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Honourable Mkhacani Joseph Mswanganyi, MP
Chairperson: Standing Committee on Finance
Parliament of South Africa

Dear Honourable Maswanganyi

SUBMISSION ON TAXATION AMENDMENT BILLS AND OTHER NATIONAL BUDGET MATTERS

Thank you for the opportunity to comment and make submissions with respect to the 2020 Draft Tax Laws Amendment Bills, and certain other matters relating to the 2020/21 National Budget. Below is the BATSA submission to your invitation.

Yours faithfully,
For and on Behalf of **British American Tobacco South Africa**



Johnny Moloto
HEAD OF GOVERNMENT AFFAIRS

EXECUTIVE SUMMARY

The COVID-19 pandemic has transformed global markets in a significant manner. In South Africa particularly, the extraordinary ban on the sale of tobacco products, lasting almost five months, has consolidated the Duty Not Paid (DNP) cigarette market at the same time seriously undermining the Duty Paid (DP) cigarette market.

According to an independent study by the Research Unit on the Economics of Excisable Products (University of Cape Town), the DNP cigarettes market grew by an unprecedented 104% during the lockdown period. The study concludes that the most popular cigarette brand in the legal DP segment, namely Peter Stuyvesant, plummeted by over 54%. It is estimated that excise revenues for the current fiscal year will fall by 32% whilst R 13.7 billion in excise revenue will be lost to the DNP market. A lot of illicit products currently sit in the market and have since the ban been selling at pre-sales ban low prices that clearly could not have paid excise duties. What is more concerning is that the ban allowed the development of strong and sophisticated transborder criminal networks of illicit players. The market has been almost completely taken over by criminal syndicates.

The Commissioner of SARS, Mr Kieswetter, pointed out at the Tax Indaba held in September 2020 that: *“Criminal networks of tobacco smugglers that were created following the Government’s temporary ban on tobacco sales “are now embedded in the supply chain and it will take us years to reverse the impact.”*

A deliberate cigarette excise framework should therefore be adopted to assist in reversing the undesirable consequences of illicit cigarette trading by allowing the legal market to recapture lost volumes and thereby grow Government excise revenues going forward. A siloed approach where illicit trade in cigarettes is viewed solely as an enforcement issue that is insulated from excise policy dynamics is improper. High prices of cigarettes aid and abate the growth of the DNP particularly in markets where affordability is an issue. This puts pressure on the already overstretched resources of the law enforcement agencies and ultimately further erodes excise revenues.

Excise Proposal

Our recommendations are as follows:

- **Tariff code 2402.2 Cigarette Containing Tobacco:** We propose that government implements an excise freeze (R870/1000 sticks) on factory manufactured cigarettes to allow consumers to afford legal cigarettes and reconfigure the market post the ban. We forecast that that legal volumes will grow by 5.8 billion sticks in 2021. Excise revenues will consequently grow by R 2.5 billion in 2021 compared to 2020 if this approach is accepted. Thereafter excise may be increased in line with inflation.
- We further urge government to adhere to its own policy on tobacco products that aims for a 40% excise incidence based on the Most Popular Price Category (MPPC). Historically, National Treasury forecasts for local cigarette revenue collection have consistently missed targets, the exception being fiscal year 2018/2019 when DP manufacturers did not pass on excise to assist in resolving consumer affordability challenges. However, the growth in illicit cigarette trade continues to supersede revenue. The main driver of the revenue fall lies in the increase in the cost base of duty paying products as a result of excise increases above the target incidence of 40% (currently excise incidence sit at 41.4%), and the overestimation of the market dynamics.
- **Tariff code 2403.91 “Homogenized” or “reconstituted” tobacco:** (Tobacco Heat Sticks). Tobacco heat sticks are tobacco products. THP contain tobacco and should therefore taxed in the same way as factory manufactured cigarettes. In the 2020/21 Budget Government

announced the taxation of tobacco sticks at a rate equal to **75% of excise on cigarettes**. And the announcement as made based on the similarity to cigarettes, both categories are sold in packs of 20 sticks. The tobacco heat stick is manufactured in the same way as cigarettes and ready for consumption without an effort to create a consumable stick as is necessary for loose tobacco. However, in the implementation of this proposal, there was a shift in calculation to loose tobacco weight measure which we want to propose that National Treasury should correct as part of the current consultation process. In the 2020 Draft Rates Bill, National Treasury converted the excise into weight measurements when in actual fact cigarette excise is charged per stick at the rate of R 870/mille and not based on the weight of the stick

The effect of this calculation shift is that heat sticks are levied excise which is equal to **28% of cigarettes** (R244.50/1000 heat sticks), The outcome is not aligned to the legislative intent of achieving 75% index of cigarette for tobacco heat sticks. The excise incidence on tobacco heat sticks MPPC (R39/20sticks) is only 12.5% (R4.89/20 divided by R39 and multiplied with 100).

The outcome is not aligned to the legislative intent of achieving 75% index of cigarette on tobacco heat sticks and will lead to Government losing millions of Rands in excise opportunities in this growing category.

The 2020 Draft Rates Bill should be amended by the creation of a new subcategory for tobacco heat sticks and the excise thereon adjusted to R652.50/1000 tobacco sticks (75% index to cigarette excise) on tobacco heated products, as per the legislative intent announced by the Minister.

- **Pipe Tobacco – HS Code 2403.19** The excise on pipe tobacco constitutes 21% of the excise payable on factory manufactured cigarettes. The excise incidence on pipe tobacco is 27% compared to an excise incidence of 41.4% on factory manufactured cigarettes. In line with the risk continuum argument, the excise on pipe tobacco should be increased to the same level of manufactured cigarettes, ZAR 1087.50 per kg. This is another opportunity for government to collect more tax revenue.
- **Enforcement against illicit trade.** Raising excise alone will not effectively deal with illicit trade. In order for our excise framework to achieve the desired objectives it should be supported by robust end to end enforcement at factory and retail levels. Government should ratify and implement the WHO FCTC Illicit Trade Protocol in line with Government's commitment in 2020. The protocol is a useful tool – at world class level to secure the supply chain and counter transborder illicit trade. As part of the SA cigarette industry, we remain committed and open to work with law enforcement agencies to eradicate the scourge of illicit cigarettes in South Africa.

COMMENTARY ON THE TAXATION AMENDMENT BILLS AND OTHER NATIONAL BUDGET MATTERS

1 Excise Rates on Factory Manufactured Cigarettes – HS Code 2402.20 “Cigarettes containing tobacco”

The COVID-19 pandemic has transformed global markets in a significant manner. In South Africa particularly, the extraordinary five months ban on the sale of tobacco products has consolidated the Duty Not Paid (DNP) cigarette market at the same time seriously undermining the Duty Paid (DP) cigarette market.

According to an independent study by the Research Unit on the Economics of Excisable Products (University of Cape Town), the DNP cigarettes market grew by an unprecedented 104% during the lockdown period. The study concludes that the most popular brand in the legal DP segment, namely Peter Stuyvesant, plummeted by over 54%. It is estimated that excise revenues for the current fiscal year will fall by 32% whilst ZAR 13.7 billion in excise revenue will be lost to the DNP market. The tables below illustrate the extent of the problem.

Pre Lockdown Brand Share	
Brand	%
Peter Stuyvesant	21.35
Courtleigh	12.79
Marlboro	9.22
Pall Mall	8.51
Camel	6.73
Dunhill	5.66
Rothmans	4.08
RG	3.9
Chesterfield	2.72
Benson & Hedges	2.28
Other	22.73

Exit Lockdown Brand Share	
Brand	%
Sharp	11.91
RG	10.16
Peter Stuyvesant	9.72
Caesar	8.14
Marlboro	6.87
Courtleigh	6.38
JFK	3.36
Camel	3.12
Savannah	2.79
Remington Gold	2.55
Other	34.98

Research Unit on the Economics of Excisable Products (University of Cape Town) “Smoking and Quitting Behavior During Lockdown in South Africa: Results from the Second Survey” (21 July 2020).

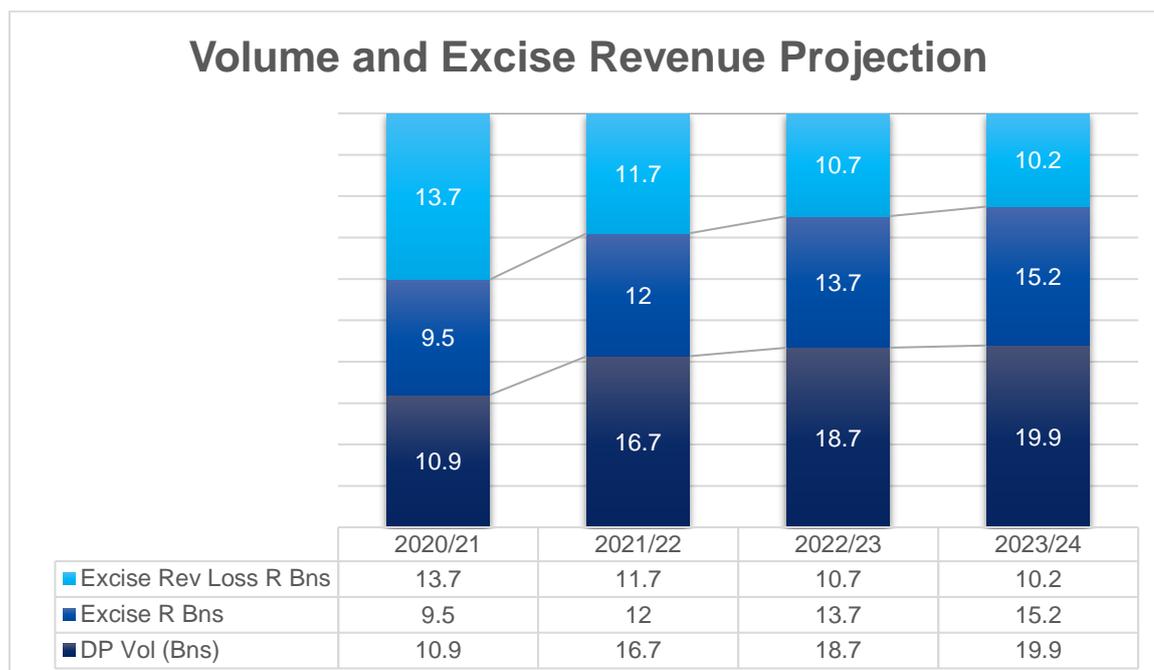
It is common cause that a significant portion of the smuggled cigarette stock that was acquired during the lockdown still sits in the market and sells below the excise value of legal cigarettes. More importantly, new and sophisticated trends of cigarette smuggling have been developed during the lockdown, making it harder for law enforcement agencies to effectively root out illicit trade in cigarettes going forward. This is all happening in the context of a record weak consumer affordability crisis in South Africa.

A deliberate cigarette excise framework should therefore be adopted to assist in reversing the undesirable consequences of illicit cigarette trading by allowing the legal market to recapture lost volumes and thereby grow Government excise revenues going forward. A siloed approach where illicit trade in cigarettes is viewed solely as an enforcement issue that is insulated from excise policy dynamics is improper. High prices of cigarettes aid and abate the growth of the DNP particularly in markets where affordability is an issue. This puts pressure on the already overstretched resources of the law enforcement agencies and ultimately further erodes excise revenues.

We therefore recommend an excise freeze at ZAR 870 per 1000 cigarettes on cigarettes containing tobacco for the 2021/22 financial year and inflation adjusted increases for the 2022/3 and 2023/4 financial years respectively. With this approach, DP cigarette volume is estimated to recover by 5.8 billion sticks, whilst Government excise revenue will grow by ZAR 2.5 billion with respect to the 2021/2 fiscal year.

For the fiscal years 2022/3 and 2023/4, DP cigarette volume is estimated to further recover by 12% and 6.4% respectively consequently growing excise revenues by 14.2% and 10.9% respectively. The table below illustrates our estimates with respect of volume and excise revenue collection.

The sale of 1 billion illegal cigarette sticks on the market represents R 870 million losses in excise revenue. After the sales ban which resulted in an unintended rapid growth in the illicit market, we are recommending that effort be put behind getting back volume in duty paid market and not to add additional excise burdens on the DP market.



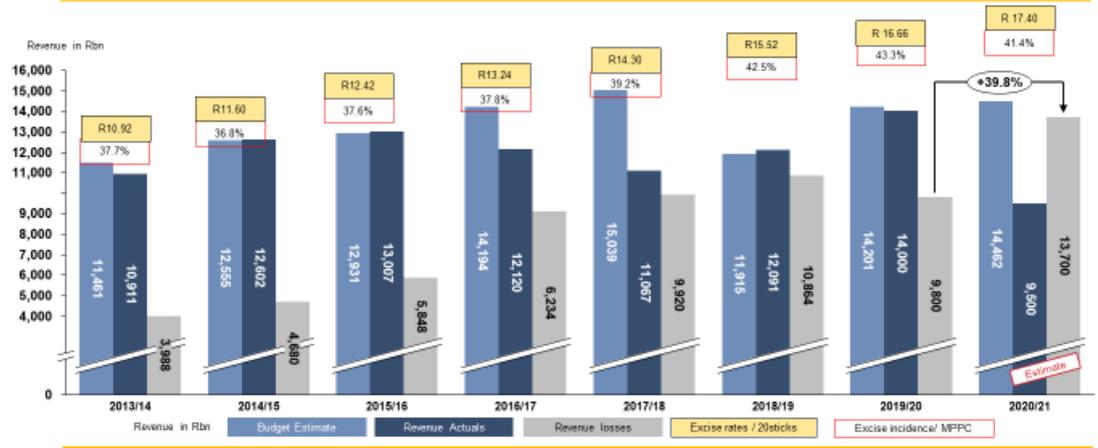
British American Tobacco South Africa Estimates (for local manufactures and importers)

40% Incidence on MPPC Policy on Cigarette Excise

Historically, National Treasury forecasts for local cigarette revenue collection have consistently missed targets, the exception being fiscal year 2018/2019 when DP manufacturers did not pass on excise to assist in resolving consumer affordability challenges. However, the growth in illicit cigarette trade continues to supersede revenue. The main driver of the revenue fall lies in the increase in the cost base of duty paying products as a result of excise increases above the target incidence of 40% (currently excise incidence sit at 41.4%), and the overestimation of the market dynamics. The table below illustrates the above points.

ILLICIT TRADE REVENUES INCREASED BY 39.8% DURING PROHIBITION

SIGNIFICANT VOLUME LOSSES DRIVEN BY PROHIBITION WILL DELIVER THE LOWEST REVENUE COLLECTION IN 12 YEARS*
POST PROHIBITION, DNP GROWTH WILL CONTINUE TO BENEFIT FROM OVER PROPORTIONAL EXCISE STRETCH ABOVE 40% POLICY



- 2018/19, Duty paid manufactures absorbed excise increase and enforcement activities started in the end of the budget year
- Budget 2007/08 Treasury collected R7,7 billion in excise revenues, off a smaller
- 40% excise incidence on MPPC policy is out of balance and additional driver for DNP growth

Sources: National Treasury local excise collections, Historic Budget Estimates vs Actual collections YoY 2013/14 – 2018 /19; MPPC on Peter Stuyvesant

Given the devastating impact of COVID 19 on consumer affordability generally, there is a stronger imperative for Government to get back to the 40% excise incidence on Most Popular Price Category (MPPC) policy by freezing the excise rate with respect to the 2021/22 financial year and thereafter, adopting gradual increases typically in line with inflation.

Our suggested approach is also in line with the Government's broad endeavor to provide the market with regulatory certainty and policy consistency. Maintaining an excise incidence of 40% on MPPC is a policy that was communicated by Government and therefore creates a legitimate expectation amongst affected stakeholders.

2 Opportunities to Grow Revenues and Balance “the Category”

2.1 Excise on Tobacco Heat Sticks

Tobacco Heated Products (THPs) are tobacco products. THPs heat tobacco rather than combust it to produce a nicotine-containing aerosol. THPs are different to electronic cigarettes which do not contain tobacco. There are several types of THPs across a range of countries however, the common feature amongst all THPs remains that they heat tobacco and do not combust it.

In the 2020/21 National Budget (“the Budget Statement”), the Honourable Minister of Finance introduced excise on THPs in the following manner;

“Taxation of heated tobacco products

*Heated tobacco products produce aerosols containing addictive substances and other chemicals that are inhaled by users. These products are not currently subject to excise duty. **Government will introduce a new category or tariff subheading for heated tobacco products in the schedule of excise duties, to be taxed at a rate of 75 per cent of the cigarette excise rate with immediate effect [our emphasis].**” - Page 43*

Notwithstanding the above, as we understand it, the excise on THPs was implemented by applying the excise duty rates indicated in terms of tariff item 104.35.11 and 104.35.13 of R 815.63/kg (which is an extrapolation of 75% of weight based excise on cigarettes i.e. R 1087.50) relating to goods classified in terms of tariff headings 2403.91.10 and 2403.91.90 to THPs (“the Weight Based Calculation”). The fallacy of the Weight Based Calculation is obvious – cigarette excise is charged per stick at the rate of R 870/mille and not based on the weight of the stick. The use of the Weight Based Calculation measure results in tobacco heat sticks being exigible for excise at an effective rate of R 4.89 per thousand sticks which translates to only 28% of the actual cigarette excise instead of 75% of the cigarette excise as proposed by the Minister in the Budget Statement, representing a remarkable loss of revenue to Government.

Under the Weight Based Calculation, the absolute excise incidence on tobacco heat sticks is just 12.5% compared to an excise incidence of 41.4% on factory manufactured cigarettes yet both products are finished tobacco products with largely similar characteristics.

The wording in the Honourable Minister’s Budget Statement referred to above stipulates that a new category or tariff subheading will be introduced to the Schedule No. 1 Part 1 and Part 2A to the Customs and Excise Act (Act 91 of 1964). A specific excise based on the current system on taxing excise on cigarettes would then be applied equal to 75% of the current excise on cigarettes (ZAR 870 per 1000 sticks). The excise on THPs should therefore be **ZAR 652.50 per 1000** tobacco heat sticks instead of ZAR 244.50 per 1000 heat stick that is yielded using the Weight Based Calculation.

We therefore recommend that the excise on THPs be adjusted to 75% of the excise per factory manufactured cigarettes which translate to ZAR 652.50 per 1000 heat tobacco sticks. This approach is aligned to the legislative intent pronounced in the Ministers’ Budget Statement.

We further recommend that a separate subcategory specific for tobacco heat sticks should be introduced under sub heading HS code 2403.91 in schedule No.1 , Part 1 and Part 2A of the Customs and Excise Act (Act 91 of 1964) to give effect to the foregoing.

2.2. Pipe Tobacco – HS Code 2403.19

The excise on pipe tobacco constitutes 21% of the excise payable on factory manufactured cigarettes. The excise incidence on pipe tobacco is 27% compared to an excise incidence of 41.4% on factory manufactured cigarettes. In line with the risk continuum argument on cigarettes, the excise on pipe tobacco should be increased to the same level of manufactured cigarettes, ZAR 1087.50 per kg.

3 **Enforcement and administrative framework**

Below, we recommend short-term (which will translate into “quick wins’ for National Treasury), medium-term and long-term enforcement interventions in the tobacco industry to ensure sustainable revenue collections and to safeguard long terms revenue objectives for the fiscus.

Intervention	Short Term	Medium Term	Long Term
WHO FCTC Illicit Trade Protocol	<i>Ratification of the WHO FCTC Illicit Trade Protocol</i>	<i>Domestication of the Protocol</i>	<i>Review domestication in line with global standards</i>
Factory Controls	<i>Volume Production Verification (Production Counters), Customs Presence, Enforcement of Export Requirements Legislative increase of illicit activity penalties upon conviction to R50,000,000 or 10 years imprisonment</i>	<i>Digital Verification Active Off-site CCTV monitoring Unique code sealing of exports SARS trackers in export packaging</i>	<i>Track and trace to first economic partner SACU alignment on single approach on Track and Trace technology</i>
Wholesale enforcement	<i>Consistent checks of prices below economic viable point (R25) Legislative increase of illicit activity penalties upon conviction to R50,000,000 or 10 years imprisonment</i>	<i>Auditing of wholesaler books for major distributors and wholesalers for compliance with VAT Act and C&E Act</i>	<i>Sales tracking to client post Track and Trace delivery as first economic actor. Implement Know Your Customer Principals to extend liability between wholesaler and retailer noncompliance</i>
Retail enforcement	<i>Consistent checks of prices below economic viable point (R25) Legislative increase of illicit activity penalties upon conviction to R50,000,000 or 10 years imprisonment</i>	<i>Enforce compliance of the VAT Act for invoicing Enforce compliance with WCO provisions on GS1 usage</i>	
Strengthen border controls	<i>Acquisition and use of scanner for high risk points of entry Implement SADC guidelines on information sharing on excisable goods movement</i>	<i>Define fix entry/exit points for all tobacco related products + power of destruction set in Excise law</i>	
End to end reconciliation	<i>Leaf imports and exports audits tracking to customer delivery Legislative increase of illicit activity penalties upon conviction to R50,000,000 or 10 years imprisonment</i>	<i>Audit movement of all tobacco related raw material and finished good</i>	<i>Implement Blockchain as a holistic solution.</i>
Forensic Laboratory	<i>Supports product enforcement, identification and prosecution for Counterfeit or DNP</i>	<i>Align Global databases for a singular view of illicit and counterfeit registry</i>	
Enforcement Training	<i>Strengthen capabilities of seizures and prosecution Legislative increase of illicit activity penalties upon conviction to R50,000,000 or 10 years imprisonment</i>	<i>MoU with D.o.H to enforce TPCA provisions MoU with SAPS to extend enforcement resources</i>	

Enforcement is a critical lever in recapturing the volumes lost to illicit trade thereby growing Government revenue year-on-year.

4 **Conclusion**

The summary of our proposals and recommendation is as follows:

Fiscal Framework Recommendations

- **Tariff code 2402.2 Cigarette Containing Tobacco:** An excise freeze (R870/1000 sticks) on cigarettes is needed to allow consumers to afford legal cigarettes and reconfigure the market post the ban. It is assumed that legal volumes will grow by 5.8 billion sticks in 2021. Excise revenues will consequently grow by R 2.5 billion compared to current year if this approach is accepted.
- **Tariff code 2403.91 “Homogenised” or “reconstituted” tobacco:** Create a new subcategory for tobacco heat sticks and adjust the excise to R652.50/1000 tobacco sticks (75% index to cigarette excise) on tobacco heated products, as per the legislative intent announced by the Minister. Currently excise incidence on THPs is only 12.5%.The index to factory manufactured cigarettes is 28% instead of 75%.
- **Tariff Code 2403.19 Pipe tobacco** Increase excise on pipe tobacco to R1087.50 /Kg (Current Cigarette rate of R870 converted with 0.8g tobacco/stick = 100% of excise incidence of cigarettes). Currently 21% index.

The excise framework should be supported by robust enforcement.

We trust you will find the above in order and we look forward for an opportunity to further engage with yourselves with respect to the above.