AN EVALUATION OF INCOME TAX INCENTIVISATION FOR SMALL BUSINESS IN SOUTH AFRICA

Surendran Pillay, University of KwaZulu-Natal

ABSTRACT

A review of income tax legislation which incentivises small business entrepreneurship in South Africa was conducted. A doctrinal research approach was adopted where comparative tax legislative approaches amongst countries that ranked highly on the global development entrepreneurship index were analysed to identify possible omissions or deficiencies in South African income tax legislation. These deficiencies were then articulated into policy recommendations for consideration by South African National Treasury for adoption.

Keywords: Tax Incentivisation, Small Business, Entrepreneurship, Taxation, Tax Policy.

INTRODUCTION

The National Planning Commission of South Africa confirmed that the South African economy lacks skill, has low competition and a vast number of job seekers who are unable to enter the labour market (National Planning Commission, 2012). The National Development Plan (NDP) predicts that small businesses will create 90% of 11 million new jobs by 2030 (Davis Tax Committee, 2014). The NDP is the guiding programme for the development of the South African economy. The plan was released in 2011 and is the blueprint for tackling South Africa's challenges, including unemployment (National Planning Commission, 2012). South Africa's unemployment rate was sitting at 30.1% in the first quarter of 2020, an increase from 27.1% observed in the first quarter of 2019. Internationally, South Africa's unemployment ranks poorly compared to other major economies (Jones, 2020).

As eluded above, a thriving small business sector is the key to eliminating unemployment in South Africa (Smale, 2013). It is for this reason that the South African government established the Department of Small Business Development (DSBD) in 2014. The primary purpose of the DSBD is to ensure that the environment in which small businesses operate is supported and encourages growth (Dhanah, 2017). This includes weakening the tax burden small businesses face by granting them tax incentives (Ssennyonjo, 2019).

A tax incentive is a benefit accorded by the government that reduces the corporate tax to firms in a specific location or firms that produce particular products or services to stimulate economic growth (Makgalemele, 2017). In South Africa, tax incentives were introduced post the 1994-elections by means of the Kats Commission of 1995. The commission focused on the evaluation and report of the tax systems and structures (National Treasury, 1995). In terms of small business enterprises, the two most significant incentives are the turnover tax of 2009 for micro-enterprises and the section 12E allowance of 2001 for small business corporations (SBCs) (Ssennyonjo, 2019).

This study focused on the effectiveness of the section 12E allowance contained in the South African Income Tax Act, established as a tax incentive provision to promote the growth of SBCs, and consequently contribute to employment and economic development in South Africa.

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It is worth noting that although tax incentives are implemented for the development of the economy, whether or not tax incentives achieve the expected results is a controversial subject (Makgalemele, 2017). In order to assess whether or not tax incentives are producing the desired results or simply reducing income tax, the Davis Tax Committee was formed in July 2013. The committee aims to promote the long-term goals of the NDP. That is, inclusive economic growth, employment creation, development, and fiscal sustainability (Smulders, 2014).

STUDY PROBLEMS

As noted earlier, South Africa's unemployment ranks as the worst when compared to other major economies (Jones, 2020) and this requires effective fiscal policy to support any other initiative taken by government to resolve. The implementation of section 12E of the Income Tax Act has incentivised small business and entrepreneurs with fiscal benefits; however, the effectiveness and attractiveness thereof are relatively unknown. The legislation thus needs to be benchmarked against fiscal legislation in countries where there has been success in entrepreneurship.

STUDY SIGNIFICANCE

Given the rising unemployment levels in South Africa (Smale, 2013) the importance of entrepreneurial growth cannot be emphasized enough. Previous studies by Cullen et al. (2002) as well as Feldstein and Slemrod (1980) have shown that lower progressive corporate tax rates create an incentive for individuals to become self-employed, thus lowering unemployment. The policy recommendations from the study regarding income tax incentive laws are thus regarded as significant in lowering unemployment and improving entrepreneurship in South Africa.

STUDY OBJECTIVES

The first objective of the study was to review the effectiveness of tax incentive legislation in supporting the development of small businesses with the second objective being to identify deficiencies and areas of improvement in the South African income tax legislation relating to tax incentivisation of entrepreneurs. The first objective of the study was achieved via a literature review and the second objective by means of a comparative analysis of tax incentive legislation using a doctrinal research approach.

LITERATURE REVIEW

In South Africa, tax incentives can be traced back to the Katz Commission of 1995. The commission had three main recommendations regarding corporate taxation. Firstly, the commission aimed to replace the Secondary Tax on Corporations (STC) by investigating the impact of a base broadening and examining multiple types of tax imputation. Secondly, the commission recommended that *"a presumptive tax be introduced, at a low rate, on the gross assets of the companies, close corporations, and inter-vivos trusts"* to recover loss of revenue due to other tax recommendations. Finally, a cashflow accounting option system for small businesses was recommended as way of supporting small business enterprises (Steenekamp, 1996).

Jordaan (2012) believes that the effectiveness of tax incentives in obtaining the expected results is a controversial subject. For example, using various research methodologies such as

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METRs in different countries, Shah (1995) found that tax incentives are not effective. That is, firms do not meet certain requirements to qualify for particular incentives, or specific incentives are not valuable to firms. In South Africa, on the other hand, Makgalemele (2017) found that tax incentives have resulted in a desirable outcome in respective industries where tax incentive programmes were executed. However, the contribution to small-medium enterprises has not been adequately investigated.

Smale (2013) states that the issue with indirect benefits is that the government cannot be certain that the money saved by the company due to tax relief will be reinvested in human capital or that it will contribute to new employment. A survey by the World Bank suggested that job creation is a result of new small businesses as opposed to existing businesses, implying that small businesses in South Africa are not expanding as expected (Lewis, 2001). The National Treasury of South Africa also conducted a survey on business organisations regarding the Learnership Tax Incentive. Results showed that tax incentives make it more attractive to hire individuals with no experience. Furthermore, incentives foster business growth and expand the labour force (National Treasury, 2016). Hoyt et al. (2008), using panel data, examined the impact of tax and location-based incentives on Kentucky counties in the United States and found that the relationship between employment and business incentives is positive and significant. However, the extent in which tax incentives affect employment depends on where the country is situated and the type of incentive.

Against this background, the objective of the study was to determine whether tax incentive legislation relating to small businesses introduced by the National Treasury of South Africa was both fair and effective in its application to stimulate the growth of small businesses in South Africa with a specific focus on section 12E of the Income Tax Act No 58 of 1962 (hereafter referred to as the ITA). Companies registered with the Cooperatives Act, Close Corporation Act or private entities registered with the Companies Act of 1973 or 2008 may have the requirements to qualify as an SBC. Interpretation Note 9 issued by the South African Revenue Services (hereafter referred to as SARS) provides a detailed indication of the provisions of section 12E (Ssennyonjo, 2019); Zolt (2014) states that tax privileges such as incentives require frequent monitoring and if a company purposefully represents itself as an SBC to benefit from the section, the entity may be liable to pay an understatement penalty (Zolt, 2014).

DATA AND METHODOLOGY

A non-empirical research review of existing literature was performed. A doctrinal research approach which is commonly used in legalistic research was used for the study and this approach includes gathering all the relevant facts, identifying and analysing the legal issue from research sources such as legislation, and then combining the issues into context and finally drawing up a conclusion (Hutchinson & Duncan 2012). Doctrinal research has been categorised firstly, as being descriptive in that it describes what the ‘current law’ is and secondly, as being prescriptive in that it identifies issues with the ‘current law’ and suggests improvements or amendments. (Chynoweth, 2008; Hutchinson, 2008; Singhal & Malik, 2012). Secondary data in the form of income tax legislation and government policies were reviewed as part of the comparative legislative analysis.

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COMPARATIVE ANALYSIS

A comparative analysis of tax incentive legislation from countries that ranked highly in the global entrepreneurship index (GEDI) is presented below. Australia, the United Kingdom, and Canada are ranked in the top five countries in the global entrepreneurship index (GEDI, 2021) and the tax incentive legislation for small business from these countries was compared to the South African tax incentive legislation to identify possible deficiencies in tax incentive legislation in South Africa.

SOUTH AFRICA

In South Africa, section 12E of the ITA grants SBCs income tax deductions and preferential tax rates for plant and machinery. According to section 12E of the Income Tax Act, an SBC is a company with a turnover of R20 million or less annually. The effect of section 12E is that a small business that meets the definition of an SBC (as contained in section 12E (4)) can obtain accelerated capital allowances of 100% on new plant and machinery in terms of section 12E (1) and increased capital allowances of 50% in year 1, 30% in year 2 and 20% in year 3 in respect of assets not brought into use for the first time by the taxpayer in terms of section 12E (2) of the ITA. The requirements contained in section 12E (4) of the ITA require that the gross income for the year of assessment cannot exceed R20 000 000 and the shareholder cannot hold shares in other companies with certain exceptions.

AUSTRALIA

The Australian Income Tax Act (hereafter referred to as the AITA) grants tax incentive allowances for entrepreneurship for businesses with an annual turnover of $5 000 000 AUD or less (ATO, 2021(a)). In terms of asset depreciation, the Australian tax laws allow for a 100% write-off on assets where the threshold for each asset is $150 000 AUD (ATO2021 (b)). There is also a simplified depreciation calculation which can be applied to a small business pool of asset and simpler trading stock rules where a taxpayer can estimate the stock at the end of a financial year and opt not to conduct a stock-take at year end (ATO, 2021(c)). The Australian tax rate for small business is set at 25% for the 2021 financial year (ATO, 2021(d)). In comparison to South Africa, the eligibility requirement of $10 000 000 AUD (which would equate to approximately R50 000 000) would indicate that Australian tax incentives might attract a larger number of small business that will qualify for tax incentive allowances. The asset depreciation tax incentives are similar to section 12E; however, the simpler depreciation calculation for a pool of assets and simplified trading stock rules which lower the cost of tax compliance is not present in section 12E of the ITA. In terms of tax rates the small business tax rate in Australia of 25% is lower than the South African rates which are progressively based and peak at 28%.

UNITED KINGDOM

The tax incentivisation rules dealing with the United Kingdom are dealt with under the provision of the United Kingdom Income Tax Act of 2007 (hereafter referred to as UKIT). The United Kingdom allows for various incentives including the annual investment allowances which allow for a super deduction of 130% on qualifying plant and machinery but are limited to £1 000 000 (UK 2021(a)). The United Kingdom has also implemented small business rate relief in

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that if the property the business operates on has a rateable value of £12000 or less there would be no business rates payable (UK 2021(b). Tax rates in the United Kingdom for small businesses are taxed at 18% against the mainstream rate of 30% for companies with profit over £300 000. When compared against the South African tax legislation, the capital allowances of 130% on qualifying plant and machinery appear to be more aggressive than section 12E. The United Kingdom provisions dealing with rates allowances are also not found in the South African tax legislation. In terms of corporate tax rates, the marginal income tax rate of 18% appears to more aggressive than the South African income tax rate of 28% (UK 2021(c)).

CANADA

Small business tax incentives are governed under section 125 of the Income Tax Act of Canada (hereafter referred to as CAITA) and section 125 of the CAITA provides that a company will qualify to be a Canadian Controlled Private Corporation if it is incorporated in Canada and its shares are not traded on the stock exchange and the company is not controlled by non-residents. For a company with annual earnings up to $500 000 CAD, the federal income tax rate is reduced from 28% to 9% with some territories offering differing amounts of relief (Mondaq, 2021). No accelerated allowances on plant and machinery are noted in the small business tax incentive legislation for Canada. In comparison to South Africa, the Canadian eligibility limit of earnings $500 000 CAD is not directly comparable with South Africa since it is based on earning as opposed to gross income. The tax rate of 9% offers a greater incentive than the South African marginal income tax rate of 28%. South Africa's capital allowance incentive on plant and machinery used in small businesses appears greater than Canada's existing legislation.

CONCLUSION AND RECOMMENDATION

In relation to the first research objective, the literature review confirms that there is evidence that tax incentive legislation can promote the development of entrepreneurship and small business. Regarding the second research objective, a comparison of South African tax incentive legislation reveals that South African tax incentive laws in relation to accelerated capital allowances are in line with tax incentive laws contained in both the United Kingdom and Australia. In relation to corporate tax rates, South Africa's tax rate of 28% (for taxable income greater than R550 000) is higher than Canada (9%), Australia (25%) and the United Kingdom (18%) and this is a possible deficiency which might need to be adjusted. South Africa's SBCs' eligibility requirement of gross income less than R20 000 000 is much lower than Australia where the requirement is up to $10 000 000 AUD (equivalent of R100 000 000) and this is a possible area of improvement in the tax incentive policy for small business. The entry requirement in South Africa is not directly comparable to the United Kingdom and Canada who base their entry requirement on profit rather than turnover.

In terms of recommendations, it is suggested that the tax rates applicable to small businesses under section 12E be reviewed as they are not aligned to tax incentive legislation globally. The South African threshold requirement for eligibility to qualify as an SBC is more stringent than Australia and should also be relaxed to allow for greater tax stimulus of small businesses in South Africa.

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