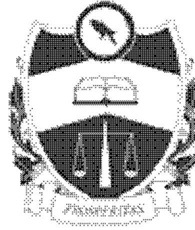

South African Institute of Tax Practitioners

15 August 2008

Mr N Nene
Chairman: Portfolio Committee on Finance
Parliament
P O Box 15
CAPE TOWN
8000

**BY E-MAIL:** ahermans@parliament.gov.za

Dear Sir

**DRAFT REVENUE LAWS AMENDMENT BILLS, 2008**

Set out below please find our comments on Draft Revenue Laws Amendment Bill, 2008 and the Draft Revenue Laws Second Amendment Bill, 2008.

## I. Draft Revenue Laws Amendment Bill, 2008

### 1. Clause 4 - : Insertion of section 25B into Act 45 of 1955

It is questionable whether the business purpose test contained in the proposed section 25B(1)(*b*)(i) is appropriate for estate duty purposes. The concern is that taxpayers will find it impossible to pass the business purpose test and therefore automatically fall foul of the general anti-avoidance provision. Surely this is not the intention of the legislature?

### 2. Clause 6(1)(*b*) - Definition of "contributed tax capital"

The proposed definition appears to deal with how contributed tax capital ("CTC") is to be determined for the future when a company issues new shares. It is unclear how the definition will operate for existing companies. The Bill should clarify how CTC for pre-existing companies is to be arrived at. Are all companies now required to investigate the amounts sitting in share capital to establish what portion thereof constitutes CTC and what part does not?

### 3. Clause 6(1)(*f*) - Definition of "pension fund"

The word "fund" should be inserted after the words "*bona fide*" in the proposed amendment to subparagraph (i) of the proviso to paragraph (*c*).

PO Box 73, Featherbrooke, 1746 Tel: 011 662 2837 info@thesait.co.za www.thesait.org.za

## 4. Clause 11(1)(*a*) and 11(2) – Insertion of section 8C(1A)

The insertion ensures that capital distributions received or accrued by a taxpayer in respect of restricted equity instruments on or after 23 September 2008 will be taken into account in the determination of the taxpayer's gain or loss on the vesting of the instrument. In light of the significant changes made to the taxation of capital distributions with effect from 1 October 2007 (refer the Revenue Laws Amendment Act, 2007), clarity should be provided on how capital distributions in respect of restricted equity instruments received or accrued between 1 October 2007 and 23 September 2008 will be taxed.

## 5. Clause 15(*b*) – Increase in basic exemption for recreational clubs

The increase in the basic exemption from R50 000 to R100 000 is welcomed as it will relieve a number of small clubs from the onerous administrative burden imposed by the partial tax exemption in section 10(1)(*c*O). However, there is incongruence between this exemption and the proposed withholding tax on dividends which we believe is unintended and should be rectified.

Clause 48 of the Draft Revenue Laws Amendment Bill provides under the proposed section 64F that dividends paid to public benefit organisations will be exempt from the dividend withholding tax, but does not mention recreational clubs. If dividends paid to a recreational club are subject to the dividend withholding tax, it is possible that a recreational club will pay 10% tax on dividends received by it; yet its R100 000 exemption may remain unutilised if the club has insufficient other non-exempt income against which to apply the exemption. It will be necessary to provide for either an exemption from the dividend withholding tax in these circumstances or for the recreational club to be refunded for such tax that it would then have overpaid.

## 6. Clause 21 - Insertion of section 12J of the Act

1. Section 12J(5) provides that -

   > "The Commissioner must approve a venture capital company if the company has submitted to the Commissioner a copy of its business plan… "

   It is not clear what the purpose of the business plan is or what it is expected to contain, nor whether the Commissioner will review the business plan as part of the approval process. We submit that this be clearly stated in order to eliminate any possible subjectivity and problems with interpretation in the approval process.

2. Section 12J(5)(iii) requires that the venture capital company must derive its gross income "solely from financial instruments". It is submitted that this requirement is unrealistic as such company may well derive other income, even if only for a small amount, for example in the form of management fees.

3. Section 12J(2) and (3) provide for a deduction up to an amount of R750 000 in respect of expenditure incurred by a natural person in acquiring shares in a venture capital company. It is possible that such a person may also hold shares in a company that meets the requirements to be classified as a "small business corporation" in terms of section 12E(4). Currently, the investment by such a person in a venture capital company will result in the other company losing its status as a small business corporation. This seems to counteract the incentive

intended by the new section 12J (that is, to improve access to equity finance by small and medium-sized businesses and generally stimulate the small business sector of the economy). We suggest that section 12E(4)(*a*)(ii) be expanded to allow the shareholders of a small business corporation to hold shares in a venture capital company as contemplated in section 12J.

## 7. Clause 23(*d*) - Amendment of section 13*quat*

1. The allowances granted under the proposed section 13*quat*(3A) amendment do not appear to be correct as they amount to a total of 113% of the cost of the building. It would seem that subparagraph (ii) should refer to 13 per cent of that **cost** (not const) in each of the **five** (not six) succeeding years of assessment.
2. There appears to be a further typing error in paragraph (*b*) as the current wording does not make sense.

## 8. Clause 25 – Deduction in respect of the sale of certain residential units

One of the requirements for the deduction, as provided for in section 13*sept*(4)(*e*) is that the employee must not pay any interest in respect of the amount owing as a result of the sale. We submit that this requirement is unrealistic, particularly as a fringe benefit will arise in terms of the Seventh Schedule to the Act if no interest is charged on the loan. The Seventh Schedule may need to be amended to synchronise with this provision if it remains.

## 9. Clause 36 – Deductions in respect of environmental conservation and maintenance

1. The proposed wording for section 37C(3) does not read correctly and should be revised.
2. In section 37C(6)(*a*), the word "total" should be inserted before the word "area" (the fourth last word of the sentence) so that the ratio reads: "the same proportion as the area of the land of which the taxpayer does not retain right of use bears to the **total** area of the land".

## 10. Clause 47(*a*) – Amendment of section 64B

The insertion of subparagraph (*l*) provides an exemption from STC for registered very small businesses. The exemption applies to the extent that dividends declared do not exceed R200 000. It should be clarified that the R200 000 limit applies to the aggregate of all dividends declared during a particular year of assessment and not to each dividend declared, as it is possible for a company to make more than one dividend declaration during a particular year.

## 11. Clause 48 – Dividends tax

1. The utilisation of STC credits for only a limited period may cause distortions in the economy as it may force companies to declare dividends that otherwise would not be declared. It is proposed that existing STC credits be allowed for a five year period to allow for a proper phase-in period.
2. Part VIII should require companies that withhold the tax to issue a certificate to shareholders confirming the amount of the dividend and the tax withheld.

## 12. Clause 61 - Paragraph 1 of the Fourth Schedule

The definitions of "labour broker", "personal service company" and "personal service trust" are to be replaced by a new definition of "personal service provider". Paragraph (*a*) of the proposed

definition of "personal service provider" refers to a person who renders services to a client "by that person personally", which means that independent contractors are included in this definition. (The Explanatory Memorandum confirms that the term "personal service provider" also encompasses independent contractors.) A number of problems arise with including independent contractors in this definition, which are set out below.

1. The proposed definition of "personal service provider" indicates that sub-paragraphs (i) and (ii) are relevant only to paragraph (*b*), which cannot be correct.
2. A problem arises in determining the amount of employees' tax that must be deducted from any payment made to a "personal service provider" and the tax rate that will apply to such a taxpayer. Appendix 1 of the Taxation Laws Amendment Act, 2008 provides that the rate of tax "in respect of the taxable income of any **employment company** as defined in section 12E of the Income Tax Act, 1962 (is) 33 per cent" (emphasis added).

   An "employment company" is defined in section 12E(4)(*b*) as follows:

   > '"employment company" means any company -
   > (i) which is a labour broker as defined in the Fourth Schedule to the Act, other than a labour broker in respect of which a certificate of exemption has been issued in terms of paragraph 2(5) of the said Schedule; or
   > (ii) which is a personal service company as defined in the Fourth Schedule'.

   No amendment to this provision is proposed in the Draft Revenue Laws Amendment Bill, 2008. Clause 18 proposes that section 12E(4)(*a*)(iv), dealing with exclusions from the definition of a "small business corporation" is to be amended to refer to "a personal service provider as defined in the Fourth Schedule" instead of "an employment company" but no similar amendment has been proposed to section 12E(4)(*b*). Whilst this appears to be an oversight, we are concerned, that if the term "employment company" in section 12E(4)(*b*) is replaced with the term "a personal service provider as defined in the Fourth Schedule", this would mean that independent contractors and personal service trusts will be taxed at the rate of 33%. Currently, independent contractors are taxed according to the tax tables applicable to natural persons and, where employees' tax is withheld from payments by their clients, the employees' tax is determined either at 25% or at an amount determined with reference to the employees' tax tables. It is surely not intended to tax independent contractors at a 33% tax rate?

3. It should also be mentioned that the introduction of the definition of "personal service provider" will be effective from the commencement of years of assessment ending on or after 1 January 2009; in other words the amendment will apply as from 1 March 2008. Independent contractors that were deemed to be employees in terms of the definition of "remuneration" in the Fourth Schedule have been taxed according to the existing rates as described above. If they are now taxed in the same way as personal service companies, what will happen with regard to the employees' tax that has already been determined for the last six months?

4. A further problem arises in that clause 31 of the Draft Revenue Laws Amendment Bill, 2008 proposes that section 23(*k*) is to be amended so that it will apply to "a personal service provider as defined in the Fourth Schedule", which, as indicated above, would include independent contractors. Previously, section 23(*k*) only applied to labour brokers, personal service companies and personal service trusts. It would be extremely unfair to include independent contractors in the scope of section 23(*k*), which effectively prohibits the deduction of valid business expenses, apart from certain very specific deductions (legal expenses, bad debts, an allowance for doubtful debts and certain finance charges, insurance, repairs, fuel and maintenance), particularly if the independent contractors are forced into the definition of a

"personal service provider" simply because one or more of their clients takes the more conservative route of withholding employees' tax and reflecting the payment under code 3616 on an IRP5 certificate. Many companies indeed take the more conservative route of withholding employees' tax from payments to independent contractors to avoid running the risk of any challenge from SARS regarding their compliance with the Fourth Schedule and independent contractors accept this treatment as they see the employees' tax withheld as being a voluntary advance payment towards their final tax liability. As a second issue, we suggest that section 23(*k*) should be amended so that it at least allows the same range of deductions as are granted for other employees in terms of section 23(*m*).

In light of the problems outlined above, we suggest that the term "personal service provider" should refer to trusts and incorporated entities only. Paragraph (*a*) of the proposed definition should therefore be deleted. Independent contractors would then be subject to the same rules and anti-avoidance provisions as currently exist.

As a separate point on the definition of "personal service provider", we question the need to prescribe that qualifying employees must be employed on a "full-time" basis. We suggest that an employee that works, for example, on a mornings-only or other flexible basis should also qualify.

It should also be noted that paragraph 5(*a*) of the Fourth Schedule, which provides for the issue of an exemption certificate for labour brokers, apparently remains unchanged, yet the definition of "labour broker" is to be deleted from paragraph 1 of the Fourth Schedule. We suggest that the definition of "labour broker" will have to be retained in paragraph 1 for the purposes of clarifying the meaning of paragraph 5(*a*).

## 13. Clause 62(*e*) – Paragraph 2 of the Fourth Schedule

The proposed amendment will allow employers to take into account a certain portion of donations made by an employee that qualify for the deduction permitted in terms of section 18A of the Income Tax Act. We understand the need to limit the permitted reduction for employees' tax purposes to 5% of remuneration. It is quite possible, however that an employee may actually be entitled to a larger deduction than what has been taken into account through the payroll since the permitted deduction is actually limited to 10% of the person's taxable income (before medical deductions) in terms of section 18A.

Paragraph 11B(4) of the Fourth Schedule allows SARS to re-determine the amount of any net remuneration derived by an employee and the amount of Standard Income Tax on Employees (SITE) payable thereon where the employee is entitled to deductions by way of pension fund contributions, retirement fund contributions, premiums paid on income protection policies and medical expenses, which have not been fully taken into account by the employer. We suggest that this provision should be extended to also allow for a re-determination to take into account the full amount of any section 18A deduction to which the employee is entitled.

## 14. Clause 66 – Insertion of the Sixth Schedule

The proposed introduction of a simplified tax regime for very small businesses is a welcome response to the real need of small businesses to reduce their administrative obligations, thereby encouraging more such businesses to become tax compliant. As indicated in the Explanatory Memorandum, small businesses play a key role in the economy in generating jobs and reducing poverty; a point that was emphasised in the Budget Speech presented by Mr Trevor Manuel earlier this year. We have concerns about a few proposals in the legislation, which are discussed below:

1. We are concerned that the proposed legislation pertaining to the turnover tax is so prescriptive that it denies benefits to many good small businesses that have the potential to create jobs and build critical skills. In this regard, we refer to the exclusion of professional service-providers from the scope of the tax regime in terms of the proposed subparagraph 3(*d*). This exclusion applies to any "natural person or company (that) renders a professional service during the year of assessment". Therefore, if such a person renders a professional service at any stage during a year of assessment, such person is debarred from electing the turnover tax. "Professional service" is defined in the proposed paragraph 1 as -

   > "any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, broking, commercial arts, consulting, draftsmanship, education, engineering, entertainment, health, information technology, journalism, law, management, performing arts, real estate, research, secretarial services, sport, surveying, translation, valuation or veterinary science".

   The definition replicates the definition of "personal services" in section 12E(4), which applies in that context to debar any such businesses from benefiting from the small business corporation concessions until they employ at least three unrelated, full-time employees (a matter that is also of concern as we suggest that the small business corporation concessions should also me made available to these businesses). The scope of the definition is extremely wide, meaning that the exclusion will apply to professionals such as doctors, lawyers, accountants, architects, optometrists, quantity surveyors, artists, nurses, consultants and many more. This exclusion is not only unfair and possibly unconstitutional, but also prejudices businesses that have good growth prospects and, probably more importantly, provide an opportunity to develop skills in areas where South Africa already has a critical skills shortage. Some "real life" examples serve to illustrate the point:

   - An optometrist starts up a small practice in a local shopping centre. She immediately needs to employ at least a receptionist and a cleaner. Later on, as her business grows, she will employ young optometrists and provide a place where they can build their skills so that they can eventually branch out themselves and establish their own practice, and so on.
   - A qualified accountant, having invested considerable time and money in his education, establishes a small practice. Again, he immediately needs at least two employees to assist with administration, cleaning and general duties. As his practice grows he registers as a training office for the purpose of training young accountants. Those accountants are then able to qualify and build their skills until they are able to start their own practices and repeat the cycle.

   Both of these businesses, just like any other small business, need all the help they can get in order to start up and grow their businesses. It makes no sense to marginalise them from making use of the turnover tax.

2. We question the proposal that a very small business cannot elect the turnover tax if registered as a VAT vendor. Whilst we understand the *rationale* in the Explanatory Memorandum that vendors are in any event required to keep detailed records, we do not agree that the VAT requirements should prevent a small start-up business from electing the turnover tax, which determines a taxpayers income tax liability. It must be emphasised that small businesses are often forced to apply for voluntary VAT registration due to market expectations; for example small businesses applying for government tenders need a VAT number. This fact alone should not preclude the business from electing the turnover tax. Furthermore, if a small business is not registered as a vendor, its costs include any VAT paid on its expenses, including the purchase

of trading stock. This increases the cost base of the business, necessitating a higher price to the client, which places the small business at a competitive disadvantage relative to its competitors in the large business sector. Forcing a small business into this position is clearly unfair. We see no reason why a small business cannot be a VAT vendor and elect the turnover tax as the method for determining its income tax liability. These are two separate taxes and the one is not necessarily dependent on the other.

3. The turnover tax applies to individuals and companies. We suggest that it should also apply to trading trusts if all the beneficiaries are natural persons.

4. The proposed paragraph 3(*a*) excludes from the ambit of the turnover tax any natural person or company that holds shares at any time during the year of assessment in any other company. This rule is relaxed in paragraph 4 in the case of a natural person that holds certain permitted investments. The list of permitted investments (which replicates what is currently provided in section 12E(4)) refers to listed companies, collective investment schemes in securities, sectional title body corporates, share block companies, property owners' associations, certain co-operatives, savings co-operative banks and friendly societies. We suggest that the list should also include shares held in dormant companies. The reason for this proposal is that an individual may hold a share or member's interest in a company that holds immovable property (either residential property or property used by the business) that does not trade. We submit that such an investment should not debar the individual from electing the turnover tax.

5. The proposed paragraph 3(*e*) excludes from the ambit of the turnover tax any business that realises more than R1 million over a three-year period on any sale of business capital assets. We submit that this limit is overly restrictive. Taking into account current property prices, it is quite possible that a very small business may sell its business property for proceeds exceeding R1 million. We therefore suggest that this limitation be revised, if indeed it is considered necessary.

6. The proposed inclusions in turnover, as far as they relate to the disposal of capital assets, are extremely punitive. The proposed paragraph 6(*a*) seeks to include 50% of the proceeds from the sale of a business capital asset in the taxable turnover of the business. This percentage is appropriate if the business is incorporated but is unfair to individuals. In terms of the Eight Schedule, an individual is entitled to an annual exclusion of R16 000 and only 25% of the net capital gain is included in his or her taxable income. We suggest that the same difference in treatment should apply if the individual is taxed under the turnover tax.

7. The proposed paragraph 6(*b*) seeks to include in turnover any previous allowances that are required to be added to taxable income in the subsequent year of assessment. As the very small business would have lost the benefit of carrying forward any previous assessed losses upon electing the turnover tax, we suggest that it is unfair to seek to tax previous allowances in this manner.

8. Paragraphs 9 and 10 deal with deregistration from the turnover tax system. We foresee that there may be a problem where a registered very small business has paid an interim tax payment during the year, as required in terms of paragraph 13, and then deregisters from the turnover tax system later in that year. It should be clarified that any such interim tax payments would then be taken into account as provisional tax payments in terms of the Fourth Schedule.

9. Paragraph 16 requires a registered very small business to keep records of *inter alia* "all assets... with a cost price of more than R5 000" and "all liabilities... which exceed the amount

of R5 000" (note that the word "exceeds" should read "exceed"). In light of the underlying *rationale* for introducing the turnover tax; that is, to reduce the requirement for record-keeping, we suggest that these two requirements are too onerous. If it is considered necessary to retain the requirement, we suggest that the amount should be much higher.

10. The reduction of the tax rates from those announced in the Budget is welcomed and will no doubt encourage more small business to make use of the opportunity afforded them under this new tax system.

**15. Clause 107 - Value-Added Tax Act: Amendment of section 41B**

The substitution in subsection (1) for paragraph (i) will have the result that the Commissioner will not publish VAT rulings. This would be disadvantageous for taxpayers, who derive guidance from such rulings and it may be seen to be unconstitutional not to provide access to information held by a state organ. It is proposed that this amendment be reconsidered.

## II. Draft Revenue Laws Second Amendment Bill, 2008

Clause 13 of the above Bill proposes removing the current choice that provisional taxpayers have when they make their second provisional tax payment. Currently, taxpayers may for purposes of the second payment rely on either the taxable income per the last assessment or 90% of taxable income for the current year. Where the taxpayer fails to comply a penalty of 20% of the shortfall in tax is payable.

The bill proposes requiring taxpayers to use 90% of the current year's taxable income. Failure to comply will in future attract the 20% penalty referred to.

The amendment is unreasonable as most auditors will only complete the audit for February year-end companies and professional practices during June or July after the close of the tax year-end in question.

To require a provisional tax payment based on 90% of income does not take account of commercial reality as the audit process does result in changes to income reflected by taxpayers and the adjustments so made often exceed 10%.

If the legislature pursues the amendment the 90% should be reduced to 75%, thereby recognizing commercial reality that accurate income figures are only known some months after the end of the tax year and that there is little prospect of taxpayers meeting the 10% margin of error required in the proposed amendment.

## III. Related matters

Electronic funds transfers and determination of date for interest and penalties

Taxpayers use e-Filing and Electronic Funds Transfers (EFT) for payment of all statutory taxes due to SARS. We believe that, in view of the electronic banking era, the current provisions of section 89*sex* of the Income Tax Act No. 58 of 1962 should be revised (the current provisions should be retained for non-electronic payments) as the section does not reflect current banking practice in relation to the accrual of interest income.

The section compels taxpayers to effect payment for taxes, penalties and interest not later than the last business day falling prior to such Saturday, Sunday or Public Holiday. In terms of current banking practice, where the transferor and transferee accounts are held with the same bank, EFT's are reflected immediately in the beneficiary's bank account, resulting in interest income accruing immediately. This situation holds true for all taxpayers using e-Filing or EFT's as SARS accepts EFT's from all major banking groups i.e. First National Bank, ABSA, Nedbank and Standard Bank.

In terms of section 89*sex* payments made by the taxpayer must be processed on the last business day prior to a Saturday, Sunday or public holiday. The presumption and literal meaning of the provision is that SARS can bank the cheque received by the taxpayer prior to the weekend or the Public Holiday in order to earn interest income immediately. The provision seeks to ensure that the *fiscus* is not out of pocket insofar as the accrual of interest income is concerned.

The theory and mechanics of the provision ignores the fact that interest is earned immediately in SARS' account when such funds are reflected in the bank account. Therefore, if a payment is due on Saturday and an EFT is processed by the taxpayer on the same day, and provided the accounts are with the same bank, interest income accrues to SARS on Saturday.

By implication, the taxpayer does not lose potential interest earned on his bank account as he processes the EFT on Saturday, and equally important the *fiscus* receives payment of taxes on the due date and starts accruing interest income from the Saturday.

The provision in essence overrides other specific provisions, for example, where PAYE is due and payable on the seventh day of the month following the month PAYE is deducted from employees. It is inevitable that due dates for payments of taxes, interest and penalties may sometimes fall over weekends.

We suggest that section 89*sex* should be amended to clearly reflect the position when taxpayers make payment to the *fiscus* through EFT or e-Filing. The legislation requiring payment to be processed before the last business day falling prior to a Saturday, Sunday or Public Holiday should be repealed or deleted for electronic transactions. We believe that the amendment to the section will have the desired effect where neither the taxpayer nor the Fiscus will be prejudiced in paying or receiving taxes on their due dates and the situation of the potential loss of interest income will not be an issue.

Thank you for considering our comments.

Yours sincerely

S Klue

Chief Executive Officer

Professor JA Arendse

Chairman: National Technical Committee

PO Box 73, Featherbrooke, 1746 Tel: 011 662 2837 info@thesait.co.za www.thesait.org.za

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