



SOUTH AFRICAN INSTITUTE OF TAX PRACTITIONERS

25 February 2008

Mr N Nene  
Chairman: Portfolio Committee on Finance  
Parliament  
P O Box 15  
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Dear Sir

#### **CALL FOR COMMENT: 2008 BUDGET**

We refer to your letter dated 14 February 2008 inviting our comments on the 2008 Budget. Our comments are set out hereunder.

#### **General Remarks**

We congratulate the Minister for a well-balanced budget that will instill confidence in the face of the economic challenges facing our country and the wider global community.

We would like to take this opportunity to thank you and your Committee for the invitation to participate in the 2008 Budget Hearings.

#### **1. PROPOSED CHANGES TO CORPORATE INCOME TAX RATE**

- 1.1. The proposal to reduce the corporate income tax rate from 29% to 28% must be welcomed. We do, however, have two comments in this regard:

- 1.1.1. We would suggest that Government should be aiming at reducing the company tax rate to 25%, possibly with a 1% reduction per year over the next three years. This would bring South Africa's company tax rate more in line with international trends, which would in turn increase the attraction of foreign investment.
  - 1.1.2. The proposal to tax closely held "passive" companies at a rate of 40% does raise some concerns, which are discussed in more detail below.
- 1.2. The difficulty foreseen with this proposal is the definition of what constitutes a "passive company" and also what constitutes a "closely held company".
- 1.3. Unfortunately, the Budget Review documentation does not go into detail as to how the legislature will define what constitutes a "passive" company. The rationale for the proposal to subject these types of companies to a rate of 40% is understood in light of the maximum marginal rate applicable to natural persons of 40%, which is also the tax rate applicable to trusts other than special trusts. However, it is unclear whether "passive" companies will still be subject to secondary tax on companies ("STC") on dividend distributions. If this is the case, it would increase the total tax due by such companies to a rate 45.45%, assuming that all after-tax profits are distributed to the shareholder.
- 1.4. It has been proposed that dividends declared to closely held "passive" companies will be subject to the dividend withholding tax. Unless there is exemption from the dividend withholding tax on dividends declared by these companies, dividends flowing through these companies will effectively be taxed twice. This would surely not be intended.
- 1.5. It is also important to consider the rate of capital gains tax ("CGT") payable by passive companies, compared to individuals. If it is the intention to treat passive companies similarly to natural persons, the inclusion rate of capital gains should also be 25%, thereby ensuring that the CGT rate payable by such companies equates the maximum payable by individuals of 10%.

- 1.6. At the time that CGT was introduced, the legislature afforded a concession whereby a taxpayer's primary residence owned by a trust and/or a company, could be transferred to the natural person without fiscal disadvantages. If Government wishes to proceed with the objective of imposing tax on so-called "passive" companies at a rate of 40%, the option should be made available to transfer the assets owned by such entities to natural persons, such that the CGT that would otherwise have been paid on such event, be rolled-over to the natural person, to be paid when they finally sell the asset personally.
- 1.7. In view of the fact that the proposed method of taxing these passive companies represents a fundamental shift in policy, we suggest that shareholders of such companies be given a window of opportunity in which to transfer the passive investments out of these companies and into their own names without incurring transactional taxes, such as transfer duty. A similar type of exemption was inserted into section 9(16) of the Transfer Duty Act in 2002 to allow the tax-free transfer of residential property from companies to individuals.
- 1.8. Further, the legislature will need to consider whether proposal regarding closely held passive companies does not breach the right to equality contained in the Constitution of the Republic of South Africa, Act 108 of 1996 ("the Constitution").

## 2. **SECOND PHASE OF STC REFORMS**

It is noted that the proposed new tax on dividends will remain at 10% and that no withholding tax will be payable in respect of dividends declared on shares held by tax-exempt entities. SARS has previously indicated that it would publish a list of approved public benefit organisations so that the members of the public, making donations to such organisations, can confirm that the organisation in question is, indeed, exempt for tax purposes. The publication of this list will also assist companies in confirming that the public benefit organisation claiming exemption is, indeed, exempt from income tax and the dividend withholding tax.

### 3. RETIREMENT SAVINGS

3.1. Retirement funds have experienced difficulties in dealing with the tax consequences arising out of divorce settlements, required to be made by retirement funds. It is noted that it is proposed that divorce settlement payments made by retirement funds will be taxable in the hands of the non-member's spouse. It is important that the legislation is well drafted to set out exactly how the tax will be paid over and that administrative procedures are in place to correctly deal with this aspect facing the retirement fund industry. As the amendments effected in this regard in the Revenue Laws Amendment Act No. 35 of 2007 were effective from 13 September 2007, we suggest that any further amendments to these provisions should be backdated to the same effective date.

3.2. We are concerned that the capping of contributions by employers and employees may be contradictory to the need to encourage individuals to provide adequately for retirement.

### 4. ON-GOING TAX LEGISLATIVE REFORM

#### 4.1. Broad-based incentive shares

4.1.1. The proposal to review certain restrictions facing companies participating in broad-based incentive share schemes must be welcomed. Unfortunately, the current monetary amount of R9 000 over a period of three years, is not meaningful and does not act as an incentive to employers to participate in broad-based shares incentive arrangements. We suggest that an amount of R30 000 over a three-year period would be more appropriate.

4.1.2. It is important also that certain of the restrictions currently contained in section 8B of the Income Tax Act, Act 58 of 1962, as amended ("the Act"), are reviewed to allow for more flexibility particularly so that employers can allot shares to a trust created for the benefit of employees instead of to employees directly.

## 4.2. Provisional tax system

- 4.2.1. The Budget Review document indicated that the provisional tax system is under review. It is important that Government consults with taxpayers extensively before proceeding to increase the number of provisional tax returns required to be submitted.
- 4.2.2. Currently, the larger proportion of provisional tax returns are probably completed by accounting firms on behalf of their clients, who face extreme pressures because of the submission of income tax returns and provisional tax returns for natural persons and companies. It will be necessary to allow significant time for accounting firms and large groups of companies to modify computer systems and enhance their human resources to comply with the submission of a greater number of provisional tax returns than is currently the case.
- 4.2.3. We suggest that, as part of the review of the provisional tax system, the deadline for making a voluntary payment should be removed. Taxpayers should not be forced to make a topping up payment by a pre-determined date.

## 5. ADMINISTRATIVE PENALTIES

- 5.1. The proposal to move to a more objective penalty system is supported as taxpayers currently have the impression that the level of penalties imposed is inconsistent within local Receiver of Revenue offices and also from one office to another, even though the taxpayer's circumstances may be similar.
- 5.2. Furthermore, as stated on page 22 of the *Budget Tax Proposals*, the current penalty tax regime relating to the imposition and remittance of additional tax and other penalties in the Tax Acts differs from one Act to another, and does not appropriately cater for less serious procedural and administrative non-compliance. It is proposed that the administrative penalty regime be revamped and that a more **objective** penalty system be introduced which

would be administered in accordance with a **defined set of criteria**. This would create more **certainty** for taxpayers.

5.3. It appears that the proposed amendments will only apply to less serious procedural and administrative non-compliance, and would not address the well-know concerns regarding the unfettered and inconsistent application of additional tax pursuant to incorrect or non-disclosure of tax, which may be as much as 200% of the incorrect or non-disclosure of tax, and may involve additional sanctions as well.

5.4. It is also fairly clear that the current system of the remittance or imposition of additional tax and other penalties in the Tax Acts (hereafter the "current additional tax system"):

5.4.1. Differs from Act to Act;

5.4.2. Imposes a maximum penalty of 200% which by far exceeds international best practice. In OECD countries penalties for **minor offences** are in the region of **10 - 30 percent** of the tax evaded while more **serious offences** involving deliberate evasion are in the region of **40 - 75 percent** of the tax evaded<sup>1</sup>;

5.4.3. In respect of the remittance or imposition of additional tax up to a maximum of 200%, undisputedly a potentially harsh penalty, allows for an almost open ended discretion taken by SARS officers;

5.4.4. Is applied inconsistently from branch to branch causing differentiation in treatment of taxpayers in comparable positions;

5.4.5. Is not applied in accordance with a defined set of criteria and is accordingly seldom applied proportionate to the failure in issue; and

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<sup>1</sup> OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series*, 2006

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5.4.6. Causes great uncertainty for taxpayers, which can only have a negative impact on compliance.

5.5. In view of the above factors, the current penalty tax regime potentially infringes upon the right to equality<sup>2</sup> and just administrative action<sup>3</sup> protected in terms of the Bill of Rights and, consequently, does not comply with the requirements imposed by section 7 of the Constitution<sup>4</sup> on all organs of state, i.e. that the state must respect, protect, promote and fulfil the rights in the Bill of Rights.

5.6. There is a clear **lack of certainty** regarding the circumstances in which SARS will exercise its discretion to remit a penalty or to what extent may serve as a basis for a constitutional attack on the validity of the relevant additional tax.

5.7. In this regard the Constitutional Court<sup>5</sup> has struck down certain sections in the Aliens Control Act<sup>6</sup> *inter alia* on the basis of a **wide discretion** given to an official. O'Reagan J held that whenever a discretion is given to an official the grounds on which it has to be exercised have to be laid down by a legislator, and stated:

"There is, however, a difference between requiring a court or tribunal in exercising a discretion to interpret legislation in a manner that is consistent with the Constitution and conferring a broad discretion upon an official, who may be quite untrained in law and constitutional interpretation and expecting that official, in the absence of direct guidance, to exercise the discretion in a manner consistent with the provisions of the Bill of Rights. Officials are often extremely busy and have to respond quickly and efficiently to many requests or applications. The nature of their work does not permit considered reflection on the scope of constitutional rights or the circumstances in which a limitation of such rights is justifiable."<sup>7</sup> (underlining added)

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<sup>2</sup> Section 9 of the 1996 Constitution

<sup>3</sup> Section 33 of the 1996 Constitution

<sup>4</sup> Act No. 108 of 1996

<sup>5</sup> *Dawood and Another v Minister of Home Affairs and Another; Shalabi and Another v Minister of Home Affairs and Another; Thomas and Another v Minister of Home Affairs and Another* 2000 (8) BCLR 837 (CC).

<sup>6</sup> 96 of 1991.

<sup>7</sup> Par 46.

5.8. In the same judgment, it was held that the mere fact that the exercise of a discretion is subject to judicial review does not "relieve the [organ of state] of its constitutional obligation to promote, protect and fulfil the rights entrenched in the Bill of Rights."<sup>8</sup>

5.9. In view of the above, it is clear that the fettering of a wide discretion is not only permitted but **mandated**, within the common law limits, by the Constitution, mostly in order to give effect to -

5.9.1. the **right to equality** (particularly the right to equal protection and benefit of the law, which would include the right to treatment consistent with that of taxpayers in comparable circumstances) - section 9 of the Constitution; and

5.9.2. the **right to just administrative action** (of the person adversely affected by the exercise of the discretion) - section 33 of the Constitution.

5.10. In respect of the right to equality, it is important to note the provisions of subsection (2) of section 9 of the Constitution i.e. -

"(2) Equality includes the full and equal enjoyment of all rights and freedoms. To promote the achievement of equality, legislative and other measures designed to protect...persons, or categories of persons, disadvantaged by unfair discrimination may be taken."

5.11. In essence, the above obliges SARS to promote consistent, impartial and proportionate application of the additional tax in respect of taxpayers in comparable circumstances. In our view, this can only be achieved

5.12. Without such measures, the additional tax provisions cannot be applied consistently and will differ from office to office, which may constitute a basis for an allegation that SARS' ad hoc application of fairly serious provisions, without a clear policy rationale for such ad hoc application, infringes upon the right to equality.

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<sup>8</sup> Par 48.



- 5.13. It is therefore submitted that it is unclear why the additional tax system will not, similarly to administrative non-compliance penalties (for "less serious non-compliance), be revamped to similarly ensure a more **objective** additional tax system administered in accordance with a **defined set of criteria** in order to create more **certainty** for taxpayers regarding the application of the additional tax system.
- 5.14. A revamping of the additional tax system should also incorporate the principles of proportionality, impartiality and consistence
- 5.15. We suggest that reference should be made to the framework for imposing penalties utilised abroad, particularly by the Inland Revenue Department of New Zealand, which prescribes graduated penalties depending on the severity of the offence committed by the taxpayer, ranging from a lower penalty in the case of an innocent omission, to a higher penalty for out-and-out evasion and fraud.
- 5.16. The proposed Tax Administration Act, which has been discussed for a number of years, should be a suitable vehicle for these revised provisions.

## 6. **SIMPLIFIED TAX REGIME FOR VERY SMALL BUSINESSES**

- 6.1. The introduction of the new turnover-based presumptive tax system for businesses with turnover below R1 million is welcomed and it will surely contribute very positively to reducing the tax compliance burden on small businesses.
- 6.2. It is stated on page 5 of SARS' *Budget Tax Proposals* that personal services rendered under employment-like conditions and professional services will be excluded from the new presumptive tax system.
- 6.3. The underlying policy rationale for the above exclusion is "to protect the personal income tax base" as, according to page 33 of SARS' *Budget Tax Proposals*, the new presumptive tax system will result in a loss to the personal income tax base system of R200 million in the 2008/09 fiscal year.

- 6.4. Although not defined, "professional services" would probably apply to, for example, legal, accounting and medical practitioners. It may be assumed that there may be several such recently qualified professionals who, for example, wish to set up practices and in respect of which the small business tax relief in issue might be very useful during the first few years of such practice.
- 6.5. Although it is an elective tax, the result being that the taxpayer in issue would effectively be excluded from the income tax system (including the deduction of expenditure and allowances) as well as the VAT system, it appears that the presumptive tax system will in all probably result in a lower income tax liability. In respect of the VAT system, the professionals described above would normally render "final consumption" services and would thus not necessarily be prejudiced by the inability to claim input tax.
- 6.6. We are concerned that the exclusion of professional services from the scope of the proposed presumptive tax system may constitute unfair discrimination, that is, such a policy may potentially infringe the right to equality contained in section 9 of the 1996 Constitution.
- 6.7. The South African Constitutional Court has held that the right to equality in the Constitution required only that the State should act rationally<sup>9</sup> when making laws which differentiate between different people. It should not regulate in an arbitrary<sup>10</sup> manner or manifest "naked preferences" that serve no legitimate governmental purpose, for that would be inconsistent with the rule of law and the fundamental premises of the constitutional State.
- 6.8. The principle of equality is a fundamental principle of a good tax system<sup>11</sup> and should be applied in developing tax policy, and the legislative objective of any tax differentiation must meet the following criteria:

- 6.8.1. It must be restricted to concerns which are **pressing and substantial** in a free and democratic society;

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<sup>9</sup> **The Pharmaceutical Manufacturers Association of South Africa and another: In re: Ex Parte President of the Republic of South Africa and Others** 2000 (2) SA 674 (CC) at paras 83-85

<sup>10</sup> **New National Party v Government of the Republic of South Africa** 1999 (3) SA 191 (CC) at para 24

<sup>11</sup> Victor Thuronyi, *Tax Law Design and Drafting*, USA: International Monetary Fund, 1996 ed., at 19

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6.8.2. Both the purpose of any unequal tax treatment and the means to effect it must have a **rational basis** (this has been said to promote the need for governmental action to relate to a defensible vision of the public good, as well as to enhance the coherence and integrity of legislation); and

6.8.3. It should not be regulated in an arbitrary manner or manifest 'naked preferences' that serve no legitimate governmental purpose.

6.9. In conclusion, the stated reason for excluding professional services from the small business tax relief does not appear to sufficiently constitute a *rational* policy to avoid a contention that such differentiation constitutes unfair discrimination i.e. potentially infringes the right to equality contained in section 9 of the 1996 Constitution.

## **7. INCREASE IN VAT COMPULSORY REGISTRATION THRESHOLD**

7.1. The increase of the compulsory VAT registration threshold to R1million is welcomed. However, no mention has been made as to whether the R20 000 hurdle for voluntary registrations will be increased.

7.2. We suggest that the R20 000 limit should remain unchanged as an increase in this amount may cause unintended complications. For example, if the limit was increased to R50 000, what would happen to a vendor that was registered on a voluntary basis (with taxable supplies of, say R30 000 per year) but whose taxable supplies now fall below the required threshold: would he be forced to deregister?

## **8. INCREASE IN INTEREST AND TAXABLE DIVIDEND EXEMPTION**

8.1. The increase in the interest and taxable dividend exemption from R18 000 to R19 000 (5.6% increase) for persons under the age of 65 and from R26 000 to R27 500 (5.8% increase) is welcomed, but in our view these increases are not sufficient to encourage individuals save. The percentage increases are below the official inflation rate and also compare unfavourably with the

increases in the primary and secondary rebates which increased by 7% and 7.7%, respectively.

- 8.2. The Reserve Bank has announced that the level of saving by households in 2006 was negative and this is expected to have deteriorated further in 2007. Government's target of halving poverty by 2014 will not be reached without incentives for households to save. We would suggest that the current monetary limits should be substantially increased, particularly for persons over the age of 65. The 5.8% increase in the exemption for this older age group effectively penalizes someone who has saved for their retirement.
- 8.3. We also suggest that foreign dividends should be deemed to be interest, as this would simplify the application of the foreign portion of the basic interest exemption.

## **9. BURSARY EXEMPTION**

- 9.1. As a developing country and particularly in the context of the need to build our skills base, education and training is fundamental. The increase in the tax free portion of bursaries granted by employers to relatives of their employees, from R3 000 to R10 000 per year, is welcomed and appreciated, as is the increase in the remuneration threshold from R60 000 to R100 000.
- 9.2. We suggest that the income threshold could be increased to a much higher level, such as R300 000 to enable more individuals to access this benefit. This is suggested in light of the current skills shortage in South Africa and the fact that education and skills are important in addressing the high unemployment rate and ultimately reducing the number of individuals that are reliant on the Government social welfare system.

## **10. DONATIONS**

The proposal that employers will be required to take section 18A donations into account in determining employees' tax will add a significant administrative burden to employers, yet is unlikely to result in a substantial increase in donations. One must therefore question whether the administrative cost justifies the benefit.

**11. INCIDENTAL USE OF LAPTOPS AND CELLPHONES**

It is proposed that the incidental private use of cellular phones and laptops should not give rise to fringe benefits taxation. Clarity will be needed on how to determine the incidental use of these items and what record-keeping will be required of taxpayers.

We trust that our comments are useful.

Yours sincerely

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