4

Taxation

Tax reform continues to ensure greater equity, broadening of the tax base, reduction of the tax compliance burden, further improvements to tax collection efficiency, and creation of an environment conducive for competition and investment.

The prevailing environment of strong demand, underpinned by structural changes in the domestic consumer tax base, is having a positive effect on the level and growth of economic activity and on tax collection. It is estimated that tax revenue collection for 2006/07 will exceed the budgeted amount by about R30 billion.

Introduction

Revenue continues to exceed estimates as a result of robust economic growth

Strong tax revenue collection trends during the first half of the fiscal year indicate a projected main budget revenue overrun for 2006/07. This healthy revenue performance is a result of higher levels of profitability in the corporate sector, increased remuneration and employment levels and robust domestic demand. The South African Revenue Service (SARS) continues to improve its systems and processes, contributing to better tax compliance and improved revenue flows.

An update on the 2006 Budget tax proposals

This chapter discusses the revised revenue estimates for the current year and over the three-year expenditure period, and reports on implementation of the tax proposals contained in the 2006 Budget. These include increased tax deductions to promote higher levels of research and development (R&D) expenditure by the private sector, relaxation of the definition of a small business corporation for income tax purposes and the small business tax amnesty.

Other tax-related developments discussed include changes in the pension and retirement fund industry that have necessitated amendments to the Income Tax Act (1962); the proposed Diamond Export Levy Bill; the revised Minerals and Petroleum Resources Royalty Bill, which was recently released for a second round of public comment; and proposed tax amendments relating to the 2010 FIFA World Cup.

Strong revenue growth has resulted in a rising tax-to-GDP ratio. Government continues to strike a balance between revenue raising and the impact of the tax burden on economic activity. In exercising the available policy choices, government will take account of the rising deficit on the current account of the balance of payments.

National budget revenue 2005/06

Audited main budget revenue was R41,8 billion higher than estimated

The audited main budget revenue outcome of R411,7 billion for the 2005/06 fiscal year was R41,8 billion higher than the original budget estimate of R369,9 billion, and R0,6 billion higher than the revised estimate of R411,1 billion published in the 2006 *Budget Review*. The main divergences in revenue were:

- Higher-than-budgeted income tax collection of R17,7 billion from the corporate sector – specifically the financial, transport, communication, retail and mining sectors, as well as personal income tax collection exceeding the projected total by R8,8 billion.
- VAT collection was R8,4 billion above estimates due to higher-than-expected levels of consumer spending.
- Taxes on international trade were R5 billion greater than expected as a result of increased imports, especially of vehicles and various consumer goods.

Table 4.1 National budget revenue, 2005/06 estimates and audited outcome

R billion	Budget estimate	Revised estimate	Audited outcome
Taxes on income and profits	**205,8**	**233,7**	**235,7**
Persons and individuals	117,6	126,5	126,4
Companies	69,6	85,9	87,3
Secondary tax on companies	8,7	11,9	12,3
Other	9,8	9,5	9,7
Taxes on property	**9,8**	**11,1**	**11,1**
Domestic taxes on goods and services	**143,1**	**152,4**	**151,5**
Value-added tax	106,0	115,0	114,4
Specific excise duties	14,5	14,6	14,5
Levies on fuel	20,7	20,7	20,5
Other	2,0	2,1	2,1
Taxes on international trade and transactions	**13,2**	**19,0**	**18,2**
Stamp duties and fees	**0,9**	**0,9**	**0,8**
Total tax revenue	**372,8**	**417,0**	**417,3**
Non-tax revenue and repayments[1,2]	9,1	8,2	8,5
Less: SACU payments	-12,1	-14,1	-14,1
Main budget revenue	**369,9**	**411,1**	**411,7**

1. Preliminary outcome.

2. Budget estimate includes R2,4 bilion proceeds from the foreign exchange amnesty.

National budget revenue: medium-term estimates

Gross tax revenue for 2006/07 is revised upwards by R29,6 billion

Based on revised macroeconomic projections set out in Chapter 2 and the revenue trends for the first six months of this fiscal year, expected gross tax revenue for 2006/07 is revised upwards by R29,6 billion to R486,4 billion.

The higher 2006/07 estimate can be attributed to strong levels of economic activity that resulted in improved corporate earnings, greater employment levels and increases in remuneration.

Upward adjustments in payments to SACU members

Additional adjustment payments to Southern African Customs Union (SACU) member countries of R7,1 billion in terms of the audited outcome of the common revenue pool for 2005/06, plus an adjustment payment in terms of the previous (1969) SACU Agreement, raises SACU payments for 2006/07 to R29,2 billion.

Main budget revenue for 2006/07 is expected to increase by R20 billion to R466,4 billion.

Revised revenue projections for 2006/07 are presented in Table 4.2, together with projections over the three-year period.

Table 4.2 National budget revenue, 2005/06 – 2009/10

	2005/06	2006/07		2007/08	2008/09	2009/10
R billion	Audited outcome	Budget estimate	Revised estimate	Medium-term estimates		
Taxes on income and profits	**235,7**	**251,4**	**278,4**	**325,4**	**349,7**	**375,0**
Persons and individuals	126,4	133,2	138,8	156,7	170,3	184,4
Companies	87,3	96,3	115,9	141,7	149,5	158,1
Secondary tax on companies	12,3	13,9	15,2	17,6	19,7	21,4
Other	9,7	8,0	8,6	9,5	10,3	11,2
Taxes on property	**11,1**	**8,9**	**10,3**	**11,1**	**12,2**	**13,2**
Domestic taxes on goods and services	**151,5**	**171,9**	**173,5**	**194,7**	**213,1**	**233,9**
Value-added tax	114,4	131,2	132,9	152,5	168,0	183,4
Specific excise duties	14,5	16,6	16,6	17,3	19,0	20,9
Levies on fuel	20,5	21,8	21,8	22,5	23,4	26,8
Other	2,1	2,3	2,3	2,4	2,6	2,9
Taxes on international trade and transactions	**18,2**	**23,6**	**23,6**	**25,2**	**26,5**	**27,8**
Stamp duties and fees	**0,8**	**1,0**	**0,6**	**0,6**	**0,6**	**0,6**
Total tax revenue	**417,3**	**456,8**	**486,4**	**557,0**	**602,1**	**650,5**
Non-tax revenue and repayments[1]	8,5	9,3	9,2	9,3	9,0	9,1
Less: SACU payments[2]	-14,1	-19,7	-29,2	-23,3	-24,7	-26,2
Main budget revenue	**411,7**	**446,4**	**466,4**	**543,0**	**586,4**	**633,5**
Percentage of GDP	*26,3%*	*26,0%*	*26,7%*	*28,2%*	*27,7%*	*27,2%*
Changes from 2006 Budget						
Total tax revenue			29,6	55,3	44,0	
Main budget revenue			20,0	51,0	39,3	

1. Preliminary outcome for 2005/06.

2. The revised estimate for 2006/07 includes adjustment payments to SACU member countries.

Implementation of the 2006 tax proposals

2006 proposals included income tax relief for individuals and small business amnesty

The 2006 tax proposals included income tax relief for individuals and a tax amnesty for small businesses. The amnesty aims to improve the culture of tax compliance and to bring more enterprises into the formal economy. The tax on retirement funds was reduced to encourage savings and preservation of retirement benefits. Substantial transfer duty relief was aimed at promoting home ownership by easing the burden on first-time buyers and lower-income home buyers.

Below we review progress with the implementation of some key 2006/07 tax proposals.

Progress report: small business tax amnesty

The small business tax amnesty aims to improve the culture of tax compliance and to facilitate the entry of small businesses into the formal economy. Amnesty applications may be submitted until 31 May 2007.

The tax amnesty provides relief to qualifying businesses for historical non-declaration or under-declaration of income tax, secondary tax on companies, employees' tax, skills development levies, unemployment insurance contributions and VAT. An amnesty levy is payable on a sliding scale of 0-5 per cent based on the taxable income from carrying on a business in the 2006 year of assessment.

SARS has established a small business amnesty unit with six regional processing centres and a dedicated call centre to assist applicants. In addition, the SARS website includes a small business tax amnesty section. Taxpayer service centre staff have been trained to assist applicants. Amnesty literature and application forms are available in all 11 official languages, and SARS is extending its internal systems to manage the amnesty application process.

A multifaceted outreach and education programme is under way in support of the amnesty programme. Izimbizo and other engagements with the public have already been held in the Eastern Cape, Gauteng, KwaZulu-Natal, Limpopo and the Western Cape. Additional outreach and education initiatives will take place in all nine provinces.

By the end of September 2006 SARS had received more than 20 000 amnesty enquiries and 1 450 amnesty applications. It is expected that the pace of applications will pick up as outreach activities raise the amnesty's profile.

The Minister of Finance has issued a notice in terms of the Financial Intelligence Centre Act (2001) that exempts advisors assisting potential amnesty applicants from the normal requirement to report transactions that may be relevant to tax evasion. This puts advisors in a better position to encourage their clients to take advantage of the amnesty. In addition, an amendment to the Auditing Profession Act is proposed that will temporarily exempt registered auditors from reporting transactions related to the amnesty.

Taxi recapitalisation

Scrapping allowance will not trigger income tax or capital gains tax

The Taxi Recapitalisation Project was approved by Cabinet in September 1999. The main objective of this project is to facilitate a safer and better-regulated taxi industry. Qualifying taxi operators will be paid an allowance of R50 000 for each taxi being scrapped.

To ensure that qualifying taxi operators receive the full benefit of the scrapping allowances, such payments will not trigger any income or capital gains tax, and the necessary amendments to the tax legislation have been proposed. Where the scrapping allowance is used to purchase a new taxi, the owner will be entitled to the full cost of the new vehicle for tax purposes.

Retirement funds

Government aims to encourage savings and preserve retirement benefits

The National Treasury continues to consult with the retirement funds industry and other stakeholders to reinforce government's objective of encouraging savings and preserving retirement benefits. Alignment of possible reforms with broader aspects of social security is also under review. Several specific reforms will nonetheless be implemented without further delay.

Firstly, in terms of the Pension Funds Amendment Act (2001), additional benefits may be payable to former members of retirement funds. However, current income tax legislation does not specifically mention these benefits. As a result, former members may not elect to preserve these pre-tax benefits in a retirement vehicle. The Revenue Laws Amendment Bill will allow these former members to preserve such benefits.

Minimum benefits for early withdrawal from retirement funds

Secondly, in December 2005 the Minister of Finance signed a statement of intent with the long-term insurance industry, in terms of which members of retirement funds are entitled to a minimum benefit when they discontinue their contributions to a fund prematurely.

Under the current provisions of the Income Tax Act, no benefits may be paid to members of retirement annuity funds prior to them reaching the age of 55. A potential problem arises when the value of the paid-up member's interest is so low that the costs over time (including administration and asset management costs) exceed the growth of the assets. A proposed amendment will allow for the value of the interest of a paid-up member of a retirement annuity fund to be paid out if the benefit is less than a certain amount, to be determined by the Minister of Finance.

Oil and gas exploration and production

Tax incentives for oil and gas exploration and production to be incorporated into law

South Africa's OP 26 leases, which provide a range of incentives for oil and gas companies (including a maximum limitation on company tax rates, enhanced deductions of exploration/production expenses and freedom from exchange control) are due to expire in June 2007. The expiry of these agreements provides an opportunity to incorporate the incentives into the body of tax laws in a more transparent manner. This requires amendments to the Income Tax Act.

The proposed amendments contain a fiscal stability clause ensuring continued availability of the incentives on a case-by-case basis as companies enter the sector. This clause will remain in place over the full life of a "new order" right and will support future investment in oil and gas. In addition, fiscal stability will remain if exploration rights are renewed, or are converted into production rights.

Research and development tax concessions

Support for new discoveries and inventions

Tax incentives to promote investment in R&D were announced in the 2006 Budget. These incentives consist of an increase in the deduction for current R&D expenditure from 100 per cent to 150 per cent, and an increase in the depreciation allowance for R&D-related capital expenditure from the current four-year write-off period to a three-year write-off period. R&D activities and expenses that will be eligible for these incentives are those of a scientific or technological nature for the purpose of new discoveries and inventions.

Minister of Science and Technology will report to Parliament on R&D expenditure

Taxpayers accessing these benefits will be required to report their qualifying R&D expenditure to the Department of Science and Technology for monitoring purposes. The information gathered will remain confidential. The Minister of Science and Technology will in turn submit an annual report to Parliament stating the tax benefits that accrued to qualifying activities undertaken by the private sector, and how such activities contributed to innovation, competitiveness and economic growth.

VAT zero-rating of municipal property rates

Municipal property rates have been zero-rated for VAT purposes with effect from 1 July 2006. This allows municipalities to claim VAT input credits on expenses incurred to administer and collect municipal property rates.

A review of VAT treatment of municipalities aims to simplify administration

This amendment triggered a review of the VAT treatment of municipalities to simplify their VAT administration. The archaic definition of a local authority in the VAT Act (1991) was replaced with a more current definition of a municipality. Most of the goods and services supplied by municipalities will henceforth be taxable at the standard rate. Other items, such as traffic fines, will remain outside the VAT net.

A transitional period lasting until the end of June 2007 will allow municipalities and other entities that were previously classified as local authorities to amend their administrative and accounting mechanisms to comply fully with the recent VAT amendments. Under the transitional arrangements no additional tax, penalty or interest will be imposed for supplies that became taxable for the first time on or after 1 July 2006.

Public and municipal business entities

A more coherent income tax framework for public and municipal entities

The National Treasury is working to establish a more coherent income tax framework for public and municipal business entities. This initiative will be aligned with the project to develop a robust governance framework for public entities.

Amendments to the Income Tax Act will, as an interim measure, exempt regional electricity distributors (REDs) from income tax for years of assessment commencing before 1 January 2014. Business entities of this nature should normally be taxable. However, a significant portion of electricity distribution is currently conducted by municipalities, which are exempt from income tax. Therefore, subjecting the REDs to income tax now could further delay the long-awaited restructuring of electricity distribution.

REDs receive cash-flow relief and avoid VAT complications

During the interim period the REDs will also be allowed to account for VAT on a payments basis (in which output VAT is only due when payments are received, instead of the usual method of accounting on an invoice basis, in which output VAT is due when an invoice has been issued). This will provide cash-flow relief to the REDs and also avoid VAT complications upon the transfer of electricity distribution assets (especially the debtors' books) from municipalities to the REDs.

Public benefit organisations

A number of changes were announced in the 2006 Budget that streamline tax on public benefit organisations (PBOs). Such organisations are subject to a partial tax regime: their income from public benefit activities is exempt from income tax, while their trading income is not. In the future, the trading income of all PBOs will be subject to a uniform tax rate. Restrictions concerning investment of PBO surplus funds are relaxed. In addition, branches and agencies of foreign PBOs will qualify for income-tax exemption if they can demonstrate that they have income tax-exempt status in their home countries.

Recreational clubs

Proposed amendments narrow exemption qualification to members' contributions

Recreational clubs receive full exemption from income tax irrespective of whether their amenities are used by the general public or by their members. In future, recreational clubs will be subject to a system of partial taxation. Clubs will only qualify for exemption to the extent that their activities are based on members joining together to share expenses (such as for sport facilities). The proposed amendments narrow the exemption qualification solely to members' contributions. Income earned from broader trading activities, investments and from non-members will generally be taxable at a uniform rate.

Windfall profits in the liquid fuels industry

The Minister of Finance appointed a task team in May 2006 to investigate possible reforms to the fiscal regime applicable to windfall profits in the liquid fuels sector, with particular reference to synthetic fuel industry.

The task team was requested to explore the following options:

- A revised subsidy regime
- A cost-based administered price regime
- A progressive formula tax
- Investment-linked tax and subsidy options.

The task team released a draft discussion document for public comment in July 2006. The issues addressed in this discussion document include working definitions for windfall profits, economic rent and "super" profits, and how these concepts are interrelated. It also discusses international examples of windfall profit taxes, and provides a useful summary of the history of government support for the local liquid fuels industry.

Recommendations include regulatory reform and investment-linked tax and subsidy regime

The task team received 19 written comments on the discussion document, and submitted its final recommendations to the Minister of Finance at the end of September 2006. The recommendations include substantial regulatory reforms and an investment-linked tax and subsidy regime. Those recommendations touching on energy policy and regulations will be referred to the Minister of Minerals and Energy.

The recommendation of an investment-linked tax and subsidy regime, which is in essence a combination of the previous subsidy regime and a progressive tax formula, will be explored further and a decision in this regard is expected during the 2007 Budget.

Diamond Export Levy Bill

Export levy is designed to support local diamond cutting industry

The Diamond Export Levy Bill arose out of amendments to the Diamonds Act (1986). The objective of the diamond export levy is to help ensure that a sufficient supply of rough diamonds is available for the local diamond cutting and polishing industry. The bill provides for the imposition of a 5 per cent levy on the export of rough diamonds, replacing the current 15 per cent levy and other levies imposed to fund the previous Diamond Board.

The bill also provides for relief measures to offset the export levy liability. These measures were introduced to minimise any unintended negative effects of the levy. Producers will qualify for offset credits based on the re-importation of rough diamonds to supply local cutters. The bill further provides for a waiver of the export levy if the Minister of Minerals and Energy grants an exemption to a producer offering diamonds for sale at the local diamonds exchange and export centre. In addition, the minister may exempt small diamond producers from the export levy. However, independent diamond dealers will not qualify for any of the proposed relief measures.

Mineral and Petroleum Resources Royalty Bill

Reduced royalty rates for refined minerals to encourage local beneficiation

The National Treasury recently released a revised version of the Mineral and Petroleum Resources Royalty Bill after a lengthy period of consultation. The revised bill retains gross revenue as the tax base. However, it reduces royalty rates for refined minerals to encourage local mineral beneficiation. Other notable changes include relief measures for marginal mines and small businesses, group relief for separate mines operating under the same holding company and special measures for mineral extractors that shift the refining process to local refiners.

Royalty payments to traditional communities will not be offset against payments to the state

With respect to the issue of double royalty payments, it was decided that royalty payments to traditional communities should not be offset against royalty payments to the state. Communities may continue to receive such royalty payments, or they may convert their future mineral royalty income streams into a direct shareholding in the mining company. The prepayment of royalties will provide communities with the resources to buy shares in the mining company and will be a tax-deductible expense for the mining companies.

Medical scheme contributions and medical expenses

Monthly caps on tax-deductible medical scheme contributions to increase

A new tax regime for medical scheme contributions was introduced with effect from 1 March 2006. Under the new rules, medical scheme contributions are tax deductible, but limited to a monthly monetary amount of R500 for each of the first two beneficiaries and R300 for each additional beneficiary. The monetary caps on tax-deductible medical scheme contributions will be increased with effect from 1 March 2007. A moderate increase in the tax-deductible caps will take account of inflationary pressures, but should ensure continued downward pressure on administrative costs.

2010 FIFA World Cup

Proposed tax amendments related to World Cup are before Parliament

The bid to host the 2010 FIFA World Cup (including the 2009 Confederations Cup) required bidding countries to sign a number of guarantees. The relevant proposed amendments to tax legislation before Parliament include the following:

- Certain goods (e.g. broadcast and other media equipment, pharmaceuticals etc.) imported specifically for hosting the 2010 FIFA World Cup will, under certain circumstances, be imported free of import taxes.
- Certain (consumable and semi-durable) goods such as t-shirts and souvenirs sold within the confines of designated sites (e.g. stadiums) during the event, and the profits on such sales, will not be subject to income tax or VAT.

- FIFA officials who are non-resident for income-tax purposes will be exempt from income tax on income that is directly connected to the championship.
- FIFA, its subsidiaries and participating national soccer associations (excluding SAFA) will be exempt from South African taxes, except taxes that are factored into the price, such as the fuel levy and excise taxes.

2010 Local Organising Committee to qualify for tax exemption

The Local Organising Committee (LOC) is likely to qualify for tax exemption in terms of the rules governing PBOs. In addition, grants made by FIFA to the LOC to facilitate the World Cup arrangements will be zero-rated for VAT purposes.

Measures to enhance tax administration

Advance tax ruling system to promote clarity and consistency

An advance tax ruling system was brought into effect on 2 October 2006 for binding general and private rulings.[1] The system will promote clarity, consistency and certainty in the interpretation and application of the tax laws, and support taxpayer compliance.

Having benefited from an extended consultative process, a revised general anti-avoidance rule within the Income Tax Act has been proposed to counter impermissible tax avoidance. Two key changes introduced focus on transactions that lack commercial substance and that are aimed at undermining the purpose of the tax laws.

SARS prioritises deeper administrative relations with Brazil, India and China

A major SARS priority in terms of international trade administration is to strengthen its relations with Brazil, India and China. This reflects global realities and is also aligned with government's foreign policy and efforts to promote South-South cooperation in global trade. In support of these initiatives, as well as new international trade patterns, a customs agreement was signed with China at the end of September 2006, and similar agreements are contemplated with Brazil and India in the near future.

[1] A binding general ruling is a public statement by SARS stating how it will interpret and apply tax law provisions in specific situations. SARS is required to follow these rulings when assessing taxpayers. A binding private ruling is a statement issued by SARS, in response to a request by a taxpayer, stating how it will interpret and apply the tax laws in connection with a specific proposed transaction. These rulings are also binding upon SARS, subject to certain conditions, but only in respect of the taxpayer who applied for the ruling and the specific transaction in question.