South African
Institute of
Tax Professionals

3 March 2014

Mr T.A. Mufamadi, MP
Chairperson: Standing Committee on Finance
Parliament
P.O. Box 15
CAPE TOWN
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Dear Mr Mufamadi

RE: CALL FOR COMMENT ON THE FISCAL FRAMEWORK AND REVENUE PROPOSALS: 2014 BUDGET

Thank you for the invitation to participate in the hearings of the fiscal framework and revenue proposals and the related 2014 budget documentation.

Set out below are the comments of the South African Institute of Tax Professionals ('SAIT') on the Budget 2014 that were developed internally as well as from consultations with stakeholders and industry role players. Our collective comments are set out hereunder.

1 INTRODUCTION

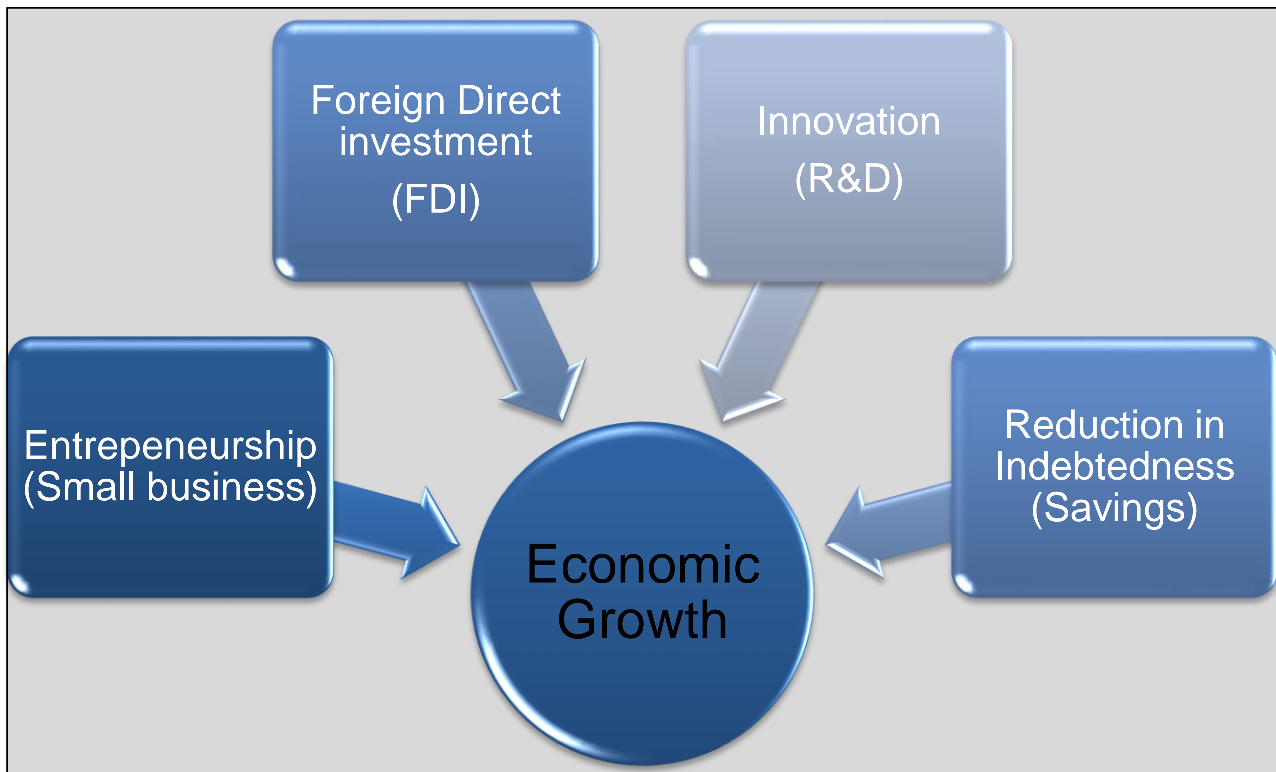
We congratulate the Minister on a rational budget considering the substantial challenges that South Africa is currently experiencing. The imposition of an expenditure ceiling that is binding for the next three years is welcomed taking into account the extent of government's borrowing over the last few years and the increasing costs of borrowing.

We welcome the fact that the main focus of the budget is on growth, development and job creation, using the National Development Plan as a guide. It is in line with these focus areas that we set out an overview of our comments below.

2 OVERVIEW OF DETAILED COMMENTS

The performance of the economy is the starting point for understanding the Budget, as it is the economy that has to deliver the tax revenue that Government spends. Mr Gordhan reminded the country that it is "ultimately the state of the global economy and the dynamism and agility of the SA economy that shapes domestic growth". Taking the economic challenges facing our country and the wider global community into account, we depict in Figure 1 below the main focus areas that we consider requires Government's broader but urgent consideration.

Figure 1: The four pillars needed to stimulate economic growth in South Africa.



The first pillar is Entrepreneurship and the stimulation of the small business sector that has the capacity to reduce unemployment. The second pillar is foreign direct investment that is also crucial to stimulate jobs and build infrastructure in the country. The third pillar to economic growth is innovation and the research and development ('R&D') that is needed in order to achieve innovation. The last important factor that will ensure economic growth in South Africa is a reduction in the indebtedness of the country and its citizens.

Each of these will be discussed in more detail below.

3 SMALL BUSINESS RELIEF

3.1 Small Business Corporation ('SBC'), Turnover Tax and Venture Capital Company ('VCC') regime changes

Small businesses are the engines of job creation but despite this sector's critical role in the economy, it is a matter of concern that this sector faces various challenges, one of which is the regulatory and legislative burden imposed on them in the form of tax legislation. Streamlining the regulatory regime and reforms to reduce compliance costs and facilitate access to equity finance for the small business sector proposed in the

budget speech are therefore most welcomed. However, our comment on the replacement of the SBC regime with a refundable tax compliance credit is reserved until further details on this credit are available.

The changes to the turnover tax regime are commendable but we question whether these changes will be sufficient to get the informal sector to become tax compliant as the take-up of the turnover tax regime in total, and not just in the taxi industry for which it was designed, was not a success. We suggest that more emphasis should be placed on relaxing the entrance requirements, marketing the incentive and on enforcement of non-compliant taxpayers.

The exemption of grants received by small and medium-sized enterprises, regardless of the source of the funds, is also welcomed as long as care is taken to prevent abuse and inconsistencies in the tax system from arising. It will also be interesting to see how this impacts the current section 12P, which covers tax exemption of Government grants.

It is hoped that the changes to encourage equity investments in small, medium and micro enterprises will improve investments into these entities and we suggest that the effectiveness of these changes be monitored closely and re-evaluated on a yearly basis.

3.2 Special Economic Zones ('SEZ') grants

The South African government has been providing numerous grants and tax incentives to various industries (some are heavily supported such as the motor industry, while some are not supported at all). The 2014/15 allocations for incentives in the DTI budget vote of R5.5 billion is virtually the same as the 2013/14 allocation of R5.4 billion. The good news, however, is that for the following two years the incentive budget allocation increases by 12.8% per annum. It is concerning that there has been a R550 million reduction in incentives in the 2014 medium term expenditure estimate over the 2013 medium term estimate. The reduction relates mainly to the Special Economic Zones ('SEZ') Programme, as the legislation is still being finalised.

If incentives and grants are used to link the key pillars of industrialisation, job creation, supplier development, innovation and localisation, it would create many opportunities for Small, Medium and Micro Enterprises ('SMME'). Unfortunately, no comment has been made regarding the 15% corporate tax rate for SEZ's and there was also no mention made of an extension on the 10 year SEZ window period. We believe it is vital that this 15% corporate tax rate be extended otherwise all the hard work in designing this job creating vehicle will be lost. We are hoping that the government uses the SEZ programme to create many new business opportunities for smaller businesses and new entrants into the market.

The Enterprise Investment Programme, which mainly focused on supporting new investment projects by small and medium enterprises, closed in September 2013. There has been no announcement on its replacement in the budget and this implies that there are no incentives for small and medium sized new entrants into manufacturing sector. This is a concern especially with Governments drive to create manufacturing opportunities for black business through the localisation and supplier development initiative.

3.3 Travel deductions

We note the changes to the new table used to calculate the deduction when taxpayers use their personal vehicles for the benefit of their employer (the brackets have been changed and consolidated at the lower end). Obviously the situation will be different for each taxpayer, but, we have tested two examples (refer below) and the amounts as per the table contained in the budget result in punitive changes in certain instances.

1. A taxpayer with a small car that is a few years old and originally cost very close to R160,000 has a fixed cost reduction from R52,033 to R46,203 (reduced 11%). Despite the fuel value having increased by 13% and the maintenance by 5%, neither increase in respect of fuel nor repairs has kept pace with the actual price increases.
2. A taxpayer with a car costing R313,000 has a fixed cost reduction from R90,688 to R84,351 (reduced 7%). The fuel value has reduced by 7,5% and the maintenance reduced 23%. This is clearly out of line with the actual costs.

This latter category would be applicable in for instance a case where a staff member who has a vehicle which cost R313,000, travels on average 37,000 km per year of which 80% on average is business. The tax deduction for the employee will decrease by R11,700 per year but the running costs in terms of tyres, services per year and fuel would have increased substantially. The concern is the economic impact that this will have on a small business owner’s staff which in turn will affect the owner’s ability to recruit and employ people in the category where they travel large distances throughout the country. Consideration to these concerns must be taken by government and the rates must be brought in line with the actual costs of fuel and maintenance.

3.4 Employment Tax Incentive

Although this relief is not only applicable to small businesses, the benefit of this incentive is really meaningful for the small business sector. We thus welcome this employment tax incentive and congratulate National Treasury on its success so far – 56 000 participants in its first month. We look forward to seeing further updates on the effects of this incentive on youth unemployment.

3.5 Small business relief – Conclusion

The commitment by government to increase the support and tax relief for entrepreneurs and small businesses is undoubtedly a step in the right direction. What is lacking though is a comprehensive focussed plan for SMMEs detailing exactly how these proposals and relief measures will be implemented and how effective they have been. We look forward to the Davis Committee’s report to provide guidance in this regard.

4 FOREIGN DIRECT INVESTMENT

4.1 Corporate tax rate

Encouraging foreign investment is one of the key aims of the National Development Plan as foreign direct investment activities will assist in broadening the South African tax base as well as stimulating employment. A high corporate tax rate though is unlikely to encourage this type of investment. Although South Africa has reduced its company tax rate (currently 28 per cent) over the last few years, global trends suggest that our rate is still relatively high compared to other countries.

Although it may seem counter-intuitive to reduce taxes to increase tax collections, research has shown (see the graphical depiction of the Laffer Curve below) that as tax rates increase so do tax collections, but only to a certain point, after which as tax rates increase, tax collections actually decline.

Figure 2: The Laffer Curve

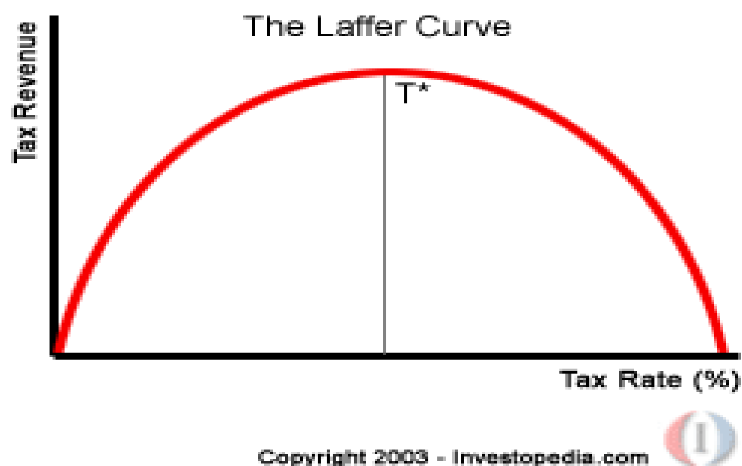


Figure 2 thus graphically depicts the representation of the relationship between tax rates and tax collections. If South Africa really wants to be the "gateway to Africa" then the mere introduction of the headquarter company regime will not be sufficient. Reducing the corporate tax rate with a corresponding increase in VAT could make up for the shortfall in corporate income taxes. South Africa's VAT rate of 14% is relatively low by international norms (the average VAT rate in the European Union is 21.5%), thus any increase in this rate would not necessarily put South Africa at a major disadvantage. To ensure equity and to counteract the regressive effects of VAT, exemptions and more zero-ratings could be inserted into the VAT Act. Different rates could be used to account for VAT on different goods (i.e. luxury goods would be subject to a higher VAT rate), although this could add to the complexity of the system and thus increase compliance costs, but nonetheless, it is an option that needs consideration taking the bigger picture into account.

4.2 Foreign direct investment - Conclusion

With the global financial crisis still lingering, reliance on corporate tax rates by government is perhaps not a wise thing. Cutting corporate tax rates to attract foreign direct investment is something that the South African government needs to consider if it wants to increase economic growth, reduce unemployment and broaden the tax base.

We also propose that South Africa formalises its International Tax Strategy, as did Ireland for instance, in order to take the necessary steps to enhance South Africa's attractiveness for foreign direct investment.

Investment in our people, investment in our infrastructure and our strong commitment to the rest of Africa can only occur if we shift our industrial and tax policy from protectionism to a more open and outward-orientated approach. Stability and certainty are cornerstones of our economic recovery, and unless clarity is provided on, for instance the practical and legislative challenges of the transfer pricing requirements, particularly for businesses involved in either entering or expanding their interests into Africa, South Africa will lose foreign direct investment to other countries that are providing these key elements.

5 RESEARCH AND DEVELOPMENT ('R&D')

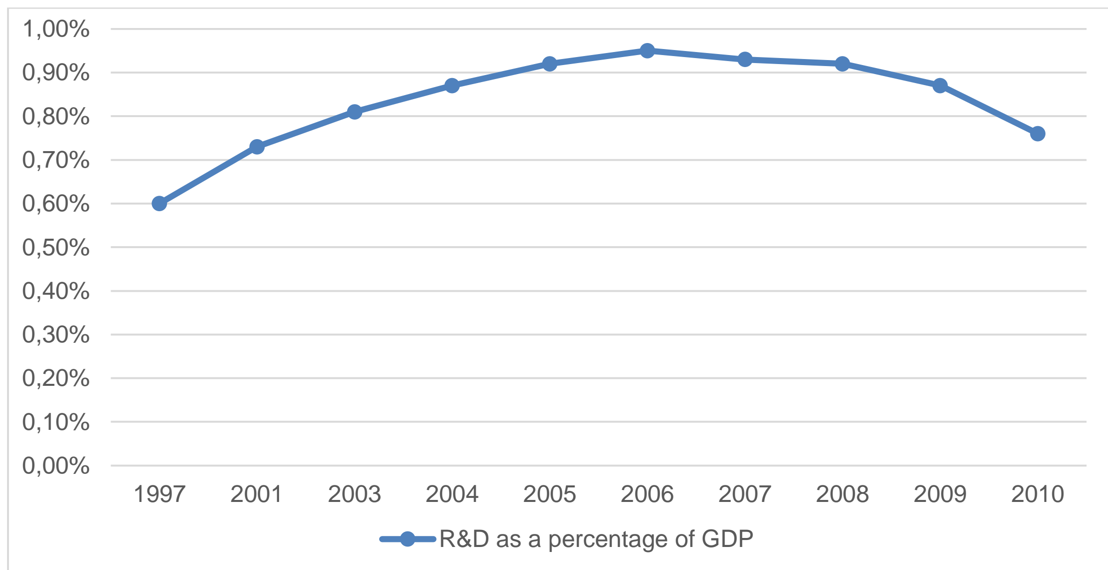
Although innovation is an important factor to stimulate economic growth and combat unemployment, it is evident from the budget speech there is limited support by Government to the Private Sector in the form of R&D tax deductions and R&D grants. This leaves the effectiveness of the purpose for the introduction of section 11D in the Income Tax Act open for discussion.

One of the purposes for introducing the R&D was for South Africa to become the innovation hub of the Sub-Saharan Africa i.e. to attract direct foreign investment by foreign companies funding research and development activities in South Africa. This was also in line with the National Development Plan according to which science, technology and innovation are included as key aspects of the South African developmental agenda. Science and technology are crucial for equitable economic growth because advances in these fields underpin economic progress, education and improvements in health systems and infrastructure.

In December 2013, the Human Science Resources Council released the results of the latest national R&D survey, which told the picture up to 2011. Having experienced a drop to just 0.76% of Gross Domestic Product ('GDP'), it is clear that there is no chance of meeting South Africa's unofficial goal of achieving R&D spend of 1.5% of the GDP by this year. As noted in Annexure C of the Revenue and Tax Proposal Chapter to the 2014 Budget Speech, the R&D tax deduction under section 11D (relinquishment of revenue by SARS) declined by 65% from R685 million in 2010/2011 to R241 million in 2011/2012. These figures do not depict a healthy situation of R&D expenditure in South Africa.

Ironically, since the implementation of the R&D tax incentive in November 2006 (see Figure 3 below) we have seen that R&D as a percentage of GDP has been steadily dropping. The ratio in 2007-08 was 0.93%, falling to 0.92% in 2008-09, then to 0.87% in 2009-10 and finally to 0.76% in 2010-11.

Figure 3: R&D as a percentage of GDP in South Africa



A key reason for the significant under-claim in R&D could be that since the implementation of specific R&D tax legislation in 2006, there has been numerous changes to the legislation resulting in inconsistency in terms of eligibility criteria and in the administration of the regime. Two amendments to the section 11D legislation which will be introduced later in the year and will be backdated to 1 January 2014. The first being the issue pertaining to clinical trials being conducted in South Africa and the second is related to the entity eligible to claim the R&D tax deduction.

Inconsistency in legislation and practice is highlighted by lack of support through section 11D to the Pharmaceutical industry. Biotechnology and Health is a focus area of Department of Science and Technology ('DST'). The only interpretation note/guidance issued was back in 2009 which stated phase 1, 2 and 3 clinical trials would be eligible for the R&D tax incentive. However, over the past 24 months, there has been no consistency in terms of evaluating pharmaceutical R&D by the DST, SARS and National Treasury as many pharmaceutical companies, who conduct these activities in South Africa, have been disallowed from claiming the R&D tax incentive.

It is also disappointing to note that the budget allocated to the Support Programme for Industrial Innovation (which is a R&D grant) will reduce from its peak of over R200 million a few years ago to a measly R50 million

per annum. For a programme that has been running for over 20 years, it is a shame that the budget is being cut as we believe that the grant had a real impact on R&D that was being done by smaller businesses.

We believe that for a R&D tax incentive to make a real difference at a national level there needs to be stability in the programme over an extended period. South Africa has not had that stability, and section 11D appears to have made no difference. Custodianship of the R&D incentive moved from SARS to the DST from the 1st of October 2012. Meanwhile, a pre-approval process has also been implemented and the adjudication committee for this is made up of members from SARS, the National Treasury and the DST.

Hundreds of pre-approval applications have been made to the DST and many of those from medium sized businesses. The original processing time was meant to be 90 days, but this deadline is not being met. Taxpayers are now in a position where, a year, or more down the line, some companies are not certain whether their activities/projects are in fact eligible for the incentive despite reassurances by the Minister of Science and Technology.

Teething problems can always be expected when a new regime is implemented. However, we hope that the DST quickly alleviates the current back log, further promotes and encourages the private sector to participate in claiming the incentive. We also hope that the National Treasury does not make many more changes to the legislation, so that there is certainty with regard to the application and extent of the legislation so that businesses can know where they stand and not be scared off, and no longer apply for the incentive.

If the current situation does not change soon, South Africa's tax help for R&D would further decline, the ratio of R&D to GDP would fall further, and we would further slip down the ladder of innovation and competitiveness.

6 SAVINGS AND RETIREMENT REFORM

It is evident that more needs to be done to encourage a savings culture in South Africa so that the necessary expansion of the economy can take place. We therefore commend the Minister for reinforcing the need for individual retirement savings, and we look forward to more information to be released around the tax efficient savings vehicles to be implemented in 2015.

It is, however, a pity that annual interest exemption has not been increased especially considering the recent increase in the interest rates. The increase in the tax free lump sum amount paid out of retirement funds from R315k to R500k is most encouraging though.

7 OTHER SPECIFIC COMMENTS

7.1 Deduction of donations made to PBO's: sec 18A of the Income Tax Act

In line with the changes affected to philanthropic foundations, it is proposed that the limitation of the deduction for qualifying donations in terms of section 18A of the Act be increased to 20 per cent of taxable income in order to increase donations made to qualifying PBOs.

7.2 Estate duty abatement in terms of sec 4A of the Estate Duty Act (No. 45 of 1955) and Donations Tax exemption in terms of sec 56(2)(b) of the Income Tax Act

In the 2007 Budget Speech, the abatement for Estate Duty was increased from R 2.5 million to R 3.5 million and the Donations Tax exemption from R 50 000 to R 100 000. Since the 2007 Budget, no change has been effected to these 'exempt thresholds'. It is proposed that both the abatement and the exemption be increased, especially with the South African inflation rate fluctuating at around 5.5 per cent.

7.3 Issues requiring further clarification

Various issues were mentioned in previous budget speeches, with no further clarification being provided in the current speech. We eagerly await more clarity on the following issues:

- Social Security System mentioned in 2008;
- Gambling Tax mentioned in 2011;
- Retirement reform proposals mentioned in 2012;
- National Health Insurance mentioned in 2012;
- Carbon tax mentioned in 2013;
- Taxation of trusts mentioned in 2013; and
- Restrictions placed on IP under the exchange-control regulations mentioned in 2014.

7.4 Tax design process

The SAIT would like to commend the National Treasury and SARS on involving stakeholders in the legislative process through the hosting of workshops and providing the opportunity for commenting on the various bills and regulations that are to be passed. These include workshops that have already been held on:

- The Tax Administration Act and the objection and appeal procedures;
- The Carbon Tax Policy document;
- Trust reforms that were proposed;
- Diesel rebate for farmers;
- VAT on electronic services.

It is encouraging to see that workshops will also be held on:

- The Acid Mine Drainage; and
- The proposed Small Business Corporation Regime changes.

Despite the above, it has been noticed that in some instances some bills or regulations are being implemented before comprehensively considering the practical ramifications it will have on business and the economy. The SAIT would like to request that the practical ramifications of all legislation first be comprehensively considered before its implementation (compared to implementing legislation with a 'catch-all phase' which will then later be narrowed down when it has undesired implications). This will ensure that our legislation provides the clarity and certainty that is required by local and foreign businesses.

8 CONCLUSION

Notwithstanding the budget being a conservative one taking cognisance of tough economic realities, it appears that it was an evaluation of the past with not enough consideration being given to the detailed economic reforms needed for the future.

An important start has been made by the initiative to reduce wasteful spending but more needs to be done - a substantive review of government spending is required. Linking government priorities to specific programmes in a more direct manner and holding responsible persons accountable for their actions is a necessity. Furthermore, priorities needs to be set, for example, will South Africa be able to invest in nuclear energy and the National Health Insurance scheme over the same period of time? Should infrastructure spend focus on improving logistics for exports or building domestic manufacturing capacity for black business?

A targeted focus on infrastructural expenditure should have a positive impact on employment and the relaxation of regulatory requirements for conducting business should also help to eliminate unnecessary impediments to productivity.

Local and foreign investors require a significantly clearer and consistent view of economic plans in South Africa and formalising our small business, R&D and international investment policies needs urgent attention. We look forward to the Davis Committee feedback on these issues and trust that it will provide government with useful recommendations in this regard.

Please do not hesitate to contact us if you have any queries in this regard.

Yours sincerely,

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