4

Taxation

The tax structure supports growth, equity and investment through a sound and consistent policy framework, robust revenue performance and steady improvements in tax administration. Tax reform efforts are currently focused on consolidation of the major reforms – introduction of a residence-based tax system and capital gains tax – undertaken over the past three years.

Policy measures announced in the 2003 Budget and given effect in the Revenue Laws Amendment Act of 2003 include incentives for urban renewal, a reduction in the tax on retirement funds, allowances to encourage business investment and adjustments to foreign business taxation. Tax provisions to facilitate the foreign exchange amnesty have also been implemented.

Preliminary projections indicate that revenue will be R5 billion less than estimated in the February Budget this year, due to lower economic growth and the reduced profits of export industries. For the MTEF period ahead, the overall tax-GDP ratio will be kept stable.

Introduction

Tax policy design and advances in the administrative capacity of the South African Revenue Service (SARS) in recent years have succeeded in broadening the tax base, which in turn contributes to a more equitable distribution of the tax burden. Tax base broadening has also made significant personal income tax relief possible – R62 billion since 1995 – while underpinning the robust revenue performance that has facilitated reductions in the budget deficit and strengthening of the overall public finances.

Improved tax policies and administration contribute to a more equitable distribution of the tax burden and stronger public finances

Against the background of several major tax reforms – notably the introduction of a capital gains tax and adoption of a residence-based income tax system – Government is mindful of the benefits of both stability in the overall tax burden as a share of GDP and consolidation of the key features of tax policy. International evidence confirms the importance of stability,

Tax policy contributes to stability, certainty and predictability of business decisions certainty and predictability in tax policy design. South Africa's broad-based and mature tax structure contributes to a stable environment for business operations and investment decisions, and at the same time provides a secure resource flow to finance public services.

Revised revenue estimates and tax policy considerations discussed

However, complete certainty in the tax environment is never possible. This year, revenue is expected to fall short of the original budget estimates. In respect of tax design, a number of refinements are being introduced this year or are under consideration for the years ahead. Both the revised revenue estimates and noteworthy tax policy considerations are discussed in this Chapter.

National budget revenue 2002/03

Higher than budgeted revenue collections of R13,2 billion

The preliminary revenue outcome of R278,4 billion for the 2002/03 fiscal year is R13,2 billion higher than the original budget estimate of R265,2 billion. A revised estimate of R275,7 billion was published in the 2003 *Budget Review*.

- Higher than projected increases in remuneration and operating surpluses of companies resulted in R9,2 billion higher than budgeted revenue from income and profits.
- Value-added tax revenue was nearly R4 billion higher than budgeted, mainly due to higher real expenditure growth and inflation rates.

Table 4.1 National budget revenue, 2002/03 estimates and preliminary outcome

R billion	Budget estimate	Revised estimate	Preliminary outcome
Taxes on income and profits	**158,7**	**165,8**	**167,9**
Persons and individuals	90,0	93,2	94,3
Companies	50,9	54,9	55,7
Secondary tax on companies	6,5	6,3	6,3
Other	11,4	11,5	11,5
Taxes on property	**4,6**	**5,3**	**5,1**
Domestic taxes on goods and services	**92,8**	**97,6**	**97,6**
Value-added tax/sales tax	66,2	70,6	70,1
Specific excise duties	10,2	10,3	10,4
Levies on fuel	15,2	15,2	15,3
Other	1,3	1,5	1,6
Taxes on international trade and transactions	**10,6**	**9,8**	**9,6**
Stamp duties and fees	**1,8**	**1,6**	**1,6**
Miscellaneous[1]	**–**	**–**	**0,4**
Total tax revenue	**268,5**	**280,1**	**282,2**
Non-tax revenue and repayments	5,0	3,9	4,5
Less: SACU payments	8,3	8,3	8,3
Main budget revenue	**265,2**	**275,7**	**278,4**

1. Receipts not yet classified.

Implementation of 2003 tax proposals

During 2003/04, further personal income tax relief was granted by substantially increasing the tax threshold and giving real tax relief for low and middle-income earners. The interest income exemption was also raised again to protect the interest income of retired persons. These significant tax reductions were supplemented by targeted tax reforms aimed at supporting business development and job creation.

Closure of compliance gap, and introduction of foreign exchange amnesty

The ongoing tax relief programme was in part made possible by a concerted tax base broadening strategy, including the SA Revenue Service's efforts to close the compliance gap in certain sectors. A foreign exchange amnesty with supporting tax measures was announced this year, which will also contribute to a broader tax base in future years.

Foreign exchange amnesty

An Exchange Control Amnesty with accompanying tax measures was announced in the 2003 Budget. Significant interest has been shown in the amnesty, and this in turn is supported by an equally impressive upward trend in applications, accelerating in the latter half of October 2003.

The 2003 amnesty provides an opportunity to regularise offshore income and assets. Many individuals and entities wish to repatriate their assets and regularise their affairs due to greater international cooperation in tax compliance efforts and enhanced surveillance of international capital flows. The current state of the world economy also suggests that growth prospects of foreign earnings are less attractive than hoped.

The amnesty window period was initially from 1 June 2003 to 30 November 2003. The amnesty provides complete coverage for criminal and civil violations relating to exchange control and/or tax violations occurring prior to February 2002. A taxpayer can 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).

Amnesty Regulations and Exchange Control Circular No. D 405, were issued in September 2003. This guidance is mainly intended to address unintended consequences, anomalies or incongruities. A number of difficulties adversely affecting the amnesty process were identified as the nature and complexity of various offshore structures were disclosed.

As far as possible, these concerns have been remedied. Most notably, the regulations deal with (i) offshore trusts; (ii) company facilitators held through trusts and multiple, unrelated applicants; and (iii) special rules for calculating the Exchange Control Levy. Similarly, the Exchange Control Circular provides relief for foreign assets of immigrants, foreign loans, pre-1997 foreign inheritances, pre-1997 foreign earned income and so-called complex company loop structures.

The 2003 Revenue Laws Bill will extend the due date of the amnesty until 29 February 2004. This extension will allow interested parties to take full advantage of the newly issued regulations and Exchange Control Circular.

Tax on retirement funds

Tax on retirement funds reduced to 18 per cent

The National Treasury has been actively reviewing the taxation of retirement funds since 2002. These efforts resulted in a workshop held in Pretoria in 2002, which focused on the broad policy options available. Since then, Government has reduced the rate of tax on retirement funds from 25 per cent to 18 per cent as an interim reform measure.

Ensuring savings for income security during years of retirement

Of particular interest is the economic impact of pension savings relative to other discretionary savings vehicles. Given the goal of a holistic approach to pension fund reforms, all aspects of tax policy on savings levels and returns need to be considered to secure policies that enhance an effective culture of savings and old age income provision. The question, for example, whether incentives in the pension area stimulate overall savings or simply shift the current level of savings into different investment alternatives, is being examined. Other issues of concern include the equity of the retirement tax system, which currently provides limited benefit to lower-income individuals.

Accelerated tax depreciation for urban development zones

Tax incentives for rejuvenation of inner city buildings

In the 2003 Budget, it was proposed that taxpayers investing in under-utilised designated urban areas receive accelerated tax depreciation allowances for investment undertaken in commercial-use buildings. The draft legislation introduces a tax incentive in response to the increasing problem of dereliction and dilapidation in parts of South Africa's major cities.

Accelerated tax depreciation for refurbishment and construction of new buildings

Taxpayers refurbishing a building (i.e., revitalising sunken capital) within a designated area receive a 20 per cent straight-line depreciation allowance over a 5-year period. If taxpayers construct a new building within a designated area, they receive a 17–year write-off period with a 20 per cent write-off in the first year and 5 per cent write-off thereafter.

15 municipalities nominated to designate areas

The incentive presently applies to 15 nominated municipalities, and discussions are in progress on the designation of qualifying inner city districts. The relevant criteria aim to ensure that the tax incentive will be complemented by appropriate development plans and other fiscal measures initiated and managed by the responsible municipality. The incentive will become effective as each municipality designates an area, as announced in the Government Gazette.

Other business tax stimulus measures

Incentives to encourage investment in productive assets, research and development and deductibility of start-up costs

In the 2003 Budget, the Minister of Finance proposed additional stimuli to support investment in specified targeted business activities. In the current legislative cycle, legislation will be promulgated to:

- Provide reinvestment tax relief on the sale of movable depreciable assets when the proceeds are fully reinvested in new depreciable assets.
- Allow taxpayers fully to claim ordinary revenue losses (as opposed to capital losses) on the sale of devalued movable depreciable business assets if the assets sold have useful lives of 10 years or less.

- Provide for full deductibility of research and development expenditure leading to the creation of an invention, patent, design, copyright or other similar property, and for accelerated depreciation of assets used for research and development.
- Provide for ring-fenced allowances for start-up expenses, including a double deduction for start-up costs of small businesses not exceeding R20 000.

Taxation of foreign business operations

In 2003, Government introduced two major changes to the residence-based income tax system, which will become effective on or after June 2004.

Removing tax on foreign dividends to encourage capital repatriations

Firstly, the tax on foreign dividends repatriated to South African shareholders falls away to the extent those shareholders hold more than 25 per cent beneficial interest in the foreign company distributing the dividend. This tax is removed because it penalised the repatriation of profits back to South Africa. The proposed change is accompanied by provision for an exchange control credit over and above the foreign investment allowance for foreign dividends, which enhances the significance of the relief.

Designated country exemption removed

Secondly, the designated country exemption is removed. This previously eliminated all tax on income arising in designated countries if that income was subject to a statutory rate of at least 27 per cent. Although originally enacted for administrative reasons, the exemption created an unintended perceived incentive for investing in developed or capital-exporting countries rather than developing countries, such as those in Africa.

Tax treatment of government grants

Currently inconsistent tax treatment of transfer payments to public entities

The VAT treatment of transfer payments to public entities and government business enterprises has not been applied consistently in South Africa, resulting in unfortunate anomalies. The Minister of Finance announced in the 2003 Budget Review that the VAT treatment of transfer payments, subsidies and grants to public entities, public private partnerships (PPPs) and other beneficiaries would be reviewed.

Payments for goods and services as a rule subject to VAT

Drawing in part on international experience, the proposals currently under consideration are as follows. Where a government department makes grants or pays subsidies to an organisation, including a government business enterprise, that is either producing goods or services on a commercial basis or in competition with commercial businesses, these payments will be treated as if government were paying for the consumption of those goods or services. Such grants or subsidies will accordingly be taxable at the same rate as the ultimate supply. The net effect will be as follows:

No VAT on grants to constitutional entities

- Grants to constitutional institutions and other national and provincial non-business public entities will typically be treated as outside the scope of VAT (not subject to VAT).
- Grants to public corporations and to national and provincial government business enterprises will be subject to VAT at the standard rate, or where the services provided by the entity are exempt from VAT, such as public transport or education, the grants will similarly be exempt.
- Similarly, grants and contributions by government departments or public entities to the establishment or activities of public private partnership initiatives will be subject to VAT at the standard rate, or in the case of services provided by a PPP that are exempt, the grants will be exempt from VAT.
- Grants and subsidies by public authorities to private, for-profit organisations will be exempt from VAT.

Grants for PPP capital projects will be exempt from income tax

It is also necessary to clarify the income tax treatment of concession contracts or similar arrangements where government enters into partnerships with private sector parties for construction of infrastructure on its behalf. In such projects, grants or payments intended to meet or contribute to the capital costs of infrastructure that belongs to government, or will revert to government, are properly regarded as of a capital nature and not as a source of revenue or profit. Grants to fund capital expenditure will therefore be exempt from income tax, but the associated expenditure will not qualify for depreciation allowances in the hands of the private investor, concessionaire or contractor.

Environmental levy on plastic bags

Internalise environmental cost by imposing a tax on plastic bags

Provision has been made for the imposition of a tax on certain types of plastic shopping bags as their disposal has a degrading effect on the environment. This decision originates from an agreement between the Department of Environmental Affairs and Tourism, organised business and labour. A levy on these plastic bags is proposed in recognition of their associated environmental costs and to curb their consumption.

The Customs and Excise Act, No. 91 of 1964, was amended to provide for the imposition of such a levy. Proceeds of the plastic bag levy will be included in national revenue, and discussions are in progress regarding the creation of an appropriate institution to promote recycling and improved waste management.

Initiatives by the SARS

Various administrative measures indicated at the time of the 2003 Budget to contribute to improved revenue collection have been initiated by the Revenue Service.

Disclosure of certain tax avoidance structures (reportable transactions)

- To curb further proliferation of undesirable tax avoidance structures, special reporting requirements are being introduced. Reportable transactions will include (i) an arrangement that contains a contingency claim that the financial or tax benefits will be reversed if successfully challenged by SARS, or (ii) an arrangement that is subject to confidentiality (by the taxpayer) relating to its tax treatment in favour of the advisor/consultant. Failure to report a reportable transaction will prevent the entity from claiming any tax benefits from the transaction regardless of its underlying substance.

Measures to reduce abuse or non-payment of withholding taxes such as PAYE, VAT and UIF

- In order to reinforce compliance with PAYE, VAT and UIF requirements and counter fraudulent misuse of amounts withheld, the amended revenue laws place a personal liability on certain persons if amounts due are not paid over to SARS, and provide for penalties of up to two hundred per cent.

Increased VAT invoice requirement

- In order to minimise the abuse of VAT invoices, for example through duplicate VAT input claims by more than one vendor, it will be a requirement from 1 March 2005 that a VAT invoice for purchases of R1 000 or more should include the VAT registration number of the recipient vendor, in addition to names and addresses.

Mineral and Petroleum Royalty Bill

Revised draft Mineral and Petroleum Royalty Bill for further comment

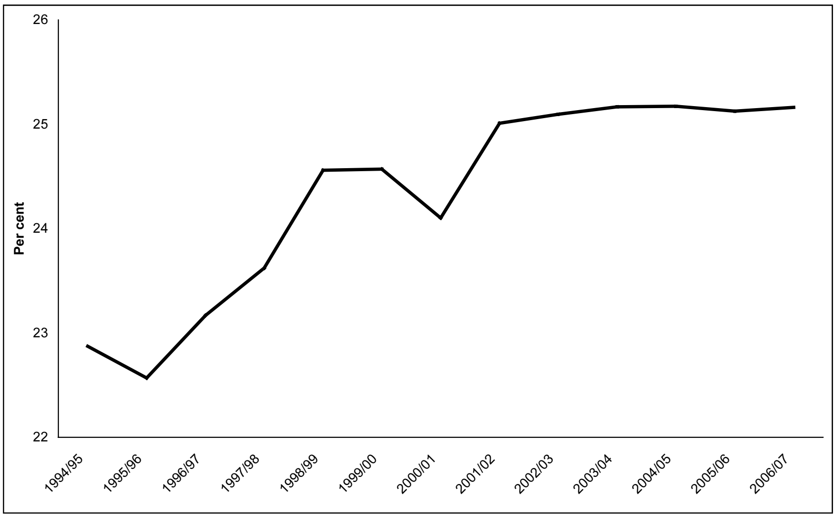
On 20 March 2003, the Minister of Finance released a first draft of the Mineral and Petroleum Royalty Bill for comment. A revised draft will be published for further comment and consultation before eventual submission to Parliament next year. Government is hopeful that all stakeholders will utilise this period constructively for further consultations with the National Treasury team and the Department of Minerals and Energy.

Revenue trends and projections

Tax-GDP ratio increased by tax base broadening and more effective tax administration

Figure 4.1 indicates that tax revenue as a share of GDP has increased since 1994/95. Although substantial personal income tax relief has been granted since 2000, the tax-GDP ratio increased from about 24,1 per cent to an estimated 25 per cent in 2003/04. The strong revenue performance can be ascribed to tax base broadening measures, windfall profits from the export sector and more effective tax administration.

Figure 4.1: Gross tax revenue to GDP



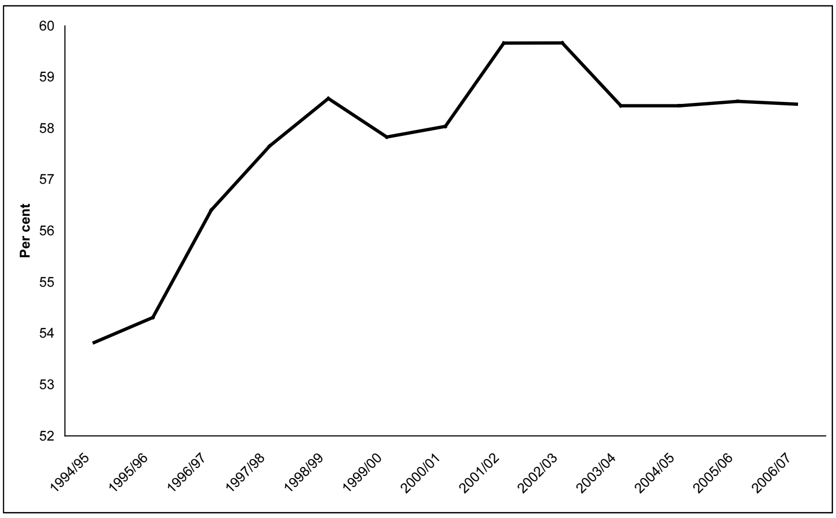
Revenue from corporate income tax increased substantially since 1994/95

Direct tax as a percentage of total tax revenue increased from 53,8 per cent in 1994/95 to almost 58,4 per cent in 2003/04. The ratio should stabilise over the medium term. The increase is partly due to the introduction of the retirement fund tax in 1996, the skills development levy in 2000 and the taxation of capital gains and world-wide income in 2001.

Tax-base broadening initiatives increase revenue contribution of direct taxes

Revenue from corporate income tax, as a percentage of GDP, increased from 2,7 per cent in 1994/95 to 5,1 per cent in 2003/04. In contrast, personal income tax decreased from 9 per cent in 1994/95 to 8 per cent of GDP in 2003/04 as a result of tax relief to the amount of R62 billion since 1994/95. VAT increased as a percentage of GDP from 5,9 per cent in 1994/95 to a projected 6,6 per cent in 2003/04.

Figure 4.2: Direct taxes as a percentage of gross revenue



National budget revenue, medium term estimates

Revised estimate for 2003/04

Revenue projections revised downwards by R4,6 billion

Based on revised macroeconomic projections set out in Chapter 2 and the revenue trends for the first six months of this fiscal year, main budget revenue is revised downwards by R4,6 billion to R299,9 billion. Revised revenue projections for 2003/04 are presented in Table 4.2, together with projections for the three years of the MTEF period ahead.

Strong rand reduces tax revenue from the corporate sector and imported goods

Due to markedly lower than expected profits, particularly in export sectors such as mining, corporate income tax and secondary tax on companies will generate R4 billion and R1 billion less revenue than forecast this year.

In line with the stronger rand, the value of imports will decline for this fiscal year, resulting in a lower than budgeted revenue collection of R1,9 billion from customs duties. Also, the lower value of imports will result in a downscaling of budgeted value-added tax collections.

Table 4.2 National budget revenue, 2002/03 – 2006/07

	2002/03	2003/04		2004/05	2005/06	2006/07
R billion	Preliminary outcome	Budget estimate	Revised estimate	Medium term estimates		
Taxes on income and profits	**167,9**	**181,5**	**176,9**	**194,1**	**211,9**	**231,3**
Persons and individuals	94,3	96,7	97,0	105,9	116,3	127,5
Companies	55,7	65,8	61,8	68,5	74,2	80,5
Secondary tax on companies	6,3	8,0	7,0	7,6	8,3	9,0
Other	11,5	10,9	11,1	12,1	13,2	14,3
Taxes on property	**5,1**	**5,9**	**6,6**	**7,1**	**7,8**	**8,5**
Domestic taxes on goods and services	**97,6**	**109,6**	**109,4**	**119,4**	**129,9**	**142,2**
Value-added tax/sales tax	70,1	81,0	80,0	87,5	95,0	104,0
Specific excise duties	10,4	11,4	11,6	12,5	13,7	15,0
Levies on fuel	15,3	16,3	16,4	17,8	19,4	21,3
Other	1,6	0,9	1,5	1,6	1,8	1,9
Taxes on international trade and transactions	**9,6**	**11,3**	**9,4**	**10,2**	**11,2**	**12,1**
Stamp duties and fees	**1,6**	**1,8**	**1,5**	**1,6**	**1,8**	**2,0**
Miscellaneous[1]	**0,4**	–	–	–	–	–
Total tax revenue	**282,2**	**310,0**	**303,7**	**332,5**	**362,5**	**396,1**
Non-tax revenue and repayments	4,5	4,2	5,9	6,0	6,6	7,2
Less: SACU payments	8,3	9,7	9,7	12,8	11,3	12,3
Main budget revenue	**278,4**	**304,5**	**299,9**	**325,7**	**357,8**	**391,0**
per cent of GDP	*24,8%*	*24,7%*	*24,8%*	*24,8%*	*24,8%*	*24,8%*
Changes from 2003 Budget						
Total tax revenue			-6,3	-5,5	-6,2	
Main Budget Revenue			-4,6	-5,3	-3,4	

1. Receipts not yet classified.

Although gross tax revenue is estimated to be R6,3 billion less than estimated, departmental revenue is revised upwards by R1,7 billion. This is mainly due to higher than budgeted revenue from administrative cellular licence fees and higher than estimated dividends from Eskom. Included in departmental revenue is self-financed spending of R423 million and foreign contributions of R67 million towards peace support in Burundi.

Main budget revenue as a percentage of GDP is estimated to remain stable at 24,8 per cent of GDP over the medium term.

Tax policy considerations for the 2004 Budget

Tax policy reform limited to elimination of fiscal drag and refinement of certain tax measures

A period of consolidation of tax reform is envisaged for the year ahead. Personal income tax relief to compensate for the effect of inflation should again be possible, and various technical refinements of the capital gains system and the world-wide income tax regime will be proposed. The review of the retirement fund tax and the appropriate tax treatment of alternative savings instruments will continue into next year, and an in-depth review of the appropriate tax treatment of financial instruments is planned.

Black economic empowerment (BEE)

Encouraging BEE at grass roots level through an enabling tax environment

Government's efforts to promote BEE have accelerated in the last two years and will remain a key issue for the foreseeable future. Many stakeholders are now urging that the tax system should accommodate, or provide incentives for, corporate ownership reorganisations in favour of empowerment partners. The importance of broadening participation in the economy and in corporate ownership is clear, and Government is exploring various options, including relevant aspects of the tax structure.

Reviewing current tax impediments to empowerment deals

The possible role of tax measures in promoting broad-based economic participation is a subject of considerable complexity, and there are both direct costs and benefits and unintended effects to consider. Tax incentives based on multifactor scorecard criteria, advocated by some commentators, are particularly hard to assess. Discretionary judgements or circumstantial considerations do not find easy application in the tax environment, partly because revenue officials are not qualified to review such criteria. However, there may be tax reform options that could remove unnecessary impediments to empowerment restructuring, or assist in broadening participation in ownership. This issue will need further examination in the coming months.

Tax treatment of health care benefits

Tax treatment of medical scheme membership and employer-provided health benefits due for review

Various options for the long-term reform of the medical scheme environment, including the possibility of mandatory medical scheme cover or some form of social health insurance, have been proposed and are under consideration by Government and other stakeholders. A significant element in this environment is the tax treatment of medical scheme membership contributions. The present arrangement is that up to two-thirds of the amount contributed for employee medical aids schemes may be paid by an employer as a tax-free fringe benefit. A further element is the treatment of health benefits provided directly by employers for chronic employee illness. Under current law, medical assistance provided on site by an employer qualifies as a tax-free fringe benefit, while off-site provision does not. This distinction has come under criticism, in part because it fails to recognise employee privacy as a relevant need.

In consultation with the Department of Health and the medical schemes industry, the National Treasury proposes to review the tax treatment of medical scheme contributions and health benefits, with due regard to the challenge of promoting equity in access to health care and to the private health care industry's important role in the South African economy and society.

Insolvency tax treatments

Supporting the restructuring of indebted business through an appropriate tax treatment of debt cancellations

During the comment process for the 2003 Revenue Laws Amendment Bill, the National Treasury identified growing concerns about the tax treatment of debt cancellations. Under current law, a debtor generally makes a capital gain if that debtor's liabilities are cancelled. This stems from the notion that a debtor is enriched from the cancellation of debt to the same extent as if that debtor received direct infusions of cash. On this view, tax principles demand comparable tax treatment.

However, there are difficulties with this approach. The laws relating to insolvency are partly designed so that indebted businesses can restructure their debts and re-emerge as viable operations, thereby protecting productive capital and employment, for example. Any taxation of such debt cancellations works against this intent. Relief for debt cancellations was included in the 2003 Revenue Laws Amendment Bill in respect of intra-group debts. Other relief options will be reviewed in 2004.

Taxation of financial instruments

Embarking on a review of the taxation of derivatives

It has become apparent that derivatives and mixed financial instruments, such as securities with characteristics of both debt and shares, are increasingly exploited for tax avoidance purposes. A preliminary review of convertible share/debt instruments is accordingly planned for 2004.

VAT registration threshold

Proposed increase in the VAT registration threshold

A review of the compulsory turnover threshold for the registration of VAT vendors is proposed. The reason for the registration threshold is to provide relief to small businesses in respect of their administration compliance burden.

VAT and transfer duties

Review the overlap between VAT and transfer duty

The VAT Act No. 89 of 1991 and the Transfer Duty Act No. 40 of 1949 have been linked to minimise or prevent the likelihood of double taxation on property transactions. However, current provisions in the VAT Act that relate to the Transfer Duty Act result in certain inequities that will be reviewed.

Rewrite of the Customs and Excise Act, 1964

Streamline customs and excise procedures

The South African Revenue Service has embarked on a rewrite of the Customs and Excise Act, No. 91 of 1964 with the intention to simplify the Act and streamline administrative provisions and procedures.

Regional tax cooperation

New SACU agreement aims to promote integration and sustainable economic development

The new Southern African Customs Union Agreement, which was signed by Heads of Government in October 2002, aims to promote economic integration, investment, and development. Member countries are cooperating in seeking improved access to key global markets. SACU Free Trade Agreement (FTA) negotiations are ongoing with India, China, Mercosur, the US, and Europe. In addition to global market integration, SACU member states have begun to consider further tax harmonisation.

SADC Tax Subcommittee is leading regional integration efforts

Within the wider SADC region, South Africa continues to seek to strengthen regional co-operation in tax matters. The SADC Tax Subcommittee is developing a common policy approach toward the use of tax incentives across the region, thereby seeking to avoid ‘harmful tax competition’. A detailed research study was carried out during 2003 and a report will be circulated to SADC member states with a view to reaching an agreed policy position.

Workshops to enhance tax administration and policy-making capacity in SADC

Other cooperative initiatives have included regional workshops on double taxation agreements, revenue estimation for excise taxes, VAT compliance and auditing of multinational enterprises and a regional conference on excise taxation, held in June 2003. The conference deliberations will be published in 2004 and will serve as reference for future excise policy work in the region. Tax officials from the region have also continued to benefit from the courses offered by the Southern African Tax Institute.