



REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM TO REGULATIONS

**ON THE DOMESTIC REVERSE CHARGE RELATING TO VALUABLE METAL,
ISSUED IN TERMS OF SECTION 74(2) OF THE VALUE-ADDED TAX ACT, 1991
(ACT NO 89 OF 1991)**

13 JUNE 2022

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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 the Government is based on self-assessment, which allows the vendor to determine its liability or refund of VAT. It adopts a subtractive or credit input method that 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, 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 a deduction of notional input tax on the acquisition of gold jewellery by VAT vendors from non-VAT vendors was allowed, 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 vendors were excluded from obtaining the notional input tax on second-hand goods containing gold, 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 is fabricated. These vendors acquire and supply Krugerrands, illegal gold, etc. These types of goods are introduced into the production and distribution chain to manufacture mainly gold in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms, 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 in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms are exported.

More specifically, these vendors utilise “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 gold obtained from 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 in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms (at the standard rate) and exports them at the zero rate, whilst deducting input tax 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 goods containing gold, in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms.

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 goods containing gold, in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms and output tax is declared at the zero-rate by the vendor that undertakes the export of these goods.

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

3. PROPOSAL

3.1 Measures adopted by other jurisdictions to curb VAT fraud schemes

Other jurisdictions that experienced the 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 Industry¹*

With effect from 1 April 2017, Australia introduced a mandatory reverse charge that applies to 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 Procedure²*

In the United Kingdom (UK), 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.
- the customer is registered or liable to be registered for UK VAT.
- the 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>) accessed 17 January 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 in relation to gold and goods containing gold, 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(2) 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 extract large amounts of VAT refunds from the *fiscus*.

- Vendors subject to DRC Regulations

The DRC Regulations will apply to all registered vendors involved in the entire production and distribution chain that make supplies of defined valuable metal, namely, any goods containing gold in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms, including any ancillary goods or services

- Goods subject to DRC Regulations

The DRC Regulations will apply to the valuable metal as defined in the Regulations, being any goods containing gold in the form of jewellery, bars, blank coins, ingots, buttons, wire, plate, granules, in a solution, residue or similar forms, including any ancillary goods or services.

Such goods may have traces of other metallic materials, but the ambit of the supply, for purposes of these Regulations, remains the supply of a gold bearing good or, including the supply of any “ancillary goods or services” (for example packaging, polishing, storage etc). As such, where a supply consists of a gold-bearing item in the forms above, together with ancillary goods or services, the full consideration in respect of both supplies will be subject to VAT at the standard rate and subject to the DRC Regulations.

- Goods excluded from the application of DRC Regulations

The following goods are excluded from the application of DRC Regulations:

- Supplies of goods produced from raw materials by any “holder” as defined in section 1 of the Mineral and Petroleum Resources Development Act 28 of 2002, or any person contracted to such “holder” to carry on mining operations in respect of the mine where the “holder” carries on mining operations;
- Supplies contemplated in section 11(1)(f), (k) or (m) of the VAT Act, 1991.

That said, the exclusions do not widen the ambit of the Regulations to all valuable metal in its entirety.

- Workings of the DRC Regulations

The DRC Regulation is conceptualised on the following basis:

- the acquiring vendor (recipient) of valuable metal and supplying vendor (supplier) of valuable metal must be registered vendors.
- the supply of valuable metal must be a supply chargeable with VAT at the standard rate.
- The recipient of valuable metal becomes the vendor liable to account for and pay the VAT (on behalf of the supplier) to the *fiscus*.
- the recipient of valuable metal (if entitled to deduct input tax, subject to sections 16, 17, 20 and 21 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 Regulations.

- the supplier of valuable metal 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 of valuable metal 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 of valuable metal is aligned with the recipient's entitlement to deduct input tax.
- if the supply of valuable metal 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 present VAT system, i.e. the DRC Regulations will not apply to transactions between such persons, as they are not transactions between vendors.
- the supplier of valuable metal must take reasonable steps to verify the VAT registration status of the recipient.
- the supplier of valuable metal 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, or in the case of recipient-created tax invoices, being issued by the recipient vendor, must notify the supplying vendor in writing by means of a statement within 21 business days of the end of the calendar month during which the output tax was declared, where the supply of valuable metal is subject to the DRC, with the particulars prescribed in the Regulations.
- the supplier and recipient of valuable metal must compulsorily inform SARS that they engage in transactions that fall within the ambit of the DRC Regulations, by updating their VAT registration status.

- 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*. 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, obtain, and retain the required records, including a list of all supplies subject to the DRC Regulations.

- the issuing of a tax invoice, debit and credit note will follow the normal VAT rules. The DRC Regulations prescribe additional information to be reflected on these documents. The DRC Regulations 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 July 2022. A registered vendor will be allowed a period of one month from 1 July 2022 to ensure that it complies with the requirements of these Regulations. This means that a registered vendor, being a recipient, will be allowed to account for and pay the VAT in respect of transactions that became subject to these Regulations in the tax period covering August 2022.