An analysis of the proposed repeal of section 11(1)(g) of the Value-Added Tax Act

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The reader is reminded of the following:

This dissertation is presented in article format, in accordance with the policies of the North-West University’s Faculty of Economic and Management Sciences, and consists of one research article.

The research article and dissertation comply with the writing style requirements of the Harvard style and the format required by the Journal of Economic and Financial Sciences.
ABSTRACT

On 17 September 2014 National Treasury announced the proposed repeal of section 11(1)(g) of the VAT Act which zero-rates the supply of certain farming inputs to farmers, as evidence was found that the section is open to abuse. It is unclear what differentiates this section from other zero-rating provisions in terms of its susceptibility to abuse. In order to decipher the proposed repeal, this paper investigates the policy considerations taken into account in including multiple rates, especially zero-rates, in the design of a VAT Act. It further evaluates how a VAT system can be abused and how the abuse of VAT is exacerbated by the inclusion of zero-rating provisions. This paper analyses the degree of balance between the policy considerations in favour of a zero-rating and the fraud risk posed by a zero-rating to establish whether the fraud risk posed by different zero-ratings can be distinguished. This balance is applied to the proposed repeal of section 11(1)(g) to illustrate the relative importance of this zero-rating provisions and that the fraud risk posed by it does not significantly differ from those of other zero-rating provisions. The paper concludes that this provision does not offer unique opportunities for abuse and that the inclusion of this zero-rating provision in the VAT Act is justified by the strong policy considerations of the Agriculture sector.
KEYWORDS

Agriculture, Fraud, Value-Added Tax (VAT), Tax policy, Zero-rating
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CHAPTER 1: INTRODUCTION

1.1. BACKGROUND

Agriculture plays a key role in the economic development of a country. However, recent studies have found that South African producers are less inclined to remain in the agricultural sector due to the increasingly challenging environment (Middelberg, 2014:112). Some of the challenges faced by the agricultural sector include factors such as unpredictable weather conditions, variable markets and high input (Meintjies, 2012:51). Given the nature of farming businesses and the seasonality of their production it is often submitted that the agricultural sector deserves special treatment when it comes to taxation, including special Value-Added Tax (VAT) treatment (OECD, 2006:2; Saavalainen et al., 2003:35; Wiktorowicz, 2004:119).

VAT is an indirect tax on consumption of goods and services in the economy (Mclure, 1987:15). In contrast to General Sales Tax (GST), which was in force in South Africa before the enactment of VAT on 29 September 1991, VAT is levied on the value added at each stage of the production and distribution process and not solely on the total value at the final stage of consumption (Go et al., 2004:2). The credit mechanism of VAT allows businesses to recover the input tax paid on purchases, thereby ensuring that the tax remains a tax on final consumption borne by the final consumer (Mclure, 1987:16). Some of the main reasons advanced for the transition from GST to VAT were the problems experienced with the recovery and evasion of sales tax, as well as the erosion of the sales tax base due to multiple exemptions (National Treasury, 2007:27).

According to Schenk and Oldman (2007:1), VAT has spread around the world more quickly than any other tax in modern history. Unfortunately, as VAT became more pervasive over time, so did the associated VAT fraud (Keen & Smith, 2007:10) – whether this is due to an actual increase in the abuse of the VAT system or merely due to an increase in the level of VAT fraud detection, is debatable. Rate differentiation is one of the main culprits that makes VAT susceptible to fraud, because it may tempt a vendor to deliberately misclassify a supply (Agha & Haughton, 1996:304). The use of a single positive rate simplifies both compliance and administration. Conversely, the adoption of a reduced positive rate or a zero-rate can result in sustained credit positions for taxpayers utilising these rates which, in turn, increases the burden of tax administration and, ultimately, impedes on the effectiveness thereof (Ebrill et al., 2001:79). Ebrill et al. (2001:79) further argue that, however deserving a measure of rate differentiation or exemption may be in some cases, they make it harder to resist pressures from other and perhaps less deserving cases for differentiation.
With the introduction of VAT in the 1990s the Value-Added Tax Committee (‘VATCOM’) was established. This committee consisted of members from both the private and public sectors, appointed by the Minister of Finance to consider the comments and representations made by interested parties on government’s Draft Value-Added Tax Bill. The committee acknowledged that applying favoured treatment to any goods or services would create the opportunity for evasion and increase the difficulty of monitoring and controlling the tax (VATCOM, 1990:5). It was, therefore, government’s intention to restrict the use of zero-rating provisions and other forms of rate differentiation and maintain a single-rate VAT system as far as possible (VATCOM, 1990:5). However, the Davis Tax Committee (2014:20), in their first interim report on VAT, found that no country in the world operates such a system and that concessions in exceptional circumstances are inevitable.

When the Draft Value-Added Tax Bill was published and it became evident that farmers would be liable for VAT like any other vendor, the VATCOM received many concerns from interested parties that farmers would experience cash-flow problems. In contrast to the sales tax system under which intermediate business-to-business sales were exempt, farmers would now be liable for VAT on inputs and the farmers would only subsequently be able to claim back the VAT levied from them (PWC, 2014:1). To reduce farmers’ compliance cost and limit the cash-flow disadvantages caused by the enactment of VAT, the VATCOM (1990:12) recommended that certain concessions be granted to farmers. One of these concessions, in terms of section 11(1)(g) of the VAT Act, was the zero-rating of certain inputs which are mainly consumed in the course of conducting a farming enterprise.

The Draft Taxation Amendment Bill published on 17 July 2014 proposed that this section be repealed due to strong evidence that this provision was being abused (National Treasury, 2014:75). The response from interested parties to the proposed repeal was, however, so significant that National Treasury agreed to postpone the repeal for at least a year to allow interested parties to further investigate the impact of this amendment (Van der Zwan, 2015:64).

1.2. PROBLEM STATEMENT AND RESEARCH QUESTION

The problem statement addressed by this paper is that, while the repeal of section 11(1)(g) might be a robust defence against the alleged fraud, it could certainly harm the policy considerations for which this provision was initially enacted and, thus, produce uncertain effects. It is submitted further that other zero-rating provisions have also proven to be susceptible to fraud and it is unclear why the agricultural sector is to be prejudiced.
The research question that this paper aimed to answer is whether the repeal of section 11(1)(g) is justified in light of the potential fraud risk; more specifically, can the zero-rating and the risk of fraud posed by it be distinguished from other zero-rated supplies?

1.3. RESEARCH OBJECTIVES

In order to answer this research question, the following research objectives were formulated:

- to describe the necessity of including zero-rating provisions in the design of a VAT system from a policy perspective;
- to describe the different types of VAT fraud and the fraud risk (if any) posed by the different zero-rating provisions enacted to achieve the different policy considerations;
- to consider the need for preferential VAT treatment, in the form of zero-rating provisions, in the agricultural sector and the possible implications of the repeal of section 11(1)(g);
- to consider the alleged fraud schemes involving section 11(1)(g) to establish whether these fraud schemes and, consequently, the fraud risk posed by the zero-rating of farming inputs can be distinguished from the fraud risk of other zero-rating provisions.

1.4. RESEARCH METHOD

In order to achieve these objectives the research mainly consisted of doctrinal research where a systematic process was followed to identify, analyse and assess the National Treasury decision to repeal section 11(1)(g) of the VAT Act (McKerchar, 2008:18). The literature used for this research was not limited to traditional legal sources, but included a detailed content analysis of prior literature on the rationale behind designing a VAT system with multiple rates to allow for the identification of the main policy considerations that gave rise to zero-rating provisions. The literature review included the analysis of the fraud risk (if any) posed by the different zero-rating provisions enacted to achieve the respective policy considerations, as identified, in order to illustrate the interaction between the policy considerations and the reputed inherent fraud risk of zero-rating provisions.

The research further explored the possible economic difficulties that might arise should the proposed repeal come into effect. The lack of prior direct research on the economic consequences of the repeal of section 11(1)(g) of the VAT Act meant that the research took on an interpretive approach. The research did not include a quantitative assessment of the degree of VAT fraud experienced as a result of the use of zero-rates in a VAT system nor set out to provide the quantitative effect of the possible economic implication the repeal of section 11(1)(g) of the VAT Act might hold.
1.5. OVERVIEW OF CHAPTERS

Chapter 1: Introduction and background, problem statement, research question, research objective and research method

This introductory chapter of the study serves to illustrate the background to and relevance of the study. This chapter states the research question and research objectives and explains the research method adopted in the study.

Chapter 2 (article): Grounds for allowing a tax deduction for employee share incentives

This chapter (article) evaluates the proposed repeal of section 11(1)(g) against the policy considerations advanced to include zero-rating provisions in the design of a Tax Act and the unintended consequence of fraud and evasion opportunities that are created by these zero-rating provisions.

Chapter 3: Conclusion

This chapter summarises the findings of the study and addresses the research question formulated in chapter 1.
CHAPTER 2: RESEARCH ARTICLE

ABSTRACT

On 17 September 2014 National Treasury announced the proposed repeal of section 11(1)(g) of the VAT Act which zero-rates the supply of certain farming inputs to farmers, as evidence was found that the section is open to abuse. It is unclear what differentiates this section from other zero-rating provisions in terms of its susceptibility to abuse. In order to decipher the proposed repeal, this paper investigates the policy considerations taken into account in including multiple rates, especially zero-rates, in the design of a VAT Act. It further evaluates how a VAT system can be abused and how the abuse of VAT is exacerbated by the inclusion of zero-rating provisions. This paper analyses the degree of balance between the policy considerations in favour of a zero-rating and the fraud risk posed by a zero-rating to establish whether the fraud risk posed by different zero-ratings can be distinguished. This balance is applied to the proposed repeal of section 11(1)(g) to illustrate the relative importance of this zero-rating provision and that the fraud risk posed by it does not significantly differ from those of other zero-rating provisions. The paper concludes that this provision does not offer unique opportunities for abuse and that the inclusion of this zero-rating provision in the VAT Act is justified by the strong policy considerations of the Agriculture sector.

KEYWORDS

Agriculture, Cash flow, Farming inputs, Fraud, Input tax, Value-Added Tax (VAT), Policy, Zero-rating
1. INTRODUCTION

Value-Added Tax (VAT) is an indirect tax on consumption of goods and services in the economy (Mclure, 1987:15). In contrast to General Sales Tax (GST), which was in force before the enactment of VAT in South Africa on 29 September 1991, VAT is levied on the value added at each stage of the production and distribution process and not only at the point of final consumption (Go et al., 2004:2). The credit mechanism of VAT allows businesses to recover the input tax paid on purchases, thereby ensuring that the tax remains a tax on final consumption borne by the final consumer (Mclure, 1987:16).

According to Schenk and Oldman (2007:1), VAT has spread around the world more quickly than any other tax in modern history. Unfortunately, as VAT became more pervasive over time so did the associated VAT fraud (Keen & Smith, 2007:10). Rate differentiation is one of the main culprits that makes the VAT susceptible to fraud, because it may tempt a vendor to deliberately misclassify a supply (Agha & Haughton, 1996:304). The problem with rate differentiation is exacerbated when zero-rates are adopted, because this can result in sustained credit positions for taxpayers which, in turn, increases the burden of tax administration and, ultimately, impacts the effectiveness thereof (Ebrill et al., 2001:79).

With the introduction of VAT, the Value-Added Tax Committee ('VATCOM') was established. This committee consisted of members from both the private and public sectors appointed to consider the comments and representations made on government's Draft Value-Added Tax Bill. The committee acknowledged that applying favoured treatment to any goods or services creates an opportunity for evasion and increases the difficulty of administration (VATCOM, 1990:5). Government’s intention, therefore, was to maintain a single-rate VAT system as far as possible. However, the Davis Tax Committee (2014:20), in their first interim report on VAT, found that no country in the world operates such a system and that concessions in exceptional circumstances are inevitable.

The unique nature of the agricultural business environment, which is to a large extent seasonal, represents one of these exceptional circumstances where an exception from a single-rate VAT is warranted (Cnossen, 1998:10; Van der Zwan, 2015:63). With the introduction of VAT it was clear that farmers would experience cash-flow problems because, in contrast to GST under which farmers’ business inputs were exempt, they would now be liable for VAT on inputs (PWC, 2014:1). To limit this cash-flow disadvantage, VATCOM (1990:12) conceded that the supply of certain inputs which are mainly used in the course of conducting a farming enterprise would be zero-rated in terms of section 11(1)(g) of the VAT Act. The Draft Taxation Amendment Bill published on 17 July 2014 proposed that this section be repealed due to strong evidence that this provision
was being abused (National Treasury, 2014:75). National Treasury, however agreed to postpone the repeal for at least a year to allow interested parties to further investigate the impact of this amendment (Van der Zwan, 2015:64).

The objective of this article is to assess the proposed repeal of section 11(1)(g) of the VAT Act by establishing whether the policy considerations and perceived fraud risk of this particular zero-rating provision can be distinguished from those of other zero-rating provisions. In order to achieve this objective, the research mainly consisted of doctrinal research where a systematic process was followed to identify, analyse and assess the National Treasury decision to repeal section 11(1)(g) of the VAT Act (McKerchar, 2008:18). The remainder of the article is presented as follows: Section 2 explores the policy considerations behind the use of zero-rates in a VAT system. Section 3 outlines how the use of zero-rates opens up the VAT system to abuse. Section 4 considers the degree of interaction between the policy considerations and the perceived fraud risk of zero-rating provisions. Based on this interaction section 5 considers the proposed repeal of section 11(1)(g) of the VAT Act. Section 6 concludes with a balanced view on the proposed repeal of section 11(1)(g) of the VAT Act from a policy and fraud perspective.

All references to ‘section’ in this article are to the sections of the VAT Act.

2. POLICY CONSIDERATIONS IN DESIGNING A VAT SYSTEM WITH ZERO-RATINGS

Depending on the broad economic and fiscal policies of a country a certain amount of revenue needs to be raised through the tax system to finance public sector activities (Bain, 2010:67; Bird & Zolt, 2003:9). The amount of revenue that can be raised through a VAT system depends heavily on the details of its design (Sullivan, 2011:11). According to the Organisation for Economic Cooperation and Development (OECD) (2014:30), there are a number of broad tax policy considerations such as neutrality, efficiency, certainty and simplicity, effectiveness, and fairness that guide the development of a taxation system. The policy choices made by policy makers will reflect not only the relative importance of each of these principles, but also the wider economic and social considerations outside the field of tax (James, 2011:19; OECD, 2014:30; Bird & Zolt, 2003:3).

In achieving these outcomes a variety of other design issues must be addressed during the design of a VAT system, including the number of tax rates used and the scope of zero-ratings and exemptions (Bird & Gendron, 2007:108; Howell, 1995:86). Williams (1996:183) and James (2011:17) contend that an ideal VAT model is ‘a broad-based VAT designed to bring within its charge every kind of economic transaction, subject to limited exceptions’. In practice, however, it appears as if no country has a simple ‘uniform’ VAT rate structure and that most value-added taxes are burdened with concessions that violate the requirements of an optimal tax policy (Bird
& Gendron, 2005:81; Mankiw et al., 2009:20). The deviation from the economic ideal by including these concessionary exceptions in the VAT system is tolerated by policy makers in an attempt to either address one or more of the broad tax policy considerations mentioned above, or simply to ease the administrative burden a VAT system imposes (Cnossen, 1991:78).

Concessionary VAT treatments normally take the form of either zero-ratings, exemptions or reduced rates (Bickley, 2003:5; Fuller, 1981:67). Zero-ratings are appropriately employed when it is the objective of the policy maker to completely eliminate the VAT on consumption, as a zero-rated supply would entail the seller’s not levying any VAT on the supply while remaining entitled to receive a refund for the invoiced VAT that accumulated during the previous stages of the production chain (Bickley, 2003:7; Fuller, 1981:65; Mclure, 1987:72). The zero-rating will, therefore, essentially render the supply free of tax on inputs as well as the value added at the final zero-rated stage. On the other hand, an exemption is appropriate when it is not regarded as feasible or desirable to tax an activity, but the policy maker would like to retain some of the VAT accumulated and collected along the production chain (Bickley, 2003:7; Mclure, 1987:72). The extent of exempt supplies and the implication thereof are beyond the scope of this study.

Owing to significant pressure from interested parties and to ensure the smooth transition from the GST system to a VAT system, various concessions were allowed with the introduction of VAT, which led to the current VAT system in South Africa being more differentiated (and with a narrower base) than was originally intended by government (National Treasury, 2007:28). The literature suggests that the preferential treatment agreed to by National Treasury by means of zero-rating provisions can be broadly classified into three distinct categories.

2.1. Zero-rating used to make goods or services more affordable to the final consumer

Zero-ratings can firstly be categorised into those used to make goods or services more affordable to the end user in order to reduce the regressive nature of VAT (Kearney & Van Heerden, 2004:522; Tait, 1988:56). The regressive nature of VAT, where the tax represents a larger portion of the income of a low-income household than a high-income household and effectively places a greater burden on the low-income earning consumers, was one of the main criticisms against such a consumption type tax (Bain, 2010:71; Go et al., 2004:3; Schenck & Oldman 2007:47). The most common method used to address the regressive nature of VAT and to ensure that the tax burden is distributed equally among consumers is to zero-rate goods that are either basic necessities or that are so meritorious as a result of their use by low-income households that they deserve not to be taxed (Bain, 2010:71; Jansen et al., 2012:88; National Treasury, 2007:57).

With the inception of VAT, the Draft VAT Bill did not contain any relief for basic foodstuffs (National Treasury, 1991:11). The VATCOM (1990:14), however, received numerous motivations that basic
foodstuffs should receive concessionary treatment due to concerns that the needy would be adversely affected by an increase in the cost of food. The VATCOM (1990:14), in line with the views of Jansen and Calitz (2015b:13), held that social objectives such as providing relief to the needy through the VAT system would be an inefficient means and that the poor should be assisted through targeted social expenditure programmes. The inefficiency of zero-rating as a pro poor policy stems from the fact that the zero-rated goods are consumed across the board by all consumers (rich and poor) (Keen 2012:7). However, due to political pressures threatening the acceptability of the VAT system (Cnossen, 1982:209) and the lag with which the targeted expenditure programmes became effective (Jansen & Calitz, 2015a:2), the VATCOM (1990:15) had no choice but to recommend that a limited number of basic foodstuffs be zero-rated.

The intention at the time was to provide the zero-rating only until an adequately targeted social assistance programme could be put into place to provide relief outside of the VAT system (National Treasury, 2007:65). Even though it has increased since the introduction of VAT, social spending on the poor has had a limited impact on the high degree of inequality in South Africa (Van der Berg, 2009). Therefore, despite government’s best intention to implement the zero-rating only as a temporary solution, it would be politically irresponsible to eliminate or reduce these zero-ratings in a South African context as long as the social security system is not optimal (Fourie & Owen, 1993:284) and inequality issues have not been sufficiently addressed.

2.2. Zero-ratings used to facilitate international trade

Secondly, as noted by Verstraeten (2009:375), Tait (1988:390) and Mclure (1987:18), zero-ratings are used to remove a supply from a countries’ VAT system where such a supply is not consumed within that country. The zero-rating of exports is common practice among countries that follow the destination principle. Taxing a supply with reference to the destination principle means that the supply will be taxed at final consumption and within the taxing jurisdiction where it will be consumed and not in the jurisdiction where the goods/services are produced, as is the case under the origin principle (Keen & Lahiri, 1998:323). Consequently, no VAT is levied on exports, but the associated input tax remains refundable to the exporting business at the same rates as domestic supplies (Zsombor, 2010:214).

With the inception of VAT, the VATCOM (1990:3) recommended that South Africa adopt the destination principle and consequently zero-rate exports. By zero-rating exports policy makers ensure that international trade remains neutral towards the enactment of VAT and that domestic products remain competitive in the open market (Zsombor, 2010:214). Neutrality is one of the key features in the design of a tax system. It implies that the same principles of taxation should apply to all forms of business, while also addressing specific features that may otherwise undermine the principle of neutrality (OECD, 2014:29). In the absence of such a zero-rate, international trade
may be distorted by VAT, as goods shipped from one country to the other may or may not be subjected to VAT, both in the country of origin (where goods are produced) and country of destination (where goods are consumed) (Feldstein & Krugman, 1990:264). Double taxation will increase the cost of imported goods, while not taxing the goods in either the country of destination or the country of origin will give imports an advantage over domestic production and, ultimately, distort international trade (Oliveira, 2001:17).

According to the OECD (2014:29), a secondary policy consideration is equity as it may also refer to inter-nation equity. As a theory, inter-nation equity is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions (OECD 2014:29). It is, therefore, clear that the zero-rating of exports is crucial to the successful application of the destination principle in VAT.

2.3. Zero-ratings used to provide cash-flow relief on intermediate transactions

Lastly, zero-rating is used to provide relief from the cash-flow burden that may arise as a result of the timing difference between paying VAT and being able to claim it back as input tax (De la Feria & Krever, 2013:7; Van der Zwan, 2015:63; Williams, 1996:52). As discussed earlier, the design of a tax system should take into account the efficiency of the specific tax system. A VAT system will be efficient if it allows government to raise maximum revenue while minimising the impact on businesses, both in terms of compliance cost and commercial decision making (Jitsing & Stern 2008:7). One of the criticisms against the credit mechanism of the VAT system is that the initial collection of VAT and the subsequent refund thereof at a later stage are inefficient and costly to businesses which have to fund the VAT for the period between remittance and refund (De la Feria & Krever, 2013:7). This is especially true when the buyer acquires the goods to make supplies over a long period of time or when a significant amount of time has to pass before the vendor is eligible for a refund (De la Feria & Krever, 2013:7; Schenk & Oldman, 2007:152).

The zero-rating of intermediate supplies between two businesses is widely viewed as inappropriate, because it amounts to an indirect subsidy of the inputs used by way of a reduced consumption tax liability (Go et al., 2004:2; Tait, 1988:54). However, notwithstanding the aforementioned point, it is contended that this subsidy might be appropriate for specific goods and services (Grinberg, 2010:334). This is especially true when it allows a transaction to take place where such a transaction might not have been feasible due to the cash-flow constraints imposed on the vendor by the additional VAT liability (Schenk & Oldman, 2007:267). In addition, an intermediate supply zero-rating between two registered VAT vendors will not result in a loss of any net revenue by government (Williams, 1996:52). The sale or transfer of an ongoing business is one such special case where it has been argued that the zero-rating of an intermediate sale
between two vendors may be acceptable (Schenk & Oldman, 2007:115; Williams, 1996:52). When the sale is between VAT registered businesses the buyer will be able to claim the VAT back as input tax and therefore this transaction does not result in any tax revenue or loss thereof. Nevertheless, the buyers cost to finance the VAT until it is recovered might be significant and might impede on his ability to perform this transaction (Schenk & Oldman, 2007:115; Williams, 1996:52).

Another, more controversial, form of intermediate supply zero-rating is the zero-rating of farming inputs (Cnossen, 1998:408; Tait, 1988:61). Part A of Schedule 2 to the VAT Act lists the types of supplies and the conditions under which a farming, agricultural or pastoral enterprise may qualify for the zero-rating provided by this section (SARS, 2015:71). This zero-rating provision will be discussed in more detail in section 5.

Based on the above discussion of the broad policy considerations behind the inclusion of zero-rating provisions in the design of South Africa’s VAT system, it is evident that they are largely driven by social and economic concerns (Lejeune, 2011:276). While they might be essential to the successful adoption, and continued implementation, of a VAT system it is undeniable that these concessions facilitate evasion and increase administrative costs (Bird & Gendron, 2005:94; Varga, 2009:316), as discussed in section 3 below.

3. FRAUD AND EVASION OPPORTUNITIES

The change from the GST system to the multi-stage invoice VAT system was made by government in an attempt to eliminate the high levels of tax evasion and fraud experienced under the GST system (Botes, 2000:284; National Treasury, 2007:27). It was advocated that levying VAT in stages would ensure that, even if the final trader attempts to evade the tax, the loss to the treasury would be limited to the tax due on the value added at the final stage of production, (Krever, 2008:12; Pashev, 2006:13). It was also believed that an invoice-driven VAT system would provide an adequate audit trail and allow the cross-checking of invoices with other South African tax systems (Botes, 2000:284).

3.1. Fraud that can arise under any consumption type tax

With the introduction of VAT, government took into account global indications that some tax evasion activities experienced under GST were also distorting VAT. Botes (2000:284), Harrison and Krelove (2005:24), Pashev (2006:4), and Agha and Haughton (1996:303) identify the following as being among the main types of fraud and evasion activities that, to varying degrees, occur in all countries administering any consumption type tax:
• Under-reported sales – By concealing sales to the domestic market, traders evade their obligation to charge tax on their sales made;
• Failure to register – Traders that are liable to register for the tax do not register and their taxable supplies are left out of the tax net;
• Misclassification of commodities – When traders have sales that are taxed at different rates or exempt, whether under VAT or GST, they may reduce their VAT liability by misclassifying their taxable supplies as the type taxed at a lower rate or not taxed at all;
• Imported goods not taxed – Goods are imported and no tax is paid at the border, or goods are imported illegally; however, these goods are then sold inclusive of VAT/GST on the domestic market and the VAT/GST is never remitted to the tax authorities.

3.2. Fraud distinct to the VAT

The VAT system involves the same principle elements as any other self-assessed consumption tax. However, it is the unique credit mechanism of VAT that allows businesses the opportunity to collect and retain a large amount of tax, which has proven to offer distinct opportunities for fraud and evasion (Keen & Smith, 2007:23; Pashev, 2006:14). The most obvious risk in a VAT system with regard to exploiting the credit mechanism of VAT is the claim for false credits or refunds (Bird & Gendron, 2005:116; Keen & Smith, 2007:23). This is the simplest method used to evade VAT and is mostly done by creating false invoices for non-existent or exaggerated purchases (Tait, 1988:307).

In addition to the credit mechanism of VAT, other design features can have a significant impact on the VAT’s exposure and susceptibility to evasion and fraud and, ultimately, its revenue-generating ability (Keen & Smith, 2007:10; Sullivan, 2011:11). In a study of the determinants of the VAT gap, Agha and Haughton (1996:305) found that the inclusion of multiple rates in a VAT system is one such design feature that adds to the vulnerability of the tax system to evasion and fraud, as compliance is reduced by seven percentage points with each additional VAT rate. The exploitation of the credit refund mechanism is, for example, exacerbated by the inclusion of zero-rated provisions, as the fictitious claim for input tax that arises in respect of zero-rated supplies effectively places the tax payer in a net refund position, resulting in an outflow of funds from the treasury (Bird & Gendron, 2005:130; Keen & Smith, 2007:10; Pashev, 2006:4). Another design feature that has an impact on the exposure of VAT to fraud is the timing differences between the payment of output tax to SARS, the claiming of input tax and the associated refunds made by SARS (Keen & Smith, 2007:10). When the fraud involves false refund claims, the quicker the refund is paid by the tax authorities, the more advantageous to the fraudster, because tax authorities would have less time to conduct verification tests (Harrison & Krelove, 2005:13).
The most common VAT fraud, or at least the feature that has proven to be especially susceptible to deliberate criminal attack, is the zero-rating of exports (Keen & Smith, 2007:12; Pashev, 2006:4). According to Ainsworth (2006:445), the difficulty with the zero-rating of exports is not only the fact that a zero-rating breaks the VAT chain, but that it is done at a particularly vulnerable spot: the interface of domestic and foreign tax administrations. Most export-related VAT fraud involves fictitious exports: the goods are exported on paper and, therefore, zero-rated, while claiming a tax credit on the inputs used, whereas the goods are, in actual fact, sold on the domestic market without levying VAT (Pashev, 2006:4). This type of VAT fraud exploits the fact that the country of dispatch and the country of arrival do not exchange information on a real-time basis, which impedes on each VAT administration’s ability to control compliance (Ainsworth, 2006:445). On the other hand, the fraudulent abuse of the zero-rate can be as simple as misclassifying a supply of food as a zero-rated supply while it is, in fact, not a zero-rated basic foodstuff, thereby claiming the input on the item but not levying any output and, essentially, creating a fraudulent net refund (Pashev, 2006:15). The zero-rating of intermediate supplies between two registered VAT vendors, is also not immune to abuse, as will be shown in section 5.

3.3. Fraud combating strategies in the VAT system

As mentioned above, the credit mechanism of VAT and other more general design features of the system are susceptible to fraud and evasion. Consequently, advocates for the VAT system have realised that the prospect of effective enforcement due to the systematic invoice-based administration and fractional collection of VAT, as mentioned earlier, is somewhat optimistic, if not fanciful (Krever, 2008:12). While traders may have an incentive to ensure that their suppliers supply them with a valid tax invoice in order to enable them to claim VAT (Agha & Haughton, 1996:303; Botes, 2000:284; Krever, 2008:12) they have no incentive to ensure that the VAT has actually been paid (Keen & Smith, 2007:7). Furthermore, in practice, there is no audit trail throughout the entire system, as a large proportion of sales are made to customers at the end of the chain who would not require a tax invoice (Krever, 2008:13).

Therefore, in addition to these general design features of a VAT system, governments adopt additional legislative, judicial and administrative measures to further combat VAT fraud. The South African VAT system includes the following additional fraud-combating features:

- Stringent requirements to register voluntarily, which reduces fraud by reducing the number of tax payers that can abuse the system (Lejeune, 2011:271).
- Certain zero-rating provisions have additional requirements that protect them from abuse. To obtain a zero-rating on the export of goods, for example, the goods have to be exported within 90 days of the tax invoice being issued and be accompanied by documentary proof as set out in practice note 30, which includes the exportation documentation as prescribed
by the Customs Act. Other zero-rating provisions such as the zero-rating of certain farming inputs or the zero-rating applied to the sale of a going concern also have strict requirements that need to be satisfied before the supply is allowed to be zero-rated (SARS, 2015:74).

- The VAT Act provides that any form of fraud aimed at obtaining undue VAT benefits, or evasion of VAT, constitutes a statutory offence that can lead to penalties and even imprisonment (Botes, 2000:284). These penalties include administrative non-compliance penalties and understatement penalties and, together with the criminal sanctions, provide a comprehensive framework to deter non-compliance (SARS, 2015:118).

There is no denying that regardless of the policy considerations identified in section 2, the inclusion of zero-rating provisions increases the susceptibility of the VAT system to non-compliance, evasion and fraud. The trade-off between the reduced amount of VAT collected as a result of non-compliance, evasion or fraud and addressing other immediate political, social or economic constraints (Agha & Haughton, 1996:303) represents a degree of interaction between the policy considerations and the abuse of zero-rating provisions. This interaction is explored in section 4 below.

4. DEGREE OF BALANCE BETWEEN POLICY CONSIDERATIONS AND FRAUD RISK

From sections 2 and 3 above, it is evident that the revenue effectiveness of a VAT system is influenced by two factors, namely the design of VAT and the non-compliance occurring in the VAT system. The difference between the potential VAT revenue, in the absence of any non-compliance, which could be collected under the current policy, and the theoretical VAT revenue, which could be collected given a hypothetical ideal VAT policy framework, represents the so-called policy gap (Davis Tax Committee, 2014:19; Ueda & Thackray, 2015:2). The policy gap in essence indicates the revenue lost by government in deviating from the ideal single uniform rate (CASE, 2013:21). The VAT ‘compliance gap’, on the other hand, is the difference between revenue actually collected and the potential revenue that could have been collected given the current policy framework (Ueda & Thackray, 2015:15).

The design of a VAT policy might not only lead to a loss of potential VAT revenue as a result of the concessions that have been allowed (Aaron, 1981; Lejeune, 2011:276), but could also impact the magnitude of the loss due to non-compliance. As some instances of non-compliance are a direct result of the increased VAT evasion opportunities these concessions create (Bird & Gendron, 2005:94; Varga, 2009:316). As discussed earlier, the credit mechanism of VAT, for example, is the design feature of VAT that has proven to be especially vulnerable to abuse due to the possibility of obtaining fraudulent refunds (Keen & Smith, 2007:10; Sullivan, 2011:11). However, in many cases, this same design feature is responsible for protecting tax revenue to
some extent due to the fractional collection of VAT which limits the possible loss to the fiscus (Pashev, 2006:12; Smith, 2014:2). The inclusion of multiple rates in the tax design, on the other hand, increases compliance issues (Ebrill et al., 2001:43; Keen & Smith, 2007:10; Tait, 19887) without protecting VAT revenue or creating additional VAT revenue.

The most clear-cut solution advocated by many is, therefore, to limit zero-ratings only to exports (Bird & Gendron, 2005:92; Keen & Smith, 2007:160), as this zero-rating is absolutely necessary for international trade to remain competitive and neutral in applying the destination principle (Oliveira, 2001:17). However, notwithstanding the sound fiscal policy advice and recommendations regarding the inefficiency of VAT concessions, the reality is that governments are often faced with political pressure and large-scale poverty and unemployment issues which cannot deal with the added burden that VAT would impose (National Treasury, 2007:59). It is for this reason that Jansen et al. (2012:91) contend that the zero-rating of VAT on equity grounds will remain part of the VAT structure. Policy makers may therefore regard zero-rating as a worthwhile exercise, despite the loss of revenue especially where it addresses a key policy consideration of tax design such as neutrality and fairness (Bird, 2008:12).

It might be harder to justify why intermediate zero-ratings, which are not advanced on equity grounds, must be tolerated despite the fraud risk they pose. While there has yet to be a conclusive answer on the matter, Grinberg (2010:334), Schenk and Oldman (2007:267) and Williams (1996:52) contend that the added business cost and cash-flow constraints caused by certain intermediate transactions might be sufficient to argue that these transactions warrant a zero-rating, especially given that, in the long run, no revenue is foregone by government on these transactions. The possible justification of intermediate supply zero-ratings is discussed further in section 5 by considering the policy considerations and fraud risk of section 11(1)(g).

5. ANALYSIS OF THE POLICY CONSIDERATIONS AND FRAUD RISK OF SECTION 11(1)(g)

Upon evidence of the abuse of a zero-rating provision, policy makers have broadly two types of responses to limit the loss of revenue (Keen & Smith, 2007:23). The first is essentially an administrative response in the sense that the zero-rating is retained while legal framework is amended to strengthen the defensive measures around the zero-rating provision (Botes, 2000:285; Keen & Smith, 2007:23). The second approach is to simply abolish the zero-rating provision altogether (Keen & Smith, 2007:23; Zsombor, 2010:219). In making this decision, policy makers consider both the design and policy considerations, as well as the tax avoidance and evasion experienced (OECD, 2010:50; Zsombor, 2010:219).
5.1. Alleged fraudulent activities involving section 11(1)(g)

Recently, National Treasury (2014:75) has contended that there is strong evidence substantiating the susceptibility of the zero-rating provision in section 11(1)(g) to abuse, as various entities have entered into activities to fraudulently obtain a VAT input deduction on farming inputs. The zero-rating is allowed only when the Commissioner is satisfied that the vendor acquiring the goods acquires such goods for bona fide farming purposes (SARS, 2015:47). The approval by the Commissioner is evidenced by the vendor’s notice of registration allowing the vendor to acquire such goods at a zero-rate. It is, therefore, the responsibility of the supplying vendor to ensure that farming inputs are supplied at a rate of 0% only where such authorisation exists thereby providing a safeguard against possible abuse. From the examples given by National Treasury (2014:75) in the Draft Explanatory Memorandum, it appears that the fraudulent input tax deduction originates as follows: a farmer, in possession of an endorsement to acquire goods at a zero-rate, would acquire goods from a supplier of agricultural goods at a zero-rate, but instead of utilising the goods purchased in his bona fide farming business, he would resell these goods to the supplier at a lower price per commodity while charging VAT at the standard rate of 14%, thereby allowing the supplier to claim a fraudulent input deduction, as the VAT charged was not paid over by SARS. This circulation of goods between the supplier and farmer could occur multiple times, resulting in recurring fraudulent input tax deductions (Harrison & Krelove, 2005:22; Van der Zwan, 2015:63).

Further concerns highlighted in the Draft Explanatory Memorandum pertain to schemes aimed at circumventing controls of suppliers relating to the enforcement of the requirement that the farmer should be in possession of the needed authorisation to obtain the goods at a zero-rate (AgriSA, 2014; National Treasury, 2014:75; Van der Zwan, 2015:63). If these schemes prove to be successful a person who does not qualify for the zero-rating would still obtain these goods at zero-rate, which effectively means that the vendor has wrongly classified the supply as a zero-rated supply and not as a standard-rated supply and, by doing so, have deprived the government of 14% on this supply (Keen & Smith, 2007:8).

It is submitted that none of these fraud schemes appear to have characteristics that make them unique to the agricultural sector, as these types of fraud schemes could and do arguably occur with any zero-rating provisions. As discussed in section 2 for example, a fraudulent input tax deduction is also obtained where goods are exported and zero-rated on paper but then sold on the domestic market and not submitting the VAT. The only unique element to the alleged fraud schemes involving section 11(1)(g) is the timing difference between the VAT periods of farmers and other vendors, since a farmer’s tax period could be as long as six months, while most suppliers have to submit VAT returns every two months. This means that the fraudulent input claim obtained through these schemes is claimed in a period before the farmer would need to submit his tax returns to the revenue authorities (Keen & Smith, 2007:12; Van der Zwan, 2015:63).
The fraudulent refund would, therefore, have been paid to the supplier before SARS even had the opportunity to cross-check invoices to ensure it was a legitimate input tax claim.

5.2. The nature of the Agriculture sector as a policy consideration

All zero-rating provisions evidently create similar opportunities for abuse. However, the magnitude of the different provisions’ abuse activities is hard to establish with the limited data available to revenue authorities (Keen & Smith, 2007:15). It is therefore submitted that the policy considerations behind the different zero-rating provision would be the tie-breaker in determining whether to amend legislative requirements regarding the provision or simply abolish the provision.

There appears to be widespread consensus that the agricultural sector deserves preferential treatment when it comes to taxation, including special VAT treatment (OECD, 2006:2; Saavalainen et al., 2003:35; Wiktorowicz, 2004:119). It is the unique nature of the sector and its inherent operations that has earned it a spot on the ‘hard-to-tax’ list (Bird, 1983). The specific difficulties that the agricultural sector raises for VAT design stem from two combining features. The first of these is the notion that the agricultural sector will be exposed to higher compliance and administration costs compared to other sectors due to the lack of accounting records as well as the financial fragility of the sector (Shoup, 1988:146; Wiktorowicz, 2004:119). The second reason advanced by many authors (Ebrill et al., 2001:102; Tait, 1988:142; Varga, 2009:323; Wiktorowicz, 2004:119) is the fact that, since the goods produced by the agricultural sector are mainly basic foodstuffs, these goods are politically very sensitive when compared to those of other sectors.

With regard to the first of the features that point towards higher compliance and administration costs, as well as financial fragility, it can be argued that similar problems are associated with other small traders, and that farmers should therefore not receive any special measures apart from the small firm exemption (Due, 1990:385; Tait, 1988:142). Wiktorowicz (2004:119) and AgriSA (2014), however, contend that the nature of farming and the seasonality of its production, combined with the time discrepancy between input and output, make the measurement and payment procedures faced by agricultural producers more complicated than those of any other (small) business. A research study conducted by The Andersons Centre (2016:46) into the cash-flow pressures at farm level showed that farming businesses, which are often described as ‘asset rich but cash poor’ will bear a greater cash-flow burden imposed by VAT than other sectors of the economy mainly due to the seasonality of the section and the timing between input and output.

5.3. Comparison of international Agriculture VAT policy considerations

These unique features of the agricultural sector is also recognised in an international context, some countries for example Poland and Romania have chosen to exempt the entire sector,
thereby excluding farmers from the administration of VAT altogether (Ebrill et al., 2001:103; OECD, 1998:118). Where the agricultural sector is exempt from VAT, agricultural producers will still be taxed to some extent because of the absence of relief of VAT paid on inputs (Due, 1990:385; Shoup, 1988:146). This unrelieved VAT creates certain problems for revenue authorities, most notably being the cascading of taxes (Due, 1990:385; Ebrill et al., 2001:103). Policy makers seek to eliminate this cascading of taxes in one of several ways, with the most universal method, being either, the zero-rating of agricultural inputs (Due, 1990:385; Ebrill et al., 2001:103; Tait, 1988:152) or by granting a presumptive tax credit, approximately equal to the tax borne on inputs by the farmer, to VAT-registered purchasers of agricultural products (Ebrill et al., 2001:104; OECD, 1998:119). The purchaser is expected to pass this benefit on to the farmer who is otherwise not involved in the VAT administration procedure. Some countries, such as Ireland, also offer the relief provided by this scheme to small farmers who are not eligible for registering for VAT (Anderson et al., 2002:76).

The United Kingdom offers farmers a choice between registering for VAT (and being able to claim input tax) and registering on the agricultural flat-rate scheme (Anderson et al., 2002:69). Under this flat-rate scheme farmers do not have to submit VAT returns or make any payments to the revenue authorities. However, the scheme allows the farmer to add a ‘flat-rate addition’ of 4% to the purchase price of goods sold to VAT-registered customers (Anderson et al., 2002:69; HM Revenue & Customs, 2012). The VAT-registered purchaser will be able to claim this 4% as input tax even though, in reality, the farmer did not withhold and pay over tax to the revenue authorities.

Ireland and Canada assist VAT registered farmers by zero-rating purchases of major farming inputs such as certain fertiliser, seeds and plants used to produce food and certain animal feeding stuff (Anderson et al., 2002:76). Since these farmers would in any event have been able to claim back the input tax levied from them, there is no cost or revenue lost to government. However, this concession assists farmers with their cash flow, as they will not have to fund the input tax paid until such time that it is refunded by revenue authorities (Schenk & Oldman, 2007:267; Williams, 1996:52). Some countries also offer modified administrative requirements for farmers to ease compliance with VAT such as longer return and payments periods, accounting for VAT on the cash basis or keeping simplified records (OECD, 1998:113). At the opposite end of the spectrum countries such as New Zealand and Denmark have succeeded in treating farmers like any other VAT liable business charging VAT at a standard rate and not allowing any concessions (Due, 1990:385; Tait, 1988:52).

From the international comparison, it is clear that most countries allow some form of preferential VAT treatment when it comes to the agricultural sector, ranging from exempting the entire sector for VAT purposes to taxing the sector but allowing concessions such as zero-rates, reduced rates
or less stringent administrative requirements (Ebrill et al., 2001:103; Anderson et al., 2002:76; OECD, 1998:113).

5.4. Agriculture VAT policy considerations in South Africa

South Africa taxes the agricultural sector at a standard rate as any other VAT-liable business. With the introduction of VAT, the VATCOM, however, recognised the need for some preferential treatment and, therefore, to reduce the administrative burden of farmers, farmers whose taxable income does not exceed R1.5 million are entitled to submit returns on a six-monthly basis as opposed to the normal two-monthly period. Similarly to Ireland and Canada, section 11(1)(g), on the other hand, was enacted by the South African government to assist farmers with the cash-flow disadvantages caused by VAT. The cash flow disadvantages of the sector that are exacerbated by VAT stems from the nature of the sector and its operations, as explained in 2.5.2 above. The added cash flow burden VAT imposes is exacerbated further by the fact that most agricultural outputs are zero-rated (National Treasury, 2007:156) meaning that the farmer cannot simply use the VAT charge from customers to fund the VAT payable by him on inputs.

National Treasury (2007:156), however, argues that zero-rating the supply of farming inputs to relieve the cash-flow burden of farmers inevitably only moves the cash-flow problem up higher in the production or distribution chain and, ultimately, more and more vendors will request the zero-rating of their inputs. It is contended that the unique seasonal nature of the agricultural industry and the timing of its cash flows make this sector deserving of such a zero-rating policy. Non-farming businesses, for instance, will usually trade with regular intervals (sales and purchases are made on a continuous basis during the year) and will, therefore, build up VAT cash flows from month to month. Consequently, they are less sensitive to the timing of VAT payments, as a part of the VAT liability is serviced by a part of the VAT refunded in the prior period.

In the absence of the zero-rating of farming inputs the lengthy and seasonal production cycles of the farming business will, however, mean that, should a farmer have reduced funds available when it is planting season due to the additional 14% VAT paid on inputs that has not yet been refunded, the farmer will be able to plant 14% less than he would normally plant which, in turn, will lead to a reduction in the yield itself (AgriSA, 2014; Jitsing & Stern, 2008:17; Meiburg, 1962:1433; PWC, 2014:5). Where the farmer is able to obtain additional capital to finance the extra cost imposed on inputs, he will be able to maintain the size of his yield; however, the increased finance cost could result in an increase in the price of basic foodstuffs. It is clear that that there is a real risk that the distortion of production decisions, due to VAT being imposed on inputs either through reduced crop sizes or increased finance cost, will result in higher food prices, as well as lower supply, which will have a knock-on effect through the agricultural value chain as substantial value is still added beyond the farm gate (AgriSA, 2014; PWC, 2014:5)
Even though developments in New Zealand and Denmark to fully tax agriculture in the normal manner indicate that the special treatment of the agricultural sector is not inevitable (Ebrill et al., 2001:104). It is undeniable that there is strong evidence that the policy consideration taken in affording special treatment to the agriculture sector is not without cause. It is further submitted that the zero-rating concession granted to the agricultural sector does not create any new or additional non-compliance or fraud risk compared to other zero-rating provisions. Based on this interaction between the policy consideration and fraud risk a case can be made that policy makers should consider strengthening existing defensive measures around the zero-rating provision as opposed to abolishing it as a result of the alleged fraud.

6. CONCLUSION

VAT is susceptible to evasion and fraud, ranging from the occasional concealed sale to sophisticated criminal attack. Zero-rating provisions create particularly striking problems for VAT, as the fraud might not merely lead to an inappropriate reduction in the tax liability, but might also move towards an outright cash payment to the fraudster, as zero-ratings could lead to net refund positions. As a result zero-rating of intermediate supplies might be even less desirable when the final supply of goods is also zero-rated. Where, for instance, the output of farming is zero-rated (because it is mostly basic foodstuffs), it provides grounds for farmers to lobby that the inputs used in the production of these goods be zero-rated. Where this is allowed, it will give their suppliers grounds to lobby that their inputs be zero-rated. It is submitted that there is potentially no logical end to this sequence until large parts of the economy is outside the scope of VAT.

A strong economic case can, therefore, be made for the removal of existing zero-ratings. However, a trade-off is necessary between the interest of business and those of the tax administrators as considered in section 4. It is clear that the unique nature of the agricultural sector, due to the seasonality of its production, the time discrepancy between input and output and the unique nature of the sectors’ output which consist mainly of basic food necessities, among other things, justify an exception to the rules of VAT. The strong policy considerations are further supported by the fact that zero-rating concession granted to the agricultural sector does not create any new or additional non-compliance or fraud risk compared to other zero-rating provisions. While a drastic change such as the repeal of section 11(1)(g) might prove to be a robust defence against alleged fraud, the discussion in this paper illustrates that it could harm the principles for which this provision was initially enacted and, thus, produce uncertain effects in an industry already burdened by uncertainties.

The question which this paper has undertaken to answer is whether the repeal of section 11(1)(g) is justified in light of the potential fraud risk; more specifically, can this zero-rating and the risk of fraud posed by it be distinguished from other zero-rated supplies? It is submitted that this
provision does not offer opportunities for abuse that is significantly different from those of other zero-rating provisions. This was established by the comparison of the general and specific fraud activities experienced with all zero-rating provisions in Section 3 to the alleged fraudulent activities involving section 11(1)(g) as explored in section 5. While the repeal may be justified in light of sound tax policy as suggested in section 2, the repeal of this section could be detrimental to a sector that plays a key role in economic development and that is already facing increasing difficulties due to economic challenges such as a lack of finance and environmental challenges such as the current drought as considered in Section 5.
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CHAPTER 3: CONCLUSION

3.1 OBJECTIVE OF THIS CHAPTER

The objective of this chapter is to provide a summary of the key findings of the study and how these findings address the research question formulated in chapter 1.

3.2 RESEARCH FINDINGS

The first objective was to obtain an understanding of the necessity of the inclusion of zero-rating provisions in the design of a VAT system from a policy perspective. It was found that an ideal VAT model would be a broad-based VAT designed to tax all forms of consumption at a uniform rate. However, no country in the world operates such a system and nearly all jurisdictions allow for some sort of concessionary treatment through reduced rates or exemption. It was further noted that policy makers include zero-rating provisions in the design of a VAT system in order to achieve broad tax policy considerations such as equity, efficiency and neutrality, as well as considerations outside the field of tax. It was found that the zero-rating provisions can be classified into one of three types, namely those used to make goods or services affordable to the end user, those used to remove a supply from the VAT where it is consumed in another jurisdiction and, finally, those used to relieve unnecessary cash-flow burdens on intermediate supplies. Policy considerations for the latter was found to be the most controversial.

Secondly, the types of VAT fraud and specifically the risk that zero-rating provisions create for evasion and fraud were investigated. It was found that VAT like any other tax is susceptible to fraud and evasion. It was further noted that the credit mechanism of VAT, which allows a VAT-registered vendor to claim input tax on purchases, creates unique opportunities for abuse. Zero-rating provisions exacerbate these opportunities, as it could place the tax payer in a net refund position, resulting in an outflow of funds from the treasury. All zero-rating provisions are susceptible to fraud; however, the degree of exposure will depend on the design features of the specific zero-rating provision. It was also found that, to mitigate the risk of abuse of a zero-rating provision, the Act normally provides for preventative measures such as documentary proof required to obtain the zero-rating provision.

The third and last objectives was to assess the policy considerations behind section 11(1)(g), as well as the alleged abuse of this section, to establish whether these can be distinguished from those of other zero-rating provisions. It was noted that the main policy consideration behind section 11(1)(g) is to assist farmers with their cash-flow burden as a result of VAT that would be
payable on inputs while most of farmers’ output is likely to be zero-rated as part of policy makers’ aim to ensure that VAT is regressive. It was established that this policy consideration appears to be justified seeing that the agricultural sector is unique from other sectors in the economy mainly due to the seasonality of its production and the fragility of its operations as a result of the time discrepancy between input and output. It was further found that, apart from the six-months VAT period on which some farmers operate, there are no other distinct features that make section 11(1)(g) more attractive or susceptible to abuse than other zero-rating provisions. It was found that, should section 11(1)(g) be repealed, a decrease could occur in the yield of commodities produced by the agricultural sector or an increase in the price of basic foodstuffs due to increased finance costs.

3.3 OVERALL

VAT is susceptible to evasion and fraud, ranging from the occasional concealed sale to sophisticated criminal attack. Zero-rating provisions create particularly striking problems for VAT, as the fraud might not merely lead to an inappropriate reduction in the tax liability, but might also move towards an outright cash payment to the fraudster, as zero-ratings could lead to net refund positions. As a result zero-rating of intermediate supplies might be even less desirable when the final supply of goods is also zero-rated. Where, for instance, the output of farming is zero-rated (because it is mostly basic foodstuffs), it provides grounds for farmers to lobby that the inputs used in the production of these goods be zero-rated. Where this is allowed, it will give their suppliers grounds to lobby that their inputs be zero-rated. It is submitted that there is potentially no logical end to this sequence until large parts of the economy is outside the scope of VAT.

A strong economic case can, therefore, be made for the removal of existing zero-ratings. However, a trade-off is necessary between the interest of business and those of the tax administrators as considered in section 4. It is clear that the unique nature of the agricultural sector, due to the seasonality of its production, the time discrepancy between input and output and the unique nature of the sectors’ output which consist mainly of basic food necessities, among other things, justify an exception to the rules of VAT. The strong policy considerations are further supported by the fact that zero-rating concession granted to the agricultural sector does not create any new or additional non-compliance or fraud risk compared to other zero-rating provisions.

While a drastic change such as the repeal of section 11(1)(g) might prove to be a robust defence against alleged fraud, the discussion in this paper illustrates that it could harm the principles for which this provision was initially enacted and, thus, produce uncertain effects in an industry already burdened by uncertainties.

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The question which this paper has undertaken to answer is whether the repeal of section 11(1)(g) is justified in light of the potential fraud risk; more specifically, can this zero-rating and the risk of fraud posed by it be distinguished from other zero-rated supplies? It is submitted that this provision does not offer opportunities for abuse that is significantly different from those of other zero-rating provisions. This was established by the comparison of the general and specific fraud activities experienced with all zero-rating provisions in Section 3 to the alleged fraudulent activities involving section 11(1)(g) as explored in section 5. While the repeal may be justified in light of sound tax policy as suggested in section 2, the repeal of this section could be detrimental to a sector that plays a key role in economic development and that is already facing increasing difficulties due to economic challenges such as a lack of finance and environmental challenges such as the current drought as considered in Section 5.
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