

FINAL DRAFT REPORT OF THE JOINT STANDING COMMITTEE ON FINANCE ON THE THIRD INTERIM REPORT OF THE KATZ COMMISSION OF INQUIRY INTO TAXATION

The Joint Standing Committee on Finance (JSCOF), having examined and considered the Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (the third Katz Report), and after having considered public responses to the Report and having discussed them in Committee, begs to report as follows:

1. INTRODUCTION

Taxation commands a great deal of public interest insofar as it affects all people as well as all private and public institutions that earn or spend money. It was therefore with serious intent that the JSCOF responded to the Minister of Finance's request to Parliament, made in terms of Rule 66(2) on 15 December 1995, that the Third Katz Report be referred to the Committee for consideration and report.

The deadline set by the Department of Finance for submission of the report of the JSCOF was 31 January, 1996. This imposed severe limitations on the time afforded the public to comment. It also meant that the JSCOF found itself in a similar position to that of last year, when it had to deal with the First Katz Report under similar time constraints. Ensuring availability of the Report to the wider public, and in particular to interested individuals, organisations and institutions who had already begun their annual Christmas holidays, proved to be extremely difficult.

Through advertisements placed in the country's major newspapers and financial publications, and through many direct approaches to key interest groups, the JSCOF received a large number of written submissions. Oral evidence was also presented at public hearings conducted in mid-January, 1996.

A concentrated exchange of views with a range of experts before the formal hearings enabled members of the JSCOF to interact confidently with the public, and to relate to virtually all the technical considerations contained in the Report.

While there was a substantial public response, the JSCOF remains conscious of the fact that there was a skewing in the number of submissions received in favour of larger institutions with particular vested interests. Given this situation efforts were made to obtain alternative views from within broader society. This report also makes a number of recommendations for broadening participation in future hearings on tax matters.

Notwithstanding the above considerations and the limited resources at its disposal, the JSCOF has endeavoured to represent the public and national interest fairly and fully. The Committee's report will now be tabled in Parliament, and hopefully form the subject of a debate.

The JSCOF wishes to record its indebtedness to an impressive array of economic and tax experts for their time, contributions and thoughtful arguments. Sincere thanks go to Messers Marius van Blerck, Anthony Chait, Des Kruger, David Clegg and Nico Czipionka.

The perspectives and contributions made by members of the Katz Commission and by the Commissioner for Inland Revenue were invaluable. Our sincere appreciation to Commissioners Katz, de V Graaff, Davis, Loots and Du Toit, as well as to Sub-Committee member Garth Griffin, not least for their availability throughout the oral hearings to engage with debate with witnesses.

The Ad-Hoc Secretariat, comprising Suzanne Tavill, Shelly Kilzer, Amanda Wright and Avron Marcus, all final year business science students from UCT, provided an added dimension of proficiency to the proceedings.

But above all, the JSCOF expresses its appreciation to those individuals, institutions and organisations who gave of their valuable time and effort to place their considered views before the Committee.

The comments and recommendations contained herein represents the consensus reached among the parties who participated in the JSCOF's consideration of the Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa - the Third Katz Report.

2. OVERVIEW OF TAX REFORM

With the formalised process of tax reform under way since mid-1994, the JSCOF felt it necessary to look beyond the specific issues reported on in the Report under consideration, and to consider a brief appraisal of the overall reform process to date.

Trying to achieve the goals of strong and sustainable economic growth, development and meaningful alleviation of poverty in a time of increasing international economic competitiveness is a daunting challenge for any country. Amongst any government's policy options are various fiscal instruments, of which taxation is one of the most influential. Reform of tax systems, and of tax structures within those systems, has therefore become a necessary pursuit for countries with such goals in mind.

South Africa, as a patently obvious case for comprehensive tax reform, has in addition to make other social and economic-related corrections to its tax system as necessitated by democratic transition. With an appreciation of this, and with lessons that can be drawn from an abundance of international tax reform experience, South Africa has determinedly embarked upon a multitude of initiatives through the work of the Katz Commission.

In conducting this overview, the JSCOF has first satisfied itself as to the appropriateness of the detailed tax reform mandate given to the Commission by the Ministry of Finance. Here, notwithstanding a certain selectivity of tax issues specified, it is clear to the JSCOF that the Commission has been given sufficiently wide scope to look into and recommend reforms in any area of the tax system.

The JSCOF also finds the various sets of parameters the Commission laid down for itself at the start of the journey (First Report, Chapter One) to be comprehensive in terms of adherence to internationally established criteria necessary for a modern tax system - one that is responsive to economic and socio-economic imperatives.

Tracing progress from these points of departure to the completion of its Third Report, the JSCOF recognises that the Commission has closely followed its itemised mandate, although it has been added to from time to time by the Minister of Finance. Each item listed has received some attention, with some now being investigated in greater detail. Across the range of these issues it can be seen that the Commission has generally remained true to the canons of taxation desirable for a good tax system. Equity, neutrality, simplicity, efficiency, etc. are precepts that the Commission has consistently tried to accommodate.

Desirable characteristics of the actual tax types have also remained focal to the Commission as it has sought to broaden bases and optimise rates and yield. Less apparent, however, are the Commission's assertions towards economic growth, where stimulatory concessions and incentives generally lose out to a somewhat purist aversion to allowing distortions in the system.

It is on the issue of balancing reform priorities that the JSCOF and members of the interested public experience difficulties when trying to understand the overall nature and extent of the reform process thus far. This in turn makes it difficult to monitor and evaluate.

The process seems to have become rather fragmented with an increasing number of issues referred for further investigation, as well as the number of new and tangential issues that have arisen. There appears to be a lack of guidance as to priorities, and hence an apparent loss of integration and balance of issues in a logical sequence and pattern. Nor is there a sense of time frame within which the reform process might be completed.

In the Commission's First Report (1.1.4) and Third Report (2.1.2) it recognised the need for "a comprehensive and systematic framework for tax reform in South Africa: (2.2.1). The Commission has, however, also argued a compelling case that it needs to engage with the issues of the day. The "incremental" approach to tax reform which the Commission calls for is acceptable in principle, but the link between the specific proposals and the bigger picture is not always clear. There is a need to avoid the "incremental" approach becoming "piecemeal", leaving uncertainties as to where the process is, where it is going and when it might get there.

A considerable number of the Commission's recommendations have been effectively implemented.

However, it would appear that there is a considerable body of work that, for various reasons, has not shown practical results. When attempting to follow the issues the Commission deals with arising from its mandate to their becoming legislated and implemented, the JSCOF notes that a number are not acted upon. It appears that through the absence of the necessary "big plan" there seems to be an inability comprehensively to consider possible consequences and to balance and integrate different facets of thinking emerging from the Commission's investigatory work. There is a danger that issues drift off into the realm of abstraction or uncertainty, earmarked as requiring further investigation at some unspecified time.

The JSCOF urges that while the necessary framework is being established the Commission consider mapping out a general strategic plan, if possible as a diagrammatic flow chart with a critical path dimension, that they intend following. This should be done to indicate how the planned reform measures across the various tax areas should develop and promote the overall goal of reform. It would be necessary to juxtapose this with issues such as:

- * data on the overall tax burden;
- * the distribution of this burden;
- * the broadening of the tax base;
- * the optimisation of tax yields;

- * the shift in the direct and indirect mix, and the impact of specific proposals on the overall progressivity of the tax system;
- * the simplification of the system;
- * the integration of reforms across the system; and
- * the handling of conflicting objectives in this broader analytic context.

It should also be able to register if the process has become bogged down by unresolved issues or the absence of decisions or implementation.

Considerable uncertainty could be tempered by documenting the planning, progress and management of this difficult, large and complex tax reform exercise.

3. GENERAL REMARKS AND RECOMMENDATIONS

While each chapter will be dealt with, issues arose that require attention or upon -which the Committee has a recommendation to make, but which do not relate to specific chapters. These include:

Perceptions of Taxation

Perceptions of taxation need to be addressed in a clear, strategic communication programme. The JSCOF holds the view that tax collection is not to be perceived of as "damaging" to the economy. Rather, tax is collected in order to raise revenue to:

- (a) assist economic growth and development; and
- (b) fund the socio-economic programmes carried out as part of the redistributive function of government.

The JSCOF therefore recommends:

- * a considered, far-reaching communications campaign that will help build tax morality and an understanding of rights, obligations and of how revenue raised is used. Such a campaign should also raise the awareness of the full range of taxes;
- * that reports such as the one under consideration should be made widely available in popular form simultaneously in order to ensure greater availability and accessibility;
- * far greater co-ordination between departments when determining their policy priorities and the tax authorities to avoid contradictions;
- * that while welcoming the fixing of a ceiling for the tax burden as a percentage of GDP, further evaluation be done of the 25% rate set, and the economic implications of higher or lower rates;
- * a clear statement be issued on our policy and principles with regard to how taxation is weighted in South

Africa and why;

* that the principle be accepted that the source of taxation should not determine who benefits from public spending or vice versa.

Release of the Third Report

The JSCOF expressed its grave concern about the mandate, scheduling and time of release of the Third Report. The JSCOF fully accept that the First Report had severe time constraints related to budgetary matters given the need to meet the constitutional requirements relating to gender and marital status. However, a holistic approach to tax reform cannot be driven by budget day deadlines. Furthermore, the release of a report with such far-reaching implications on 15 December, when the whole country starts its holiday, with a three-week deadline within which to comment, makes meaningful public participation virtually impossible. This is a disservice to the Report and to Parliamentary commitment u public participation.

The JSCOF recommends that:

- * the mandate for the remaining work of the Commission be clearly set out;
- * as the more urgent aspects of the work are completed they be released for comment rather than waiting for one comprehensive report;
- * a comprehensive final report be tabled by June 1998.

Furthermore:

- * the Katz Commission will need to closely examine the tax implications of the new constitution once it is adopted;
- * the Commission should also pay urgent attention to likely tax implications of any move towards removing exchange controls;
- * consideration should be given to organising workshops at which future reports of the Commission are presented to a broad range of organisations and interest groups to assist them in formulating their own views and positions. This could help to broaden the representation before the JSCOF in subsequent hearings.

Comprehensive overhaul and consolidation of the Income Tax Act

The Income Tax Act has not been overhauled or consolidated for almost 30 years. As a new Revenue Service is established, new people will join the team. It is essential for the Act to be completely reworked and made more accessible.

The JSCOF recommends that:

- * a special team, to work closely with the CIR/SARS, be established by the Department of Finance to undertake such a rewrite, in plain language, and focusing on streamlining and consolidation. A programme

of work and an outline of approach to achieve this should be presented to the JSCOF by June, 1996.

Interaction with and Responsibility of the FF.

Repeated concerns were raised about referral of tax issues to different structures and the resulting delays. An example of this would be the Katz Commission looking at Regional Service Councils levies only to include in their recommendation that this matter be referred to the Finance and Fiscal Commission. A broader concern is the uncertainty arising around taxation and the provinces, for instance the role of the FF with regard to taxation on gambling, user charges where applicable, etc.

The JSCOF recommends that:

- * the Commission ensures effective consultation with the FF.;
- * the uncertainty and tensions arising among provinces and with the central government regarding investment incentives and tiers of taxation and the principles and powers be urgently clarified.

Administration of Inland Revenue and Customs and Excise

The first Katz Report dealt primarily with the urgent need for fundamental reform in both Inland Revenue and Customs and Excise. It clearly stated that unless administration became more effective all other recommendations would be rendered futile. The past year has seen a continued decline in the efficiency of both offices with a further loss of skilled personnel and consequent decline in effective tax collection or the administration of customs regulations. The practical situation gravely impacts on our economy and the tax morality of the country.

The JSCOF noted the planned establishment of the new South African Revenue Service on 1 April, 1996. The hearings reviewing this process expressed concern at the length of time taken to reach this point, but welcomed the steps being taken

Mindful of the negative climate prevailing in the existing services, and the enormous task involved in establishing the new service, the JSCOF noted:

- * the clear perspectives and outline of the change management required expressed by the head of the task team;
- * the extent of the reform necessary to ensure effectiveness;
- * the need to determine the legal framework and draft the appropriate legislation;
- * the imperative of harnessing expertise, including international assistance;
- * the management plan, including recruitment of skilled staff, provision of training and equipment;
- * the public commitment of the PSC to greater autonomy and an approach that focused on maintaining basic guidelines and effective monitoring and reporting.

The JSCOF nevertheless expresses its serious concern regarding:

- * when the intended reforms will result in increased efficiency and effectiveness;
- * that the staff recruitment under way appears to be for all available posts, and does not concentrate on getting key personnel in place quickly;
- * the possible contradictions and tensions arising from recruiting new personnel into existing services while the services structure, objectives and culture are in the process of fundamental change;
- * the low morale of the existing staff;
- * the absence of time frames in which to deal with the existing backlogs.

The JSCOF therefore recommends:

- * the Cabinet, Department of Finance and the Public Service Commission finalise the legal framework and complete the draft legislation as a priority;
- * that expertise in change management be brought in to assist in changing prevailing negative attitudes
- * that activity analysis and the cost of activities be completed as soon as possible;
- * that while all vacancies have been advertised, staff recruitment be differentiated and the applications for posts of 8 chief directors and 20 directors be processed with immediate effect; * a full progress report be presented to a hearing of the JSCOF before the presentation of the Budget on 13 March, 1996.
- * the criteria and selection process of the new Board of Directors for SARS be subject to public comment prior to appointment.
- * that consideration be given to requesting the Katz Commission to evaluate progress to date and assess the degree to which the measures under way meet the concerns on tax administration raised in its first Report;
- * the Minister of Finance ensure a comprehensive communication strategy for both the launch and the new approach of SARS.

Assessment of the Tax Amnesty

The JSCOF received an evaluation of the Tax Amnesty as recommended in the First Katz Report. While the CIR regarded it as the most effective amnesty to date, it is clear that the objective of bringing more tax payers into the system has had limited success. The question of writing off of capital as well as interest and penalties for small black business was raised by NAFCOC during the hearings.

The Committee noted the difficulties raised, including:

- * that the amnesty was too restrictive and did not facilitate entry into the tax system by small black businesses which had outstanding tax obligations, including capital, interest and penalties;

- * the inability of the CIR to follow up issues;
- * weakness in the communication strategy and insufficient attention to education of the taxpayer;
- * the low tax understanding accompanied by lack of accounting skills among those targeted by the amnesty.

The JSCOF recommends that:

- * the amnesty in its present form should not be extended;
- * the new SARS and the Department of Trade and Industry Special Unit unit to establish small and medium enterprises develop a comprehensive tax strategy to reach small business;
- * a partnership between SARS and business be formed to reach small and micro enterprises to assist with tax matters, as well as to provide and bring them into the tax regime, support services and assistance;
- * the regulations introduced in March 1994 that interest and penalties be paid prior to principal be reviewed, and that consultation be held on this matter with the Office of the Auditor General;
- * those who, as part of the amnesty procedure, applied to pay the principal amount but withdrew when confronted with the demand to first pay capitalised interest, be contacted and efforts made to facilitate payment of the principal debt;
- * the Department of Finance, together with the CIR, continue discussions with representatives of business to find a solution to the outstanding problems raised with regard to the impact on small business and the implications for government's SMME strategy; and
- * the new SARS have an effective, positive outreach programme to reach individuals and small business still outside the net;
- * every effort be made to solicit advice on a continuing basis from members of the public on how tax collections can be tightened up.

Targeting Poverty

The JSCOF heard a number of submissions, and comments which were made during other hearings, that address the question of poverty and income inequality in our society.

Proposals made in the hearings and written submissions, include that:

- * The old age rebate be scrapped, along with the means test, so that all people who reach the age to qualify for a pension receive one. This measure would certainly improve the conditions of pensioners with low income but who do not qualify in terms of the means test. It would also reduce the bureaucracy required for administration and reduce the significant delays in the payment of pensions to new pensioners who do qualify in terms of the means test. The cost to the fiscus should be investigated;
- * The pensions of tax payers over the age of 75 be tax-exempt;

* Greater attention be paid to making more gender aware policy decisions, particularly as women predominate among the poor and there are clear inequalities between women and men in terms of income, and the manner in which this income is earned;

* Submissions were made on behalf of non-profit making NGOs to broaden the local donor base for development NGOs using the tax system, affording them tax exempt status.

4. TOWARDS A GUIDING FRAMEWORK - CHAPTER 2

RECOMMENDATIONS OF THE KATZ REPORT

2.8.1 The commitment of the Government to avoiding increases in the present percentage of national and provincial tax revenue to GDP of about 25% is supported [para. 2.3.9.]

2.8.2 The question of VAT reform should be further investigated, both with respect to an increase in the standard rate and a narrowing of the set of zero-rated items. The scope for appropriate poverty relief to accompany VAT reform should be evaluated [para. 2.4.6]

2.8.3 The relationship between income tax reform and income distribution should be examined further, including issues such as in para 2.5.2 " Internationally, personal income tax reform has focused in recent decades on reducing the distortionary effects and thus the overall burden of tax, while continuing to raise a significant share of revenue. Objectives of reform have included:

- (a) broadening the base by removing or limiting deductions, exemptions and other preferences;
- (b) reducing the gradation of the marginal tax schedule;
- (c) reducing the number of marginal rate brackets;
- (d) reducing the maximum marginal rate;
- (e) raising the tax threshold, thereby removing lower income taxpayer from the register enhancing progressivity and simplifying administration; and
- (f) adjusting brackets, credits, standard deductions and other nominal amounts for inflation.

2.8.4 A stepwise or incremental approach to tax reform is recommended, rather than a comprehensive tax reform introduced in one package. The development of an explicit transition strategy, including improvements in tax administration, should be undertaken as an important foundation for this incremental approach (para 2.7.1,2.7.3-4)

PUBLIC SUBMISSIONS ON THE KATZ REPORT:

A number of submissions recommended a multi-tier VAT system, where luxury goods were taxed at a higher rate than staple consumption goods. Concern was expressed over administration's capacity for such a project. Many submissions commented on the regressive nature of VAT and hence the continuation of

zero-rating was supported until poverty relief programmes could be implemented.

RECOMMENDATIONS OF THE JSCOF:

The recommendations 2.8.1 to 2.8.4 are broadly supported with the addition that:

- * the impact on the wider economy of maintaining a tax level of 25% of GDP, and how this figure was determined, be investigated;
- * the principle be accepted that there be no move towards targeted relief as an alternative to zero-rating basic necessities until there is certainty that effective delivery structures with widespread acceptance are in place and that such a move enjoys wide support in the community at large. This is clearly not the case at present. The JSCOF therefore recommends that there be no removal of zero-rated items at present;
- * while acknowledging the comparative wideness of the current VAT base, further investigation to seek out remaining possibilities for extending the VAT system to cover areas not currently subject to VAT is recommended;
- * mechanisms be established to allow a fuller debate on the desirability or otherwise on introducing a differentiated rate of VAT, including consideration of the administrative capacity necessary to make such a system effective;
- * an investigation be undertaken by the Commission into the benefits reaching the poor through VAT zero-rating, including an analysis of price escalation of zero-rated goods compared with goods on which VAT is imposed at the standard rate;
- * ways to enhance progressivity in the system, including raising the tax threshold and further adjusting brackets for fiscal drag, be investigated as part of an holistic approach to tax reform; * regressive taxes in an unequal society must take the inequalities between women and men into account, as women are more likely to benefit from zero-rating;
- * an evaluation be made of revenue forfeited through zero-rating vis-a-vis the benefits of targeting poverty and development programmes through the use of such revenue.

5. DEDICATED TAXES AND USER CHARGES - CHAPTER 3

RECOMMENDATIONS OF THE KATZ REPORT:

3.9.1. The Commission recommends that the earmarking of general tax revenues, including income taxes, the value added tax and customs duties, should be avoided. With regard to those excise taxes which can advantageously be assigned to particular departments or programmes, caution should be exercised, taking account of the issues noted in paragraph 3.3.6. Apart from other considerations, further earmarking of specific taxes should not be considered until a satisfactory system of intergovernmental financial transfers is in place and provinces have developed sound revenue bases.

3.9.2 The Department of Finance should submit to Parliament at the time of the annual budget a statement

of estimated consolidated revenue and expenditure of the entire general government sector, including extra-budgetary funds and agencies.

3.9.3 The financing of the Multilateral Motor Vehicle Accident Fund by means of an earmarked fuel levy should be reviewed.

3.9.4. Consideration should be given to the assignment of a percentage of the fuel levy to road construction and maintenance within the broader budget process.

3.9.5 The introduction of a graduate tax was not supported.

3.9.6 In determining policies regarding user charges for publicly provided services, explicit assessment should be undertaken of the interaction of fee schedules with the structure and incidence of taxation.

3.9.7 The assignment of user charges to the institutions responsible for providing associated public services is favoured, where such charges represent cost recovery, fully or in part, rather than their appropriation as general or provincial revenue.

PUBLIC SUBMISSIONS:

Public submissions indicated that user charges should not be levied on services of a public nature required by the State, but rather on trading and economic services. A general warning was to bear in mind the existing tax burden when levying individual taxes, so as not to increase the already high tax burden on individuals. There was great support for the recommendation that further dedicated taxes should not be introduced, so that most allocations are intra-budget. It was brought to light that a progressive tax should only be levied under one comprehensive system. Several individual progressive taxes may have a compound regressive effect.

RECOMMENDATIONS OF JSCOF:

The recommendations of the Report are broadly supported including that there be no introduction of a tax on university graduates. In addition:

- * the Department of Finance should provide a time frame within which recommendation 3.9.2 could be given effect;

- * given the extent of the debt burden of the Multilateral Motor Vehicle

Accident Fund both the Departments of Finance and Transport must ensure such a review takes place urgently;

- * the Department of Finance speedily investigate what institutions could operate user charges, and determine the policy within which such charges should be imposed, prior to any such introduction. The FF should be conferred with regarding possible imposition of provincial charges;

- * before imposing user charges, careful analysis should be undertaken to ensure that individual progressive taxes do not have a compound regressive effect;

* user charges be examined to prevent discrimination against women and girl children, for example in education.

6. LAND TAX-CHAPTER 4

RECOMMENDATIONS OF THE KATZ REPORT

The Commission believes that there is no reason in principle why a rural land tax at local government level should not be given serious consideration. There is sufficient international experience with the implementation of such a tax, and its implementation will not represent a new tax in South Africa.

The Commission's Sub-Committee investigated the possibility of a national tax on agricultural land. Due to the findings, the Commission does not recommend a national land tax in the short to medium term.

18.13 The Commission believes that there is sufficient evidence to justify the possible implementation of a rural land tax at local government level, but that further investigation be undertaken to ascertain the merits of a local level land tax and to ensure that, if introduced, the implementation of such a tax should not have undesirable distorting effects.

The issues which in particular, require further investigation include the following:

- a) whether the envisaged benefits of a local level rural land tax will actually arise;
- b) what the proper roles are of the national and provincial governments with regard to a local level rural land tax;
- c) what the contents are of the framework within which the proposed tax should be implemented;
- d) what the factors are that should be taken into account to ensure that, from an administrative point of view, the envisaged tax operates properly, including the definition of a tax base, the identification of the party liable for the tax, the assessment of taxable value, the tax rate, as well as the appropriate exemptions, tax relief, administration, collection and enforcement;
- e) the relationship between the proposed land tax and other revenues, including, more particularly, RSC levies, as well as the relationship between the tax and fiscal transfers;
- f) whether the envisaged tax should be regarded as a net addition to the tax burden or whether it should replace other existing revenues; and
- g) the ways in which such a tax could be linked to urban local tax systems, including co-operation in the implementation of valuation methods and ways of using the tax to smooth the urban-rural interface in South Africa.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

Property taxes need to be unified and apply to all land in urban, rural and communal areas relative to their

demand for and consumption of services.

There was concern that the commission confined its investigation to rural land and has therefore excluded, among others, urban land, minerals and precious metals, fishing, water and communications.

The mining industry in particular is opposed to the implementation of a land tax because it could act as a barrier to entry to new land owners, its revenue raising potential is relatively low due to high collection costs, redistribution through a land tax system has been proved unsuccessful and its high administrative demands. Others held that any land tax, irrespective of the level, must take into account of new entrants to farming, poor market support for black farmers and the lack of financial support.

If a land tax were to be implemented, due consideration and adjustments must be made to taxes such as RSC levies, income taxes, transfer duty, donations tax, estate duty, VAT and agricultural taxes in general. It was strongly felt that a land tax implemented at a local level should benefit the local level. Determination of land value would always have a measure of subjectivity and potential for corruption. Urban land valuation should be revised to a national standard and rural valuation brought in.

RECOMMENDATIONS OF JSCOF:

The JSCOF concurs with the essence of the recommendations of the Commission that further work be done as outlined above. Substantial public comment was received on the proposals. The JSCOF therefore recommends that: provincial and local investigations into rating and taxing systems, including the treatment of agricultural land, be evaluated as part of the ongoing work of the Commission or perhaps the FF.; the public comments received form part of the proposed further investigations, including direct contact with the authors where possible; in further investigation sensitivity be shown with regard to valuation methods, possible production distortions and the possible impact on the large number of marginal farms; the practicalities of implementing a land tax be explored.

7. REGIONAL SERVICE COUNCIL LEVIES - CHAPTER 5

RECOMMENDATIONS FROM THE KATZ REPORT

18.14) Regional Services Council levies should be investigated as a matter of priority by the Financial and Fiscal Commission who should liaise with the Commission in this matter, particularly with a view to ensuring that any continuation of such levies fits within the holistic framework for taxation as recommended by the Commission.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

Responses, regarding this chapter, were received mainly from large institutions which were opposed to any tax not based on profits. RSC levies are based on turnover and thus directly increase costs. This, in turn, affects the viabilities of businesses operating as price takers, unable to pass this increase on to their customers. An example of such a business are the mines. There was strong opposition to the view that taxes of any kind should be collected by means of private agents, operating on a commission basis, for the following reasons:

- * private agents are not bound by the secrecy provision of the Income Tax Act
- * collecting taxes on a commission basis could lead to unscrupulous tactics; and
- * the payment of commission reduces revenue which may have to be funded by means of an increase in rates

RECOMMENDATIONS OF JSCOF

The recommendation is supported, with the addition that: the current practices of RSC levy collection be urgently investigated and an immediate prohibition be placed on the use of private agents or tax collection on a commission basis in order to prevent abuse; an evaluation be made of how effectively and efficiently these levies are currently being allocated and their appropriateness to the new local government system. the FF. should investigate the concerns raised as a priority. the distortionary effects on other areas of taxation and the possible disincentive that could arise from increased rates of such levies, needs to be borne in mind.

8. CAPITAL GAINS TAXES - CHAPTER 6

RECOMMENDATIONS OF THE KATZ REPORT

6.7.1 The commission recommends that, by reason of the lack of capacity on the part of the tax administration, there should not be a capital gains tax in South Africa at this stage. When restructuring tax administration has been completed in line with the Commission's recommendations in its first report, the contentions for and against a possible introduction of this tax and its suitability for South Africa should be revisited and cognisance should be undertaken of the considerations set out in this Chapter [para 6.6.2; 6.6.4]

6.7.2 If at any time in the future it is decided that a capital gains tax should be implemented in South Africa, then the date on which the tax is introduced should be designated as the "benchmark date" and all assets owned by taxpayers at that date should have a value assigned, being the market value on that date.

This recommendation is necessary in the opinion of the Commission to promote certainty and thereby to allay concerns on the part of prospective investors both local and foreign. [para 6.3.11-12]

PUBLIC SUBMISSIONS ON THE KATZ REPORT

Support was expressed for the proposal that Capital Gains tax not be implemented. Many submissions commented on Inland Revenue's inability to administer the collection of such a tax, the problems of valuation and resultant small yield.

RECOMMENDATIONS OF JSCOF:

The Commission's report does not deal conclusively with the question of Capital Gains tax, perpetuating uncertainty. Aware of the reluctance at a recent conference of the Commonwealth Association of Tax Administrators to advocate a capital gains tax in countries that had not already instituted them, the JSCOF recommends that:

- * the present weakness of Inland Revenue to administer this or any other tax should not form the basis of an in-principle decision whether or not to impose such a tax, but rather act as a spur to address the problems of administration;
- * the substantive arguments for or against imposing such a tax should be the determining factors;
- * no capital gains tax be imposed at this stage; and
- * the principle of a benchmark date is fully endorsed.

9. CAPITAL TAXES - CHAPTER 7

RECOMMENDATIONS OF THE KATZ REPORT

7.4.1 The commission supports the principle of a capital transfer tax, which would encompass the present estate duty and donations tax. This is a matter to which the Commission will return in a future report. [para. 7.1.12]

PUBLIC SUBMISSIONS ON THE KATZ REPORT

There were limited comments on this issue. Of those received, some suggested that the exempt amount under estate duty be increased to account for inflation, while others suggested an increase of the rate. Comments again called for the Commission to deal conclusively with the matter of capital transfer tax, appealing for a decision to be made with regard to the rate and level of any rebate so E to remove the prevailing uncertainty.

RECOMMENDATIONS OF JSCOF:

The Commission's motivation for recommending further investigation into a tax on capital transfers arising from gifts or deceased estates is an attempt to achieve vertical equity, and consolidate two existing forms of taxation. Every effort should be made to ensure that decisions are taken to provide certainty. The JSCOF recommends further investigation into the subject with special reference to:

- * administrative costs vis-a-vis yield;
- * flat versus marginal rates;
- * possible effects on unit trusts and individuals, on savings and capital accumulation and the micro- and macro-economic implications;
- * any capital transfer or other "wealth" tax should be set at a rate that would not be perceived of as "punitive".
- * the detailed investigation already completed by the CIR should inform this further investigation; and

* the implications of the prevailing threshold and the rate of death duties be evaluated, taking into account international comparisons;

* in the interim, the Minister of Finance should consider whether an adjustment is required to the threshold, as well as to the current rate of 15%.

10. RETIREMENT FUND TAXATION - CHAPTER 8

SUMMARY PRECIS:

The present system under which retirement fund contributions and the income of retirement funds are exempt, while payments to pensioners are taxed - the EET system - undermines the integrity of the tax system, results in a major loss of revenue, and creates opportunities for tax sheltering and arbitrage. A new system in which exemptions are allowed to encourage provision for retirement, but in which the build up of retirement funds and pensions are taxed - EET - is proposed instead.

RECOMMENDATIONS OF THE KATZ REPORT

Contribution Deductibility 8.14.1) The idea of "capping" Rand values of deductible contributions should not be pursued. Deductible contributions should be limited to 15 per cent of aggregate remuneration in respect of employers and 7,5 per cent of taxable income in respect of employees. [paras. 8.7.1; 8.7.6]

8.14.2) Separate deductibility limits should be set for benefit funds and Medical

Aid arrangements. [para. 8.7.10]

8.14.3) A basis should be established for, limiting the scale of benefits that can be offered by defined benefit funds. [para. 8.7.7]

8.14.4) As part of an employers tax return, a schedule should be required in support of any claim for retirement fund contribution and in which details are disclosed of:

(a) the name of the retirement fund and its registration number;

(b) total members' remuneration over the year;

(c) members' contribution; and

(d) employers contributions. [para. 8.7.9(b)]

8.14.5) Simultaneous membership by an employee of more than one approved fund offered by his or her employer should be disallowed. [para. 8.7.9(c)]

8.14.6) The feasibility of allowing balance of cost" schemes to be recognised should be investigated. [para. 8,7,9(d)]

Taxation of Fund Income 8.14.7) It is recommended that approved funds be taxed on interest, rental and other "trading" income ("fund taxable income") at a flat rate of 30 per cent. [para. 8.8.4]

8.14.8) Existing "pensioner funds should be given the option to convert from the "old" to the "new" regime. [para. 8.8.7]

8.14.9) The taxation of income accruing to Medical Aids and other benefit funds should be further investigated. [para. 8.8.8]

Taxation of Benefits

8.14.10) Within each retirement fund that pays pension annuities to retired members, it is proposed that a "pensioner fund" be formed to hold assets backing the liabilities in respect of pensioners. [para. 8.9.3]

8.14.11) It is recommended that a value be determined of all benefits deemed to accrue on death or retirement, whether lump sum or in the form of an annuity, and that tax at a progressive rate be determined on this "capital sum" and that tax be paid at this stage. [para. 8.9.4]

8.14.12) In arriving at the taxable amount of the "capital sum", the following deductions should be allowed:

(a) on withdrawal from a Fund: R2000;

(b) on death or retirement: where A equals the amount from the capital sum applied to purchase an annuity, the sum of:

(i) R50 000;

(ii) the lesser of A and R120 000; and

(iii) provided A is greater than R120 000, the lesser of R210 000 and 50 per cent of (A-120 000);

subject to the overall limit if the capital sum. [para. 8.9.10]

8.14.13) The monetary amounts and schedules to be used in determining the taxable amount and the tax due should be regularly reviewed. [para. 8.9.8]

8.14.14) Consideration should be given to establishing minimum criteria in terms of which pension annuities will qualify for the deduction envisaged. [para. 8.9.11]

8.14.15) The taxable amount arising from the net "capital sum" should be taxed according to the following schedules, the rates to be applied to that part of the taxable amount that falls within each band, without any offset against any other losses of the taxpayer:

Tax Rate

Withdrawal

Death and Retirement

15%

Less than R25 000
Less Than R150 000

25%
R25 000 to R75 000
R150 000 to R450 000

35%
R75 000 to R125000
R450 000 to R750 000

45%
More than R125 000
More than R750 000

[para. 8.9.15]

8.14.16) There should be a convention for the sequence to be used to allocate the tax liability to different parts of the "capital sum", as follows:

- (a) first, any lump sum in excess of R50 000;
- (b) second, that portion of the capital sum to be applied to the purchase of the annuity (A), up to a maximum of 25 per cent of A;
- (c) third, the first R50 000 of the lump sum;
- (d) fourth, the balance of the purchase price of the annuity. [para. 8.9.17]

8.14.17) Pension annuities should be payable free of tax in the hands of the pensioner once tax is paid on the "capital sum" and income of the fund has been subject to tax. To the extent that is impractical to move existing pensioners onto the new basis, old funds should be closed to further contributions and would retain their "untaxed" status and pensions paid would remain taxable in the hands of recipients. [para. 8.9.19; 8.9.21]

8.14.18) Lump sum payments on termination of service, including payments in respect of "deferred compensation" arrangements, should be treated as if they were retirement benefits, and included in the "capital sum" for the purpose of determining tax liability. [para. 8.9.23]

8.14.19) The minimum age at which benefits paid on retrenchment are treated as retirement benefits for tax purposes should be reduced from 55 to 50. [para. 8.9.24]

Equality between Private and Public Sector

8.14.20) Exemptions from tax of lump sum benefits payable from "funds established by law" should be withdrawn. [para. 8.11.41]

8.14.21) Accrued rights to exempt lump sum benefits should be recognised and determined by reference to

the service of members up to the date of the change. Withdrawal benefits, unless transferred to another approved fund, should be subject to normal tax scales. [para. 8.11.4; 8.11.6]

8.14.22) The commission favours the same tax treatment of the income of public sector retirement funds as it recommends for the private sector. If, on consideration, it is decided that certain public sector funds should be exempted, such exemption should apply only to funds which by their nature have extensive restrictions on their investment policies. Exemptions should be subject to appropriate principles, explicit application for exemption and publication by the commissioner for Inland Revenue of the names of exempt schemes. [para, 8.11.7-8]

8.14.23) Public sector funds should comply with similar limitations on deductible member contributions, multiple membership and employer contribution rates as private sector funds. A framework should be established for the control and monitoring of defined benefit funds in the public sector. [para. 8.22.9]

Retirement Annuities

8.14.24) The maximum contribution rate to retirement annuities should be increased to 22.5 per cent of taxable income. [para. 8.12.2]

8.14.25) Employed persons should be permitted to contribute the sum of 22.5 per cent of "non-retirement funding income (as defined) and the difference between 7.5 per cent of "retirement funding (income and allowable contributions to an occupational fund to retirement annuities. [para. 8.12.3]

8.14.26) The rules determining acceptable benefits from retirement annuities should be amended to allow for lump sum benefits, or equivalently, the full commutation of pension benefits. [para. 8.12.4]

Miscellaneous

8.14.27) As part of a general review of the legislation applicable to pension and provident funds, the relevant tax legislation should be revised. The distinction between pension and provident funds in the Income Tax Act should be abandoned in favour of reference to " approved retirement funds". [para. 8.12.5]

8.14.28) The tax treatment of non-retirement benefit funds should be reviewed to ensure consistency with the proposed treatment funds. [para. 8.12.6]

8.14.29) The registration and approval process for retirement funds should be rationalised. [para. 8.12.7]

RECOMMENDATIONS OF JSCOF:

Given the extent of debate, the number of submissions received and the diversity of argumentation, this Chapter is dealt with differently from the others.

The bulk of submissions received commented on the recommendations contained in Chapter 8. The detailed submissions, virtually all from vested interests in the retirement industry, will be submitted to the Minister of Finance along with this report.

There was extensive debate throughout the hearings on this matter, with views both for and against the core

proposal, namely to change to an EET system of taxation. There were also sharp differences of views about the numbers used. The approach followed is one of trying to capture the essence of the arguments and focus on the principles that need to be addressed, not the detail.

The Katz Commission has presented a compelling argument, that was acknowledged in varying degrees in many submissions made to the JSCOF, that the present system of taxation of retirement funds is in need of major overhaul. Among other things, the present arrangements:

treat pension and provident funds differently; treat private and public funds differently; encourages too high an incidence of lump sum payments; provide a huge incentive to contractual savings (retirement industry savings) at the expense of discretionary savings; allow for significant tax arbitrage and sheltering, thus undermining the integrity of corporate taxation; result in a massive deferral of current revenue, which the Commission estimates adds up to an annual loss of R 11 billion (a figure disputed in various submissions); and provides a major incentive, the benefits of which accrue disproportionately to higher income earners and to men.

The Commission has recommended that the present EET system be replaced by an ETT system, and has also put forward various proposals concerning limits (expressed as a percentage of earnings) to tax free contributions to retirement funds by employees and employers, a 30% tax on interest, rental and other "trading" income of retirement funds, and limits on tax free lump sums that can

be accessed on retirement. The Commission argues that these proposals would rectify many of the deficiencies in the present system and be consistent with the overall principles of holistic reform it has argued for in all its reports. It also maintained that its proposals would alter the distribution and form of savings, whereby a greater incentive is given for lower and middle income earners. At the same time, it acknowledged that there are many issues which require further consideration and negotiation.

Many of the submissions made to the JSCOF, which came predominantly from within the retirement industry itself, argued strongly against several of the specific proposals. Some also supported a retention of a modified EET system, although others appeared to be prepared to accept a move to ETT at a lower rate than the 30% rate of tax as proposed. COSATU and FedSal also expressed concern at the possible reduction of benefits to lower income pension fund members.

In essence, with the introduction of the four-funds approach, the 30% rate of tax is already in place for endowment policies owned by individuals.

Several of the witnesses appearing before the JSCOF argued for a postponement of any decision on a move towards a new system until the Smith Committee report has been fully discussed and there was clarity on government policy towards retirement in general. The JSCOF does not support this, for the following reasons:

It would lengthen the period of uncertainty in a situation in which there is an urgent need for clarity and certainty; There would be no guarantee that it would lead to any greater consensus in circumstances in which powerful vested interests are at stake; The Katz Commission has taken account of several of the main recommendations of the Smith Committee. Its proposals were endorsed in evidence presented to the JSCOF by witnesses and Commissioners who had also served on the Smith Committee; The brief of the Katz Commission, as a tax committee, differs from that of the Smith Committee; and There is quite a broad consensus on several matters of principle, and in particular on the need for reform.

In order particularly to reduce the uncertainty and avoid an issue which has been pending for several years dragging out inordinately, the JSCOF recommends that government take an early decision on certain broad matters of principle, and simultaneously announces procedures for further negotiation on matters of detail. The matters of principle on which an early decision could, in our view, be taken would include the following:

Pension and provident funds should be treated on the same basis, as should private and public funds; While government should continue to provide an incentive to taxpayers to provide for their retirement, there should be neutrality between incentives for different forms of saving; The incentive to taxpayers to provide for retirement should be weighed together with other priorities, and not be seen to be disproportional. In particular the opportunity cost of the estimated annual loss of revenue of R11 billion should be examined holistically in the context of the overall priorities of tax reform, and of expenditure; There is a need to reform the system to reduce opportunities for tax arbitrage and sheltering.

The Katz Commission has also, in our view, put forward sufficient justification for an early announcement by government of acceptance of the principle of a move to the ETT system. Further delay in taking such a decision would lead to greater uncertainty.

Given perceptions that the recommendations could impact on the retirement benefits of lower income earners, the JSCOF recommends that any such announcement be accompanied by a firm commitment to reduce the overall tax burden on individuals, especially those in the lower income brackets. This would also be consistent with the principle of holistic reform.

Any change arising as a result would, of course, require new tax legislation. It is in the process of preparing and presenting such legislation that matters of detail, could be further debated and discussed. This should include discussions on the Smith Committee recommendations.

However, the taxation of the income build-up, the lump sum, and the monthly pension, as well as the transitional arrangements and the wider economic Impact, should be investigated by the Department of Finance. Such investigation should feed into the process of further discussion with all interested parties. A report on the results of this investigation, as well as on the progress of such discussions, should be tabled before the JSCOF by no later than June 1996.

With regard to the Public Sector the JSCOF recommends that:

* government pronounces that all rights to which public sector employees at national, provincial and local level, are entitled at the date of introduction of the new system continue to enjoy the benefits of the previous dispensation;

* that "pay as you go" system be urgently investigated. The JSCOF heard evidence from a witness, who also served on the Smith Committee, express the view that a move towards a "pay as you go" system of payment of public sector pensions could dramatically reduce public debt service and

11. SECONDARY TAX ON COMPANIES AND DIVIDENDS - CHAPTER 9

RECOMMENDATIONS FROM THE KATZ REPORT

Retention of the STC

18.49) The Secondary Tax on Companies should be retained at this time.

Further Investigation of the Imputation System

18.50) Movements towards some form of imputation system is favoured in principle. While the administrative restructuring is in progress that will remove the practical inhibitions to the kind of comprehensive reform required for an imputation system, further research into alternatives should continue and empirical evidence should be gathered as to how foreign systems are progressing with removing some of the difficulties currently experienced with similar systems.

Reduction in the STC Rate

18.51) The Commission favours a substantial reduction in the STC rate from its present level, in order to reduce the burden of the combined corporate tax rates and minimise the distorting effects of the STC.

STC on Foreign Branches

18.52) No branch tax should be introduced, but the current law should be amended formally to remove the STC obligation on foreign branches which is simply not being enforced.

Assessed Losses, Capital Gains and Exempt Recipients

18.53) No amendments in respect of assessed losses, capital gains and exempt recipients should be made at this time. Adjustments might be considered at a later stage if fiscal and administrative circumstances allow.

Reinvestment within Groups

18.54) Exemptions or a credit refund system to cater for reinvestment within the group context should be investigated, including their impact on administration.

18.55) The current exemption from STC in terms of section 64B(5)(f) of the Act should be extended to comprehend situations where a group subsidiary's shares are held by more than one shareholder within the group of companies which are themselves wholly owned subsidiaries.

18.56) The requirement for a section 64B(5)(f) exemption that the holding company should derive its profits solely from sources within the Republic should be revised to refer to "substantially all" so as to allow for a legitimate application of the *de minimis* principle, and the period over which there may be no non-RSA profits should not encompass more than one year of assessment prior to the year in which the dividend is declared.

Intra-Group Loans

18.57) The provision for the exemption of intra-group loans for STC purposes should be extended to encompass loans between wholly owned companies and subsidiaries whether the holding is direct or

indirect. For this purpose, "wholly owned" should be defined to allow for equity share holdings by full-time employees in terms of share incentive schemes, not exceeding 10 per cent of the company's equity share capital

Deemed Distributions

18.58) The present ambiguity regarding the scope of the exclusion from a deemed distribution (in terms of section 64C of the Income Tax Act) of amounts distributed to part shareholders in excess of profits and reserves available for distribution by way of a dividend, should be clarified by way of legislation or an appropriate practice note.

Prescription

18.59) The final proviso to section 79(1) as regards Undistributed Profits Tax should be extended to STC.

Exemption of Interest Received

18.60) Section 10(1)(hA) of the Income Tax Act should be amended so as to prevent the exemption of interest received which this section provides to foreign companies which are managed and controlled outside South Africa from applying in respect of business conducted in the Republic.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

Many of the submissions, which came primarily from business organisations, argued in favour of an immediate reduction in the STC rate. Some wanted it to be completely abolished and dividends taxed in the hands of the taxpayer. It was felt, however, that if it was not scrapped, a reduction to an amount of approximately 10-15% was needed. There was a general consensus among those agreeing with the reduction of the STC rate, that the proposal to scrap STC on foreign branches would be problematic. One submission in particular cautioned that if the total effective tax rate of corporates (48% with STC) fell below the maximum marginal rate for individuals (45%) large scale tax arbitrage could result. Individuals will opt to take dividends from companies instead of salaries.

The recommendation that as long as STC remains in force, amendments should be affected to alleviate the inhibition on group reinvestment and to exempt loans between wholly owned companies and subsidiaries, was welcomed. The recommendation that if STC is retained that progress be made towards an imputation system was supported.

RECOMMENDATIONS OF JSCOF:

The Committee noted that: STC has now been recognised in virtually all double taxation agreements being concluded between South Africa and her major trading partners, and that there is now a greater understanding of the tax both within the country and abroad; and the revenue yield generated by STC at the 25% rate is significantly below that previously obtained when the rate was set at 15%.

The JSCOF supports the recommendations with the additions that: STC be retained for the time being, although the level of the rate could be further considered; while an imputation system is ideal, it requires a very sophisticated administration and prior to any decision being taken further research be undertaken with specific emphasis on the administrative implications and complexities of an imputation and alternative

systems; STC on foreign branches be removed provided that a final branch profits tax at the same rate be simultaneously introduced; while accepting the recommendation that no amendments be made in respect of assessed losses, capital gains and exempt recipients at present, the proposal that adjustments could be considered at a later stage is rejected, as this would defeat the very objective of STC; the exemption of interest received granted to foreign companies should be withdrawn in respect of business carried on in the Republic.

12. GROUP INCOME TAXATION - CHAPTER 10

RECOMMENDATIONS OF THE KATZ REPORT

The Commission recommends the adoption of a system of group taxation of the consolidation basis. A gradual approach to the introduction of a system of group taxation is proposed, beginning with a simplified consolidation method.

The main features of the proposed simplified consolidation method are the following:

- (a) For the purposes of qualifying for group tax relief, a group should comprise a holding company and all its wholly owned subsidiaries. The term "wholly-owned" should be defined to refer to both direct and indirect interests held by the holding company, determined on the equity share capital of the companies concerned, with allowance for equity shares to be held by full-time employees, including executive directors, in terms of share incentive schemes, not exceeding 10% of the companies equity share capital.
- (b) The consolidation tax liability of a group will be calculated from sub-returns required for each member company in which taxable income or assessed loss will be determined on the basis of the current tax regime, save for a number of limited proposed adjustments.
- (c) The initial assessed losses of the member companies will be ring-fenced, and any loss incurred by a company in the group in a subsequent year of assessment will only be available to be set off against income from another company in the group in the same year of assessment.

Specific anti-avoidance legislation should be considered, together with application of the existing general anti-avoidance measures.

It is recommended that progress towards a full consolidation system, based on principles of loss offset and adjustments to taxable income which are widely followed internationally, should be deferred until the impact of the shift to group taxation on the fiscus can be evaluated and the problems of administration have been identified and addressed.

PUBLIC SUBMISSIONS ON THE KATZ REPORT:

The submissions received were largely supportive of the main recommendations. The requirement of a "common specialised activity" was, however, criticised as not being applicable to many South African companies and thus the impact of this recommendation was considered likely to be less widespread than might initially appear to be the case. Objections to the fact that the companies in a group will be jointly and severally liable for income tax were also received. Many submissions recommended that group taxation

should extend to VAT as well as income tax and that the Commission's grounds for not recommending this were felt to be insufficient and the matter was thus seen as requiring further investigation. The proposed system was also criticised as resembling a loss transfer approach rather than a consolidation approach which was preferred by some.

RECOMMENDATIONS OF JSCOF:

The Commission's recommendations are supported, with the following additions: anti-avoidance legislation be drafted; the characteristics of a consolidation approach vis-a-vis a loss transfer arrangement be clarified.

However, any decision should be informed by the following concerns:

* the need to investigate how far reaching the definition of "wholly-owned" companies is on the potential loss of revenue to the fiscus.

13. TAX AVOIDANCE - CHAPTER 11

RECOMMENDATIONS OF THE KATZ REPORT

11.8.1) The Commission recommends that section 103(1) of the Income Tax Act be amended as set out hereunder, it being recorded that the draft below has been included to illustrate the principles which are being recommended by the Commission rather than to be prescriptive of the precise wording to be adopted.

(a) section 103(b)(i) be amended to read as follow:

a) (i) was entered into or carried out:

(a) in the case of a transaction in a business context, by means or in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

(b) in the case of any other transaction, being a transaction not falling within (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or";

(a) the following proviso be inserted at the end of section 103(1):

" provided that the provisions of this section shall not apply where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act, read as a whole." [para 11.5.8]

11.8.2) This new provision should only apply to transactions entered into after the implementation of the new section. [para 11.5.9]

11.8.3) The Commission recommends that section 103 be amended to embody the principle contained in Practice Note No. 20 dated 25 June 1995; that is that the raising of additional assessments in terms of

section 103 is subject to the restrictions imposed by the first proviso to section 79 of the Act, so that additional assessments may not be raised after the expiry of three years from the date of assessment unless the Commissioner is satisfied that the amount which should have been assessed to tax was not so assessed or the fact that the full amount of tax chargeable was not assessed, was due to fraud, misrepresentation or non-disclosure of material facts. [para. 11.7.3-4]

PUBLIC SUBMISSIONS ON THE KATZ REPORT

There were not many responses from the public on this chapter, but some of those that did comment questioned whether the proposed new wording for section 103(1) of the Income Tax Act would have the desired effect. Others felt that the proposed new wording was too broad and in effect collapsed the distinction between tax avoidance and tax evasion.

RECOMMENDATIONS OF JSCOF:

The above recommendations address the principal defects of prevailing anti-avoidance provisions and are supported. However the JSCOF recommends that:

* as the wider implications of the business test are preferable, the use of the "context of trade" (11.5.8(a)) and not of "business context" (11.8.1

(a)(b)(i)(aa)) be used;

* given that tax avoidance has become so widespread, involving millions of Rands, improved administration may well need to be bolstered by stronger measures. To achieve this, the question of imposition of interest, to apply to schemes entered into after a date to be determined, should be

considered;

* improved tax administration must be complemented by a greater tax morality. Serious consideration should be given to the imposition of harsher penalties where appropriate, as well as to the desirability or otherwise of publishing the names of the transgressors and the penalties imposed on them.

14. STATEMENT OF TAXPAYERS RIGHTS - CHAPTER 12

RECOMMENDATIONS OF THE KATZ REPORT

Principles to be encoded in a Statement of Taxpayers Rights 18.88 The basic rights of taxpayers should be articulated in a dear public Statement of Taxpayers Rights. The principles to be encoded in this statement should include: a) expeditious and timeous tax administration;

b) fair, impartial and consistent application of the law;

c) full disclosure, in simple language, of the reasoning behind adverse decisions;

d) respectful, courteous and helpful treatment of taxpayers; and

e) privacy of information.

Appointment of a Tax Ombudsman

18.89 In addition to recognising the role of the Public Protector in this regard, an independent Tax Ombudsman should be appointed to protect taxpayers' rights and mediate between taxpayers and the revenue authorities.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

The proposal to introduce a tax ombud was welcomed by most submissions especially due to the fact that he or she will be independent of the Finance Department and the Receiver of Revenue. Concerns were raised that the election of the ombud should be an issue for national debate before decisions are taken.

A number of the submissions expressed dissatisfaction with the proposal that the Statement of Taxpayers rights not be made into a law. It was felt that only through legislation would the taxpayers rights be observed. Other submissions argued that the Statement of Taxpayers Rights did not itself need to be embodied in the legislation itself, but that various associated matters should be legislated, including:

- * non-payment of interest in cases where there is an undue delay by the tax office;
- * a mechanism to recover costs from the tax authorities where the courts rule against the tax authorities;
- * automatic assessment of a submitted return after the lapse of a certain period; and
- * the shift of the onus to the tax authorities if an appeal is not timeously dealt with.

The submissions also raised several other issues needing further consideration:

- * should duties of taxpayers also be included in the statement;
- * should taxpayers rights include the right to equal treatment regarding interest compensation in the event of tax underpayments and overpayments as well as the right to an efficient revenue service; and
- * instead of a statement there should rather be a charter between taxpayers and the government.

It was felt that the Commission's recommendations ignored the important role which the publication of rulings play in ensuring that taxpayers are treated equitably under similar circumstances.

RECOMMENDATIONS OF JSCOF:

The JSCOF supports the recommendation of encoding a public Statement of Taxpayers Rights, and what should be contained therein. However, we recommend that:

- * this should include clearly set out taxpayer's obligations and duties and the title should change accordingly. It should also include rights as to indirect taxes; as the SARS is being established within a culture of service to taxpayers, such a statement need not be legislated at present, but that effectiveness be regularly

monitored including through the specialised unit envisaged below; the Commission be more gender sensitive in its use of terminology.

While accepting the principle contained therein, the recommendation to appoint a separate Tax Ombud is not supported at this stage. The JSCOF expressed concern at the proliferation of such oversight bodies. Further consideration of alternatives is needed, including the possibility that the Public Protector's Office establish a specialised, skilled tax unit to achieve this purpose.

15. FURTHER ASPECTS OF THE TAXATION OF SMALL AND MICRO- ENTERPRISES - CHAPTER 13

RECOMMENDATIONS FROM THE KATZ REPORT

Criteria for qualifying as Small Business Undertakings

18.90) The following criteria are proposed for the taxation of natural persons as small business undertakings (SBUs)

1 employment of less than 50 but more than 5 employees;

2 annual turnover of less than R2 million; or

3 capital assets utilised (excluding fixed property) valued at less than R2 million.

18.91) In the event of a business shrinking in size to such an extent that it complies with the definition of a SBU, the taxpayer should not be afforded the benefit of the cash basis of taxation.

Period of Qualification for the Cash Basis of Taxation

18.92) Taxpayers who satisfy the qualifying criteria for the cash basis of taxation, should be allowed to elect to be taxed on this basis at any time after the regulations have come into operation. It is proposed that taxpayers who so elect should be deemed to qualify from the beginning of the tax year. Upon ceasing to qualify, a taxpayer should be deemed to have qualified up to the end of the tax year.

Phasing Out of Previous Allowances

18.93) With regard to the recoument of allowances when a taxpayer ceases to qualify as a SBU, a phasing-out period of at least two years should be granted.

Anti-Avoidance Measures

18.94) Consideration will have to be given to the formulation of anti-avoidance measures if a special tax dispensation is granted to small businesses.

THE PUBLIC SUBMISSIONS ON THE KATZ REPORT

The one general concern prevalent in the submissions was that the recommendations apply only to natural persons and therefore by implication not to companies and close corporations. It was their belief that the criteria proposed in paragraphs 13.2.1-2 were too generous. It was suggested that the criteria be worded so as to exclude a Small Business Unit where any one of the three criteria is not met. It was requested that the provisions of the Act, relating to the determination of the taxable income derived from a SBU, be finalised, published and implemented as soon as possible.

Others were of the view that this tax would over-complicate the tax system and may unfairly discriminate against some other taxpayers. It was also felt that being taxed on a cash basis would not work because it would be very easy to manipulate cash flow.

Though some submissions felt the criteria were too generous, others felt they were too restrictive, and that as a minimum they should be brought into line with the definitions published in the Small Business Enabling Act.

There was a strong objection, from one submission, to the exclusion of incorporated businesses from these provisions. To avoid having to define different economic activities for tax purposes, the higher criteria should apply to all businesses.

At least one submission argued that the Department of Trade and Industry definition of small, medium and micro-enterprise (SMME) turnover as R6 million should be used. Loss of revenue to the fiscus should be balanced against the rate of failure of SMMEs because of working capital problems as well as high employment potential they provide and the resultant SITE and PAYE generated. It was believed that a turnover of R6 million would be a better indicator of the stability of the business.

Another recommendation was that paragraph 13.3.4 of the Katz Report should allow for cases of political evidence, that is, in these cases the right to be classified and taxed as on the SBU should be granted. In South Africa, various businesses operate in violent and crime ridden areas, and any advantage could help.

Finally, it was suggested that during the phasing-out period, recoupment should not mean "recovery of wavered taxation" but should mean the "inclusion of previously excluded amounts". The phasing-out period should be 36 months, as it would allow the SBU to stabilise its cash flow.

RECOMMENDATIONS OF JSCOF:

The JSCOF expressed its concern at the Commission's seeming lack of progress and co-ordination with the Department of Trade and Industry on this all-important provision. While recognising that the establishment of a vibrant SMME sector is not simply tax-driven, no substantive tax proposals were forthcoming in the Report. It would seem that policy proposals are in place, but that an enabling environment, including tax provisions, have not been addressed.

Furthermore, utilising a targeted and segmented approach, instruments should be created to draw more businesses into the taxation system. A complementary framework both inside and outside the tax system needs to be created.

The Commission's recommendations are broadly supported. However, the JSCOF further recommends that:

the qualifying criteria for a Small Business Unit be considered where those corporations have only natural persons as members; the problem of definition be resolved. The definition and criteria used needs to be further examined to ensure harmony of framework with the DTI; the definition of a small business enterprise as proposed be reconsidered in the light of information from the CIR that 84% of all VAT registered taxpayers could qualify, at a ceiling of R2m turnover per annum. the legislative framework to enable a cash basis of taxation be drafted and enacted as a priority; and ways to address the costs of compliance experienced by small business be found.

16. VALUE ADDED TAX IN RESPECT OF FINANCIAL SERVICES - CHAPTER 14

RECOMMENDATIONS OF THE KATZ REPORT

14.4.1) The Commission adopts the recommendation that section 2(1) of the VAT Act, 1991, should be narrowed as set out in paragraph 8.7.2(a)-(d) of the Sub-Committee's Report, which appears in this Report as Appendix C, thereby bringing into the VAT the following:

- (a) all fee based financial services;
- (b) all fee based services in respect of life insurance and other superannuation funds.

14.4.2) Whereas the Sub-Committee recommended in paragraph 8.7.2(e) that the financial services levy be retained for the life insurance and pension industry and be removed for banks and other financial institutions, the Commission recommends that the financial services levy be abolished.

14.4.3) The Commission adopts the recommendation by the Sub-Committee made in paragraph 9.1.4 of its Report that a specialist team at the office of the Commissioner for Inland Revenue be established to investigate the adoption of a more refined definition of financial services. The Commission also supports the publication of a detailed practice note following consultation with the Council of Southern African Bankers, the Life Office Association and the Fund Managers' Association of South Africa and other players.

14.4.4) The Commission adopts the recommendation that a definition of a basis of apportionment should receive the urgent attention of the office of the Commissioner for Inland Revenue, as outlined in more detail in paragraph 9.2.10 of the Sub-Committee's Report.

14.4.5) The Commission adopts the recommendation made in paragraph 9.3.4 of the Sub-Committee's Report that self-supply rules whereby specified supplies and functions are valued at market prices and are deemed to be supplied by institutions to themselves, should not be introduced.

14.4.6) The Commission recommends that, regardless of whether a system of group income taxation be introduced or not, VAT grouping provisions should not be implemented mainly due to the complexity of such a system. In contrast, the Sub-Committee, in paragraph 9.4.7 of its Report, recommended in favour of VAT grouping, should group income taxation be introduced.

PUBLIC SUBMISSIONS OF THE KATZ REPORT:

The general tenor of the submissions received was in favour of the Katz recommendations. However,

support for the scrapping of the Financial Services Levy was called for in most submissions received. Other proposals urged great care in the adoption of a more refined definition of financial services. It was suggested that wide consultation take place when making this decision. The need for the Government to give greater attention to the issue of poverty alleviation through the expenditure side of the budget was mentioned. The final point raised was the need to maintain the status quo in the retirement industry in the light of the Katz Commissions proposals regarding this chapter.

RECOMMENDATIONS OF JSCOF:

The JSCOF is in support of the recommendations made by the Commission, and draws attention to the recommendation that a definition of a basis for apportionment should receive the urgent attention of the Commissioner for Inland Revenue.

There is no rationale for the tax exemption many financial services currently enjoy, such as bank charges provided by banks and other institutions. In this regard, the Minister of Finance should consider the appendix 8(A) contained in the Commission's Report for the forthcoming Budget.

17. TAX ON GAMBLING - CHAPTER 15

RECOMMENDATIONS OF THE KATZ REPORT:

Income Tax

18.101 Operators: The normal income tax principles should be applied to all gambling and casino operations. 18.102 Gamblers: The normal income tax principles should be applied to the winnings of gamblers. 18.103 lotteries: The normal income tax principles should be applicable to operators of lotteries, with the sole exception of the National Lottery which would be exempt from income tax.

Value Added Tax

18.104 All gambling, casino and lottery activities, with the exception of the National Lottery, should be subject to VAT. 18.105 The National Lottery should be treated in the same manner as Government Departments, in that the inputs be subject to VAT but no output VAT be charged. 18.106 The normal R150 000 annual threshold should be applicable in respect of small lotteries.

Other Taxes

18.107 The foregoing recommendations do not detract from the Constitutional right enjoyed by the provinces to impose certain taxes on the industry.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

All submissions endorsed normal tax principles for gambling operators. However, they strongly disagreed with recommendations to impose VAT, and this question formed the core of the submissions. Many raised the constitutional provision enabling provinces to impose tax on gambling excluding VAT, and argued that if VAT were imposed it would make such a provision illusory, crowding out provincial rights. Others argued

that the uncertainty around taxation was deterring investment; VAT plus a provincial tax would over-tax the industry and result in its downscaling; high taxation would force gambling underground; the Katz proposal would impose a dual tax on the same revenue base; legalised gambling was an incentive to provinces and would result in investment in hotels, conference centres and other tourist facilities enhancing provincial revenue and significant job creation; substantial investments were required; if VAT was imposed the tax base was not certain as the provinces had no control over its increase; if VAT was imposed it should be transferred to the provinces from which it was collected; not only does the fiscus receive nothing from the illegal gambling that currently prevails, but such illegality significantly contributes to criminal activity including drug smuggling.

RECOMMENDATIONS OF THE JSCOF:

The JSCOP noted that the submissions and presentations were all from parties or organisations with a vested interest in gambling. The common thread, whether from the provincial ministers or the industry, was a call for a decision.

The JSCOF supports the Katz recommendations. Many arguments were put forward for gambling to be VAT exempt. However, in recommending against such an exemption the JSCOF considered that this would have serious implications for tax abridge and disputes could well arise about where casinos operate given that many establish complexes that include hotels, shopping malls etc.

The JSCOF therefore recommends that:

the tax structure must take account of the gambling industry's structure and careful attention needs to be paid to the proposed legislation; the provincial authorities, together with the law enforcement agencies and the CIR, need to ensure appropriate action against illegal gambling; all gambling, casino and lottery activities, barring the National Lottery, be subject to VAT provided that the VAT so collected be transferred to the province from which it was raised; the provinces impose their own levy over and above VAT, which in essence is an economic rent for the licence provided; horizontal equity be dealt with in the broader provincial allocations, and that the FFC's views be obtained; investigation be undertaken as to how local or district government can share in the revenue generated from gambling, casinos and lotteries operating within their jurisdiction; recommendations made by the Standing Committee on Gambling be taken into account, including on the impact of gambling on low income households and the potential revenue base of provinces.

18. EMPLOYEE SHARE OWNERSHIP - CHAPTER 16

RECOMMENDATIONS OF THE KATZ REPORT

Tax Treatment of Share Gains 18.108 In the case of employee share purchase schemes (where the employee is at risk), save where the employee is a dealer in securities (as determined by reference to ordinary income tax principles), any gain made by the employee on scheme shares should be treated as a capital gain. This principle should be confirmed in an appropriate practice note.

Fringe Benefits Tax in respect of Loans in respect of Share Purchase Schemes

18.109 In employee share purchase schemes which have the features set out hereunder, although the fringe benefits tax provisions of the Seventh Schedule will continue to apply in respect of loans granted in terms of such schemes, the employees should be permitted to elect to pay the fringe benefits tax due either on the current basis or on the earlier of the expiration of five years as from the date of the granting of the loan or when the shares are resold. Interest should accumulate at the stipulated rate on the liability to pay fringe benefits tax from the date on which it arose in terms of the Seventh Schedule until the payment of the fringe benefits tax. As a matter of administration there should be an obligation on the employer to keep records of the amount of fringe benefits tax payable by the employee as well as the interest thereon. If the employee fails to pay such tax then the employer should be liable for such tax.

18.110 The concession proposed above should apply to employee share purchase schemes with the following features:

- a) the benefits of the scheme should not be limited to senior executives but should be available to all permanent employees;
- b) provisions should be made for the voluntary sale of an employee's shares on leaving the company; and
- c) the scheme should be approved by the Commission for Inland Revenue.

PUBLIC SUBMISSIONS ON THE KATZ REPORT

The submissions stated that the Commission had not proposed any real incentives or relief measures, apart from a deferral of the fringe benefits tax on soft loans advanced to participating employees under the share purchase trust scheme. It was felt that for this to be meaningful, it would have to provide that such deferred fringe benefits tax would only be payable when the shares in

question are realised and to the extent that the employee derives a gain on their realisation. If the actual surplus on sale of the shares is less than the deferred fringe benefits tax the employees tax liability should be limited to such surplus. Some did not support the sale of share purchase scheme shares by the employees and the taxation of the gain.

Some submissions believed it unfair to make the employer liable for the tax if the employee fails to pay the tax although a right of recovery is granted to the employer. This is merely shifting the burden of tax administration onto business instead of the Revenue authorities. Where this option is to be granted to a taxpayer the Revenue authorities should satisfy themselves that the tax will be paid by the employee before granting such concession.

It is very difficult administratively to account for fringe benefits tax. The tax deferral magnifies the administrative problem. One alternative would be to institute a minimum threshold below which fringe benefits tax would not be levied.

Some argued that employee share ownership schemes should be tax exempt. Given the low wage rates for the majority of workers, the conversion of wage increases into shares does not appear to be a viable option. The extension of employee capital ownership and control can be more effective through pension fund acquisitions. The advantages of such schemes over Employee Share Ownership Schemes are:

* collective ownership of significant blocks of capital which translates into some degree of effective control;

individual employee risks associated with the spread of capital ownership is minimised; ability to trade-off real wage increases now for retirement income, and - increases in the rate of savings. The importance of this matter extends beyond simple tax issues:

A number of important issues were raised in public hearings, these included:

- * a portion of shares to be included as part of a retirement/pension programme;
- * support for the 5 year deferred tax scheme on the sale of shares;
- * recommendation that all employees participate in the schemes, where the distribution of the shares are done - equally; or proportionate to salary; or proportionate to length of service; or a combination of the aforementioned; this is a manner to decrease concentration of the JSE and achieve a real unbundling of companies; criticism that the report does not recognise the factors that allow employees to buy shares and gain control. In connection with this, it was said that ESOPs need to be placed on an equal footing with other benefit plans; and employees must have certain rights e.g., rights to information and secret voting; and - tax benefits that encourage sole proprietors or business firms without succession plans to sell the enterprise to employees.

RECOMMENDATIONS OF THE JSCOF:

The JSCOF noted the concerns of the proponents of ESOPS, namely:

- * that the Katz recommendations would not in fact remove, as claimed, tax disincentives to employees; and that international experience suggested that tax incentives for employers, while not the only factor, was a critical element in promoting such arrangements.

The recommendations and public comment clearly indicate the need for further investigation, consultation and discussion with both business and labour on the principle of employee share ownership schemes prior to any decision being made. Any such decision will, of course, depend on the priority attached to promoting such schemes weighed against other priorities.

19. MISCELLANEOUS - CHAPTER 17

RECOMMENDATIONS OF THE KATZ REPORT:

Incentives for personal saving:

The Commission remains convinced that the provision of tax incentives for personal saving would do little more than result in a redirection of personal saving between the various instruments and vehicles that are available and call for a higher rate of personal tax to finance the incentives, which would reduce after-tax income out of which savings have to be made.

PUBLIC SUBMISSIONS ON THE KATZ REPORT:

The overall impression from submissions received on this topic indicate a general dissatisfaction with the

lack of recommendations on this topic.

Marketable Securities Tax:

KATZ'S RECOMMENDATIONS:

17.4.1 The commission reiterates the recommendation in its first report that the marketable securities tax should be abolished, together with the various stamp duties on share transactions.

PUBLIC SUBMISSIONS:

The submissions strongly supported this recommendation with many arguing that it was essential to bring the JSE into line with other top exchanges and give South Africa a competitive edge.

Taxpayer education:

KATZ'S RECOMMENDATIONS:

17.4.2 Initiatives to provide taxpayer education and to make local revenue offices more accessible to taxpayers are urgently needed.

PUBLIC SUBMISSIONS:

Submissions indicate a general plea from the working class for tax department representatives to explain PAYE and how much should be deducted from their wages, ~1 assist with claims in respect of SITE, especially for part time seasonal workers. All submissions recognised the importance of this matter.

RECOMMENDATIONS OF THE JSCOF:

Incentives to Encourage Personal Savings

We cannot agree with the Commission's comment that incentives for personal saving could only be financed by a higher rate of personal tax, when incentives are granted for contractual savings. In view of the very low level of personal saving incentives to encourage personal discretionary saving should be investigated.

Marketable Securities Tax

The recommendation to abolish MST and stamp duties made by the Commission needs to be informed by the following points: The impact on the restructured JSE particularly with regard to settlement systems, rolling settlement, the establishment of a central depository and an electronic scrip register as well as on financial security; evidence arising from recent international swap transactions that if the rate is too high when compared internationally a real danger exists that traders move their business to other international markets; The discrepancy in that these taxes apply to the JSE, and not the bond or derivatives market; that the body of evidence and recommendations of previous inquiries is to abolish MST and Stamp Duty, and that the decision is dependent on revenue needs

The JSCOF therefore recommends:

* that the timing of this decision be determined by budgetary constraints.

Taxpayer Education

The recommendation is fully supported. However, the JSCOF expresses its concern at the inadequate efforts in this regard to date. We recommend that:

* the CIR, together with the Department of Finance, should ensure that a specialised communications team be established, working with representatives of bodies such as Nafcoc (particularly through its provincial structures, Fabcos, Abasa etc., to ensure an effective information and advice programme is in place as soon as possible; the new SARS should assume responsibility once it is established.