REPUBLIC OF SOUTH AFRICA

DRAFT EXPLANATORY MEMORANDUM TO DRAFT REGULATIONS

ON THE DOMESTIC REVERSE CHARGE RELATING TO VALUABLE METALS, ISSUED IN TERMS OF SECTION 74 OF THE VALUE ADDED TAX ACT, 1991(ACT NO 89 OF 1991)

6 OCTOBER 2021

[W.P. – '21]

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1. BACKGROUND

1.1 VAT system in general

Generally, the VAT system makes provision for persons that meet the requirements (referred to as vendors) to register for and to charge and collect VAT on the supply of goods or services. The mechanism of charging, collecting and paying the VAT to Government is based on self-assessment, which allows the vendor to determine its liability or refund of tax. It adopts a subtractive or credit input method which allows the vendors to deduct the VAT incurred on enterprise expenses (input tax) from the VAT collected on the supplies made by the vendor (output tax). The vendor may deduct the VAT paid during the preceding stages of the production and distribution chain (that is, the burden of the VAT is on the final consumer whilst maintaining neutrality in the business chain). The subtractive method also serves as a reliable method of accounting to ensure that the VAT is paid on every transaction.

In essence, the characteristics of the VAT system is that the final consumers pay the VAT. VAT is levied on every taxable supply, vendors collect the VAT at each stage, and the allowable input tax is deductible by vendors.

A tax invoice is critical to the VAT system. The purpose of a tax invoice is to reflect information on the VAT rate applicable, to enable a vendor to prove their right to deduct input tax, and most importantly, it also allows the tax authority to cross-check the transactions, i.e. that what is reflected by the seller is the same as what is in possession of the recipient. The tax authority is able to verify that the VAT charged by the supplying vendor and the input tax deduction by the recipient vendor match. However, if the tax periods of the vendors are different or, for example, the vendor deducting the input tax makes the deduction in a later tax period, the tax authority can

only verify the information on whether the input tax deducted has been remitted to the tax authority, *post facto*.

1.2 Previous VAT fraud scheme in respect of second-hand goods constituting gold

Although the general VAT system subscribes to the canons of taxation and best practice of VAT principles, however, VAT on second-hand goods, particularly second-hand gold, was and still is a target of abusive and fraudulent activities. The *post facto* verification of VAT charged against VAT deducted has led to the South African Revenue Service (SARS) having challenges in curbing these malpractices.

It came to Government's attention that while the acquisition of gold jewellery by VAT vendors from non-VAT vendors should allow for the deduction of notional input VAT, in practice this provision significantly contributed to creating an enabling environment to obtain fraudulent input tax deductions. Jewellery is smelted along with gold coins and illegally acquired raw gold.

As a result, in 2014, changes were made to the definition of "*second hands goods*" in the VAT Act to the effect that second-hand goods made from precious metals were excluded from obtaining the notional input tax, unless such goods were re-sold in the same or substantially the same state as they were bought in.

2. REASONS FOR CHANGE

Government has identified a new *modus operandi* used by vendors to extract undue VAT refunds from the *fiscus*. These vendors have moved away from making fictitious input tax deductions (resulting in VAT refunds) under the pretence that the goods are second-hand goods, containing gold. Instead, various fictitious businesses are registered for VAT purposes as vendors and required documentation are fabricated. These vendors acquire and supply the following f goods, namely, Krugerrands, illegal gold, etc. These types of goods are introduced into the production and distribution chain to manufacture mainly gold bars, gold doré and gold granules, for export purposes. These vendors diligently submit VAT returns that, in most cases, reflect

minimal amounts of VAT payable to SARS, but large amounts of VAT refunds are claimed when the gold bars, gold doré and gold granules are exported.

More specifically, these vendors utilize “invoice-farms” to create a paper trail to authenticate and re-characterise the supply of Krugerrands, illegal gold, etc. and VAT at the standard rate is charged, i.e. a deliberate and purposeful misrepresentation of the nature, type and origin of the Krugerrands, illegal gold, etc. Further, numerous other fraudulently registered vendors are interposed between the initiating vendor supplying the Krugerrands, illegal gold, etc. and the last vendor that acquires the gold bars, gold doré and gold granules (at the standard rate) and exports them at the zero rate, whilst deducting input tax deduction and claiming a VAT refund. This VAT refund may then be effectively shared with the other interposed vendors in the production and distribution chain.

Due to the interposing of numerous vendors, i.e. the creation of multiple layers, between the initiating vendor and the vendor that ultimately undertakes the exports, it is very difficult for SARS to detect at which stage the fraudulently re-characterised goods and fabricated documentation entered the production and distribution chain to supposedly manufacture the gold bars, gold doré and gold granules.

The overall scheme is therefore aimed at effectively capturing the VAT refund at the final stage of the production and distribution chain, where input tax is deducted on the acquisition of the gold bars, gold doré and gold granules and output tax is declared at the zero-rate by the vendor that undertakes the export of the gold bars, gold doré and gold granules.

The estimated financial impact of the above-mentioned schemes is estimated at billions of rand a year.

3. PROPOSAL

3.1 Measures adopted by other jurisdictions to curb VAT fraud schemes

Other jurisdictions that experienced above-mentioned similar types of fraudulent activities and schemes introduced the concept of a Domestic Reverse Charge Mechanism on goods and services that are prone to abuse and malpractice.

- *Australia – Reverse Charge in the Valuable Metals Industry*[1]

  With effect from 1 April 2017, Australia introduced a mandatory reverse charge that applies on business-to-business transactions of valuable metals. This applies to sales between Goods and Services Tax (GST)-registered suppliers and GST-registered purchasers on all taxable supplies of gold, silver or platinum. A reverse charge transaction makes the purchaser responsible for remitting GST, rather than the supplier. It makes it easier and faster for businesses in the valuable metal industry to meet their GST and reporting obligations.

- *United Kingdom – Domestic Reverse Charge Procedure* [2]

  In the United Kingdom, the VAT domestic reverse charge procedure is an anti-fraud measure designed to counter criminal attacks on the UK VAT system by means of sophisticated fraud. The reverse charge only applies to supplies where:
  - those supplies are specified supplies of goods or services as set out in section 3 of the UK VAT Act.
  - your customer is registered or liable to be registered for UK VAT.
  - your customer is buying the goods or services for a business purpose.

[1] (https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions) **17-Jan-2020**
[2] (https://www.gov.uk/vat) Domestic reverse charge procedure (VAT Notice 735); Published 27 April 2015

3.2 Measure proposed by South Africa to curb VAT fraud schemes

In order to curb VAT fraud schemes, it is proposed that similar to other countries, South Africa introduces a Domestic Reverse Charge ("DRC"). This DRC will be introduced through Regulations in terms of section 74 of the VAT Act. The policy objective of the DRC Regulations is that it is an anti-abuse measure aimed at removing the opportunity for fraudulent vendors to re-characterise gold and goods containing gold, make minimal VAT payments to SARS and extracting large amounts of VAT refunds from the *fiscus*.

- *Vendors subject to DRC Regulations*

  The DRC Regulations will apply to all vendors involved in the entire production and distribution chain that make supplies of the defined goods, i.e. where Krugerrands, illegal gold, etc. is acquired and supplied to manufacture gold bars and gold doré and gold granules.

- *Goods subject to DRC Regulations*

  The DRC Regulations will apply to specified types of goods, considered to be valuable metals, which will include any ancillary supplies thereto. As such, a new definition of a "*valuable metal*" will be included in the DRC Regulations.

  However, the DRC Regulations will not apply to all valuable metals in its entirety. The DRC Regulations will apply to the valuable metal, being goods that are supplied as a gold bearing bar or similar item. Such gold bar or similar item may have traces of other metallic materials, but the ambit of the supply, for purposes of this Regulation, remains the supply of a gold bearing bar or similar item or ancillary supplies thereto. The definition will also have an exclusion, but the exclusion does not widen the ambit of the Regulation to all valuable metals in its entirety.

In this regard the VAT rules regarding single supplies, mixed supplies and composite supplies will be applicable as these are prone to abuse and malpractice.

- *Workings of the DRC Regulations*

  The DRC Regulation is conceptualised on the following basis:

  - the acquiring vendor (recipient) and supplying vendor (supplier) must be registered vendors.

  - the supply must be a supply chargeable with VAT at the standard rate.

  - the recipient of the goods becomes the vendor liable to account for and pay the VAT (on behalf of the supplier) to the *fiscus.*

  - the recipient (if entitled to deduct input tax, subject to sections 16, 17 and 20 of the VAT Act) is only allowed to deduct the input tax on the acquisition, if the recipient has accounted for and paid to SARS the VAT charged by the supplier in accordance with the principles prescribed by the DRC Regulation and which input tax must be deducted at the latest, within 12 months from the date of receipt of the tax invoice.

  - the input tax deduction must be done in the same tax period in which the output tax (charged by the supplier) is to be accounted for and paid by the recipient.

  - Notwithstanding the 21-day period contemplated in section 20(1) and section 20(1B), a tax invoice must be issued on the date of the supply.

  - the supplier will not be entitled to input tax on irrecoverable debts as the recipient will account for and pay the VAT to SARS, on behalf of the supplier.

- the supplying vendor remains liable to levy/charge the VAT on the supply but will not collect such VAT from the recipient vendor. The remittance of that VAT to the *fiscus*, is now an obligation placed on the recipient vendor. Hence, the VAT payable on the supply is aligned with the recipient's entitlement to deduct input tax. From a VAT reporting perspective, the recipient will net-off the VAT on the supply and the input tax deduction (subject to section 16, 17 and 20 of the Act) in the same VAT return.

- if the supply is made to an end user, e.g., a fully exempt business or a person not registered for VAT, the VAT is to be charged, accounted for and remitted under the rules prescribed in the current present VAT system, i.e. the DRC Regulation will not apply to transactions between such persons, as they are not transactions between vendors.

- the supplier must take reasonable steps to verify the VAT registration status of the recipient.

- the supplier is required to maintain and retain, as part of VAT recordkeeping, a list of all supplies subject to the DRC Regulations.

- The recipient, after having received the tax invoice from the supplier, must notify the supplying vendor in writing by means of a statement within 21 days of the end of the calendar month during which a tax invoice was issued to the recipient vendor, where the supply is subject to the domestic reverse charge, with the particulars prescribed in the Regulations.

- the supplier and recipient should compulsorily inform SARS (via a notification status under their registration) that they engage in transactions that fall within the ambit of the DRC Regulations, by updating their VAT registration status.

- in instances where exports are undertaken, mandatory Customs and Excise supervision must be done, to prevent dealing with discrepancies on export matters *post facto*.

- if the recipient, *inter alia*, omits to account for and pay the domestic reverse charge VAT, the supplier and recipient shall be held jointly and severally liable for any VAT loss suffered by the *fiscus* elsewhere in the production and distribution supply chain. The supplier will not be held liable if it meets the prescribed administrative requirements, such as taking reasonable steps to verify the recipient's VAT registration status, maintaining the required records and obtaining statements of compliance from the recipient.

- the issuing of a tax invoice, debit and credit note will follow the normal VAT rules. The DRC Regulations will prescribe additional information to be reflected on these documents. The DRC Regulations will further prescribe the accounting, reporting and payment obligations of the supplier and the recipient, respectively.

4. EFFECTIVE DATE

The proposed DRC Regulations will come into operation on 1 January 2022.