenue streams regarding credit cards, the majority of the revenue is generated by merchant and interchange fees (refer to Section 6.2.7). Merchant and interchange fees are taxable supplies under VAT as per the proviso of Section 2(1).

8.3.2 Problems with treatment of financial services linked to credit cards under VAT in South Africa

Exempting financial services typically causes the following distortions according to the literature:

- Tax income leakage is caused (Ebrill *et al.*, 2001:85).
- There is an increased cost to suppliers of exempt supplies due to the apportionment or denial of input tax credit, which causes an increase in the price for financial services (Benedict, 2011:190). This is also referred to as tax cascading.
- Financial services companies will rather self-supply than outsource to avoid incurring the cost of the input VAT (De la Feira & Walpole, 2009:911; Ebrill *et al.*, 2001:86; Gendron, 2008:498).
- Exemption of financial services under the VAT also creates extra and difficult administration of apportionment of input tax. (Ebrill *et al.*, 2001:88; Firth & Mckenzie, 2012:19; Gendron, 2008:499).
- Exemption under the VAT of certain supplies can also lead to foreign company supply bias. (De la Feira & Walpole, 2009:912; Firth & Mckenzie, 2012:19). This is due to foreign supplies usually being taxable supplies in the form of zero-rating. The entity will then gain access to a higher portion of the input credits.
- A theory also exists that it might set the stage for more exemptions as precedents are set (Ebrill *et al.*, 2001:89).

Exempting financial services on credit cards under VAT in South Africa causes the following distortions:

- Tax income leakage is caused. This is due to the intermediary not being input-taxed at the final stage, as opposed to the consumer at the final stage.
- Increased costs to banks are incurred due to the trapped input VAT. The participant indicated that the trapped VAT exceeded a billion Rand for his employer last year (refer to Section 6.2.5).
- The bigger banks will be in a better position to self-supply than the smaller banks. They will do this to avoid the input VAT on outsourced services. The bigger banks will have specialised departments for certain functions as opposed to the smaller banks that will have to outsource. Stitt (2011:195) came to the same conclusion and the view is supported by the participant of the interview (refer to Section 6.2.5).
- Administrative burden and high compliance cost of apportionment are caused. This is confirmed by the participant of the interview (refer to Section 6.2.5). The

administrative burden that is caused by apportionment is not emphasised enough in the literature. It is only when this topic is discussed with someone dealing with apportionment every day on a huge scale that one can truly understand the extreme administrative burden that apportionment places on these entities and individuals. The compliance cost is high as this includes the staff to perform these functions and the design of accounting systems.

Most of the distortions that were identified correspond with those found in the literature.

8.3.3 Proposed treatment of financial services linked to credit cards in South Africa

The following alternative methods were identified as the most promising alternative methods after critically evaluating all the different methods identified (refer to 7.4.3):

- full taxation of all financial services with implicit charges (interest) taxed at a lower rate
- full taxation of fee-based charges and exemption of financial services with a partial input recovery

These methods were selected due to the following reasons (refer to Section 7.4.3):

- These are fully compatible with South Africa's credit invoice method.
- The administration relating to these methods is relatively simple. No detailed apportionment calculation is required or requests for binding rulings.
- These methods either remove the cascading effect of trapped input VAT completely or to a large extent.
- These methods keep the needs of vendors and the government in equilibrium. Government will still generate the same revenue from VAT and the vendor will be alleviated from the administrative burden and compliance cost.
- The government will also save on administrative and compliance costs.
- The changes in the legislative and accounting systems so as to implement these proposals will be minimal.

8.4 SUMMARY

The taxation of financial services under VAT is a very contentious issue and will remain one for many more years. Most countries apply exemption due to a lack of alternatives, as opposed to a matter of principle. The problems/distortions caused by exemption are severe. It is clear that no methods exist that will eliminate all these problems/distortions, but methods do exist that will ease most of these problems/distortions.

8.5 CONTRIBUTIONS AND SUGGESTIONS FOR FUTURE RESEARCH

This study was done with credit cards as delimitation. It contributes to a better understanding of the South African credit card market with specific reference to the different financial services that are rendered by credit card companies. It also shed more light on the complications caused by exempting financial services under VAT. Although this study was done with credit cards as delimitation – the findings will be applicable on most types of interest earned.

Two alternative methods are proposed by this study. These methods might decrease the current problems/distortions caused by exempting financial services under VAT. As this study has a non-empirical design, all findings must be tested empirically. A detailed study of these alternative methods will be valuable in future research.

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APPENDIX A
- Data collection instrument-
Semi-structured interview

Semi-structured interview

Appearance at the interviews

I will ensure that I am appropriately dressed for the interviews, on time and respectful towards all of the staff of the companies' that will be participating.

Opening of the interview

The following will be incorporated into the opening:

- Introduce myself and provide small back ground of myself.
- Thank the participant for participation.
- Stress that participation is voluntary, anonymous, confidential, the interview may be exited at any stage and that the participant reserves the right not to answer question at own discretion.
- Request the participant politely to sign the informed consent form.
- Ask permission to record the audio of the interview and to make notes during the interview.
- Briefly explain the research problem and the purpose of my proposed study.

Themes and question

All questions are open-ended and do not need to be asked in the exact order. Some questions might not be asked and other may added as the themes are identified.

Respect the participants time and ensure that interview does not exceed 60 minutes.

The following themes and questions may be explored:

Themes	Questions
Participant's understanding of taxation of financial services under Vat.	<ul style="list-style-type: none"> • How are loans and interest taxed in South Africa under VAT? • Explain the VAT treatment of loans and there related interest adopted by your employer? • With VAT being a consumption tax, do you think loans and their related interest should be taxed under VAT? • Do you agree that the current treatment of loans and interest under VAT in South Africa is appropriate? • What problems (distortions) do the current treatment of loans and interest under VAT cause your employer?
Different services bundled-up in the interest margin earned.	<ul style="list-style-type: none"> • What services are included in your service offering that are charged explicitly and implicitly? • Explain the treatment under VAT for the services rendered for credit cards?

Themes	Questions
	<ul style="list-style-type: none"> • What motivates your employer's decision to either charge something explicitly and implicitly? • Do some of the revenue streams (implicit charges) cross-subsidise the other? • The services rendered for credit cards – will it be possible to charge them explicitly. • What is the nature of these implicit charges?
Difficulty to separate these implicit charges.	<ul style="list-style-type: none"> • Can these implicit charges be separated? • What are the technical challenges in separating these implicit charges?
Alternatives to exemption of financial services under Vat.	<ul style="list-style-type: none"> • Can you think of alternatives to exemption of financial services under VAT that might be practical?
General	<ul style="list-style-type: none"> • Ask participant if there is anything that is relevant to the study that he/she would like to add or share?

Closing of the interview

The following will be incorporated into the closing:

- Thank the participant for the participation and the information shared.
- Negotiate access for the second semi-structured interview.
- Ask whether the participant wants a copy of the research report upon conclusion of the research.

This data collection instrument was compiled with the help of a checklist (Saunders *et al.*, 2012:397).

APPENDIX B
- Informed consent form -



**Informed consent for participation in an academic
research study – Phase 2**

Dept. of Taxation

THE VAT TREATMENT OF FINANCIAL SERVICES LINKED TO CREDIT CARDS

Research conducted by:

Mr. R. Coetzee (96221772)

Cell: 082 934 8417

Dear Respondent

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

The purpose of the study is to identify alternatives to the exemption of loans and interest under Vat and to evaluate their practicality and feasibility alternatives to exemption

Please note the following:

- This study involves a semi-structured interview. The interview will be anonymous and 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 interview as completely and honestly as possible. This should not take more than 60 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 M. van Oordt (012 420 5148) if you have any questions or comments regarding the study.

Please sign the form to indicate that:

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

Respondent's signature

Date