

DAVIS TAX COMMITTEE

SMALL AND MEDIUM ENTERPRISES: TAXATION CONSIDERATIONS, INTERIM REPORT, JULY 2014

Intended use of this document:

The Davis Tax Committee is advisory in nature, and will make recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.¹

¹ Minister of Finance, Mr Pravin Gordhan “Davis Tax Committee: Terms of Reference” July 2013.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

CONTENTS

| | |
|--|-----------|
| LIST OF ABBREVIATIONS | 4 |
| CHAPTER 1 - INTRODUCTION | 5 |
| 1.1 THE ROLE OF SMALL AND MEDIUM ENTERPRISES IN THE ECONOMY | 5 |
| 1.2 DETERMINING WHAT A SMALL AND MEDIUM ENTERPRISE IS | 5 |
| 1.3 ISSUES ARISING FROM THE APPLICABLE DEFINITIONS | 8 |
| 1.4 THE LIMITATIONS OF RELYING ON THE SMALL AND MEDIUM ENTERPRISES SECTOR AS A REVENUE CONTRIBUTOR | 12 |
| 1.5 CHALLENGES OF PAST INITIATIVES TO ENSURE REVENUE CONTRIBUTIONS BY SMES..... | 13 |
| CHAPTER 2 - INCOME TAX PROVISIONS FOR SMES | 15 |
| 2.1 SECTION 12E: DEDUCTIONS FOR SMALL BUSINESS CORPORATIONS..... | 15 |
| 2.2 SECTION 12J: THE VENTURE CAPITAL COMPANY SYSTEM..... | 22 |
| 2.3 OTHER INCOME TAX PROVISIONS RELEVANT TO SMES..... | 25 |
| CHAPTER 3 - MICRO BUSINESS TURNOVER TAX | 26 |
| 3.1 THE WORKING OF MICRO BUSINESS TURNOVER TAX..... | 26 |
| 3.2 EVALUATION OF THE EFFECTIVENESS OF THE MICRO BUSINESS TURNOVER TAX SYSTEM | 26 |
| 3.3 RECOMMENDATIONS..... | 28 |
| CHAPTER 4 - VALUE-ADDED TAX AND SMALL BUSINESSES | 32 |
| 4.1 CONCERNS REGARDING THE BASIC VALUE-ADDED TAX VOLUNTARY REGISTRATION THRESHOLD | 33 |
| 4.2 CONCERNS REGARDING THE BASIS OF VAT REPORTING | 34 |
| 4.3 CONCERNS REGARDING VAT PERIODS..... | 35 |
| 4.4 CONCERNS REGARDING VAT REFUNDS | 36 |
| CHAPTER 5 - OTHER INCENTIVES RELEVANT TO THE SME SECTOR | 37 |
| 5.1 THE EMPLOYMENT TAX INCENTIVE ACT | 37 |
| 5.2 INCENTIVES PROVIDED BY THE DEPARTMENT OF TRADE AND INDUSTRY ... | 42 |

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

| | |
|--|-----------|
| CHAPTER 6 - GENERAL COMPLIANCE CHALLENGES FOR SMES | 44 |
| 6.1 A STUDY ON COMPLIANCE CHALLENGES FOR SMALL BUSINESSES..... | 44 |
| 6.2 EVALUATION..... | 46 |
| 6.3 RECOMMENDATIONS | 47 |
| APPENDIX 1: | |
| SUMMARY OF PRELIMINARY SMALL BUSINESS PROPOSALS | 49 |
| APPENDIX 2: | |
| LIST OF PARTIES CONSULTED BY DTC SMALL BUSINESS SUB-COMMITTEE | 50 |

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

LIST OF ABBREVIATIONS

| | |
|-----------------|---|
| CGT: | CAPITAL GAINS TAX |
| DTC: | DAVIS TAX COMMITTEE |
| DTI: | DEPARTMENT OF TRADE AND INDUSTRY |
| ETI: | EMPLOYMENT TAX INCENTIVE |
| FSB | FINANCIAL SERVICES BOARD |
| FTA: | FORUM ON TAX ADMINISTRATION |
| INCOME TAX ACT: | INCOME TAX ACT, 1962 (ACT NO. 58 OF 1962) |
| MSB | MINISTRY OF SMALL BUSINESS DEVELOPMENT |
| NT | NATIONAL TREASURY |
| NDP: | NATIONAL DEVELOPMENT PLAN |
| PAYE: | PAY-AS-YOU-EARN |
| RCR: | REFUNDABLE COMPLIANCE REBATE |
| SARS: | SOUTH AFRICAN REVENUE SERVICE |
| SBC: | SMALL BUSINESS CORPPORATION |
| SME: | SMALL AND MEDIUM ENTERPRISES |
| TAA: | TAX ADMINISTRATION ACT, 2011 (ACT NO. 28 OF 2011) |
| VAT ACT: | VALUE-ADDED TAX, 1991 (ACT NO. 89 OF 1991) |
| VCC: | VENTURE CAPITAL COMPANY |

CHAPTER 1

INTRODUCTION

1.1 THE ROLE OF SMALL AND MEDIUM ENTERPRISES IN THE ECONOMY

South Africa's National Development Plan (NDP) states that:

'Small and expanding firms will become more prominent, and generate the majority of new jobs created. They will also contribute to changing apartheid legacy patterns of business ownership. They will be stimulated through public and private procurement, improved access to debt and equity finance, and a simplified regulatory environment.'²

The role of small and medium-size businesses has been accepted by the NDP as representing a critical sector for the promotion of employment, particularly in labour-absorbing industries. The NDP suggests that:

'A large percentage of the jobs will be created in domestic-orientated activities and in the services sector. Some 90% of jobs will be created in small and expanding firms. The economy will be more enabling of business entry and expansion, with an eye to credit and market access. By 2030, this share of small and medium-sized firms in output will grow substantially. Regulatory reform and support will boost mass entrepreneurship. Export growth, with appropriate linkages to the domestic economy, will play a major role in boosting growth and employment, with small- and medium-sized firms being the main employment creators'.³

Given that government has accepted the parameters of the NDP, it stands to reason that the DTC seeks to prioritise the examination of the tax system and its impact upon the promotion of small and medium size businesses including an analysis of tax compliance costs, a possible streamlining of tax administration, the simplification of tax legislation and the role of incentives.

1.2 DETERMINING WHAT A SMALL AND MEDIUM ENTERPRISE IS

At the outset of this investigation it is necessary to set out a categorization of small and medium-size businesses. There is currently no universally accepted definition of small and medium size businesses in South Africa. For instance, the NDP, the National

2 South Africa: National Planning Commission 'National Development Plan: Vision for 2030' (11 November 2011) at 144.

3 South Africa: National Planning Commission 'National Development Plan' at 119.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

Small Enterprise Act, 1996 (Act No. 102 of 1996) as amended and the Income Tax, 1962 (Act No. 58 of 1962) as amended, each have their own interpretations and definitions.⁴

It follows that the lack of a uniform definition for small and medium-size businesses presented the DTC with considerable difficulty.

1.2.1 Definitions in the NDP

The NDP identifies three categories of business within the SME sector which it defines as survivalist, lifestyle and entrepreneur.

Survivalist businesses: Briefly the NDP appears to regard a survivalist business as essentially a home-based business or one which operates on the streets. Typically businesses of this nature display a manifest lack of the use of any capital equipment and predominantly take the form of cash businesses which do not compile more than the most basic of financial records. These businesses include taxi operators, spaza shops, taverns, casual construction workers, hawkers, informal subcontractors and gardeners.

Lifestyle businesses: The NDP defines a lifestyle business as one based at home (often in middle- and upper-class areas) or a business which has a single office. An example of this kind of business would include the doctor, the electrician, the plumber, the artisan, the engineer, the accountant, a franchisee, a broker, a consultant, small assembly in production as well as technology.

Entrepreneurial businesses: These types of businesses are defined in the NDP as concerned with expansion of business by an entrepreneur who wants to develop a brand, expand its market share or even develop a franchise. Entrepreneurs may invent a new process, a new product, or even a new market. It is these types of businesses in which venture capitalists may show an interest in investing. It is this category of business, which the NDP considers will be most successful in the generation of employment.

1.2.2 Definition in the National Small Enterprise Act, 1996

The National Small Enterprise Act, 1996 defines a small enterprise as follows:

4 Other statutes that of relevance on this matter are: The Broad-Based Black Economic Empowerment (BBBEE) Act 53 of 2003 read with the BBBEE Codes of Good Practice and the Employment Equity Act 55 of 1998 read with its Codes of Good Practice

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

‘a separate and distinct business entity, together with its branches or subsidiaries, if any, including co-operative enterprises, managed by one owner or more predominantly carried on in any sector or subsector of the economy mentioned in column 1 of the Schedule and classified as a micro-, a very small, a small or a medium enterprise by satisfying the criteria mentioned in columns 3, 4 and 5 of the Schedule’.

What is relevant about the Schedule for the purposes of this analysis is that in all the sectors or sub sectors of the economy which are mentioned in the Schedule, the key criteria for determining whether the enterprise can be classified as medium, small, very small or micro turns on the total full-time equivalent of paid employees, the total turnover and the total gross asset value. Save in the case of agriculture, a medium-size business is defined as a business which has a total full-time paid employee compliment of 200 or more employees. A small business has 50 employees, a very small business 20 employees and a micro business 5 employees. The total turnover for a medium-size business ranges from a minimum of R 5 million in the case of agriculture to R64 million in the case of wholesale, trade, commercial agents and allied services. Small businesses range from R3 million to R32 million, very small from R500 000 to R6 million and micro businesses generally are defined with a turnover of up to R200 000. Turnover seems to be the most preferred indicator to use internationally and even locally.

The gross asset value (excluding fixed property) fluctuates from R5 million to R23 million for medium-size businesses, from R1 to R6 million for small businesses, and from R500 000 to R2 million for very small businesses. Micro businesses have a gross asset value of R100 000.

1.2.3 Definition in the Income Tax Act

For the purposes of income tax, two definitions are relevant to this analysis. The first relevant definition is that of a micro business, as set out in Part 2 of the Sixth Schedule to the Income Tax Act, in terms of which a person qualifies as a micro business if that person is (amongst other qualifying requirements):

- (a) a natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency); or
- (b) a company

where the qualifying turnover of that person for the year of assessment does not exceed an amount of R1 million.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

The second definition in the Income Tax Act that is relevant to this analysis is that of a small business corporation (SBC) that is set out in section 12E(4) of the Income Tax Act. This section defines a SBC as any close corporation or co-operative or any private company, all shareholders of which are at all times during the year of assessment natural persons where the gross income for the year of assessment does not exceed R20 million per annum (with effect from the 2014 year of assessment). Other qualifying requirements are also applicable.

This approach of considering level of turnover figures has been applied in other jurisdictions to determine what constitutes a small and medium enterprise. A survey⁵ of 12 countries which employ a definition of a Small and Medium Enterprise (SME) including Australia, Austria, Canada, Finland, France, Germany, Ireland, Netherlands, New Zealand, Spain and Switzerland shows that turnover figures are a critical factor in the definitions employed, although there are marked differences in the thresholds. Only Finland, Ireland and New Zealand use a single SME definition across different government departments. The balance of jurisdictions has a similar range of definitions as in South Africa.⁶ Although the question of a uniform definition of a SME for all applicable legislation in South Africa falls outside the scope of this enquiry since it affects more than one government department, it is an issue that is deserving of careful consideration.

In its deliberations with certain groups who made representations, the DTC had the opportunity to consider the issue of an appropriate SME definition. In this regard, the DTC had the benefit of considering the views of the Forum on Tax Administration (FTA) regarding the issue, in which twelve jurisdictions were examined. It is common to employ turnover as the yardstick for a definition. It is, however, possible that the widespread recommendation of a 'one size fits all' SME definition may hold significant problems.

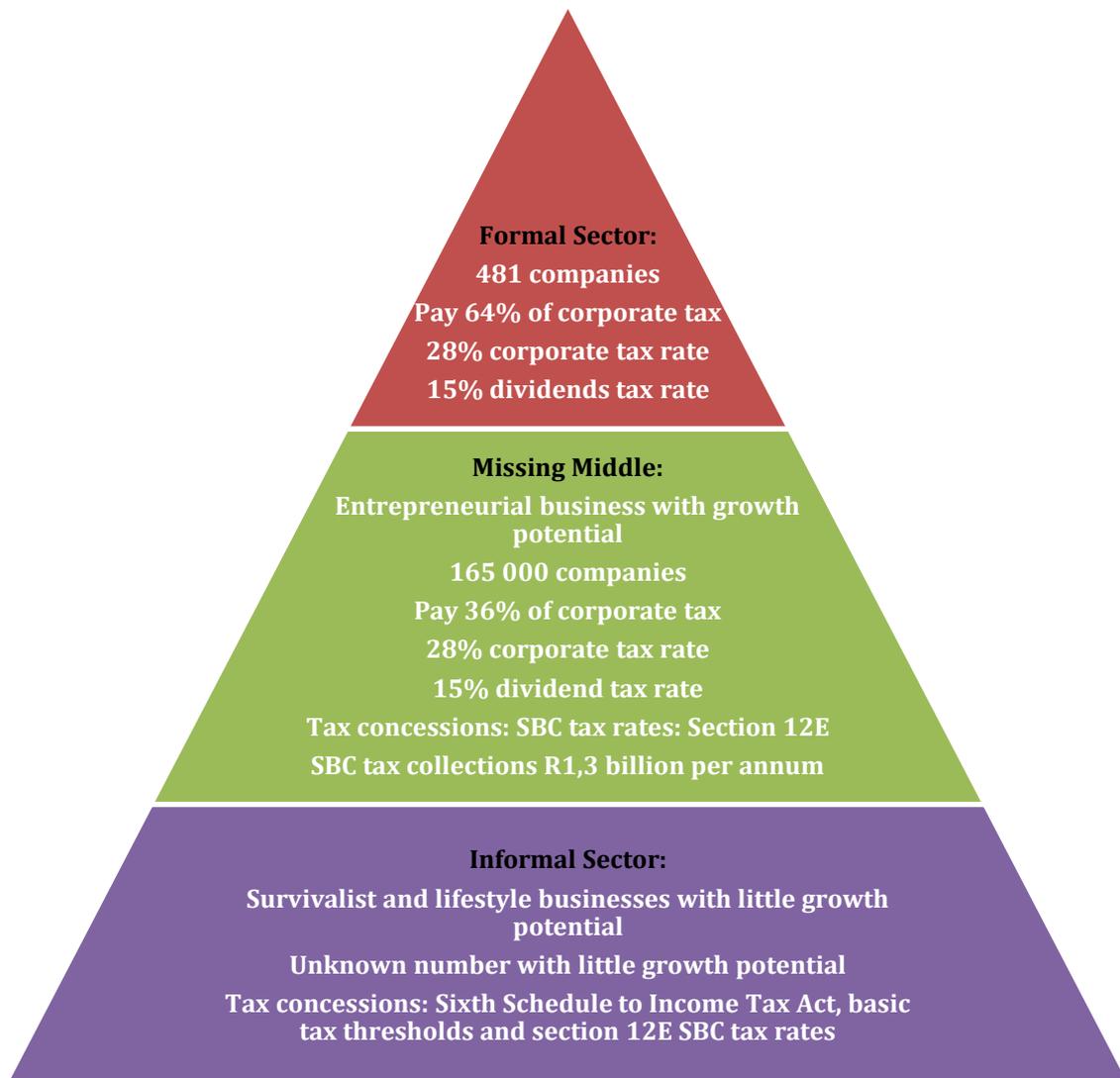
1.3 ISSUES ARISING FROM THE APPLICABLE DEFINITIONS

For the purposes of this report the following graphic developed by the DTC, illustrates the range of entities that fall within the applicable definitions:

5 Forum on Tax Administration: SME Compliance Subgroup (November 2013).

6 Ibid.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014



1.3.1 The Missing Middle and its Challenges

In the graphic the concept of the 'missing middle' is employed to mean entrepreneurial businesses with growth potential. The very thrust of the NDP is predicated on the assumption that small and expanding firms must become more prominent and generate the majority of new jobs. However, the NDP notes that total early-stage entrepreneurial activity rates in South Africa are about half of what is reported in other developing countries.

The observations in the NDP are reinforced by research conducted on behalf of the Economic Policy Division of National Treasury which noted that South Africa has disturbingly low levels of growth in the SME sector, notwithstanding extensive institutional organisational infrastructure which was established by government for

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

SME financing and development. The NDP notes that, based on preliminary research which employed data from Statistics South Africa, it is estimated that SMEs accounted for but 8.5% of the total investment by non-financial corporations in 2012 compared with 12.9% in 2010. Investment declined mostly in the trade and manufacturing sectors over this period.⁷

Accordingly, the challenge is to ensure that this 'missing middle', that is, the entrepreneurial business, plays a critical role within the economy. This can be achieved by first creating a more enabling environment for these enterprises to grow and expand their operations and employ more people. Secondly conditions must be created under which 'start ups' can flourish and more entrepreneurs are encouraged to enter the market.

Within this context, the specific question of excessive regulation and its attendant costs becomes an important consideration for analysis. Neil Rankin⁸ contends, pursuant to his research, that there are significant costs associated with regulation. Of particular importance are the costs of staff time spent dealing with regulations and the cost of paying for outside consultants. The cost of regulation falls disproportionately on smaller firms, particularly with respect to tax costs. Smaller firms have similar levels of tax costs compared to the larger firms but these costs comprise a larger proportion of the total regulatory costs. According to Rankin,⁹ tax compliance costs in respect of employees are much higher for smaller firms as are the costs associated with complying with local authority regulations. Furthermore, 80% of firms in his sample reported that regulatory costs had increased in the two years immediately preceding his study

In summary, the burden imposed by excessive regulation affects firms, particularly in that regulatory compliance is costly for small firms while the benefits of compliance are insignificant. The disincentive effect on economic growth is manifest, as is conduct, which seeks to avoid regulation through the under-declaration of revenue, the payment of bribes to regulators and inspectors or the failure to register the entity.

In the light of these findings, the DTC's concern is to ensure that the existing tax system best promotes the kind of small and medium-size activity prefigured in the NDP

⁷ Research conducted on behalf of the economic policy division dealing with the contribution to small and medium size enterprises to investment and employment in South Africa and the role of development in finance institutions (2013: Internal Document made available by National Treasury to the DTC.

⁸ Neil Rankin 'The Regulatory Environment in SMME's: Evidence from a South African Firm Level Data: Development Policy Research Unit: University of Witwatersrand: Working Paper 06/113'

⁹ Ibid.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

and where necessary is designed to ensure that the costs of compliance (discussed in chapter 6) do not retard growth in this important sector. This view is supported by the World Bank Tax Compliance Burden for Small Businesses study (2007) and the Counting the Cost of Red Tape for Business in South Africa study (2004) by the SBP (originally Small Business Project).

1.3.2 Revenue Contributions from the SME Sector

The South African economy is dominated by a small number of large businesses, often referred to as the formal sector. Total RSA tax collections for the 2014/15 fiscal year are budgeted at R999 billion. Corporate tax collections for the 2014/15 fiscal year are budgeted at R199 billion.¹⁰ 600 526 companies have submitted tax returns for the 2011 year of assessment. 434 674 reported R nil taxable income or an assessed loss. 165 852 reported taxable income. 64% of the corporate tax recovered was paid by 481 companies reporting taxable income of more than R100 million per annum.¹¹ In the main these companies pay income tax at a flat rate of 28%.¹² In terms of section 64E of the Income Tax Act, dividends tax is imposed at 15% on cash dividends at shareholder level while dividends *in specie* are taxed at the same rate at the company level.

At the other end of the scale is the informal sector. This sector consists in the main of survivalist businesses as defined by the NDP.

The informal sector has little prospect of making a significant direct tax contribution as the taxable income of businesses seldom exceeds the 2014/15 personal income tax threshold (R70 700 per annum) or the turnover tax threshold (R150 000 per annum).¹³

The above is not to say that the informal sector makes no tax contribution. Indirect tax collections are substantially bolstered by non-refundable VAT and duties paid on informal sector inputs.

Between the informal and formal sectors is the 'missing middle' of entrepreneurial business. As noted, it is within this category that the possibility of meaningful job creation may be fulfilled.

¹⁰ National Treasury 'Budget Review' (2014).

¹¹ SARS 'Tax Statistics (2013) Table 3.6.

¹² SARS 'Tax Statistics' (2013).

¹³ This comment excludes the potential contribution of the 'grey economy' operating within the informal sector.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

Since 2001, National Treasury and SARS have been attempting to incentivise this missing middle, principally through the Small Business Corporation 'SBC' concept as defined in section 12E of the Income Tax Act.

Within the category of companies reporting taxable income of less than R1 million are 45 670 SBCs that were liable to taxation in the 2012 year of assessment.¹⁴ Collectively these SBCs declared taxable income of R9,2 billion. At the flat corporate tax rate of 28% a potential tax base of R2,66 billion exists. This is virtually halved by the SBC tax incentive and reduced to R1,399 billion. Thus the cost of the SBC incentive, to which reference will be made presently is R1,261 billion.¹⁵

1.4 THE LIMITATIONS OF RELYING ON THE SME SECTOR AS A REVENUE CONTRIBUTOR

The greatest limitation upon this enquiry is the existence of very little research at this point to assess the true impact and magnitude of the SME sector. A SARS/ University of Pretoria report¹⁶ argues as follows:

'As no reliable national statistics on the total small business population in South Africa exist, it is not possible to confirm whether or not the respondents to the survey were representative of the total small business population in South Africa. If the nature of the respondents of other small business studies are used as an indication of the true small business population (the detailed breakdown (per size, nature, turnover) of all small businesses on the SARS database was also not available at the time of preparing the report), then it is evident that the small business respondents in this study were biased towards the higher end of the small business spectrum (based on turnover and number of employees) and this should be borne in mind when evaluating the results discussed below.'¹⁷

The NDP suggests significant potential within the SME sector to achieve its goals.

'The small business project's, small and medium size enterprise growth index 2011 show that net new employment is not typically created on a significant scale

14 SARS 'Tax Statistics' (2013)

15 These figures correlate to the cost of the SBC incentive reflected in the Budget Review 2013 at R1,3 billion.

16 SARS and University of Pretoria 'South African Small Business Tax Compliance Cost Survey' (2011).

17 Statistics South Africa and the DTI conduct regular, comprehensive firm-level surveys to provide the requisite data needed to assess the extent of problems within the SME sector. Although SARS data does exist, it is generally confined to data relevant to tax collection and does not necessarily assist a coordinated and evidence-based national SME strategy.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

in existing businesses. This is usually the preserve of newly established business entities which tend to be smaller in size.¹⁸

The DTC has used the NDP and its approach to SMEs as the basis for this interim report. Careful research cautions against the unqualified adoption of the approach taken by the NDP to the effect that job creation is best generated mainly by the SME sector. For example, Kerr *et al*¹⁹ contend that the closure of enterprises contribute a substantial amount to job destruction, being around 27% in all enterprises and 25% when the sample is limited to manufacturing enterprises. While internationally job creation and destruction are higher with smaller firms, Kerr *et al* find similar results of high rates of job destruction in smaller firms, but not job creation.

In the light of this important paper, which certainly provides an important qualification to the approach of the NDP, further research is required. However, for the purpose of this interim report, the DTC has worked on the assumption that SMEs do make a significant contribution to job creation.

1.5 CHALLENGES OF PAST INITIATIVES TO ENSURE REVENUE CONTRIBUTIONS BY SMEs

Since 2001, SARS has made commendable efforts to encourage the use of the SBC concept in its application of the associated tax policy from National Treasury. Perhaps these initiatives have gone even further than the SARS mandate which is primarily to recover the tax that is due. In many instances the SARS interventions have been interpreted by the public to be that SARS is responsible for the growth of the SME sector.

- It is a fundamental principle of tax administration that SARS should not exist to assist business in anything other than compliance with tax legislation. Under the South African Revenue Service Act 34 of 1997, SARS is mandated to do the following:
- Collect all revenue due
- Ensure maximum compliance with tax and customs legislation
- Provide a customs service that will maximise revenue collection, protect our borders and facilitate trade.

18 South Africa: National Planning Commission 'National Development Plan' at 146.

19 Andrew Kerr, Martin Wittenberg and Jairo Arrow_'Job creation and destruction in South Africa: working paper No 92 : South African Labour and Development Research Unit' (2013).

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

Clearly SARS would be in breach of its mandate were it to become actively involved in the promotion of the SME sector beyond the consequences for the sector which flow from the tax system.

The overall conclusion from desktop research and interactions with small businesses through their trade associations is that most problems faced by small businesses do not stem from tax. Hence the challenge facing the DTC is how to craft a solution that can assist in solving those other problems without deviating from the regulatory mandate of the tax system.

It is thus important to emphasise that, given the limited mandate of SARS, other policy initiatives which are considered to be supportive of the sector must be provided by other government departments, such as the DTI and the MSB.

CHAPTER 2

INCOME TAX PROVISIONS FOR SMEs

2.1 SECTION 12E: DEDUCTIONS FOR SMALL BUSINESS CORPORATIONS

As alluded to in chapter 1, section 12E was introduced in the Income Tax Act in 2001 granting preferential tax rates and income tax deductions to SBCs for the acquisition of any plant or machinery.

As explained in chapter 1, an SBC is defined in section 12E as any close corporation or co-operative or any private company as defined in the Companies Act, 2008 (thus excluding trusts, sole proprietors and partnerships), all shareholders of which are at all times during the year of assessment natural persons where the gross income for the year of assessment does not exceed R20 million per annum (with effect from the 2014 year of assessment). In the context of the terms adopted in Chapter 1, the SBC concept represents a tax incentive primarily for entrepreneurial businesses with growth potential.

With effect from the 2014 year of assessment,²⁰ an SBC is defined to be a company (thus excluding trusts, sole proprietors and partnerships) with a gross income not exceeding R20 million per annum. A range of limitations relating to shareholding and professional service businesses are included in the legislation to prevent abuse.

SBCs are not taxed at the flat company tax rate of 28%. Instead, a progressive tax rate is applied. The relevant tax rates for the period 1 April 2014 to 31 March 2015 (set out below) are deemed to have come into operation on 1 April 2014 and apply in respect of years of assessment ending during the period of 12 months ending on 31 March 2015.²¹

| | |
|----------------------|--|
| R0 – R70 700 - | 0% |
| R70 701 – R365 000 - | 7% of the amount above R70 700 |
| R365 001 – R550 000 | R20 601 + 21% of the amount above R365 000 |
| R550 001 and above | R59 451 + 28% of the amount above R550 000 |

20 Section 12E of the Income Tax Act.

21 Taxation Laws Amendment Act, 2013.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

In addition, an SBC qualifies for a 100% write-off of new machinery used in a process of manufacture.

2.1.1 Evaluation of the Effectiveness of Section 12E Incentive

The calculations below by the DTC, based on figures provided by SARS reflect the potential tax saving, dependent on taxable income based on the tax rates contained in the 2014 Budget Review:

| | | | Max | Corporate | | Max Saving | |
|--------------------|-------------------|---------------------|------------------|--------------------|---------------------|--------------------|----------|
| | Corporate | Dividend Tax | Corporate | At SBC rate | Dividend Tax | Company vs | C |
| Taxable | Tax at 28% | | All in | | | SBC | A |
| Income | | | | | | Pre Div Tax | |
| Loss or 0 | | | | | | | |
| 100 000 | 28 000 | 9 391 | 37 391 | 2 100 | 12 770 | 25 900 | |
| 200 000 | 56 000 | 18 783 | 74 783 | 9 100 | 24 900 | 46 900 | |
| 300 000 | 84 000 | 28 174 | 112 174 | 16 100 | 37 030 | 67 900 | |
| 400 000 | 112 000 | 37 565 | 149 565 | 27 951 | 48 528 | 84 049 | |
| 500 000 | 140 000 | 46 957 | 186 957 | 48 951 | 58 833 | 91 049 | |
| 600 000 | 168 000 | 56 348 | 224 348 | 73 451 | 68 680 | 94 549 | |
| 700 000 | 196 000 | 65 739 | 261 739 | 101 451 | 78 072 | 94 549 | |
| 800 000 | 224 000 | 75 130 | 299 130 | 129 451 | 87 463 | 94 549 | |
| 900 000 | 252 000 | 84 522 | 336 522 | 157 451 | 96 854 | 94 549 | |
| 1 000 000 | 280 000 | 93 913 | 373 913 | 185 451 | 106 246 | 94 549 | |
| >1000000 | | | | | | | |

The DTC has identified various problems with the SBC tax incentive, some of which are fundamental to the very objectives of a SME incentive.

(a) The incentive is not beneficial to SBCs with no taxable income

A fundamental problem with the SBC tax incentive is that it provides no relief to an SBC with no taxable income. From the above table, SBCs with no taxable income

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

comprise 40 633 of the 86 333 active SBC population (47%).²² However, the SBCs which receive no incentive are in as much need of financial intervention from government, if not more, than SBCs liable to tax. Of crucial importance is that the tax compliance burden is a factor of the size of the business, not the actual tax liability.

The key question is whether the tax concessions that amount to R1,36 billion flowing from the SBC tax regime have achieved their objective. SARS statistics show that the R1,36 billion SBC tax incentive, spread across 45 670 taxable SBCs results in an average concession of R27 610 per SBC.²³ This statistic is in itself misleading. 25 636 SBCs have taxable income of less than R100 000. Thus, the tax benefit is very small. On a mean level of R50 000 taxable income, the concession may be as little as R14 000.

The maximum SBC tax benefit applies when taxable income exceeds R550 000 per annum. At this level the benefit can be as much as R94 549 (per the 2014/2015 tax rate tables, exclusive of dividends tax). A mere 4 519 SBCs qualify for such benefit.

(b) The incentive mainly benefits SBCs with high taxable income

Within the 45 670 taxable SBCs there are 12 658 within the sectors of Agencies, Financial Services and Insurance and the medical profession. Presumably these fall within the SBC definition as they employ three or more who are not connected persons in relation to the owners of the SBCs in question. Collectively these SBCs enjoy R387 million (24%) of the total R1,36 billion SBC incentive.

Based on the SARS statistics for the 2012 year of assessment, 289 476 sole proprietor/partnership taxpayers have been assessed, reporting taxable income of R55,7 billion and tax payable of R18,3 billion. A considerable proportion (34%) of these taxpayers is within the fields of insurance, finance, real estate, medical and veterinary professions.

It is, however, questionable whether it was the intention of the legislature to provide the SBC incentive to these categories of taxpayers. First, if these taxpayers were to be granted the SBC incentive it would at least quadruple the cost of the incentive. Given the current constraints of the national budget this is not a viable option. Secondly, the inclusion of small professional businesses in the SBC incentive package has the potential to distort the employment market, as was previously experienced before the inclusion of the 'personal service company/trust' definition in the Fourth Schedule to the Income Tax Act.

²² Calculated from SARS 'Tax Statistics' (2013).

²³ Calculations by DTC based on SARS Statistics.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

(c) Misuse of the incentive by secondary trades

Concerns have been expressed regarding secondary trades conducted by employed taxpayers. The SBC tax incentive is readily available to such taxpayers. This allows taxpayers to benefit from both the SBC incentive, the basic tax threshold and lower personal marginal tax rates.

Many SBCs are family-owned SMEs. This allows a family to benefit from the SBC incentive, the basic tax threshold in the Income Tax Act and the lower personal marginal tax rates if salaries are paid to family members, irrespective of their actual contribution to the SBC.

The SBC tax incentive is disqualified if any shareholder or member holds an interest in another company, with limited exceptions. This provision is designed to prevent multiple ownership of SBCs. However, the provision acts as a barrier in cases in which SBCs seek external investors in the pursuit of growth prospects.

(d) The high costs of administering the incentive

Professional fees incurred by a SME in the administration of the SBC tax incentive are far greater than would be the case were the SME to be registered for Turnover Tax (discussed in chapter 3), as a sole proprietor or partnership. The DTC has received complaints that the professions are 'over-prescribing' the use of SBCs in the pursuit of fees. Given that in excess of 175 000 SBCs have been registered and only 86 333 are currently active there would seem to be merit in this complaint.²⁴

The accelerated allowances in sections 12E and 12B are timing differences and have minimal effect. Total claims (based on SARS internal reports) are in the region of R220 million per annum.

It is thus clear that, notwithstanding that the incentive is expensive and cumbersome to administer, it seems to constitute a reward for an established successful business. The SBC tax incentive currently costs R1,3 billion per annum. A considerable amount of the benefits of the incentive are legally claimed by taxpayers who were not the specific target of the incentive. It, however, mainly benefits established, profitable, niche SMEs. This represents a tiny minority of the SME sector in South Africa today. The SBC tax incentive is of little or no value in commencing a business or assisting an ailing business in an assessed loss position.

²⁴ Various studies indicate that this represents a small proportion of the total SMEs in South Africa.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

(e) Lack of merit in determining the incentive by tax cost of incorporation

Since inception the SBC incentive has been determined with reference to the 'tax cost of incorporation'. In short, the SBC incentive reduces the SBCs corporate tax liability to approximately the same level as would be paid if the SBC were taxed at personal income tax rates. Yet the owner of the SBC can achieve the same effect by simply paying a tax-deductible salary from the SBC to the owner. Thus there is no merit in determining the SBC incentive on the basis of the tax cost of incorporation.

(f) The complexity of the SBC definition

The extensive provisions contained in the SBC definition should be revisited. Given that the refundable compliance rebate incentive is restricted to R20 000 per annum per SBC there is scope to simplify the definition. In particular:

- The current turnover limit of R20 million per annum could be increased to R50 million which, based upon a number of carefully considered representations made to the DTC, is a realistic figure to capture businesses which remain within a 'breakeven' category.
- Currently the SBC concession is forfeited if any shareholder holds an interest in any other company, excluding primarily listed companies and stokvels. This is intended to prevent the multiple ownership of SBCs by one taxpayer. It is suggested that this onerous provision could be substantially simplified if it were changed to exclude any SBC where 'any shareholder holds any interest in any other SBC'.
- The present SBC concession is forfeited if any shareholders comprise a company or trust. This restriction creates an adverse consequence if any passive investor acts as financier of the SBC. It is suggested that this onerous provision could be simplified if it were changed to instances in which 'corporate shareholders hold more than a 33,3% interest in any other SBC'.

When the SBC incentive was implemented in 2001, there was good reason at the time to compensate the SBC for the onerous tax rates and arbitrages that existed then. The reduction in both corporate and personal income taxes for all taxpayers since 2001 is sufficient reason to completely reassess the need for the SBC incentive.

2.1.2 Recommendations regarding the SBC Incentive

It is recommended that the current SBC incentive be withdrawn and the resource redeployed in the form of a new incentive that focuses on rewarding the tax-compliant

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

SBC and compensates for some of the additional costs incurred in achieving tax-compliant status. This reward could take the form of a refundable compliance rebate (RCR). Of critical importance is that the RCR will simply redeploy the current SBC incentive at no additional cost to the national budget. The fundamental features of RCR should include the following:

- The rebate would not be granted to small businesses with turnover of less than R1 million per annum. These businesses will be assisted by the turnover tax system (discussed in chapter 3) that must be refined to less than R335 000 per annum thereby allowing for the simplest of annual tax returns with no resultant tax liability. Importantly, these businesses are unlikely to be registered for VAT and employees' tax and thus their compliance requirements are substantially reduced. See chapter 4 which deals specifically with VAT.
- The SBC definition should be simplified and crafted in a manner that promotes the tax compliance rebate. All other income tax allowances relating to SBCs should be withdrawn as they merely create confusion and are not used to any major extent. SBCs should be granted the same tax allowances as any other company.
- The rebate would only be paid to tax-compliant SBCs that have submitted all requisite income tax, VAT and employees' tax returns within 9 months of the end of the year of assessment, thus rewarding the compliant taxpayer and making a substantial contribution to the additional compliance costs incurred by the taxpayer.
- The DTC recommends that the rebate would escalate according to turnover in 4 bands:

0 – R335 000 = 0

R335 000 – R500 000 = R10 000 per annum

R500 000 – R1 000 000 = R15 000 per annum

R1 000 000 and above = R20 000 per annum

Based on the existing R1,36 billion SBC incentive and the 2012 SBC tax register the present cost to the fiscus of the existing incentive could be redeployed as follows, based on a table provided by SARS:

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

| 2012 Tax year | Cumulative | Compliance | |
|-------------------------------------|---------------|---------------------|----------------------|
| | | Number of taxpayers | rebate R |
| A: 1 to 100 000 | | | |
| B: 100 000 to 250 000 | 13 683 | - | - |
| C: 250 000 to 500 000 | 8 201 | 10 000 | 82 010 000 |
| D: 500 000 to 750 000 | | - | - |
| E: 750 000 to 1 000 000 | 12 507 | 15 000 | 187 605 000 |
| F: 1 000 000 to 2 500 000 | | - | - |
| G: 2 500 000 to 5 000 000 | | - | - |
| H: 5 000 000 to 7 500 000 | | - | - |
| I: 7 500 000 to 10 000 000 | | - | - |
| J: 10 000 000 to 14 000 000 | | - | - |
| K: 14 000 000 + | | - | - |
| Turnover record missing from return | 51 942 | 20 000 | 1 038 840 000 |
| Grand Total | 86 333 | | 1 308 455 000 |

This proposal would immediately increase the number of taxpayers benefitting from the SBC incentive from 45 670 to 72 650. The remaining 13 683 SBCs could potentially have their compliance burden reduced through the Turnover Tax system (discussed in chapter 3). SBCs in a loss position would receive the incentive, provided turnover exceeds R335 000 per annum.

Alternatively, and in the interests of simplicity, the RCR should be granted at the rate of R15 000 to all SBCs with turnover exceeding R335 000 annum. Below that level the taxpayer would qualify for almost complete tax exemption based on the turnover tax proposals.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

- Compliant taxpayers should automatically receive an annual tax clearance certificate upon assessment and payment of the compliance rebate.
- It is emphasized that this proposal will redeploy the current incentive to specifically address the principal tax concern of SBCs. There should be no additional cost to government.
- By contrast, the lifestyle business (as defined in the NDP) does not generate a significant growth in employment and should not constitute the target of any special treatment particularly when consideration is had to the objectives of this sector as envisaged by the NDP.
- The DTC is unaware of any other international initiative of the nature of the RCR proposal contained above in other jurisdictions. It is quite simply suggested that the current SBC incentive is not achieving its goal and that a revised incentive, focused on the primary problem of tax compliance, should be considered. As such, if the RCR is implemented, the effectiveness of the proposal should be comprehensively reviewed after three years.

2.2 SECTION 12J: THE VENTURE CAPITAL COMPANY ALLOWANCE

Section 12J of the Income Tax Act provides for a deduction for investors in venture capital companies (VCCs). It came into effect on 1 July 2009 and has been amended extensively over the years. In summary section 12J provides as follows:

- An investor may claim a deduction for expenditure actually incurred to acquire shares, issued to the investor by an approved VCC and not on the purchase of VCC shares from another investor.
- The Commissioner may approve a company as a VCC which complies with a number of criteria; and
- Qualifying investee companies must also comply with specific criteria including a ban on impermissible trades such as financial advisory services, liquor, tobacco, arms or ammunition, and any trade carried on mainly outside South Africa.

2.2.1 Evaluation of the Effectiveness of the Venture Capital Company System

Since this allowance came into operation in 2009, there are only 3 Venture Capital Companies registered under section 12J of the Income Tax Act. This fact is indicative of the ineffectiveness of section 12J.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

The requirements of section 12J are far too complicated and inflexible. Apart from these complications there are fundamental problems with the VCC scheme:

- (a) The common opinion is that a VCC target company has to have an asset value of R50 million and prospective profit of R5 million per annum to justify its cost of entry. Merchant bankers claim to bankroll in the region of 1 in 100 target companies investigated.
- (b) Post the 2009 financial crisis, there are very few target companies that meet the expectations of investors. The few opportunities that do are able to enter VCC arrangements irrespective of the tax consequences.
- (c) Costs of a VCC investment, ranging from due diligence to legal fees on sale and shareholder agreements are not less than R1 million.
- (d) VCCs by their very nature are looking for dividend returns. Most SMEs are simply too small to afford to support owner shareholders and meet the investors' expectations of dividend returns.
- (e) There remain many mining prospects in South Africa that are potentially targets for the 'junior mining' VCC incentive. However, the extensive requirements, expense and time taken to approve mining licences today simply make VCC proposals in respect of junior mining unattractive to the investor, irrespective of the tax incentive available in section 12J.
- (f) In any event, the 'appetite' of the private investor for tax-deductible investment in speculative high-risk opportunities has diminished and has even been tarnished by the 'scheme' fiasco of the 1980s and 1990s.
- (g) Potential investors correctly see the section 12J incentive as no more than a timing difference that is recouped on sale of the target company.
- (h) However, the SARS- University of Pretoria report has concluded that the SBC tax profile is too expensive to administer in most SMEs. If this is accepted then how can a SME support the enormous administration costs applicable to a VCC arrangement?

2.2.2 Recommendations on the Venture Capital Company Allowance

- (a) Despite the sunset provision for 30 June 2021, it would be all too easy to simply abandon the section 12J initiative. However, this would incur the consequence

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

that a fundamental objective of the NDP (to provide access to finance) would be ignored.

- (b) The provision of financial facilities for the SME sector is not within the SARS tax administration mandate and the tax policy mandate of NT. This is a project that should be addressed by the FSB, DTI and MSB. The SARS involvement should be confined to the administration of tax incentives that may be applicable to structures approved through the FSB, DTI and MSB.
- (c) DTI and MSB must assess, design and implement a financial assistance package that addresses the needs of emerging businesses in South Africa. To the extent that tax incentives are needed to supplement such a package, this must be determined in conjunction with the DTI and NT. Such an approach would be similar to the development of the new Special Economic Zone initiative of DTI.²⁵
- (d) There will always be emerging micro businesses in need of finance that would simply be too small to facilitate support from the DTI or financial institutions. Many of these businesses secure funding from family and private so-called 'angel investors.' Currently the angel investor in a failed micro business obtains only Capital Gains Tax relief for lost capital.
- (e) It is suggested that SARS and NT consider the implications of the creation of a separate tax incentive to encourage angel investors. This may be achievable through the extension of the Bad Debt Allowance to allow for the full write-off of failed investments in micro businesses, which may act as an encouragement to angel investors.

²⁵ In the research conducted by the Economic Policy Division of Treasury: the contribution of small and medium enterprises between investment and employment in South Africa and the role of development finance institutions (2013) it is noted that the lack of access to finance is a key barrier to expansion of SMEs confirming the thrust of the DTC's report, namely, that tax is but a factor in SME development but of itself is not a silver bullet to the creation of a more expansive SME sector. The report found that the lack of finance is the greatest impediment to growth to SME's in manufacturing and tourism as well as firms employing fewer than 21 people. The Small Enterprise Financing Agency is the lead government institution in promoting SME lending and has a mandate to provide finance to the SME sector directly and also through intermediaries. While the report noted that there has been some success in direct funding the wholesale product continues to face challenges. In particular the development of the credit guarantee scheme by commercial banks which represents the main risk-sharing mechanism which is in place declined by 90% since 2006. The report cites a World Bank survey suggesting the scheme is complicated to administer. For this reason the report proposes a more intensive investigation into the best practices and prudential standards employed in SME lending with specific reference to South Africa.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

2.3 OTHER INCOME TAX PROVISIONS RELEVANT TO SMEs

2.3.1 The Section 12H Training Allowance

Access to the section 12H training allowance was raised by both the professions and business bodies. The observation was that SMEs in reality have limited access to training allowances because the qualification and compliance requirements are far too stringent.

Training is fundamental to the growth of the SME sector. The administrative requirements attached to the training allowance in section 12H are far too onerous for SMEs.

All SMEs should be encouraged to implement training interventions at all levels. It is suggested that a separate, simpler solution be developed for the SME sector. This could include a specific training incentive of 150% of the cost for SBCs coupled with the removal of the fringe benefits tax restrictions on bursaries paid in respect of staff members family (subject to the provision of a suitable avoidance provision).

2.3.2 The Fourth Schedule to the Income Tax Act

The Fourth Schedule to the Income Tax Act should be amended to exempt the SBC (as defined in section 12E) from the provisional tax requirement to estimate taxable income at year-end, as many SBCs simply do not have the internal resources to achieve an accurate measurement until after year-end.

The professions have requested that the 'personal (professional) service provider' concepts contained in the Fourth Schedule to the Income Tax Act be reconsidered. The provisions are overly harsh now that employees' tax is imposed on directors' emoluments. The implications of this request should be comprehensively considered by SARS and NT.

CHAPTER 3

MICRO BUSINESS TURNOVER TAX

A second and important component of the tax dispensation for SMEs is the micro business turnover tax which, given the approach to SMEs adopted in this report, would apply in the main to 'survivalist businesses' as defined in the NDP.

3.1 THE WORKING OF MICRO BUSINESS TURNOVER TAX

This tax applies to a natural person or a company, the turnover of which must not exceed R1 million per annum. Income from professional services cannot exceed 20% of the total business income. The proceeds from the disposal of capital assets by the business may not exceed R1,5 million in the current and immediately preceding two years.

Dividends tax is not payable on the first R200 000 of dividends paid during the year of assessment.

The tax rates for the 2014/15 year of assessment are as follows:

| Taxable turnover (R) | Rate of tax (R) |
|-----------------------------|---|
| 0 – 150 000 | 0% |
| 150 001 – 300 000 | 1% of the amount above 150 000 |
| 300 001 – 500 000 | 1 500 + 2% of the amount above 300 000 |
| 500 001 – 750 000 | 7 500 + 4% of the amount above 500 000 |
| 750 001 and above | 20 000 + 6% of the amount above 750 000 |

As at 4 July 2013 there were 7 827 active micro businesses, 139 with addresses unknown, 59 dormant, 74 in estates, 345 in active and 49 suspended.

3.2 EVALUATION OF THE EFFECTIVENESS OF THE MICRO BUSINESS TURNOVER TAX

- (a) The core question which arises in this context can be framed thus: Why should a small business that was paying no tax previously suddenly engage with SARS to register for a new simple tax system only to have to pay tax and incur the cost of complying with the statutory requirements as a result of being constantly

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

monitored by SARS? The manner in which this question is answered may help explain why the tax system is having no effect on the growth of what has been defined in this report as a survivalist business in South Africa.

- (b) Further compliance problems have been triggered by sections 22 and 25 of the TAA, read with the public notice issued under section 66 of the Income Tax Act, which requires all businesses irrespective of the size of turnover to register with SARS within 21 days of commencing trade. It does not appear that the Sixth Schedule overrides section 22 of the TAA when SME income does not exceed R150 000 per annum, that is, all businesses irrespective of their turnover must register with SARS by law.
- (c) There would be a justification to create a total exemption from tax within TAA for 'survivalist businesses' (as defined in the NDP). As indicated in Chapter 1 there are substantial consequences to the adoption of this approach. These will include:
 - (i) Discontent among registered taxpayers caused by the inconsistent treatment of unregistered taxpayers. There are currently in excess of 15 million taxpayers registered with SARS of which approximately 5 million are above the personal 2014/15 tax threshold of R70 700.
 - (ii) If survivalist businesses grow they will exceed the exemption thresholds. The non-registration of survivalist businesses leads to an accumulation of a tax liability which discourages registration at a later date. The presence of a total exemption threshold immediately creates an incentive for dishonest taxpayers to keep business income below the threshold.
 - (iii) Remaining unregistered could have severe consequences for such businesses in the event of a roll-out of employment tax incentives and the national health insurance plan.
- (d) There remain an unknown number of businesses which exceed the tax and VAT registration thresholds that continue to be unregistered despite all SARS's initiatives. The DTC remains doubtful as to whether a further tax amnesty that goes beyond the terms of a Voluntary Disclosure Program contained in the TAA would have any prospect of success. On the contrary, SARS, working with South African banking property and car registration facilities, may well be able to enforce the law through taxpayer selection and risk profiling.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

3.3 RECOMMENDATIONS

- (a) Sections 22 and 25 of the TAA should not be amended as to do so could well create an environment for widespread tax evasion. However, sections 22 and 25 should be amended to reduce the adverse consequences of non-registration if no tax liability actually exists and the taxpayer's turnover is less than R1 million per annum (this figure is based on the recommended bands in chapter 2 above).
- (b) 'Survivalist businesses' must be provided with a simple form of tax registration so that they can become compliant with the TAA. Thus the Sixth Schedule should be retained despite the disappointing level of registrations to date.
- (c) The Sixth Schedule should be extended to create a total exemption from tax up to a turnover of R335 000 per annum. (This is justified by applying a 20% net profit percentage to a turnover of R335 000, creating taxable income approximate to the current personal tax threshold of R70 700. Compliance requirements for predominantly survivalist businesses below this level should be achieved through the simplest of annual declarations containing taxpayer details, bank account numbers and a statement to the effect that turnover did not exceed R335 000 in the relevant year of assessment. This recommendation should exclude the majority of survivalist businesses from further tax compliance requirements.
- (d) The base level of R335 000 turnover per annum should be revised annually to take account of the increase in the personal tax threshold resulting from annual fiscal drag adjustments.
- (e) The current turnover tax levels above the base level of R335 000 need little adjustment if a net profit percentage of 20% of turnover is assumed, (the personal tax liability of the net profit is substantially similar to the turnover tax liability.) Applying this logic, the 6% turnover tax level on income from R750 000 to R1 million should be reduced from 6% to 5%. The resultant turnover tax thresholds would thus be refined as follows:

| | | | | |
|---------|-----------|----|--------|--------------------------------------|
| 0 | 335 000 | 0% | | 0% of turnover |
| 335 001 | 500 000 | 2% | | 2% of the amount above R335 000 |
| 500 001 | 750 000 | 4% | 3 300 | plus 4% of the amount above R500 000 |
| 750 001 | 1 000 000 | 5% | 13 300 | plus 5% of the amount above R750 000 |
| | | | 25 800 | |

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

The calculations in the table above were developed by DTC based on the Income Tax Act.

- (f) There are indications that the 20% average net profit percentage is overly optimistic and that the turnover tax thresholds should be based on a 10 percent average net profit. This would substantially increase the turnover tax thresholds as follows:

| | | | | |
|---------|-----------|----|-------|--------------------------------------|
| 0 | 335 000 | 0% | | 0% of turnover |
| 335 001 | 500 000 | 1% | | 1% of the amount above R335 000 |
| 500 001 | 750 000 | 2% | 1 650 | plus 2% of the amount above R500 000 |
| 750 001 | 1 000 000 | 3% | 6 650 | plus 3% of the amount above R750 000 |
| | | | | |

- (g) If the turnover tax thresholds could be increased based on a 10 percent average net profit, subsistence businesses with turnover of less than R1 million would be left with **both** a negligible tax exposure and the bare minimum of tax compliance obligations. This would constitute a most generous concession and would answer many of the criticisms levelled at the turnover tax system.
- (h) Currently the turnover tax system contains the restrictive requirement that the taxpayer 'opt in' for a period of 3 years. This requirement substantially reduces the burden on SARS that would be created if taxpayers were allowed to freely migrate between the turnover tax and the income tax basis of taxation. However, the requirement leaves the turnover tax system subject to much criticism.
- (i) In order to allay the above criticism it is suggested that taxpayers be allowed to elect to exit the turnover tax system on a once-off basis. In other words, once they have exited the turnover tax system they will not be allowed to re-elect the system in a subsequent year of assessment.
- (j) The Sixth Schedule turnover tax bands currently extending to the R1 million turnover level should be maintained at the current level as the turnover tax system is primarily directed at survivalist businesses.
- (k) The current turnover tax system allows for bi-annual payments on an elective basis. This creates confusion and an additional administrative burden with no prospect of creating a meaningful revenue stream. All taxation liability determined

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

under the turnover tax system should be discharged by way of an annual declaration made on or before 31 May each year.

- (l) No tax compliance rebate should be extended to turnover tax taxpayers as this has the potential to encourage the registration of 'ghost taxpayers' simply to obtain the rebate. In any event the turnover tax package is most generous and the compliance obligations are minimal.
- (m) SARS should actively monitor all declarations made by survivalist businesses in order to combat tax evasion committed by larger businesses concealed within the mantle of survivalist business. In particular annual turnover tax declarations should be compared to the banking activity of the taxpayer.
- (n) SARS should rigorously examine the data received from financial institutions to detect unregistered taxpayers who are obviously trading and in receipt of income exceeding the turnover tax threshold of R1 million per annum. SARS should publicize the new initiative relating to profiling and taxpayer selection to encourage taxpayer compliance and to publicize what will be the key deterrent to tax evasion.
- (l) Considering the responses from both registered and non-registered micro businesses, it is apparent that taxpayers are of the opinion that communication and information-sharing from SARS is lacking.
 - Registered taxpayers noted that:
 - SARS should remind taxpayers of the submission of Turnover Tax returns via email.
 - SARS should also communicate with micro businesses by SMS.
 - Campaigns should inform micro businesses of the Turnover Tax system.
 - Brochures about the turnover tax system should be distributed to micro businesses.
 - Non-registered taxpayers noted that:
 - Campaigns should be launched to inform micro businesses of the benefits of the Turnover Tax system in relation to its ease of administration and cost-effectiveness.
 - Brochures about the turnover tax system should be distributed to micro businesses. Awareness should be created about legislative changes that could affect micro businesses.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

It is therefore recommended that SARS develop a communication strategy specifically aimed at taxpayers who could potentially fall within the turnover tax system. The strategy could include focussing on issues such as communication by sms, web-based communication (and e-learning) and the establishment of a unit or desk in SARS Contact centres that would focus on turnover tax education.

It would appear that some taxpayers are not satisfied with the level of service rendered by SARS. This shortcoming can be addressed through training interventions to improve the service level of call centre staff, tax consultants and branch officials.

CHAPTER 4

VALUE-ADDED TAX AND SMALL BUSINESSES

VAT vendors with turnover not exceeding R1 million need not register for VAT; compulsory registration only exists for vendors with turnover in excess of that figure. Natural persons operating small businesses may use the cash method as opposed to the invoice method for VAT.

In spite of the above, 50% of all VAT registrations comprise vendors with turnover below R1 million. Collectively these vendors pay 4% of total VAT collections and claim refunds totalling 6% of total refunds.

The DTC has received a range of conflicting recommendations from the professions and the business community on VAT registration thresholds. In short, the one school of thought is that SMEs be granted a wide exemption from the VAT system (to the extent of R2 million turnover per annum). The other is that SMEs be included in the VAT system, irrespective of turnover, so that SMEs can benefit from the ability to reclaim input tax.

It is unfortunate that the debate regarding VAT registration thresholds is clouded by the stark reality of extensive VAT fraud. The VAT system is widely targeted by fraudsters seeking to claim VAT refunds based on fictitious VAT registrations, fraudulently generated tax invoices and the exploitation of VAT timing differences. This is not unique to South Africa; it is a worldwide problem inherent in any VAT system and is aggravated by the ability to file VAT returns through the internet. This disturbing pattern of fraud holds considerable influence for any proposed changes to the current VAT system in that recommendations need to take account of possible further breaches of the integrity of the system.

Much of the frustration associated with the VAT system and the SME sector primarily relates to delays caused by onerous VAT registration requirements and delayed VAT refunds. This is a direct consequence of SARS making a concerted effort to combat VAT fraud. Failure to do so would have a disastrous consequence on VAT collections. As VAT constitutes 28% of total tax revenue the system has to be rigorously protected.

In as much as there is the widespread call for deregulation of VAT reporting requirements within the SME sector, it is imperative that the VAT system be protected against fraudulent activity.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

4.1 CONCERNS REGARDING THE BASIC VAT VOLUNTARY REGISTRATION THRESHOLD

The DTC has received representations on questions of voluntary registration for VAT purposes. Before the promulgation of the Taxation Laws Amendment Act, 2013, a minimum annual turnover requirement of R50 000 per annum was enforced. Following the latest amendment, the VAT Act allows for voluntary registration under the following three circumstances:

The R50 000 test

A vendor will be allowed to register as a VAT vendor when the value of taxable supplies has historically exceeded an amount of R50 000 in the previous months.

The reasonable expectation test

A vendor will be allowed to register on a voluntary basis when it can be reasonably expected that leviable VAT supplies will exceed R50 000 in the next 12-month period. A vendor electing this option will be required to account for VAT on a payments basis until the vendor's taxable supplies have exceeded R50 000. Regulations will be issued to govern the detail of how this option will be dealt with in practice; in particular the question of onus of proof required of persons who have reasonable grounds on which to base their expectations of future revenue and the consequences of not achieving the desired level of turnover will need to be addressed.

The nature of activities test

Registration may be allowed on a voluntary basis when the nature of the vendor's activities is such that the latter would only generate VAT supplies from a future date. Industries which may fall into this category include forestry, mining and exploration and farming. Regulations will also be issued to govern this category of registration with the new rules coming into effect from 1 April 2014. This requirement has now been removed allowing any business to register for VAT, regardless of turnover, subject to the condition that a business must account for VAT on a cash basis until the R50 000 turnover level has been achieved.

The DTC recommends that the effects of the new amendment be closely monitored by SARS in order to determine its effectiveness.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

4.1.1 Evaluation of the effectiveness of the 2013 Amendments

The revised provisions contained in the Taxation Laws Amendment Act, 2013 rigidly enforce the compulsory VAT registration threshold of R1 million per annum. This is in contrast to submissions received by the DTC that the compulsory VAT registration threshold be increased.

These thresholds were addressed in the Taxation Laws Amendment Act, 2013. Where the vendor's value of taxable supplies has exceeded an amount of R1 million for the previous period of 12 months, the rule remains unchanged.

Compulsory registration is required of a vendor who has entered into a written contract under which the vendor will be required contractually to make taxable supplies in excess of R1 million in the following period of 12 months. Previously registration was required when there were reasonable grounds for believing that the total value of taxable supplies would exceed R1 million in the following 12 months. Finally where a vendor supplies electronic services from outside South Africa for a cumulative consideration in excess of R50 000 on or after 1 April 2014, compulsory registration is required.

4.1.2 Recommendations

In reviewing these submissions, it is the view of the DTC that the compulsory VAT registration threshold compares favourably to international standards. There does not appear to be any justification for raising the compulsory registration threshold. Indeed it is in the interest of any business with a turnover exceeding R1 million to maintain proper books and records thus being able to recover input tax. The VAT system also acts as a check against the level of income declared for income tax purposes.

4.2 CONCERNS REGARDING THE BASIS OF VAT REPORTING

In summary, VAT income and expenditure can be reported on a cash basis or an accrual basis. At present the VAT system prefers the accrual basis. Small businesses owned by natural persons are offered the concession to report VAT on the cash basis when supplies do not exceed R2,5 million per annum.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

4.2.1 Evaluation of VAT Reporting

The accrual basis creates a substantial additional compliance burden within the SME sector in which many vendors do not maintain comprehensive accounting systems containing debtor and creditor balances. Instead only cash transactions are recorded.

4.2.2 Recommendation

A simple recommendation would be to extend the option of the cash basis of VAT reporting to all SBCs as defined in section 12E of the Income Tax Act. This would even have the benefit of curbing the potential for VAT fraud where input tax is reclaimed and there is no intention of the vendor ever settling the liability.

There may, however, be other substantial implications that may arise as a result of allowing SBCs to elect the cash basis. This will be considered by the DTC during the course of its investigations into the VAT system during 2014.

4.3 CONCERNS REGARDING VAT PERIODS

The DTC has received submissions to the effect that the SME sector be allowed to submit VAT returns on a biannual or even an annual basis.

4.3.1 Evaluation of VAT Periods

The primary problem with VAT compliance lies in the accurate recording and filing of compliant tax invoices needed to substantiate VAT input deductions. Integral to a VAT system is that tax invoices are captured and filed as soon as possible after conclusion of the transaction. The implementation of bi-annual or annual VAT periods for the SME sector has the potential to encourage procrastination and even worsen the situation.

Biannual and annual VAT periods also raise the potential of delaying VAT refunds or creating substantial accumulated VAT liabilities. This could be disastrous to some SMEs.

4.3.2 Recommendation

In view of the above the DTC makes no recommendation on the change in VAT periods at this stage.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

4.4 CONCERNS REGARDING VAT REFUNDS

The DTC has received numerous complaints concerning delays in the processing of VAT refunds, including claims that delays have contributed to eventual and unnecessary business failure. It is apparent that the current SARS help desk facilities do not adequately address the needs of the SME sector.

Currently section 190 of the TAA allows SARS to withhold any tax refund indefinitely pending an audit or investigation. This provision is tempered to some extent by SARS having to pay interest when a delayed refund is finally effected.

The TAA and the VAT Act contain procedures that may be pursued by a VAT Vendor when a VAT refund is withheld. However, the SME VAT vendor has, in reality, no remedy. The professional fees that would be incurred in the pursuit of these remedies are beyond the means of smaller vendors. And the timeframe of instituting such procedures do not recognise the immediate need of the vendor to obtain the refund.

4.4.1 Recommendations

The simple recommendation would be to place stringent time limits on SARS concerning all tax refunds. However, the wider implications of such a recommendation will have to be more fully assessed during the DTC's review of the VAT system in 2014.

In the interim it is noted that a distinct improvement to the situation could be achieved if SARS were to create a separate help desk or other communication alternative for the SME sector.

In summary, these recommendations should be read in the light of the substantial investigation into the VAT system the DTC will be undertaking during 2014.

CHAPTER 5

OTHER INCENTIVES RELEVANT TO THE SME SECTOR

5.1 THE EMPLOYMENT TAX INCENTIVE ACT

The Employment Tax Incentive Act, 2013 gives effect to the announcement by the President in his 2010 State of the Nation Address, and the 2010 Budget, that Government would table proposals to subsidise the cost of hiring younger workers.

In response to the high rate of youth unemployment, Government wishes to implement an incentive mainly aimed at encouraging employers to hire young and less experienced work seekers, as stated in the NDP. The incentive is one among many that will fall under the umbrella of the Government's youth employment strategy, the National Youth Accord, which outlines a programme of action to address youth unemployment.

Commitment 6 under the National Youth Accord calls for the development of support and incentive mechanisms to expand the intake of young workers by the private sector. This incentive will complement existing government programmes, such as the Expanded Public Works Programme and Community Work Programme, skills development under the auspices of the Further Education and Training colleges, the Sector Education and Training Authorities, the National Skills Fund and programmes that support enterprise development under the Industrial Policy Action Plan.

The incentive is meant as a temporary programme to stimulate demand for young workers, and this incentive cannot possibly address all structural issues in the youth labour market. The first phase of the incentive is intended to be simple and easy to implement using existing tax administration platforms. NT and SARS will monitor the incentive closely to evaluate the impact. After a review of the effectiveness and impact of the incentive after two years, the second phase can include additional policy features and possible refinement.

The envisaged incentive reduces the cost of hiring young people to employers through a cost-sharing mechanism with government, while leaving the wage the employee receives unaffected. Employers who are registered for tax will be eligible to decrease their employees' tax that is payable for hiring a qualifying individual. These employees must be between the ages of 19 and 29, possess a South African ID and must receive a salary that is between the minimum wage for that specific sector and R6 000 per month. A minimum wage of R2 000 applies where no sectoral determination is

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

applicable. The employee cannot be related or connected to the employer in any way. Domestic workers will not be eligible for the incentive.

The incentive will be available for the first two years of employment. The value of the incentive is prescribed by a formula, which has three components for different wage levels. For monthly wages of R2 000 or less, the incentive value is 50% of the wage, for wages that are above sectoral minima. For monthly wages that range from R2 001 to R4 000 the value of the incentive is R1 000 per month per qualifying employee in the first twelve months. For monthly wages between R4 001 and R6 000 the value of the incentive tapers down from R1 000 per month to zero. The value of the incentive is halved for the second year of employment.

The incentive will also apply within Special Economic Zones (SEZ) and designated industries in which the age restriction will not apply. Public entities identified by the Minister of Finance by regulation can also be eligible.

The incentive commenced on 1 January 2014. Employers will be able to claim the incentive for employment that commences after 1 October 2013. Employers registered for employees' tax purposes will be able to use the incentive by reducing the employees' tax payable in that month by the incentive amount. If the incentive exceeds employees' tax otherwise due in a particular month, an employer will be allowed to carry the excess amount forward to the next month within certain limits.

In order to fast-track the implementation of the incentive, the initial structure will not accommodate reimbursements to employers of any excess amounts generated. However, the proposals do include a 6-monthly reimbursement process which may be initiated through an announcement by the Minister in the Government Gazette. It is envisaged that by implementing the reimbursement process, the incentive will be made more accessible to informal sector employers that only employ low-income earning employees.

As it is not intended that the tax incentive be available to employers that do not meet their legal obligations towards employees, or to employers that structure their affairs to the detriment of employees for the sole purpose of maximising their access to the tax incentive, three exclusions dealing with abuse or the exploitation of the incentive are included:

(i) An employer bound by a sector determination or a bargaining counsel agreement will be disqualified from receiving the incentive in respect of employees when the employer does not pay the relevant minimum wages. A minimum of R2 000 per month is proposed for an employer that is not bound by a specific limit.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

- (ii) An employer will be disqualified from receiving the incentive if the employer has displaced an employee in order to further access the tax incentive. The exclusion is linked to an unfair dismissal finding which resulted from the employer having unfairly discriminated against the employee on the ground that the dismissal was made for the purpose of enabling the employer to access the incentive (for example, displacement owing to age, nationality and the like). A further penalty is prescribed to discourage employers from engaging in such objectionable behaviour.
- (iii) As a final exclusion aimed at addressing potential abuse by specific employers or within particular sectors, the Minister of Finance after consultation with the Minister of Labour may prescribe any conditions by regulation that may be necessary in respect of the granting of the tax incentive.

Operating and administering the incentive through SARS's pay-as-you-earn (PAYE) system will enable detailed monitoring and evaluation. In determining the value of the incentive for a particular month, the employer must follow five steps:

- (i) Identify all qualifying employees in respect of that month;
- (ii) Determine the applicable employment period for each qualifying employee;
- (iii) Determine each employee's 'monthly remuneration';
- (iv) Calculate the amount of the incentive per qualifying employee; and
- (v) Aggregate the result.

There are effectively 6 different calculations depending on the applicable employment period and the 'remuneration' of the qualifying employee, pursuant to the table below. The incentive will be available for a maximum 24-month period per qualifying employee, broken up into a 'first 12 months' and a 'next 12 months'. In calculating whether the 24-month period has expired, and if not, whether the qualifying employee falls within the first or next 12-month period, the total number of months that the qualifying employee was employed by the eligible employer, as well as by any associated institution in respect of that employer, must be taken into account.

If a qualifying employee is only employed for part of a month, the employee's "remuneration" must be grossed up as if the employee had been employed for the entire month ('monthly remuneration').

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

In order to target labour market activation for entry-level employees, the incentive is limited to employees who do not earn more than R6 000 in monthly remuneration (R72 000 per annum).

Whether an employer is eligible for an incentive for a specific employee depends in part on the employee's actual remuneration. Therefore, it is possible that an employee can qualify in one month but not the next.

| Monthly Remuneration | Employment Tax Incentive per month during the <u>first 12 months</u> of employment of the qualifying employee | Employment Tax Incentive per month during the <u>next 12 months</u> of employment of the qualifying employee |
|-----------------------------|--|---|
| R0 - R2 000 | 50% of Monthly Remuneration | 25% of Monthly Remuneration |
| R2 000 - R4 000 | R1 000 | R500 |
| R4 000 - R6 000 | Formula: R1 000 – (0.5 x (Monthly Remuneration – R4 000)) | Formula: R500 – (0.25 x (Monthly Remuneration – R4 000)) |

Even though there may be an incentive amount available to an employer in a particular month, the employer may not reduce the employees' tax payable with the incentive amount if the employer has failed to submit any tax return or owes SARS a tax debt on the last day of that month (excluding cases in which the employer has entered into an agreement with SARS). To the extent that the incentive cannot be used it can be rolled over for use in future months.

5.1.1 Evaluation of the Employment Tax Incentive Act

The DTC has already identified that there is a substantial component of the SME sector that is not registered for tax. For this reason, unregistered businesses have nothing to gain from the Employment Tax Incentive (ETI).

This is not to say that if the ETI was truly accessible to the SME sector it would create a substantial incentive for the SME sector to register for tax purposes. The tax system is in desperate need of such an incentive.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

A further benefit of ETI is that the SME sector would be encouraged to comply with basic wage levels and general labour regulations. In this regard it is noted that StatsSA has identified that many of the estimated 500 000 employees within the informal sector are employed at below the minimum wage.²⁶

The principal tax incentives for the SME sector currently contained in the Income Tax Act do not stimulate employment and provide incentives for the business owner only. It is debatable whether this was ever the intention of the incentives.

There is a strong argument for the case that tax incentives for the SME sector should be focused on rewarding or encouraging employment creation rather than rewarding the business owner.

The general reaction to the ETI act has been that it is too complicated to be of much use to the SME sector. ETI administration is indeed complex. However, it is noted that stringent controls will have to exist to prevent abuse of any tax incentive system.

The proposed ETI system is driven by the deduction of the ETI incentive from the employees' tax liability. This immediately creates the problem that many SMEs have an insufficient employees' tax liability to absorb the ETI incentive.

Section 10 of the ETI Act creates the concept of a refund of ETI. However, the procedures for such refunds have yet to be published in the *Gazette*. Until such regulations are published the value of the ETI incentive to the SMME sector is highly questionable.

5.1.2 Recommendations

ETI has enormous potential to stimulate growth within the SME sector, particularly in rural areas.

The SARS regulations pertaining to the refund of ETI should be implemented as a matter of urgency.

The DTC has identified various flaws in the current SME tax incentive packages where qualification is largely dependent on turnover. Perhaps, ETI in a slightly revised form, may well be a better overall proposition to encourage tax compliance.

26 Survey of Employers and the Self-employed (2009).

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

5.2 INCENTIVES PROVIDED BY THE DEPARTMENT OF TRADE AND INDUSTRY

For the sake of completeness, the key incentives which are provided by the Department of Trade and Industry (DTI) may be summarised as follows:

- (i) Co-operative incentive scheme: This scheme deals with cost-sharing grants for registered primary cooperatives to improve vitality and competitiveness.
- (ii) Black business supplier development programme: This programme deals with cost-sharing grants for black businesses to assist in improving their competitiveness and sustainability.
- (iii) Incubation support programme: This programme assists in building successful enterprises with the aim of revitalising communities and strengthening local and national economies.
- (iv) Small Enterprise Development Agency (SEDA) technology programme: This programme supports technology business incubation, quality and standards and technology transfer services and support of small enterprises.
- (v) Support programme for industrial innovation: This programme is designed to promote technology development in South Africa.
- (vi) Technology and human resources for industry programme. This programme deals with cost-sharing grants which support specific science, engineering and technology research collaboration.

The DTI has recently announced that it is in the process of submitting proposals to Cabinet that would expand upon the existing position.

In May 2014 the President established a new Ministry of Small Business Development. At this stage it is not known to what extent the above programs will be assumed by the MSB.

5.2.1 Evaluation

The provision of financial facilities for emerging businesses is an objective of the NDP. Whilst recognising this, it must be noted that SARS would be exceeding its mandate if it were to provide any direct financial assistance to the SME sector. SARS interventions must be confined to tax incentives and allowances that may encourage

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

other institutions or investors to assist in financing entrepreneurial growth in South Africa.

In the course of this review it has become readily apparent that tax legislation alone cannot provide the range of solutions that are needed to encourage South Africa's entrepreneurs. Further, it is not the direct responsibility of SARS and NT to do so.

5.2.2 Recommendations

The business community has made the recommendation that the assistance needed by the entrepreneur should be forthcoming from the DTI, MSB business and community initiatives and universities. The DTC supports these recommendations. SARS and NT should support such initiatives, but only to the extent of their mandate.

There is substantial potential for large businesses to become more involved in the encouragement of entrepreneurship through corporate social investment initiatives. There is, however, no certainty with regard to the income tax consequences attached to corporate social investment expenditure. It can be argued that expenditure is not tax deductible under section 23(g) of the Income Tax Act. It is suggested that this be addressed by either:

- A binding general ruling, or
- The recognition of 'entrepreneurship' as a separate classification within the Ninth Schedule to the Income Tax Act.

CHAPTER 6

GENERAL COMPLIANCE CHALLENGES FOR SMEs

General compliance issues were raised in the vast majority of submissions made to the DTC. These relate to all taxes that relate to the SME sector.

6.1 A STUDY ON COMPLIANCE CHALLENGES FOR SMALL BUSINESSES

The DTC was also referred to the very instructive research conducted by Dr Sharon Smulders²⁷ regarding compliance. Dr Smulders conducted a survey in which a questionnaire was sent to 88 057 Small Business taxpayers, defined for the purposes of her study as a business with a turnover of R14 million or less. The study was based on returned questionnaires of 5 865 which represented a response rate of 6.7%. Although the majority of the respondents conducted their activities in the professional services sector, trading in the form of close corporations, this research provides some indication of the costs of compliance with respect to the category of businesses with which the work is concerned.

A four-step approach was adopted to quantify the tax compliance costs incurred by small businesses. This involved the following:

- (a) Establishing the hours spent by small businesses on tax-compliance activities.
- (b) Obtaining an indication from respondents of who performed the internal tax compliance activities in the business; owners, employees, unpaid friends/relatives, and the percentage of time each of these persons spent on these tax activities.
- (c) Respondents were requested to provide what they considered to be an appropriate hourly value fee for each of the categories of persons performing the tax compliance activities.
- (d) The internal tax compliance costs were quantified by multiplying the total compliance hours spent on each tax by the percentage of time spent by the different category of persons on each tax and further multiplied by the appropriate cost (hourly rate) of internal time as was established.

²⁷ Sharon Smulders, Madeleing Stiglingh, Riel Franzsen and Lizelle Fletcher 'Tax compliance costs for the small business sector in South Africa – establishing a baseline' (2012) 10 No. 12 *Ejournal of Research* at 184.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

The study revealed that it took small businesses, on average, 255 hours per annum to deal with all tax-compliance-related matters. Businesses on the turnover tax system spent a total of 155.02 hours to comply with both the turnover tax system and PAYE.

It was also found that total time spent by a micro business on tax compliance amounted to approximately two thirds of the time (61%) taken by a normal business (businesses not registered on the turnover tax system) with a turnover of less than R1 million registered for VAT and non-paying custom and tariff duties. It therefore did appear that the turnover tax system had reduced the number of hours required for tax compliance activities. The study also found that VAT was the most time-consuming tax for small businesses.

The study indicated that the majority of internal time spent on tax-compliance activities was taken by the owners who performed 63% of the tax-compliance activities with employees performing 34% and the remaining 3% being spent by unpaid friends or relatives.

In calculating the appropriate average hourly costs of compliance the study adopted the view that the owner would most likely perform the role of financial manager while the employees would fulfil the role of bookkeeper. These functions were then used as the most appropriate representation for quantification of the costs of compliance. The hourly values that were used were R249.48 for an owner and R140.63 for an employee.

The following table (adopted from Dr Smulder's Report) provides a record of the results of the survey in respect of the quantification of time spent:

| TAX / PERSON | Mean (R) | Median |
|------------------------|------------------|------------------|
| VAT | 20,317.75 | 6,367.27 |
| IT | 15,821.91 | 6,568.87 |
| PAYE | 16,532.52 | 7,552.72 |
| CGT | 540.09 | - |
| Customs | 116.50 | 1.59 |
| Excise | 28.05 | 0.55 |
| Total all taxes | 53,356.81 | 20,491.00 |
| Turnover Tax | 14,030.34 | 6,365.87 |

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

The conclusion reached in this study was that *the South African small business population is still in need of tax reform that will assist in minimising tax-compliance costs so that it can concentrate on one of the countries primary needs, namely, job creation.* This conclusion is endorsed.

6.2 EVALUATION

- (a) As is evident from the summary of the research conducted by Dr Smulders set out in this Chapter, the compliance burden remains the major area of concern. The table indicates that the cost to SMEs of complying with the VAT requirements is the highest of all taxes. This is not surprising given that most SMEs are required to complete six VAT returns per annum.
- (b) Since 1997 SARS has reduced the compliance burden of individual taxpayers. This has benefitted 15,3 million personal income taxpayers of which 5.4 million exceed the 2013/14 tax threshold. In the main this has been achieved by shifting the compliance burden from employee to employer. The unintended consequence has, however, been to increase the burden on the SME sector which does not possess the internal resources to meet the increased compliance burden. Nor do most SMEs possess the financial resources to secure assistance to meet the requirements of compliance.
- (c) The consequences of non-compliance created by the TAA are severe and must be considered. It is unfair to expect the sector to comprehend and implement all the complex provisions of the TAA. For example, Section 190 of the TAA empowers SARS to withhold VAT refunds indefinitely pending an audit or investigation, which is far too onerous in the context of the SME sector and should be reconsidered. See chapter 4 on VAT.
- (d) This is not to say that there have not been attempts to deal with the problem. Since 2001 there have been various programmes to assist the SME sector including the introduction of a tax package for small business, the small business tax amnesty of 2007 and the turnover tax system for micro businesses of 2009.
- (e) The fact that the compliance burden is a problem does not mean that it would be prudent to recommend deregulation of the sector. The problem is less about the loss of direct tax collections (R1,3 billion) but rather about the obvious consequences of creating an environment in which further tax evasion can be concealed. This is already a major problem with VAT which represents the largest single target for fraudulent tax activity in South Africa. SARS has been confronted

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

with fraudulent VAT refund claims averaging approximately R2 billion a month. The full statistics are still awaited from SARS at this stage.

- (f) There has been a representation concerning amendments to the TAA; in particular concerning the important question of compliance costs for SMEs when the same information is repeatedly requested by SARS.
- (g) SARS's power to gather information was extended significantly in chapters 4 and 5 of the TAA. Greater powers were deemed necessary because 'too many requests for information by SARS result in protracted debates as to SARS's entitlement to certain information'.²⁸ Understandably, the collection of information is central to SARS's mandate. As stated in its Strategic Plan 2013/14 – 2017,²⁹ 'by increasing and integrating data from multiple sources SARS would increasingly be able to gain a complete economic understanding of the taxpayer and trader across all tax types and all areas of economic activity'. Significantly the same document acknowledges that 'the relatively high costs of compliance might be a reason for noncompliance by small business'.³⁰

6.3 RECOMMENDATIONS

- (a) The DTC supports the widespread call from the professions and business community that SARS should establish comprehensive separate lines of communication and offices for the SME sector. Dedicated purpose-trained SARS officers could well become a critical mechanism for the implementation of a more vibrant sector as envisaged in the NDP. Perhaps this is a matter that can receive further attention from the newly appointed tax ombudsman.
- (b) Regard must therefore be had to costs incurred in connection with information gathering by SARS. In this connection, the Australian Tax Office's *Access and Information Gathering Manual* is illuminating. The latest version which took effect on 1 November 2013, states, amongst other things, the following:

'These guidelines are to assist my staff and ensure we apply professional and, as far as possible, an open approach to the exercise of our access and notice powers. These powers must be used with the utmost care and we aim only to fulfill my obligations under the legislation. A consultative approach to obtaining

28 SARS 'Short Guide to the TAA' at 23.

29 SARS 'Strategic Plan 2013/14 -17' at 25.

30 SARS 'Strategic Plan 2013/14 -17' at 43.

Davis Tax Committee:
Small and Medium Enterprises:
Taxation Considerations, Interim Report, July 2014

information should be the norm. Consultation generally involves advance notice and flexibility in meeting reasonable request.'

The document continues:

'In deciding whether to seek access, and in determining how much detail to seek, officers should always try to minimize the costs of the recipient of meeting access requests. Particularly in cases of seeking bulk data, requests should only be made if there is a reasonable chance that there will be a substantial compliance impact relative to cost.'

- (c) The DTC was urged to recommend amendments to the TAA to align it with the above Australian approach:
- Taxpayers should be absolved from complying with subsequent information requests by SARS when the same information or documentation has already been provided to SARS on a previous occasion and the taxpayer can furnish proof that the information or documentation has been so delivered. Save in the case where, SARS still requires resubmission of documentation or information which the taxpayer can prove has been provided previously, the taxpayers should be compensated, for example in a case where the documentation has been misplaced by SARS.
 - The request should only be made once SARS has satisfied itself that the information cannot be obtained within SARS.

These amendments would reduce compliance costs for small business. The DTC recommends that SARS consider such an amendment to apply to small business as defined. Failing such an amendment, a similar publicly expressed commitment as is the case in Australia should be considered.

It should be noted that all of the discussion, analysis and recommendations constitute an interim report of initial findings of the DTC. Further consideration of the challenges of the SME sector will be ongoing throughout the duration of the DTC's work.

Davis Tax Committee:
 Small and Medium Enterprises:
 Taxation Considerations, Interim Report, July 2014

APPENDIX 1: SUMMARY OF PRELIMINARY SMALL BUSINESS PROPOSALS

| Business Type | Turnover Level | Incentive proposed | Relief provided | Expected return for the fiscus? |
|----------------------------------|----------------|--|--|---|
| 1) Survivalist Micro business | <R335 k | No tax liability | Simple tax registration form (No RCR) | Increased number of registered taxpayers |
| 2) Survivalist Small business | R335 – R1m | Refundable Compliance Rebate (RCR) applicable | Progressive tax tables for Turnover tax Proposed removal of the mandatory “opt-in” 3 year period to give taxpayer the option to choose Annual declaration | Increased number of registered taxpayers Increased tax compliance in the major taxes administered by SARS |
| 3) Small Business Corporation | R1m - R20m | Refundable Compliance Rebate VAT compliance on a cash basis | Increase the threshold to R50m | Increased number of registered taxpayers Increased tax compliance in the major taxes administered by SARS Increased tax collection by SARS from these businesses |

Davis Tax Committee:
 Small and Medium Enterprises:
 Taxation Considerations, Interim Report, July 2014

APPENDIX 2: LIST OF PARTIES CONSULTED BY DTC SMALL BUSINESS SUB-COMMITTEE

| ORGANISATION/INDIVIDUAL | CONTACT ATTENDEE |
|------------------------------------|---------------------|
| Academy of Public Finance | Jeffrey Owens |
| ACCA | Nokuthula Ntshela |
| Afrikaanse Handelsinstituut | Andre de Jager |
| BUSA | Costa Pierides |
| Business Partners Ltd | Ben Bierman |
| CIPC | Rory Voller |
| DTI | Matthews Radebe |
| Endeavor | Catherine Townshend |
| Gauteng Enterprise Propeller (GEP) | Lesley Kwapeng |
| Grovest | Jeff Miller |
| IAC | Ehsaan Nagia |
| Individual | Michael Dyke |
| National Treasury | Hayley Reynolds |
| Reserve Bank | Gill Marcus |
| SACCI | Neran Rau |
| SAICA | Piet Nel |
| SAIPA | Ettiene Retief |
| SAIT | Sharon Smulders |
| SARS | John Hanssen |
| SAVCA | Erika van der Merwe |
| SEDA | Mendu Luhabe |
| SEFA | Litha Myataza |
| Wits University | Thami Mazwai |