South African Institute of Tax Professionals

31 August 2014

Judge D. Davis and Prof. M.Lester
Davis Tax Review Committee

BY E-MAIL: VPILLAY@SARS.GOV.ZA; TAXCOM@SARS.GOV.ZA

Dear Judge Davis and Prof.Lester

RE: CALL FOR COMMENT: SMALL AND MEDIUM ENTERPRISES ("SME") INTERIM REPORT JULY 2014

Thank you for the opportunity presented by the Davis Tax Committee (hereafter "DTC") to contribute
commentary and assist in developing the debate on the taxation of small businesses.

Set out below, is the consolidated commentary on the Interim Report developed from both an internal review of the provisions as well as from consultations with members, stakeholders and industry. The commentary reflects the collective view of members, stakeholders and industry role players consulted.

1 POLICY ON DEFINING SMALL BUSINESS

1.1. Policy objectives

The findings by the DTC regarding the difficulty and dangers of defining the scope of what constitutes a SME to which the tax incentives should apply, makes it so much more imperative that the overall government policy regarding SME's should be expressly determined and coordinated. This would make it more clear what the various government departments try to achieve in implementing the coherent policy and where the tax system fits into this strategy.

It is submitted that determining the tax system's function without such a coherent formal policy will create increased risk for failed proposals and create further confusion and uncertainty among the SME community as to what government is trying to achieve. It is agreed that from a policy perspective, the scope of what constitutes a SME for particular legislation should be determined with reference to what the proposed policy outcome is, but taking into consideration that alignment, where practically possible, should be done in respect of such concepts of SME between the various legislation to reduce compliance costs and decrease the complexity of the overall policy.

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081

PO Box 712
Menlyn Retail Park
0063

Though we also agree with the DTC's findings that the tax system, including SARS as the administrator thereof, is not the forum to address many of the concerns relating to SME development in South Africa, we remain of the opinion that SARS' policy mandate cannot merely be limited to enforcing tax compliance among SME's. The lack of tax compliance is a result of many factors, including market forces, cost of such compliance as noted by the DTC, the complexity of being compliant and historical development deficiencies in the sector. In this regard the informal economy, which remains very material yet totally unregulated, is of great concern as the performance of and contributions made by SME's are currently only measured in the formal sector.

In respect of the latter we respectfully disagree with the DTC that an ongoing tax amnesty for SME's would not be more useful than the current voluntary disclosure program. The latter is not only a daunting prospect by being compelled to quantify historical liabilities, it is also financially onerous as it still imposes substantial financial penalties and interest on the disclosing taxpayer, which for a SME in the informal economy provides no real incentive to become part of the formal economy. The current system in many instances provides a choice between being compliant and closing down or being non-compliant and still having a livelihood, though this is a risky choice. It is submitted that formalizing SME's is of far greater benefit in the long term than the quick fiscal benefit of imposing penalties and interest and historical tax charges on non- compliant SME's. The long term benefit for compliant SME's is that the continual increased tax base will decrease the current tax collection pressures imposed on them.

1.2. Excluded professions and businesses

In respect of the proposals made we welcome the proposed turnover threshold increase to R50 million. However the continued policy exclusion of certain professions and businesses based on the fact that a perception seems to exist that they do not meaningfully create employment remains a concern. If the latter is the only real concern in respect of the excluded group, this could more readily be addressed by adding a minimum employee threshold for such businesses. This would ensure that all SME's are treated equally, but also ensuring that businesses of a specific type which may or may not habitually create meaningful employment, are also included in instances where they do create meaningful employment, the latter being the ultimate goal.

1.3. Purpose of replacing SBC

Paragraph 2.1.2 states that the current SBC regime is not achieving its goal and should be replaced by the RCR, focused on the primary problem of tax compliance. This focus of incentivizing tax compliance rather than SME development seems to be a central theme in the report. It is submitted that this policy intention is misplaced as policy should rather support a conducive business environment, including tax, rather than employing carrot and stick approaches to good tax compliance which should be a symptom of such a good business environment, not a means to achieving it. The report correctly states that many factors contribute to supporting SME's in achieving success, on the same basis many factors contribute to the compliance status of SMEs including:

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
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0063

- Cost of compliance both for time and money
- Complexity of the tax system and legislation
- The level of skill and acumen of the SME owners and in the market
- The complexity of administration and lack of support from SARS etc.

1.4. Target for incentive

The DTC has found that the majority of the incentive is utilized by niche SME's which were not the target group, yet conceding that such claims are within the confines of the provision. No policy guidance is given as to what exactly the target group is and why the niche SME's who seemingly are utilizing the benefit of the incentive legally do not fall within this target group. It is accordingly very difficult to respond as to the appropriateness of this policy as the proposed RCR does not seemingly seek to exclude this identified niche SBE's.

The statement is also made that no incentive is available to those who are starting a business or have assessed losses, yet this statement is in direct contradiction with the finding that these financing matters are better dealt with by other government departments.

It would seem that debate still exists regarding not only what an SME is but which of those SME's are part of the "target group". It is submitted that profit making SME's should not be excluded from the target group merely on their success but should rather be the focus of such incentive. Where SME's fail, it is clearly stated in the report that tax, though a problem is not the major hurdle facing SME's and should therefore not be used directly or indirectly as part of the solution to assist in overcoming such problems. The contradiction of the finding in the DTC report is clearly captured in paragraph 1.5 in the following:

"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.".

and

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

However on the same basis, matters that are to be dealt with by other government departments should not form the basis for a change in tax policy or law. We reiterate our request that more research and consultation should be conducted with more concrete facts before the current system is summarily replaced.

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
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0063

Furthermore, the identification of owner managed businesses as constituting an abuse of the incentive further emphasizes the point that the "target group", from a policy perspective should be clearly determined. It is submitted that the majority of SMEs are owner managed and therefore will entail the owner receiving a salary. Where the services by the owner or family member does not justify the salary, this is an avoidance issue to be addressed by SARS. However the blanket statement that family owned and owner managed business are getting a double benefit not only pierces the corporate veil for no apparent reason but unfairly targets the group as being exploiters of the incentive. The salaries of owners managers are subject to income tax like any other business and the tax position should not be aggregated with the corporate entity in determining the legitimacy of the use of the incentive.

2 REFUNDABLE TAX CREDIT PROPOSAL

2.1. Effectiveness of SBC regime

The finding that the SBC regime does little to support small business growth appears to be contrary to the findings of a survey done by SAIT amongst its members. The results of the survey indicated that the SBC regime provided a substantial benefit to small businesses in the form of reduced taxes having to be paid as well as an upfront deduction of the cost of manufacturing assets. The cash flow of these entities was thus immediately improved. According to the findings of the DTC, only 7 827 businesses were registered on the turnover tax regime ("TT") in 2012. It was also found that 34 391 businesses had taxable income of R1 million or less and could potentially have chosen the TT regime over the SBC regime but appeared not to have chosen this option. If only the numbers of businesses are taken into account it seems strange that a system that is more widely used is being replaced by a system that is less widely used by small businesses.

It is also evident that many businesses chose to be on the SBC regime rather than the TT despite the fact that their 'turnover' was R1 million or less (indicating that they could potentially also qualify for the TT regime). When asked why this was the case, it was found that the main reason was that they would have paid more tax on the TT regime, this is particularly true for businesses that were in a loss position though the DTC has made proposals to correct this. The SBC regime clearly did support small businesses, and in some cases, it supported small businesses more than the TT regime did. Reasons for replacing the SBC regime with an annual refundable tax compliance rebate (RCR) are thus not clear as it was clearly benefiting small businesses according to the findings of SAIT's survey.

We suggest that more consultations and research be performed to establish exactly why businesses chose the SBC regime over the TT regime before a system that appears to be working is replaced in its entirety. This is especially applicable in instances as noted in the report that all SARS' SME data had not been made available to further clarify the factual conclusions reached on the effectiveness of the SBC regime.

2.2. Refundable tax compliance rebate (RCR) – to replace SBC regime

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
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0063

It is proposed that the SBC regime be replaced with a RCR of R20 000. Furthermore, all businesses with a turnover of between R1 million and R50 million will pay tax at a rate of 28 per cent as opposed to the sliding scale previously afforded to SBCs. It is assumed that these entities will not be afforded the accelerated asset write offs anymore either, although the report is silent on this matter.

The introduction of a RCR is welcomed for small businesses with a taxable income of R53 574 or less as they will be in a better position than they were using the SBC regime. However, for businesses with a turnover of more than this amount, they will be in a worse off position than if they were on the SBC regime. A small business with taxable income of more than R550 000 (4 519 businesses per DTC report) will stand to lose R79 298 each year if the new RCR system is introduced. This is a substantial amount that could be used by a small business to employ an additional staff member or purchase assets or trading stock.

The intention of the NDP is to assist small businesses, however, the proposed RCR appears to do the opposite for small businesses that have a taxable income of more than R53 574. Further research and consideration of the proposed changes is warranted. If the RCR regime is to be implemented, it should rather replace the turnover tax to benefit taxpayers with a taxable income of less than R53 574.

2.3. Refundable tax compliance rebate (RCR) - value

The purpose of the RCR of R20 000 is to assist small businesses with their tax compliance costs and to incentivize tax compliance. Research conducted by Prof. Sharon Smulders in 2012 indicated that internal tax compliance costs for small businesses amount to R53 356 per annum (with external costs amounting to just under R10 000 per annum). It is evident that the R20 000 is relatively low compared to the total tax compliance costs actually incurred by small businesses.

Although it is recognized that the *fiscus* cannot fully subsidize the tax compliance costs for small businesses, it is evident that the R20 000 incentive is not sufficient for small businesses taking into account the fact that small businesses with taxable income of more than R53 574 will be worse off than they were under the original SBC regime.

Though the proposal for a graduated band is welcomed, the increase in the turnover threshold to R50m at the cost of nearly 80 per cent of the cash value of the incentive for SME's in the current R20m threshold makes no sense. It is submitted that should the RCR be implemented and a trade-off must be made, the current incentive value of nearly R93 459 should be retained rather than increasing the threshold band to R50m and reducing the incentive to a negligible R20 000.

2.4. Refundable tax compliance rebate (RCR) – eligibility

The RCR of R20 000 will be available to small businesses only if they are compliant in terms of their tax returns and liabilities within 9 months after the end of the year of assessment. It is assumed that the "compliance" requirement is in respect of the year of assessment to which the RCR relates, thus affording the taxpayer effectively 9 months to get compliant for that year. However, the proposed legislation in the draft Taxation Laws Amendment Bill, 2014 does not seem to interpret it this way as it is firstly unclear whether all taxes (that is income tax, VAT, PAYE etc.) and its returns are referred to in the proposals and secondly whether it requires compliance up to date of claiming/payment of the RCR rather than for the year in respect of which the credit is claimed. It is submitted that within the complex tax compliance environment, this proposal is only practical if in principle the SME is afforded the opportunity to correct all compliance in respect of the year of assessment in which the RCR is payable within 9 months after such year of assessment.

3 CORPORATE SHAREHOLDING

The limitation of the shareholding in SBCs to natural persons has always been a problem, though SARS' concerns of abuse by splitting of income remains valid. However, it did result in the exclusion of many valid SMEs and more importantly, prevented capitalization of SBCs by corporates taking securitized interests in SBCs for such funding. The revisiting of this requirement, especially to facilitate funding needs of SBCs is welcomed.

4 VAT

4.1. Cash basis of compliance

This proposal is welcomed as it would provide SMEs, who find the cash flow need to operate on the basis as a one solution fits all approach can be detrimental to SMEs who need the ability to change as circumstances change.

However, the finding that the VAT system also imposes the most onerous administrative obligations is also noted and correctly should be addressed, notwithstanding the fiscal risks attributable to any tax that becomes refundable from monies not directly paid to SARS.

4.2. VAT refunds

Though it is accepted that SARS do need to manage risk in the VAT system by verifying refunds, it should also be done in an administratively fair manner. We submit that in principle, SARS should be subject to some form of reasonability limitation in managing such risk by being subject to a time period to release a VAT refund once an audit or verification is instituted.

5 VENTURE CAPITAL COMPANIES

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
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0081

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0063

The ineffectiveness of the venture capital company regime does not surprise as it again reflects a misplaced policy that business would participate merely on the basis of a tax incentive being available. Businesses' main focus remains making a profit based on the risk taken and tax incentives merely contribute to this decision. However, when the administrative burden on the tax component exceeds any of the other profit driver benefits, plus the associated risk with any tax incentive, it will not incentivize the uptake of such commercial ventures. This was the basis of much criticism by many tax professionals on the introduction of section 12J.

The same principle applied to section 12H which has been amended on various occasions for the same reason, namely lessening the administration and risk involved in qualifying for the incentive. This we understand has led to an increase in the uptake of the incentive, though further administrative revisiting is advised for SMEs, which proposal is welcomed.

6 PERSONAL SERVICE PROVIDERS

The possible revisiting of the personal service provider regime would be welcomed as this regime imposes not only a tax burden on these entities but also an administrative burden and risk on the taxpayers doing business with them.

It is submitted that the introduction of dividends tax at 15 per cent has removed any tax arbitrage between doing business as an individual or through a company as the effective rates after dividends tax is almost exactly the same. Furthermore, though the regime was introduced to avoid sham employee relationships that avoid the limitations of section 23(m), it should also validly be recognized that these companies and trusts are in reality subject to the risk of profit and loss and are not afforded the protection of labour legislation as with employees.

A discussion document as to the continued need for this regime by National Treasury and SARS on this matter would be welcomed.

7 MICRO BUSINESSES

It is proposed that micro businesses be able to elect out of the regime on a once-off basis as opposed to being locked into the regime for 3 years. It is submitted that this just transfers the decision problems for the SME from the persons outside the regime to those inside the regime. It has already been noted that the tax contribution by SMEs to the *fiscus* is less than substantial, therefore the concern that there may be tax leakage if SMEs can annually elect in or out of the system seems to be nonsensical. Where a specific regime better supports the growth of an SME, it is submitted that such entities should freely be able to choose the tax regime most suitable to ensure sustainable growth. Due to the tax consequences of such move in some instances, in specific if the taxpayer is also a VAT vendor, it would not be made lightly. In all other instances it is unclear what the perceived harm would be to the tax system.

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

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C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081

PO Box 712
Menlyn Retail Park
0063

South African Institute of Tax Professionals

Yours sincerely,

Erich Bell
Acting Head of Tax Technical

Cc: cecil.morden@treasury.gov.za
Cc: ismail.momoniat@treasury.gov.za
Cc: klouw@sars.gov.za

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

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C/O Garsfontein & Matroosberg Roads
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0063