The South African Institute of Tax Practitioners

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Dear Madam

CALL FOR COMMENT – 2011 DRAFT TAXATION LAWS AMENDMENT BILL, 2011 DRAFT TAXATION LAWS SECOND AMENDMENT BILL

Thank you for the opportunity to comment on the draft Taxation Laws Amendment Bill, 2011 ("DTLAB").

Set out below please find the comments provided by the National Tax Technical Committee of the Institute. Specific comment on the Turnover Tax on Micro Businesses was authored by Professor Jackie Arendse.

1 Clause 20 – Amendment of section 8E of the Income Tax Act, Act 58 of 1962

Problem statement:

1.1 The clause proposes amending the period of three years, currently contained in section 8E of the Income Tax Act, Act 58 of 1962, as amended ("**the Act**"), to a period of 10 years. Thus, any dividends paid on preference shares, with a term of less than 10 years, will be treated as interest in the hands of the recipient, whilst the entity paying the dividend will still be treated as having paid a dividend.

1.2 Many Black Economic Empowerment ("**BEE**") transactions rely on funding models, which utilise preference shares with a term of three to five years, and the proposal to extend the three years to 10 years will result in BEE transactions becoming too costly and, thus, undermine Government's stated intention of encouraging BEE and the compliance of business with the BEE Charters in place.

Proposed solution:

1.2 The proposal to extend the three years to 10 years should, if an adjustment is to be made, to be increased to a period of five years so that BEE transactions may continue to utilise preference share funding on a cost-effective basis. Alternatively, the entity paying the dividend should be regarded as having paid interest, with the result that the company becomes entitled to deduct the dividend so that there is equality of treatment between the recipient of the dividend and the entity paying the dividend. Furthermore, the proposed amendment is retrospective, as it will result in any dividends paid on existing instruments being treated as interest in the hands of the recipient, as the effective date is determined by taking account of the date on which dividends or foreign dividends are declared, and not the date on which the instrument was issued.

1.3 Clause 21 contains proposals regarding the treatment of pre-existing instruments in respect of dividends received on third-party backed shares, but no similar provision has been proposed insofar as section 8E is concerned. It is, thus, recommended that the amendments proposed to section 8E should not apply to pre-existing instruments, where certain specified criteria are met and the Commissioner determines that the provisions should not apply to the instruments in question.

2 CLAUSE 21 – INCERTING SECTION 8EA INTO THE ACT

Problem statement 1:

2.1 The Explanatory Memorandum indicates that section 8EA is being introduced into the Act to address what is referred to as “tax avoidance”. However, clause 21 of the Bill provides that the dividends received in respect of third-party backed shares must be deemed to be income received by the person, without the entity paying the dividend receiving any deduction therefor. This is iniquitous by virtue of the fact that National Treasury seeks to subject the dividend to tax as normal income in the hands of the recipient only without allowing a corresponding deduction to the entity paying the dividend, which amounts to economic double taxation.

Proposed solution 1:

2.2 Should National Treasury persist in treating the dividends in question as income in the hands of the recipient, it should allow for the entity paying the dividend to obtain a deduction for that amount. This would accord also with the manner in which the general provisions of the Act deal with tax avoidance, whereby the transactions are effectively set aside and the tax payable by the parties, is not more than what would otherwise be the case in total.

Problem statement 2:

2.3 The Explanatory Memorandum indicates that, in order not to disturb certain pre-existing arrangements, the South African Revenue Service ("**SARS**") will be given the authority, after consultation with National Treasury, to treat pre-existing instruments as falling outside of the new regime, if certain criteria are met. It is not understood how SARS is empowered to do this, if such power is not conferred by the statute itself. In addition, reference is made to the fact that SARS, in consultation with National Treasury, will determine which instruments would not be subjected to the new provisions and that the secrecy provisions will be relaxed for this purpose.

Proposed solution 2:

2.4 If it is intended to proceed with the proposal referred to in the Explanatory Memorandum, it is necessary to amend section 4 of the Act to empower SARS to make disclosure of information to National Treasury. Currently, SARS is not empowered to inform National Treasury of specific information regarding taxpayers, as this would contravene the secrecy provisions contained in section 4 of the Act.

3 CLAUSE 75 – AMENDING SECTION 45 OF THE ACT

Problem statement:

3.1 The clause proposes that any disposal of assets made on or after 3 June and before 1 January 2013, will not be capable of falling within the provisions contained in section 45 of the Act. It is common cause that the Budget Review and related documentation contained no indication that section 45 was to be amended in this manner, and the proposed amendment has, therefore, caused serious disruption to business and the restructuring of groups in South Africa, and created great uncertainty. A significant number of transactions were under consideration, which would have relied on section 45 and the manner in which the amendment has been proposed, without prior warning, has undermined confidence in South Africa in the eyes of foreign investors in that there is a lack of certainty in the tax system in South Africa.

Proposed solution:

3.2 SARS and National Treasury have indicated that they are concerned that certain transactions, relying on section 45 of the Act, have undermined the corporate tax base. Instead of treating all taxpayers in the same manner, and assuming all taxpayers to be denuding the tax base, the amendments to this section should be more targeted.

It would appear that National Treasury and SARS are aware of certain transactions abusing the provisions of section 45, and those transactions should be attacked under the current statutory provisions, judicial precedent and also the General Anti-Avoidance Rule contained in sections 80A to 80L of the Act. It would be far preferable if specific amendments were introduced to section 45, seeking to ensure that excessive gearing does not arise and that deductions for interest should only be allowed, so long as the recipient of that interest is taxed thereon in South Africa. To summarily suspend the operation of section 45 is bad for the tax system and undermines confidence in the tax system. It would, therefore, be far preferable if specific amendments were introduced to section 45 to address the concerns identified and aired by National Treasury and SARS.

4 CLAUSE 106 – SMALL BUSINESS: MICRO-BUSINESS TURNOVER TAX RELIEF

Problem statement:

4.1 The Explanatory Memorandum lists three possible shortcomings of the existing Turnover Tax system:

- the rate structure may be too high for many informal businesses;
- the prohibition from being registered under the value-added tax; and
- the three-year lock-in period.

These have been addressed by the following amendments in the draft Taxation laws Amendment Bill, 2011:

4.2 The rate structure has been amended for years of assessment commencing on or after 1 March 2011. This amendment is welcome as it reduces the tax burden on micro businesses, making this tax system more attractive to small businesses.

4.3 De-linking the value-added tax and the turnover tax for years of assessment commencing on or after 1 March 2012. This amendment is welcome as addresses one of the problems originally identified with the turnover tax system and broadens the scope of businesses that may qualify for the turnover tax.

4.4 Relaxing the three-year lock-in period, but this is countered by a new provision that disallows a business from subsequently re-electing the turnover tax once they have migrated away from it, effective for years of assessment commencing on or after 1 March 2012. We welcome the removal of the three-year tie-in but do not see the merit in introducing a barrier to re-entry later on. If a business grows too big to qualify for the

turnover tax system it will have to migrate onto the small business corporation or normal tax provisions, but if it subsequently shrinks there seems to be no good reason to prevent that business from migrating back into the turnover tax system. The small business corporation provisions in section 12E allow those companies to elect every year whether they qualify as a small business corporation or not. We see no reason why the same should not apply with the turnover tax. These businesses should be allowed to make the election at the beginning of each year of assessment.

4.5 Whilst these specific amendments are generally acceptable, subject to our specific comments above, they really only address some of the more superficial aspects of the turnover tax system and unfortunately will not solve the inherent problems of the system. We suggest that deeper thought should be given to the purpose behind the turnover tax system and then ensure that the amended provisions in the Sixth Schedule adequately facilitate this purpose.

Introduction to proposed solutions:

4.6 The turnover tax system has two specific objectives:

4.6.1 to bring unregistered small businesses (informal sector) into the tax net; and

4.6.2 to provide a simpler tax system for very small businesses to increase tax compliance.

4.7 Statistics released by SARS confirm that the first objective has not been met as very few new businesses have registered as micro businesses. The Explanatory Memorandum to the draft Taxation Laws Amendment Bill, 2011 states that the majority of micro business registrations have involved existing businesses that elected to migrate onto this system. This confirms that the turnover tax system is not attracting informal businesses into the tax net.

4.8 The objective of encouraging informal small businesses to register as taxpayers is important as part of the need to broaden the tax base and raise the level of tax compliance in South Africa. The main criticism of the turnover tax system, since its inception, has been that it is overly-complicated and in our view this has been the main hindrance to a broader take-up by small businesses. We strongly suggest that, as part of the 2011 amendments, consideration should be given to simplifying the turnover tax system so that it is easy to understand and apply. Small businesses operating in the informal sector would be more attracted to register for the turnover tax if they could understand all the provisions of the Sixth Schedule. At present this is a challenge even for experienced tax practitioners.

4.9 Specific areas of complexity that need to be addressed are:

Definition of "Professional service"

The very wide scope of the definition of "Professional service", which encompasses –

"any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, consulting, draftsmanship, education, engineering, financial service broking, health, information technology, journalism, law, management, real estate broking, research, sport, surveying, translation, valuation or veterinary science."

4.10 Bearing in mind the intention behind turnover tax (being to reduce compliance costs for very small businesses), we would recommend that the reference to "professional services" should be adequately clarified or excluded altogether.

4.11 Alternatively, a similar ruling relating to 'unconnected employees', as contained in the small business corporation, section 12E provisions, could be introduced and that the 'professional service' restriction does not apply if for example one or two or more employees are full time employed, are not shareholders or members of the micro business and are not connected persons to any of the shareholders or members of the micro business.

The provisions relating to capital gains tax

4.12 Paragraph 3(a) of the Sixth Schedule which provides that -

"A person does not qualify as a micro business for a year of assessment where—

(a) that person at any time during that year of assessment holds any shares or has any interest in the equity of a company other than a share or interest described in paragraph 4".

It is unclear what happens when a person is married in community of property. Our view is that this exclusion should not apply where a spouse of a person married in community of property holds shares in another company. This needs to be clarified.

The determination of taxable turnover

4.13 The submission of six-monthly returns, which is very similar to the provisional tax system that applies to other taxpayers. It may be simpler to introduce a basic monthly payment, perhaps at a fixed rate determined at the beginning of the year, with a topping up provision (or refund in the case of overpayment) at the end of the year. The penalty clause could apply where there are instances of substantial underpayment during the year.

4.14 One of the fundamental shortcomings of the turnover tax system is that it is overly-prescriptive in terms of the exclusions listed in paragraph 3 of the Sixth Schedule. While these measures are intended to counter the risk of abuse, our view is that the real extent of this risk has been overly exaggerated taking into account the possible loss of revenue to the fiscus, in view of the fact that qualifying turnover is always capped at R1 million. We do not agree with the exclusion of professional persons (para 3(b)) and sole traders earning investment income in the form of dividends, which would be subject to the dividends tax in any event. We also suggest that sole traders with interest not exceeding the exemption limit in section 10(1)(i)(xv) should be permitted to elect the turnover tax system for their business income.

4.15 We also recommend that the tax write-off benefits provided for in terms of section 12E should also apply to sole traders and not only to companies and close corporations.

4.16 Finally, we are concerned about the proposed amendment giving power to SARS to choose whether to register a business for turnover tax or income tax. This power is justified on the basis that it will ensure that taxpayers cannot alternate between both tax systems as a mechanism to artificially slow the audit process. However, it would be unfair if SARS decides that a certain business should be subject to a tax system that results in a higher amount of tax being payable. This is not an acceptable way to deal with non-compliance. The penalty system is contained in the tax legislation for this purpose and should be used in these instances.

Please do not hesitate to contact us should you wish to discuss the above.

Yours faithfully

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