4

Taxation

National revenue this year is expected to exceed the February budget estimate marginally, with gains in personal income tax and VAT receipts offsetting the anticipated shortfall in corporate tax proceeds.

Policy measures announced in the 2004 Budget and given effect in the Revenue Laws Amendment Act of 2004 include broad based employee equity participation, tax relief for investments in South Africa from countries within the Common Monetary Area, clarity and more consistency for taxation of government grants to exempt entities and the tax treatment of hybrid financial instruments.

2005 Budget tax proposals will focus on simplifying tax compliance for small enterprises, revised tax treatment of health care benefits and deductions against motor vehicle allowances and amendments to facilitate the hosting of the FIFA World Cup in 2010. Retirement funding arrangements, a review of mining industry taxation and fiscal reform relating to protection of the environment are also under consideration.

Introduction

Decade of fundamental tax reform broadened tax base and reduced rates

South Africa, after a decade of fundamental reforms of its tax structure and improvements in revenue administration, has succeeded in broadening the tax base and reducing marginal tax rates. The revenue buoyancy of the tax structure has been enhanced, evidenced in the steady growth of gross tax revenue alongside progressive personal income tax relief since 1995.

Reforms focused on income tax system

Although tax reform has mainly focused on the income tax system, excise taxes have undergone simplification through the introduction of a more coherent specific rate structure for alcohol taxation, international benchmarking of the tax burdens on alcohol beverages and rationalization of *ad valorem* duties.

Further structural tax reforms in the area of mining and financial service industries

The 2005 tax proposals will take account of the changing global economic environment, competition amongst nations for foreign direct investment, a narrower tax compliance gap and a significantly stronger local currency. The period ahead will see consideration given to structural tax reforms relating to the mining sector, the retirement industry, protection of the environment and outstanding aspects of the tax treatment of financial services.

Revenue in 2004/05 expected to be marginally higher than budget estimate

The revised revenue estimates and notable tax policy considerations are discussed in this chapter. This year's aggregate revenue collection is expected to be marginally higher than the original budget estimate.

National budget revenue 2003/04

Revenue R5,1 billion less than budgeted

The audited main budget revenue outcome of R299,4 billion for the 2003/04 fiscal year was R5,1 billion less than the original budget estimate of R304,5 billion, and marginally below the revised estimate of R300,3 billion published in the 2004 Budget Review. The main divergences in revenue were:

- R1,9 billion more than estimated personal income tax revenue
- R4,9 billion less than budgeted company tax revenue
- R2,9 billion less than estimated international trade tax receipts, mainly due to lower rand values of imports than originally estimated
- R2,4 billion more than expected in interest, dividends and other non-tax receipts.

The 2003 Budget also included an announcement of an exchange control amnesty, with accompanying tax measures. Proceeds of the exchange control levy have yet to be finalised.

Table 4.1 National budget revenue, 2003/04 estimates and audited outcome

R billion	Budget estimate	Revised estimate	Audited outcome
Taxes on income and profits	**181,5**	**176,0**	**175,9**
Persons and individuals	97,3	98,9	99,2
Companies	66,6	61,5	61,7
Secondary tax on companies	8,0	6,0	6,1
Other	9,6	9,6	8,8
Taxes on property	**5,9**	**6,5**	**6,7**
Domestic taxes on goods and services	**109,6**	**110,6**	**110,2**
Value-added tax	81,0	81,0	80,7
Specific excise duties	11,4	11,7	11,4
Levies on fuel	16,3	16,4	16,7
Other	0,9	1,5	1,5
Taxes on international trade and transactions	**11,3**	**8,8**	**8,4**
Stamp duties and fees	**1,8**	**1,5**	**1,4**
Total tax revenue	**310,0**	**303,3**	**302,5**
Non-tax revenue and repayments	4,2	6,7	6,6
Less: SACU payments	-9,7	-9,7	-9,7
Main budget revenue	**304,5**	**300,3**	**299,4**

Foreign exchange amnesty

An Exchange Control Amnesty with accompanying tax measures was announced in the 2003 Budget providing taxpayers with the opportunity to regularise their offshore income and assets. In November 2003, after receiving some 10 000 applications, the Minister of Finance announced an extension of the deadline for the submission of applications from 30 November 2003 to 29 February 2004.

A taxpayer could regularise his or her affairs by paying an Exchange Control Levy of 10 per cent of the market value of an illegal asset retained offshore or 5 per cent if that asset is repatriated. Illegal tax liabilities will be forgiven generally without additional cost (or at an additional cost of a 2 per cent levy for certain domestic tax violations).

A total of some 43 000 applications were received before the deadline of 29 February 2004. By September 2004, a total of 16 033 applications had been adjudicated with total levies payable of about R826 million. It is envisaged that the adjudication of all the applications will be completed by 30 May 2005.

In reaction to a number of representations, further administrative concessions were made in terms of which certain categories of offshore income and assets could be regulated via a declaration to the Exchange Control Department of the South African Reserve Bank. In terms of this concession, approximately 11 300 applications were received by the deadline of 29 February 2004. An additional 1 227 applications were received by the Exchange Control Department of the South African Reserve Bank relating to the unwinding of 'loop structures' and levies amounting to approximately R52 million have been paid in this regard up to the end of August 2004.

In terms of applications approved for emigrants to transfer their remaining blocked assets abroad, a total amount of R238,2 million in respect of the 10 per cent exit charge has been credited to the Corporation for Public Deposits.

National budget revenue: medium term estimates

Revenue projections revised upwards by R1,2 billion

Based on revised macroeconomic projections set out in Chapter 2 and the revenue trends for the first six months of this fiscal year, main budget revenue is revised upwards by R1,2 billion to R328,2 billion. Revised revenue projections for 2004/05 are presented in table 4.2, together with projections for the three years of the MTEF period. Higher than projected increases in remuneration together with buoyant consumer spending are projected to offset the tax revenue impact of lower company profits in export sectors such as mining and manufacturing.

Revenue importance from corporate taxes swings back to personal income tax and VAT

Gross tax revenue in 2004/05 is estimated to be R1,9 billion higher than estimated mainly due to higher than projected revenue of R3,8 billion from personal income tax and R4 billion from value-added tax. Corporate income tax is expected to yield R6,2 billion less than budgeted this fiscal year. Departmental revenue, after inclusion of anticipated amnesty proceeds for this year, is estimated to be R690 million less than budgeted, mainly due to lower than budgeted interest income and administrative fees.

Over the MTEF period, rising corporate taxes and further tax base broadening measures will contribute towards increased revenue buoyancy resulting in a slight increase in the overall tax burden.

Table 4.2 National budget revenue, 2003/04 – 2007/08

R billion	2003/04 Audited outcome	2004/05 Budget estimate	2004/05 Revised estimate	2005/06	2006/07	2007/08
				Medium term estimates		
Taxes on income and profits	**175,9**	**193,5**	**190,3**	**208,1**	**229,8**	**254,3**
Persons and individuals	99,2	106,7	110,5	121,0	132,7	147,2
Companies	61,7	69,7	63,5	70,0	78,1	86,4
Secondary tax on companies	6,1	6,8	6,9	7,2	8,0	8,8
Other	8,8	10,3	9,4	9,9	11,1	11,9
Taxes on property	**6,7**	**6,9**	**8,1**	**8,6**	**9,2**	**10,0**
Domestic taxes on goods and services	**110,2**	**121,5**	**125,9**	**138,6**	**152,9**	**168,4**
Value-added tax	80,7	89,5	93,5	104,0	115,0	126,8
Specific excise duties	11,4	13,1	12,9	13,6	14,9	16,4
Levies on fuel	16,7	17,4	18,0	19,4	21,2	23,2
Other	1,5	1,5	1,5	1,7	1,8	2,0
Taxes on international trade and transactions	**8,4**	**10,5**	**10,1**	**10,7**	**11,9**	**13,1**
Stamp duties and fees	**1,4**	**1,3**	**1,2**	**1,3**	**1,5**	**1,5**
Total tax revenue	**302,5**	**333,7**	**335,6**	**367,3**	**405,2**	**447,3**
Non-tax revenue and repayments	6,6	6,6	5,9	7,8	7,2	7,9
Less: SACU payments	-9,7	-13,3	-13,3	-12,1	-13,2	-14,7
Main budget revenue	**299,4**	**327,0**	**328,2**	**363,0**	**399,1**	**440,5**
per cent of GDP	*24,3%*	*24,6%*	*24,5%*	*24,7%*	*25,0%*	*25,1%*
Changes from 2004 Budget						
Total tax revenue			1,9	2,8	6,6	
Main budget revenue			1,2	2,7	5,1	

Implementation of the 2004 tax proposals

Personal income tax relief of R4 billion in 2003/04, together with relief for property purchases

After a decade of reform that has accelerated since 2000, the 2004/05 fiscal year saw less dramatic tax policy changes and due to affordability constraints, more moderate tax relief than in the previous three years. Individuals received R4 billion of income tax relief along with an increased interest exemption, further contributing to a long-term commitment to foster a culture of savings in South Africa. An additional area of relief was directed at low- and middle-income individuals seeking to purchase a home. The transfer duty exemption threshold for real property purchases was raised to R150 000 and the stamp duty for mortgages was eliminated. In sum, Government has continued with its stance of moderately easing the tax burden on individuals despite a more constrained fiscal environment.

Economic empowerment tax initiatives (BEE)

Government is committed to measures that promote broad-based empowerment for employees, and is aware that many company restructurings are being undertaken that will facilitate black economic empowerment. The current tax system is being reviewed in order to remove unwarranted tax impediments to empowerment and other measures that hinder economic growth.

Tax measures to encourage broad-based share ownership for employees

Many countries have tax incentives that facilitate employee share ownership based on the theory that broad-based employee ownership enhances productivity. In the South African context, these incentives have the added benefit of promoting black empowerment for a broad-based group of individuals. A 2004 amendment to the tax laws will allow an employer-company to issue its own shares free of tax for its employees (or for employees within the same corporate group) while providing a deduction for the employer. This incentive requires shares to be issued on a non-discriminatory basis and at no or minimum cost to employees so that all low-income employees can fully and equally participate. Rules also exist that encourage employees to retain their shares rather than sell them for short-term gain.

Anti-avoidance measures

Taxpayers exploit through the utilization of hybrid instruments the divergent tax treatment of interest and dividend income

An area of concern noted in the 2004 Budget was the exploitation of the distinction between debt and equity (through so-called "hybrid" instruments) so as to take advantage of both interest deductions for the debtor and creation of tax-free dividends in the hands of the creditor – thereby avoiding either taxable income for the creditor or a secondary tax on companies liability on the part of the issuer. The matter has been addressed in three ways:

- Rules have been introduced to ensure that certain forms of hybrid instruments would be penalised if those instruments contained features that are inconsistent with their labels
- Artificial enhancement of interest deductions through circular cash-flow transactions has been disallowed
- Certain swaps converting taxable interest into non-taxable dividends have been disallowed.

Less attractive tax dispensation for share option compensation schemes for executives

Another area of ongoing concern was the extensive use of equity-based schemes developed for executives and other top management personnel. These schemes effectively allowed a privileged class of taxpayers to enjoy disproportionate advantages in the fringe benefits tax treatment of options, restricted shares, convertible debentures and deferred shares, among others. The legislative change effectively treats all these equity-based instruments as fully taxable deferred salary, much like "share appreciation rights". Deferred taxation in this instance means that Government collects the full value of the equity benefit when realised as ordinary income.

Tax treatment of capital flows

Incentivising capital inflows and preventing tax free capital outflows

Government seeks, within the bounds of acceptable international norms, to encourage capital inflows and prevent artificial tax-free outflows. Relief has accordingly been provided for interest-bearing investments held by residents of the Common Monetary Area (Namibia, Swaziland and Lesotho). Investments of this kind will now be exempt from tax, just like interest-bearing investments held by residents of other foreign countries. The previous failure to exempt these forms of interest stemmed from anomalies relating to exchange control at a time before South Africa shifted to a worldwide basis of tax in 2001.

Legislative change to clarify existing STC treatment of outbound dividend distributions – none of which is of a discriminatory nature

In respect of capital outflows, there remains a concern about transactions designed to create a tax-free shift of distributable profits offshore, leading to a permanent flight from the South African tax net. One such arrangement involves the shifts of assets offshore via foreign trusts. Anti-avoidance rules have been enacted in this regard, but they contain a technical defect that arguably limits their impact on South African sourced (as opposed to foreign sourced) assets. This defect has accordingly been remedied. In addition, a question of interpretation of South Africa's double tax agreements has been addressed. Multinational companies have attempted to use the non-discrimination articles of these agreements to allow for the distribution of dividends offshore free of the secondary tax on companies. This would place foreign-owned multinationals at an unfair advantage compared with their domestic counterparts. The misinterpretation was initially dealt with in a Media Release dated 26 August 2004, and amendments subsequently followed to remove any remaining uncertainty.

Public entities, grants and public private partnerships

Clarity in VAT approach towards government grants or subsidies

The 2004 Revenue Laws have dealt with inconsistencies or uncertainty in the treatment of appropriations in favour of constitutional institutions, regulatory bodies and non-business public entities. Such grants or transfers will fall outside the scope of VAT – effectively, they will be exempted. Grants to municipalities will be zero-rated and ad hoc grants or subsidies to private for-profit organizations (for example, for export marketing assistance or drought relief) will also be zero-rated.

Government grants to PPPs and government business enterprises will attract VAT

However, government grants or subsidies to an organisation (including a public corporation and a government business enterprise) that produces goods or services on a commercial basis or in competition with commercial businesses should be viewed as payments for goods or services. These grants will therefore be subject to VAT at the same rate as applies to the ultimate supply of those goods and services. Annual grants or transfers to public corporations, government business enterprises or public private partnerships (PPPs) will be subject to VAT at the standard rate. If the activities of the entity are exempt from VAT (for example public transport or education), the grants will be exempt.

Enhancement of South Africa as a regional distribution hub

Certain problems associated with VAT and the re-export of goods were identified in the 2004 Budget. The import of duty-free goods by a vendor triggered VAT output payments along with corresponding VAT input credits and created cash-flow problems for importers/exporters upon re-export, as they had to wait for refunds. This has been addressed by allowing duty-free goods to remain outside the VAT net as long as these goods are stationed in a customs warehouse solely for re-export. In addition, a revised set of rules has been added to treat the importation of goods into customs controlled areas within Industrial Development Zones (IDZs) as an importation for home consumption with corresponding customs and excise rebates. The VAT rules have been adjusted to ensure that these changes do not adversely impact VAT-free treatment upon entry into a customs controlled in an IDZ.

Customs duty free goods destined for re-export will remain outside VAT net in support of regional distribution centre initiatives

Ad valorem customs and excise duties

The *ad valorem* duty exemption on motor vehicles with a carrying capacity of ten persons has been amended to apply to vehicles with a minimum carrying capacity of at least fifteen persons. This serves to ensure that the exemption applies only to minibuses, as originally intended.

Ad valorem duty exemption on vehicles with a capacity of 15 persons or more

The *ad valorem* customs and excise duties on all computer printers, recorded and prepared unrecorded media (including magnetic tapes and stripes), certain cosmetic products, print film, photo copying apparatus, watches and clocks, have been abolished.

Ad valorem excises eliminated on certain goods

Tax policy considerations for the 2005 Budget

In recent years the personal income tax base has been broadened and compliance simplified by restricting the tax-deductible expenses that employees can claim. The 2005 Budget will include proposals to restrict the deductibility of motor vehicle allowances. Measures to assist in making basic health care benefits more affordable to low income earners will be proposed, and tax compliance by small enterprises will be simplified.

Tax simplification for wage earners, reducing compliance burden for small businesses and improved tax treatment of health care benefits

Tax issues relating to small enterprises

In 2003, the South African Revenue Service (SARS) undertook to review administrative and tax compliance concerns of small businesses. It has become evident that there may also be tax policy issues related to small enterprises that warrant review.

Reviewing tax compliance burden for SMMEs

Reviewing overregulation and company law provisions that may impede growth of SMME-sector

Possible tax reforms that ameliorate the tax burden on small and medium-sized enterprises will accordingly be reviewed. Account must also be taken of other developments in the regulatory framework, such as the current review of the Companies Act by the Department of Trade and Industry. Consideration is therefore being given to a limited set of policy changes in 2005 to simplify tax compliance by small businesses, with a view to more comprehensive changes to follow once related reforms are clarified.

Tax treatment of health care benefits

Review of tax treatment of medical aid contributions and employer-provided medical assistance in progress

The tax treatment of medical expenses and medical scheme membership has come under scrutiny with a view to improving access to health care benefits and reducing the costs of health services. Issues of concern include both medical aid contributions and medical related expenses incurred either by the individual taxpayer or by the employer for the benefit of employees. The tax treatment of these benefits has unintended effects and is not satisfactorily aligned with the objectives of health policy. Options for reform are under review, in consultation with the health care industry, employers and other stakeholders.

Deduction of business travel cost against the motor vehicle allowance

Adjustments in claiming deemed business travel cost in terms of the motor vehicle allowance

The ease with which deemed business travel cost can be claimed against a motor vehicle allowance is a source of unfairness and inefficiency in the personal income tax structure. It also impacts in unintended ways on the demand and supply of passenger cars. A related concern is the *ad valorem* duty structure on imported and domestically produced motor vehicles. Tax reform proposals with possible revenue-raising effects will be included in the 2005 Budget.

Pension fund reform

Tax reforms relating to retirement funding will be aligned with regulatory principles and reform

The National Treasury is currently undertaking parallel reviews of the South African retirement fund industry from both a regulatory and a tax perspective. The aim is to promote and protect individuals' savings for their own retirement. A discussion paper on the regulatory aspects of pension funds will be released later this year. Work on the tax aspects of the pension fund industry is ongoing, and will in due course also be released by way of a discussion document. Areas of concern already identified include the portability of retirement funds upon employment transfers, incentives that favour early withdrawals and the interplay between retirement savings and other pension fund provisions such as death and disability benefits.

Mineral taxation

Revisions to the Royalty Bill are ongoing for eventual Parliamentary submission in 2005

The 2003 Mineral and Petroleum Royalty Bill is currently being revised, taking into account comments from various stakeholders and additional industry financial data. It remains Government's view that the royalty (to be implemented in 2009) should be imposed on a gross *ad valorem* basis, but a number of critical issues have still to be addressed, as noted in the 2004 *Budget Review.* Submission to Parliament of a revised Bill in 2005 will be preceded by further consultations with industry.

Reassessment of mining tax structure and allowances

A holistic mining tax review has also been proposed, in view of the broader reform of the mineral rights position in the country and long-standing concerns in respect of low effective tax rates of mining companies. The National Treasury and SARS will in due course release recommendations relating to the gold mining tax formula, the appropriateness and international comparability of current mining investment allowances, allowances for exploration activities and the possible role of tax measures to assist the small-scale mining sector.

FIFA World Cup 2010

Clarification of tax treatment for hosting the soccer world cup competition

South Africa's hosting of the Soccer World Cup in 2010 will require clarification of the tax treatment of the operations and activities of the international football association, FIFA and other parties involved in hosting the event. These matters are subject to various assurances made as part of the bid to host the event, and may require legislative amendment in 2005 to remove uncertainties.

Value-added tax

Introduction of explicit place of supply rules and adjustment of monetary thresholds

Unlike most international VAT systems, the South African VAT Act does not have any explicit place of supply rules. This needs to be reviewed. Such rules are intended to provide certainty with regard to VAT liability in the case of service-related international transactions. Consideration will also be given to the adjustment of the monetary threshold for compulsory VAT registration.

Environmental fiscal reform

Fiscal policy paper on environmental taxes to be released

The National Treasury released a discussion document on environmental fiscal reform in October 2003. Comments on this document were received from a number of stakeholders. Based on the findings of the discussion document and comments received, a draft policy paper was developed that will be released for public comment before the end of the year. The main objective of the policy paper is to provide a coherent framework to guide the National Treasury, other departments and sub-national spheres of government when considering the introduction of environmentally related charges and levies.

Sub-national sphere taxes

Provinces seek to address vertical fiscal imbalance by proposing own tax instruments

The Constitution makes provision for provincial governments and municipalities to impose taxes to raise additional own revenues. A number of provinces are considering introducing instruments to raise additional own revenue and consideration will accordingly be given to such proposals in 2005.

Consideration is given to replace the RSC levy system with other buoyant revenue instruments

Municipalities have critical service delivery and developmental responsibilities. Consideration is currently being given to reform the RSC levy system, an important source of own revenue for certain categories of municipalities. Moreover, the pending restructuring of the electricity distribution industry will impact adversely on the finances of many municipalities. Measures that would provide a sound, independent source of municipal revenue, contributing to financial autonomy and accountability, are therefore under review.

International tax cooperation

South Africa and China to participate in work of the OECD's Committee on Fiscal Affairs

On 16 June 2004 South Africa and China officially joined the Committee on Fiscal Affairs (CFA) of the Organisation for Economic Co-operation and Development (OECD).

The CFA provides a forum for senior tax officials in which different approaches to tax policies and administrative procedures can be discussed. It is also a leading authority on tax treaties, the taxation of multinational corporations and strategies for combating tax avoidance and evasion. It publishes comprehensive cross-country tax statistics and contributes to the development of consistent tax policies and improved approaches to tax administration. Countries with observer status participate fully in the work of relevant OECD committees. The closer interaction of South Africa and China with CFA member countries will enrich policy debates in the OECD as these two developing countries' views and experiences with managing public finance issues can provide useful lessons for global discussions on appropriate tax policies.