Evaluating the design of special economic zones as a tax incentive in South Africa

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ABSTRACT

Special Economic Zones (SEZs) are defined as special demarcated areas that often contain favourable provisions for administrative procedures, streamlined legislation or compliance requirements and fiscal benefits often in the form of tax incentives offered by government. The South African economy experiences several challenges on a socio-economic level and it is part of the South African government's vision to address these challenges by 2030. The tools to address the issues faced by the country are weaved within the provisions of the National Development Plan (NDP). SEZs also contain specific objectives and one of the secondary objectives specifically aspires to support the vision of the NDP.

The literature review aimed to answer the research question which critically considered if the South African SEZ model was properly designed to facilitate it to serve as a meaningful tax incentive. The research explored the theory associated with SEZs as well as the general principles associated with tax incentives. It was found that the SEZs offer generous tax benefits, which included corporate income tax inducements and indirect tax concessions. The research highlighted the required characteristics of a meaningful tax incentive and established a criteria against which the design of the South African SEZ model could be measured against. The criteria broadly focussed on objectives, aiming to be effective, containing stability and promoting transparency. The study identified that the South African SEZ regime did conform to be classified as a tax incentive and established that the design of SEZs in South Africa imitated some of the desired characteristics of a meaningful tax incentive, however some shortcomings and improvements have subsequently been identified.

It was found that there was not a clear connection between the objectives of SEZs and their aim to support the NDP. Some deficiencies have also been noted with regards to the aim of being effective as there were issues with regards to monitoring the cost effectiveness on a national level as well as providing room for flexibility to support a qualifying company. There were some weaknesses identified that related to stability, as provisions restricting transactions with related parties resulted in uncertainty for previous investors. Areas for improvement have also been identified pertaining to promoting transparency as it should reflect improved government communication, regulation and the application process to locate within a SEZ.

KEYWORDS

Connected person, Cost-effective, Economic objectives, Economic policies, Foreign Direct Investment, Infrastructure, Qualifying company, Qualifying criteria, Regime, Special Economic Zone, Tax incentive, Tax policy, Tax rate

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List of Abbreviations

B-BBEE	Broad Based Black Economic Empowerment
BEPS	Base Erosion and Profit Shifting
CCA	Customs Controlled Area
DTI	Department of Trade and Industry
ETI	Employment Tax Incentive
FDI	Foreign Direct Investment
FHTP	Forum on Harmful Tax Practices
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IDZ	Industrial Development Zone
MTC	Model Tax Convention
NDP	National Development Plan
PAYE	Pay As You Earn
SAIT	South African Institute of Tax Professionals
SBC	Small Business Corporation
SDI	Spatial Development Initiative
SEZ	Special Economic Zone
VAT	Value Added Tax

CHAPTER 1: INTRODUCTION

1.1 Background

South Africa has a very comprehensive economic policy which includes provisions to help the country obtain a competitive international advantage for the industrial and manufacturing sector. The above mentioned are all listed in the government's Economic Programme of Action, which includes the creation of Special Economic Zones (SEZs), designated to drive an increase in foreign investment in the country's economy. The goal of promoting economic growth in these zones will predominantly be achieved by granting tax incentives which would encourage both local and foreign investment. The aim of these incentives is to increase South Africa's economic appeal to all investors in these identified zones (SARS, 2017a).

SEZs are described in the Special Economic Zones Act (16 of 2014) (South Africa, 2014), hereinafter referred to as the Special Economic Zones Act, as geographical regions identified for particular economic activities which could stimulate the growth of the economy on a national scale. A region will only result in a SEZ when it has been developed, brought into operation and thereafter managed by someone who is in possession of a valid SEZ permit (SARS, 2017b).

Prior to the introduction of SEZs in 2014, South Africa introduced in December 2000 for the first time a similar concept namely, Industrial Development Zones (IDZs). The IDZs were also acknowledged by the government to encourage companies to operate in these zones while making use of the available tax incentives offered at that time (Erasmus, 2011:3). As of date, all IDZs that became operational before 9 February 2016 will effectively be converted to SEZs as stipulated by the relevant legislation. The SEZs have become, (since being proclaimed on 9 February 2016), a critical tool for driving industrial development because of the following (DTI, 2018:4):

i. They promote the development of industrial clusters;
ii. They enhance required infrastructure in industrial areas;
iii. They promote better planning between the government and private sector;
iv. They monitor the deployment of other development tools.

1.1.1 Regional tax incentives

As proclaimed in the Special Economic Zones Bill of 2013, it was proposed that Special Economic Zones should be introduced. These zones would receive similar Value-Added Tax (VAT) and customs relief as the Industrial Development Zones, which was already in place at that time (Gad & Radloff, 2013).

Based on the introduced IDZ regime, there were five operational Industrial Development Zones identified in South Africa. These IDZs are generally different from SEZs in a way that they were focusing on increasing exports and catered only for VAT and customs incentives. The SEZs, however, also include income tax incentives and employment tax incentives, additional to the VAT and customs relief measures that were already in place (SARS, 2017c:1).

1.1.2 Popularity of regional tax incentives

Tax incentives are general tools that are implemented by governments to stimulate economic growth. Currently there is a general trend across different African countries to implement regional tax incentives. SEZs have become a very attractive concept in Africa due to governments' views that they could provide a possible solution for poverty. SEZs are a concept that identifies demarcated areas which contain propositions for special incentives of a variety of economic activities which are reinforced through distinct agreements with the government (Nyakabawo, 2014).

China had a major success with their implemented SEZ model and plenty of African governments are eager to explore the opportunities by implementing something similar in their respective countries (Bräutigam, 2011). A study conducted by KPMG found that it is becoming very common for African countries to offer various tax incentives to support manufacturing, industrial and agricultural activities. Another incentive that is becoming very popular in these African countries is introducing SEZs and Free Port Zones (Mohammed, 2016). These incentives generally include the following:

- It was found in the study that 21 out of 28 countries offered SEZs to drive foreign investment in the respective countries;
- South Africa introduced new legislation in February 2016 that identified fifteen additional areas as possible SEZs;

- Countries like Swaziland and Zimbabwe are also currently developing similar legislation to be introduced as SEZs;
- It was noted that the corporate income tax rate was reduced to range between zero and a percentage of fifteen, which is notably lower than the average corporate tax rate of 29% across the countries surveyed;
- The majority of these countries included additional incentives in the form of exemptions from Value Added Tax, import or export duties and accompanied by enhanced capital allowances.

1.1.3 Considerations for the implementation of an SEZ model

Specifically for developing or third world countries, the motivation for implementing SEZs generally is based on a foundation of economic policies and infrastructure requirements of the respective country (Farole, 2011a). The SEZ model serves as a useful tool to enhance the overall economic growth objectives as specified in the specific national economic strategy of a country. It is therefore imperative in the design of the SEZ model to take into account the existing policy frameworks of the country in which it is situated, because this will increase the likelihood of reaching their predetermined objectives (FIAS, 2008:9).

South Africa faces numerous economic challenges. One of the biggest challenges is industrial development which could be a key driver for economic growth. It should be a priority for South Africa to create economic opportunities in a diverse range of geographical regions, especially rural and undeveloped areas, to enable job creation and infrastructure improvements (Scheepers, 2012:15). For this purpose a SEZ model can be a useful tool to support the objectives of industrial and economic development policies nationally.

It is therefore crucial for governments implementing new SEZs to consider the locations chosen for the specified zones, taking into account existing national economic strategies or policies to identify the challenges that the proposed zones should focus to address (Bernstein, 2012:4). SEZs are definitely not a “one size fits all” toolkit and have to be designed specifically to complement the needs, challenges and economic objectives of the country as a whole.

1.1.4 Relevance of SEZs in South Africa

During 2014 the Special Economic Zones Act (Act 16 of 2014) was promulgated with the aim to replace the previous IDZs incentive. The SEZ incentive is aimed towards entities operating in a SEZ as promulgated by the minister. The SEZ incentive scheme was inactive until the effective date was proclaimed on 9 February 2016.

The new SEZ legislation continues to cover the previous IDZs as these had a specific sectorial focus (Mavuso, 2015). Recent changes proposed by the Taxation Laws Amendment Bill (2017b) to section 12S (containing the legislation for SEZs), emphasise the importance of the relevant sections to government and the South African Revenue Service. It was noted that under section 12S, additional provisions to be classified as a “qualifying company” were added, including an expansion on certain limitations associated with the current SEZ legislation to narrow the scope.

During the 2018 national budget speech, finance minister Malusi Gigaba announced that he has approved six SEZs that will allow qualifying companies to be subjected to lower corporate tax rates and would allow them to qualify for employment tax initiatives for employees of all ages. He further announced that “of the incentives budget, R4.9 billion is allocated for industrial infrastructure projects over the medium term for SEZs, government-owned industrial and critical infrastructure projects to promote industrial development and increase investment and exports of value-added commodities” (South Africa, 2018b). This indicates that SEZs are currently still a main focus point for the South African government as it is very important to promote economic and industrial development in the identified zones.

In contrast with General Motor’s withdrawal from South Africa, one of the biggest car manufactures in China, namely BAIC, is making the biggest-yet car investment in South Africa with a brand new R11 billion plant at Coega (Matavire, 2017a). The main reason for the location is due to the fact that Coega is a SEZ, where all businesses operating in this zone could receive special tax breaks and other advantages. This emphasises the role SEZs play in the economy to lure foreign investors that can contribute to stimulate fiscal growth in the South African economy.

1.1.5 The National Development Plan

In May 2010, former President Jacob Zuma appointed a National Planning Commission (a body compiled from experts outside the government's direct sphere), to assist with the compilation of the National Development Plan (NDP) (Alexander,2017). Summarised, the NDP is an exclusive plan to unite South Africans, grow a transformed and inclusive economy, focus on improving capabilities and develop a better relationship between the state and the private sector. It also aims to solve the country's challenges and achieve the primary economic objectives such as eliminating poverty and decrease inequality before 2030 (South Africa, 2015c:1).

The NDP was launched in 2011 after the commission's Diagnostic Report was released in June 2011 which identified South Africa's most significant weaknesses since 1994. Included in the NDP are nine primary challenges that government intends to address (South African Government, 2011:15). For this study, only some of them will be highlighted, as there is a link between them and the possible objectives of the implementation of SEZs:

i. Too few people work;
ii. Infrastructure is poorly located, under-maintained and not sufficient to support greater economic growth;
iii. Spatial patterns exclude the poor from the economic development;
iv. The economy is not sustainable due to being too resource intensive.

The NDP aims to establish an entrepreneurial and innovative economy and enable communities to develop their own resources and capabilities to alleviate poverty while government remains supportive until the goal is reached (South African Government, 2011:16). The plan identifies that the old consumption based model is not sustainable for the economy and that there is a need for progressive taxation and an increase in inclusivity is required to develop a stable economy in South Africa. The NDP stresses the fact that national capabilities such as human capital, physical infrastructure, technologies and management skills should be developed to enhance the global competitiveness of the country (South African Government, 2011:17).

The proposed focus areas to develop the capabilities include a few key areas but for the purpose of this study only the following will be highlighted due to a link with the objectives of SEZs:

i. Creating jobs and livelihoods;
ii. Expanding infrastructure;
iii. Transforming urban and rural spaces;
iv. Building a capable state; and
v. Transforming society and uniting the nation

A key demographic observation in the plan is that the percentage of South Africans living in rural areas has declined by about 10% since 1994, but in 2011, 60% of the population lived in urban areas with an estimation that the percentage will increase to 70% in 2030 (South African Government, 2011:19). It is therefore still crucial to focus on the remaining population not residing in urban areas to elevate their communities and demographical areas to ensure all regions within the country contribute to the overall economic performance. It is therefore a requirement for the SEZ model to be supportive of the overall economic goals and to address the economic challenges as identified in the NDP.

1.2 Problem statement

The problem identified was to establish whether the Special Economic Zones model in South Africa is designed effectively to serve as a tax incentive.

The research question that this paper aimed to answer is: does the design of the SEZ model in South Africa enable it to serve as a meaningful tax incentive?

1.3 Objectives

The following objectives have been identified to focus on the research question conveyed in the aforementioned problem statement:

1.3.1 Main objective

The core objective of this study is to evaluate whether the design of the Special Economic Zones model applied in South Africa enables it to serve as a tax incentive.

1.3.2 Secondary objectives

The main objective will be reached by investigating the subsequent secondary objectives:

1. Exploring the development of SEZs locally and globally, while subsequently considering the tax incentives available to South African companies operating within such a zone (addressed in Chapter 2).
2. Identify the characteristics of meaningful tax incentives that stimulate the economy over the long term without damaging the tax base of the host country (addressed in Chapter 3).
3. Evaluate the design of the SEZ model against the design elements and characteristics identified of a well-structured tax incentive, while taking into account existing government policies in place, specifically referring to the NDP (addressed in Chapter 4).

1.4 Research Methodology

1.4.1 Ontology and epistemology

Ontology can be defined as "the study of being". It is a philosophical study which considers the world we are investigating and the nature of existence within a world of reality (Crotty, 2003:10). The ontological assumptions within a study are the ones that react to the posed question 'what is there to know or to be discovered?' (Guba & Lincolin, 1989:83). Ontology is therefore the researcher's perspective of the world in which a study is conducted, and can be guided by different research views.

A relativist approach is one of the research views that can be perceived by the researcher while conducting the study. This approach defines the researcher to respect different views and opinions and view reality to be independent from numerous circumstances and external factors (Johnson & Onwuegbuzie, 2004:16). During research to evaluate the design of SEZs as a tax incentive, a relativist view was assumed as the researcher is an accountant who supports a similar relativist view to the understanding, interpretation and application of legislation, as well as to general literature and factors existing outside the scope of legislation.

Epistemology strives to construct a philosophical foundation for deciding what type of knowledge is possible to gather and how we can guarantee that they are both reliable regarding adequacy and appropriateness (Crotty, 2003:3). Constructivism recognises that reality is a product of human intelligence interacting with practical experience. As the researcher made use of mental activity in the process of gathering knowledge to investigate the underlying reality, a constructivism epistemological stance was therefore taken in the research conducted.

1.4.2 Research paradigm

The ontology and epistemology affects the paradigm selected by the researcher to conduct the study. A relativist's view is categorised as either an interpretive or anti-positivist paradigm. An interpretive research paradigm believes that reality consists of people's subjective experiences; and therefore an inter-subjective epistemology and ontological view is adopted. The researcher, whose philosophical paradigm is defined as interpretive, is of the view that there is no single correct route or a particular method to knowledge (Willis, 2007:4).

Therefore the main aim of the research was not to attempt to prove a single truth or to provide definite answers to questions, but rather to gain an understanding of the field of the research conducted. A qualitative research approach intends to disclose a target audience's perceptions that forms an integral part of the behaviour within a certain topic which allows for the results of qualitative research to be more descriptive rather than being predictive (Qualitative Research Consultants Association, 2016).

1.4.3 Research approach

The research approach decided upon for this study was to focus on a qualitative tradition which forms part of a cross-sectional field analysis between the relevant tax laws contained in the Income Tax Act (58 of 1962) that relates to SEZs and the link between economic challenges and objectives within the field of general economics as contained in government's policies and strategies. Secondary data was utilised from available sources where statistics were a requirement to reach appropriate conclusions. Information from literature was interpreted through a systematic review and correlational approach to answer the questions posed and to reach the relevant conclusions.

1.4.4 Research method

This study was conducted through a non-empirical research methodology which includes a literature review of academic sources such as publications, dissertations, applicable legislation and articles. The literature review was performed consulting various academic sources to obtain a better understanding of SEZs. This includes investigating the potential of SEZs to attract foreign direct investment (FDI), scrutinising the different forms of SEZs globally, also examining the rationale for establishment, and then to consider if SEZs can promote structural change for social and economic sustainability (Farole, 2011b:1-19).

The literature review addressed the identified questions as part of the main research question posed in the problem statement. Additionally to references used prior to the literature review, supplementary resources have been consulted to provide guidance in order to determine the outcome on the research question. The literature review created a foundation for structuring the research objectives into a meaningful layout while advancing research in a constructive manner. The descriptive research method facilitates theory development and narrows down topics where a plethora of information was present, while prevailing areas where thorough research is a necessity (Webster & Watson, 2002).

The core objective of the literature review was to establish a reasonable basis of reliable sources of information to assist in constructing an answer to the question whether the current SEZ model is effectively designed to serve as a meaningful tax incentive in South Africa, while subsequently considering the country's economic strategies and challenges as identified per the NDP. A qualitative research study was launched to gather information from a widespread of available sources. The majority of sources included other dissertations, articles, academic journals, websites, and data within tables or figures, official SARS documents, legislation and other government policies.

Due to the qualitative nature of the study there was no specific targeted population that was used to narrow down the research sample. Information from all relevant available sources was gathered and processed. The research procedure included the collection of the appropriate information for the study, which was contained in the form of a Meta-Analysis. A Meta-Analysis is a review and analysis of research conducted in the past which allows the researcher to make recommendations or modifications for future studies (Sheppard, 1988:325).

In order to achieve the research objectives, a doctrinal research was conducted while following a systematic method to identify, evaluate, analyse and interpret the correlation between section 12R and 12S of the Income Tax Act (58 of 1962) together with the Special Economic Zones Act (16 of 2014) while keeping in mind the research objectives and problem statement. The research continued to explore whether the South African SEZ model is properly designed to serve as a meaningful tax incentive.

The research did not include a quantitative assessment of the effects of tax incentives on the fiscus regarding the foregone costs for income tax not collected due to tax relief from SEZs. The research performed in this study should be able to assist policy makers in their decisions when considering possible amendments to the current SEZ model in South Africa. Through inspection of the relevant legislation and policies, the researcher was enabled to obtain a better understanding of the structure of the model in place. This was mainly achieved through examining the policy guiding the SEZs (Department of Trade and Industry, 2012:7) and the relevant legislation in place to regulate the tax implications of South African SEZs.

The next step investigated the tax incentives offered in the Income Tax Act (58 of 1962) through section 12R and 12S to identify the incentives offered in SEZs. A critical study was performed to obtain additional information about the characteristics of meaningful tax incentives that enable a country to grow economically without eroding the local tax base by over compromising on foregone tax revenue from the collection of taxes. The research focused to define the design elements and desired characteristics associated with a well-structured and meaningful tax incentive. It was established that FDI could possibly be attracted through the different available tax incentives, depending on the individual characteristics (Morisset, 2000:1).

The study aimed to identify the history and global concepts associated with SEZ models implemented worldwide, which were used as a platform to obtain an understanding of SEZs globally. The theory obtained have been applied within the context of the current SEZ model used in South Africa to support the evaluation undertook by the researcher in order to reach conclusions whether the model was designed and implemented as a meaningful tax incentive. Based on the research performed as set out above, the topic was covered sufficiently and the researcher was enabled to understand significant terminology, legislation and developments that revolve around SEZs and tax incentives. This empowered the researcher to draw appropriate conclusions and answer the research question to a prodigious extent.

1.5 Chapter division

This study comprises out of the following chapters:

Chapter 1: Introduction to the mini-dissertation

This chapter introduces the background research done to gather information about the topic. This chapter provides a summary of core concepts that relate to the topic and also contains the research question, research objectives and research methodology.

Chapter 2: SEZs implemented globally and in South Africa

This chapter explores fundamental aspects associated with SEZs, as well as the rationale for establishing such a zone. This chapter provides a focus on the tax incentives available to companies in South African SEZs, as well as exploring the different available SEZ models based on global implementation of SEZs.

Chapter 3: Tax incentives as instruments to promote economic growth

This chapter identifies the characteristics of well-structured tax incentives, including the design elements associated with meaningful tax incentives that serve the purpose of incentivising taxpayers without eroding the tax base of the host country.

Chapter 4: Evaluating the South African SEZ model as a meaningful tax incentive

This chapter evaluates whether the South African SEZs serve as a meaningful tax incentive through an evaluation of the South African SEZ model against the design elements and characteristics identified from meaningful tax incentives.

Chapter 5: Conclusions and fundamental findings

This chapter summarises the conclusions reached through the research described in the previous chapters and highlights the fundamental findings based on the research objectives and problem statement listed in chapter 1.

This chapter summarises the study and provides a conclusion for the weaknesses identified in the SEZ model in use to identify areas of improvement. This chapter also formulates possible recommendations or suggestions for future studies based on identified shortcomings within the specific field of research.

CHAPTER 2: SEZs IMPLIMENTED GLOBALLY AND IN SOUTH AFRICA

2.1 Introduction

As noted in Chapter 1, SEZs are useful global government tools for countries striving for improved socio-economic development (see 1.1.3). There are different variations associated with the term "Special Economic Zones", as they refer to a broad range of zone orientated concepts. SEZs are defined as "geographical delimited areas administered by a single body, offering certain incentives to businesses which are physically located within the zone" (FIAS, 2008:2). The aim of this chapter is to explore the historical development of SEZs globally, including the characteristics of SEZs and the rationale for establishing such a zone. The chapter will also aim to provide a backdrop of information regarding the development of SEZs in South Africa, as well as the associated incentive benefits offered by the SEZ regime.

Despite the different classifications available to define these SEZs, there are certain characteristics that are associated with the overall concept of an SEZ. SEZs are characterised as demarcated or defined geographical areas which are established by legislation. This is often different to common legislation applied to the rest of the country in order to offer benefits that are only available to investors physically located within these zones (Zeng, 2015:3). SEZs are also renowned to offer "static" economic benefits such as creating employment opportunities, increase exports, contributing to government revenue and providing incentives for FDI in the country. They are also known to offer "dynamic" economic benefits like focusing on skills development, technology innovations, diversifying the economy and increasing overall productivity and performance of the local economy (Saggers, 2015: 12). This chapter aims to address the first research objective identified in 1.3: this is to establish whether the Special Economic Zones model in South Africa is effectively designed to serve as a tax incentive.

2.1.1 Policy characteristics of SEZs

In order for a SEZ to meet the characteristics set out above in 2.1, the zone needs to be administered through a policy framework. Aggarwal (2004:10) noted that the policies employed to establish a SEZ also contain some identifiable characteristics:

a) Extra-territoriality and geographic restrictions

SEZs are designed to be viewed from outside the host country's borders as zones controlling the flow of people and goods. The concept of "extra-territoriality" embeds the true concept of a SEZ, which differentiates it from enterprise zones or business zones (Aggarwal, 2004:10). The benefits available under the traditional SEZ model are restricted to a demarcated geographical area. The reason for the geographical limitation is supported by logistical and administrative motives such as shipping efficiencies from a single location or to simplify administration requirements (Klemm, 2010:15).

b) Taxation Inducements

For many SEZs the provision of taxation incentives is a key characteristic to allow for taxes to be waived on the export and import of goods and earned profits through the operations located within the SEZ (Leslie, 1993:4). In some SEZs, tax holidays are offered allowing businesses located within the zone to be exempt from paying corporate income taxes for a period of time (OECD, 2017:17).

c) Infrastructure provision

The zones often provide for the infrastructural needs of the foreign investors such as roads, railways, storage facilities and productive space or other elements. Recent SEZs have shown that many zones are located near existing air- or seaports to reduce the requisite for new infrastructure developments (Scheepers, 2012: 74).

d) Focussing on exports

SEZs normally restrict the sale of the produce to the international market within a Special Economic Zone. The domestic sale of goods produced within such a zone would lead to no real incremental benefits as it would only result in cheap manufactured produce to be sold at a lower price within the local economy (Saggers, 2015:15).

e) Ownership restrictions

The zones may regulate the ownership status of enterprises located within these Special Economic Zones and may require a percentage of local shareholding in combination with the foreign ownership (Aggarwal, 2004:10).

2.2 History of Special economic Zones

2.2.1 General

The world's first official Free Trade Zone originated in Ireland namely, the Shannon Free Trade Zone, which dates back to 1959. The zone was established by the Irish government to stimulate employment opportunities and generate revenue for the country as a zone within a rural area. This zone offered a very low corporate income tax rate compared to other countries in Europe, which was 12.5%. The Shannon zone was also known for a unique customs regime compared to the rest of the country and other investment incentives (Erasmus, 2011:8).

Towards the mid-1960s industrialisation has been a key focus point for countries all over the world. An Export Processing Zone (EPZ) is usually an industrial fenced-in area which is located within a developing third world country. These zones were renowned for their manufacturing activities for export purposes that offered free trade conditions. Foreign investors could normally take advantage of low labour costs to produce goods for exports while benefiting from tax incentives and minimalistic regulatory requirements. During the 1960s Mexico was known as one of the developing countries where the Mexican government offered cheap labour to United States businesses as a tool to address the unemployment issues that the country was facing (Saggers, 2015:16).

During the course of the 1960s and 1970s, developing countries used EPZs to address the vulnerability of their interiorly focused domestic economies. These countries included Brazil, India and Malaysia, which all made use of EPZs to drive an export-focused economy by making excess labour available to foreign investors. Baissac (2011:41) noted that in Asia, countries adopted EPZ programmes to move away from traditional exports and China became known as one of the proponent countries that made use of economic zones.

Since the 1980s, EPZs increased in popularity as a result of globalisation. These zones were, however, criticised for abusing human labour and exploiting natural resources due to the focus on producing the goods within the zone at a lower cost to maximise profits once the goods are exported. Despite the criticism towards the EPZ model, towards the end of the 1990s there was a minimum of 500 EPZs globally which provided employment to over 27 million people (van Heerden, 2002:15).

2.2.2 India

India was one of the first Asian countries to establish an EPZ in Kandla in 1965. After recognising the success of the EPZ, the government introduced a new Special Economic Zones policy in April 2000 (Farole, 2011b:35). This new policy aimed to stimulate economic activities to encourage the export of goods and services, attract foreign and local investment, address unemployment and develop infrastructure (Scheepers, 2012:28).

The Indian SEZs offered various tax and non-tax incentives which contributed to the overall success of the implementation of these zones. Goods could be imported duty free into these zones and procurement sourced locally from outside of these zones, was also acceptable (Erasmus, 2011:11). Income generated from exports was exempt from income tax for the initial five years since establishment and thereafter 50% for the following five years, with an additional 50% exemption on all of the reinvested export profits for the following five years thereafter (Scheepers, 2012:28). Shira (2013:4) noted that the SEZs allowed for exemptions from the minimum alternate tax, central and state sales taxes, as well as any service tax, while offering economic benefits which included external loans to a maximum of $500 million per year granted by the SEZ units without any maturity restrictions.

Other tax incentives that form part of the characteristics of the Indian SEZ model are classified into four categories and include other favourable income tax exemptions for the first five years of operations (Pakdeenurit *et al*, 2014:4). Businesses relocating to the SEZ will be exempted from capital gains. Other indirect tax incentives also include the importation of duty free goods, no excise duty on goods procured from a Domestic Tariff Area, and no VAT and Central Sales Tax on goods procured from a Domestic Tariff Area (Shira, 2013:3).

2.2.3 China

China is known for its successful SEZ programme which enabled the country to achieve economic transformation. The first Chinese SEZs were initially established in 1978 to restructure the country's economy with the aim of promoting capitalism and foreign investment. China started with four initial zones in the coastal areas which served as a prototype for the aim of economic restructuring (Pakdeenurit *et al*, 2014:4). During the 1980s and the 1990s the number of zones increased to include other towns and regions further away from the coast. These zones were established through specific legislation, taxation, land, labour, finance and other incentives that would have facilitated a liberal trade and investment regime (Baissac, 2011:41). The Chinese SEZ model was proven to be effective as the country was ranked the biggest manufactured goods exporter in the world and most attractive developing country for FDI (Woolfrey, 2013:7).

As to date, the Chinese SEZs have increased to over 200 zones of different types and diverse focus areas (Farole, 2011b:36). China's SEZs are known for being more than just geographical identified areas but rather jurisdictional separate identifiable zones. These zones are referred to as "new districts" because they are located within some of the main cities. One of the biggest free trade zones is the Waigaoqiao Free Trade Zone which has offered numerous tax incentives since establishment in 1990, as well as non-tax incentives as foreign companies could receive funding in the form of special subsidies from the Shanghai Municipality. Businesses are exempt from customs duties and VAT on all raw imported materials i for the purpose of manufacturing. The zone also offered the same relief for the importation of machinery, components utilised in the manufacturing process and office equipment required for the business activities conducted within the zone (Scheepers, 2012:30).

China's SEZs enjoy a preferential tax rate of 15% compared to the normal corporate income tax rate of 33% for businesses located outside the SEZs. For foreign investment entities operating within these zones with a proposed operation term exceeding 10 years, a two year tax holiday is available and thereafter 3 more years of half reduction of corporate income taxes (Saggers, 2015:63). A lifelong corporate income tax rate of 10% is available to foreign investment entities who export over 70% of their produce. The zones also offer duty free imports on manufacturing equipment or components and up to a 100% refund of income taxes for any profits re-invested in China. All after-tax profits can be moved freely out of China without any restrictions while other benefits include virtually no customs duty and income tax exemptions for foreign investors working within the SEZs (Wei, 1994:40).

During 2011 two additional SEZs were declared in the northwest region of China located in the Xinjiang province, with the aim of developing the economy of an underdeveloped region. These zones offered various incentives, including favourable tax incentives and low-interest loans for projects that aimed to improve local infrastructure (Shira, 2013:8). The preferential tax regime in these zones included five year tax free periods provided that a minimum of 70% of the businesses' income was generated through specific industries, including renewable energy, construction industry, agriculture, information technology, education, healthcare and sports. Upon expiration of the tax free period, the income tax would be calculated at 25% which will be reduced by 40% for two years following the tax free period (Brunschweiler, 2014:3).

In 2015 the Chinese government implemented three additional Free Trade Zones, each assigned with a specific strategic objective in mind. Fujian was established to support trade with Taiwan, Guangdong supports economic integration with Hong Kong and Tianjin assists the development of offshore financial markets. Free Trade Zones are used in China to pilot different policies and experiment with different forms of tax benefits (Farole, 2011b:36). In the Shanghai Free Trade Zone a company can pay their income tax liability in instalments over a period of five years to assist with the monitoring of cash flow. The majority of the zones allow for duty free imports of machinery and equipment for use by the company located in the zone (Shira, 2017).

2.3 Rationale for establishment

Chapter 1 (see 1.1.3) identified that SEZs have various motivations for implementation by governments. The main purpose of establishing an SEZ is to improve the prosperity of the country and its people. The aim of the SEZ is to attract foreign business capital to invest in the country and in return privileges are offered by the government through policies, regulation and the provision of infrastructure (Pakdeenurit *et al*, 2014:1). According to Farole (2011b:24), the rationale for establishing SEZs is to induce structural economic changes to enhance socio-economic sustainability in a country.

The rationale behind the establishment of SEZs is based on the following three economic objectives (Tang, 2008:4):

i. Enable the country to be more competitive in a global competitive environment. This includes improving logistics services and infrastructure, as well as offering favourable fiscal incentives to lower transaction costs and increase the export of goods or services (Pakdeenurit *et al*, 2014:2).

ii. To be more attractive internationally through the use of fiscal and non-fiscal incentives that will allow the country to attract FDI (Scheepers, 2012: 14).

iii. Increase industrial synergies through integration of domestic and zone-based industries that will enable overall growth in the broader economy of the country.

It was noted by Tang (2008:4) that one of the economic objectives of SEZs is to lure FDI through inducements which distinguishes SEZs from the rest of the country based on the incentives available under their economic regime. These incentives are generally categorised as tax and non-tax incentives. Tax incentives reduce payable tax and is generally only available for a defined period of time to ensure that investors do not have unlimited preferential treatment for an undefined period of time (OECD, 2017:16). Non-tax incentives usually include improved administrative procedures, streamlined customs procedures, the provision of infrastructure or less complex regulatory and administrative requirements within a zone (Murray, 2013:6).

2.4 Categories of Special Economic Zones

As noted in Chapter 1 (see 1.1.3), SEZS are not a “one size fits all” economic tool. Governments need to consider the specific objectives that they would like to meet in a political and economic context based on existing government policies in place. SEZs are a broad concept due to the existence of various classifications of SEZs; each contains diverse objectives and unique policy implementation (Murray, 2013:5). This section will provide an outline of the various types of SEZs and their purposes:

a. Free Trade Zone

This is one of the most frequently used SEZs, also known as Commercial Free Zones (Farole, 2011b:27). They are fenced-in duty free areas offering warehousing, storage and distribution facilities focusing on export operations and international trade. These zones have streamlined regulatory requirements for regulated tariffs, labour guidelines and environmental protocols and they are located close to national ports offering less rigorous customs requirements (Scheepers, 2012: 20). The Free Trade Zone is the most extensive type of SEZ as it aims to provide critical facilities for trading, shipping, imports and exports (Pakdeenurit *et al*, 2014:1).

b. Traditional Export Processing Zone

These zones have similar characteristics as Free Trade Zones as they are also fenced-in areas in industrial estates that are export driven (Saggers, 2015:15). However, they are different in concept as they do not incentivise investors with the same tax and regulatory benefits of Free Trade Zones. The area within the estate is devoted to export-orientated enterprise activities and the actual manufacturing occurs in these zones to provide a functional advantage to investors benefiting from the geographic concentration of production activities (Farole, 2011b:27).

c. Enterprise Zones

Enterprise zones are established by either national government or local government in charge of a specific region of the country with the aim that the zone will allow for an improved quality of life for the local community. These zones are geographically identified areas that provide tax, expenditure and regulatory inducements as a tool to achieve a country's economic development strategy as a whole (Pakdeenurit *et al*, 2014:2). Enterprise zones offer tax incentives to invested capital, creating labour opportunities and overall development to revitalise an underdeveloped area. This enhances employment prospects for residents in distressed communities to promote the competitiveness of the community or the country as a whole (Leslie, 1993:4).

d. Hybrid Export Processing Zone

According to Woolfrey (2013:3) this type of zone is called a Hybrid Export Processing Zone because it is a combination of an export orientated focus of the Traditional Export Processing Zone, with a subdivided devoted area for non-export related activities to take place. These zones are a more modern version of the Export Processing Zones and are open to a wider variety of industries as it allows local firms to be located together with the export-orientated businesses in the same geographical region categorised as an Export Processing Zone (Farole, 2011b:225).

e. Single Factories

Pakdeenurit *et al* (2014:2) defines that the main purpose of implementing such a SEZ is to promote the specialisation of a local firm within a specific industry in order to compete with a global competitor within a similar industry. These zones are also known as free enterprises that are not restricted to a specific geographical area in order to receive incentives. This Special Economic Zone focus on specific government identified enterprises or operations, which will improve development of a particular industry regardless of the location of the economic activities (Scheepers, 2012:21).

f. Freeports

Freeports can include economic regions and populations which can accommodate all types of economic activities where the defined business operations could be tax exempt while the relevant indirect taxes like VAT or excise duties, still apply. These zones are not restricted to rural or urban areas and generally incorporate ports and airports to accommodate various economic activities (Pakdeenurit *et al*, 2014:2). These zones may have specific objectives to promote the trade of goods or services, including tourism and retail sales, and could even make provision for on-site residence for employees or investors through a range of incentive benefits (Woolfrey, 2013:3).

2.5 IDZs in South Africa

Chapter 1 (see 1.1) highlighted that a concept known as Industrial Development Zones (IDZs), was introduced in South Africa for the first time in December 2000. IDZ is a form of a SEZ but there are, however, certain key differences in the overall concept of a Special Economic Zone. An IDZ is usually a purpose-built industrial estate which is located on specific and separately identifiable premises. IDZs are usually close to or linked to an international trade port in the form of an airport or shipping port and are usually export orientated zones (Moses, 2017:7).

South Africa introduced a policy developed by the Department of Trade and Industry (DTI) and thereafter, on 1 December 2000, introduced the IDZs. The aim of the IDZs was to attract foreign and local investors in areas identified by the minister of Trade and Industry. There were originally five regions which have been proclaimed as Industrial development zones (Scheepers, 2012:63).

Coega IDZ, located in Port Elizabeth, focused on automotive, general processing, agro-processing and chemical industries (Chinguno, 2011:8). The Eastern Cape Development Corporation (2018) endorses that the Coega IDZ was the largest IDZ in the Southern Hemisphere but, although being decreed in 2001, the first investment was only made in 2005. Coega holds investments from multinational firms including the German industrial group MAN Ferrostaal who invested R1,8 billion in a stainless steel precision strip in the development zone which became fully operational in 2007. East London IDZ was designated in 2002 and focussed on industries relating to automotive biofuels, food, timber processing and the automotive industry (DTI, 2017). The automotive industry contributed to 90% of the activities due to the investment made by Mercedes Benz, one of the key investors (Saggers, 2012:23).

Richards Bay IDZ also proclaimed in 2002 focused on the sectors of aluminium, furniture, ship repairs, and wood processing (Tang, 2008:5). The Richards Bay IDZ experienced numerous challenges in the beginning which stalled its inauguration for almost eight years due to a land dispute between the local government and the proposed zone operator. The land was situated in a designated area containing endangered fauna and flora species and the original 525 hectares of pre-approved land were reduced to 345 hectares due to the environmental risks imposed to the local ecosystem (Chinguno, 2011:12). The first operator permit was only issued to Tata Steel in 2011, the only investor operating within the zone until 2013. Tata Steel made an investment of R960 million and provided permanent employment to 184 members of staff and 85 full-time contract employees (Anon, 2013).

OR Tambo International Airport (ORTIA) IDZ was designated in 2010 to focus on the jewellery, manufacturing and aerotropolis industries (Chinguno, 2011:13). In 2009 a special purpose vehicle company called the Gauteng IDZ Development Company was issued an IDZ operator permit. This company is a subsidiary of the Gauteng Growth Development Agency and will focus to develop the OR Tambo IDZ. This zone will be developed in different phases over a ten to fifteen year period. The first phase focuses on establishing a jewellery manufacturing precinct which aims to be completed before the end of 2018 (Donald, 2018).

Although not yet fully operational, the construction of the first phase created employment for 110 temporary contract workers with over 1000 jobs envisaged from the operations of the ORTIA IDZ project. At this stage the IDZ is still only a government funded initiative but opportunities for public and/or private partnerships will arise when phase two is being rolled out. Well-known local food companies such as In2Food group, have already indicated interest to be located in the ORTIA IDZ and negotiations have been entered with diamond and jewellery companies, as well as metal refining companies, to also consider relocating to the zone (Donald, 2018).

Saldanha Bay IDZ located in the Western Cape was designated in 2013 to promote the oil, gas, marine repair and engineering industries (Chinguno, 2011:17). The Saldanha Bay IDZ Licencing Company was successfully awarded the operating permit in 2013 to establish the IDZ over a period of 30 years. A private port terminal operator owned by the HARPS investment group, has recently invested R1.8 billion over a five year period to establish Africa's first offshore supply base to provide services to oil and gas companies that operate close to the African coastline (Moses, 2017:20).

The IDZs were characterised to receive fiscal incentives from the government which included relief of particular taxes generally levied in South Africa. Goods that have been imported into a customs controlled area (CCA) within an IDZ were relieved from the excise duties, import customs and economic restrictions while the goods are in storage subject to further processing. Within the IDZ, all imported raw materials or goods used in manufacturing would not be subjected to the normal import customs and excise duties (Scheepers, 2012:48).

A specific rebate, rebate item 498.01, would allow for the payment of customs and excise duties to be dismissed which would assist entities in these zones with the management of their cash flow (Saggers, 2012:12). It was acceptable for IDZ operators to procure goods from outside the zones as local goods and services acquired from outside the IDZ of a CCA were charged VAT at a rate of zero percent (Scheepers, 2012:51). Imports from outside the so called "BLSN" countries (Botswana, Lesotho, Swaziland and Namibia), were subjected to VAT levied at a reduced fee of 10% instead of using 14% on the value of the import, to calculate the VAT charge applicable for the import of such goods (SARS, 2016a).

2.6 SEZs in South Africa

Chapter 1 (see 1.1) identified that SEZs ensued from the previous IDZ regime. The previous IDZ programme contained limited fiscal incentives which focused mainly on providing relief in terms of customs duty rebates and VAT exclusions. SEZs are regulated by the SEZ Act (16 of 2014) and have become effective since it has been proclaimed on 9 February 2016, with a focus to drive industrial development through offering a wider range of tax incentives than the previous IDZ regime (DTI, 2018:4). As to date, seven areas have been designated to serve as SEZs which include Coega, Richards Bay, East London, Saldanha Bay, OR Tambo (Gauteng), Dube Tradeport and Maluti-A-Phofung. The first five zones form part of the transitional provisions of section 39 of the SEZ Act (16 of 2014) which aim to convert all previous Industrial Development Zones to Special Economic Zones (Vallie, 2017).

South African SEZs are defined by The Policy on the Development of SEZs as: "geographically designated areas of a country set aside for specifically targeted economic activities, which are then supported through special arrangements and support systems that are often different from those that apply to the rest of the country" (DTI, 2012). SEZs allow for a regulatory regime to differ from the rest of the country to offer business support and fiscal incentives to companies operating within the zones (Moses, 2017:6). By introducing the new SEZ model it was highlighted that there was a need for improved fiscal incentives to boost FDI. As part of the improved proposed fiscal incentives to be added to the previous IDZ regime section, 12R and 12S were added to the Taxation Laws Amendment Act No. 39 of 2013 (Saggers, 2015:28).

South Africa experiences problematic socio-economic challenges which include, amongst other, passive economic growth, high unemployment figures, wealth distribution inequality and severe poverty, as well as other challenges induced by spatial development and regional inequalities (DTI, 2012:9). The South African government is focused to transform the economy to be more competitive globally as an industrial economy. The NDP proposes details to eliminate poverty and address inequality by 2030. The SEZs form part of the tools that could enable the country to accelerate the development objectives by supporting the macro-economic policies such as the NDP (Vallie, 2017).

2.6.1 South African SEZ Income Tax Incentives

The purpose of this section is to define the tax incentives offered by the South African SEZ regime. The incentives focus on all three of the major tax sources that contribute to generating government revenues. These incentives fall within the scope of corporate income taxes levied on profits generated by companies, personal income taxes on salaries or wages earned by employees, and indirect taxes which include exclusions or reductions from customs duties and VAT.

2.6.1.1 Section 12R: Reduced corporate tax rate

The fiscal incentive available in the form of a reduced corporate tax rate for qualifying companies is contained in the provisions of section 12R of the Income Tax Act (58 of 1962). Before a company is entitled to the incentive benefits under section 12R, it is important to note that certain requirements have to be met (Steenkamp, 2016:301).

A "qualifying company", as defined in section 12R, requires the company to be a resident company for tax purposes and therefore needs to be incorporated or have its place of effective management in South Africa (Gad & Radloff, 2013). It is important to note that permanent establishments or company branches which are not deemed to be residents of South Africa will not be able to benefit from the incentives offered under section 12R, as they do not meet the requirements of the definition of a "qualifying company". It is posed that the purpose of the first requirement is to exclude foreign incorporated companies and companies incorporated in "tax havens" from enjoying the income tax benefits offered by the South African SEZ regime (Chimbombi, 2016:37).

The SARS Interpretation Note No. 6 (Issue 2) (SARS, 2015) provides practical guidance to establish the place of effective management, which is an alternative requirement under section 12R(a)(ii) if the company is not incorporated in South Africa. The Interpretation Note defines the place of effective management as: "The place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made" (SARS, 2015:4). The interpretation note stresses that the place of effective management should take all the facts into consideration and the company bears the onus to prove its place of effective management as stipulated in section 102 of the South African Tax Administration Act (28 of 2011) (South Africa, 2011).

Clegg & Stretch (2018) noted that a trade which is approved by the minister of Trade and Industry needs to be carried out in a SEZ which is designated by the Special Economic Zones Act (16 of 2014). The phrase "carries on a trade" is primarily inserted to ensure that the core income generating operations of the company take place in the SEZ (Chimbombi, 2016:39). The services provided by the company are discretionary based on a list of disallowable goods or services which may not be produced or delivered in the SEZs in order to continue qualifying for the tax incentives and other benefits.

The company is required to operate from a fixed place of business within the SEZ and section 12R(d) requires that the qualifying company should derive more than 90 percent of its income from the trade within one or more SEZ (Steenkamp, 2016:301). This will prevent the possibility of a company shifting profits or income earned in the SEZs to activities outside the SEZ just in order to qualify for preferential tax benefits.

These provisions may have a significant impact on service organisations who regularly provide services at the premises of clients, not necessarily always located within the SEZ. The 90% requirement may also increase the compliance obligations for companies that intend to operate within a SEZ as they would likely need to incorporate additional subsidiaries to distinguish income derived for the company holistically, from normal business activities outside the zone (Saggers, 2015:29). As it is unclear what exactly constitutes a "fixed place of business", the business activities and its location should be determined on a factual basis. This should be conducted through a case-by case assessment of the business activities for the company as a whole (Chimbombi, 2016:40).

As per section 24(4) of the SEZ Act (16 of 2014), the first income tax concession available under section 12R is a reduced corporate tax rate of 15% for taxable income derived within the SEZ, as opposed to the normal corporate tax rate for South African companies of 28%. Companies operating in the following sectors classified as "Section C: Manufacturing" in the Industrial Classification (SIC Codes), will not qualify for the incentives offered under section 12R (Clegg & Stretch, 2018):

- Distilling, rectifying and blending of Spirits (SIC Code 1101)
- Manufacturing of wines (SIC Code 1102)
- Manufacturing of malt liquors and malt (SIC Code 103)
- Manufacturing of tobacco products (SIC Code 12)
- Manufacturing of weapons and ammunition (SIC Code 252)
- Manufacturing of bio-fuels if it may negatively impact food security

The rationale for the rate of 15% is unclear, but it was noticed that it could be possible that the previous rate for dividends tax (15%) was taken into account to bring the effective tax rate applicable for a subsidiary of a foreign company in line with the effective tax rate of a South African company with a subsidiary which are operating outside the zone where dividends tax will not be withheld for distributed profits as dividends to a resident company (Saggers, 2015:30).

National Treasury (2015:36) identified a reasonable risk that taxable profits could be artificially shifted from outside the SEZ to a connected person who represents a qualifying company located within the SEZ and enjoying tax benefits, including the lowered corporate tax rate of 15%, and suggested that that an anti-profit shifting measure should be put in place to mitigate the risk. This resulted in an amendment by the Taxation Laws Amendment Act (25 of 2015) (South Africa, 2015b) to section 12R(4)(c), which now contains an additional provision that disqualifies companies from applying the lowered tax rate of 15% if more than 20% of the tax deductible expenditure or more than 20% of the income of the company, is generated or incurred between connected persons who are either a South African resident or a non-resident who has a permanent establishment in South Africa.

The amendment addresses the risk identified by National Treasury to avoid artificial profit shifting from taxable connected persons outside the SEZ to the qualifying company within the SEZ which is eligible for the tax concession. The essence of the provision, according to the Explanatory Memorandum on the Taxation Laws Amendment Bill (South Africa, 2015a), is to prevent existing companies in South Africa, who are taxable connected entities, from branching out to a SEZ and then prohibiting them from allocating existing business to their connected SEZ company.

Section 12R(5) limits a qualifying company to enjoy the tax benefits offered under section 12R. The benefits will cease in respect of any year of assessment ending on or after January 2024, or ten years after commencement of trade activities within a Special Economic Zone (Saggers, 2015:32). Although the expiration date is 2024, the provision has only came into force on 9 February 2016 leaving only 8 years left before it ceases to apply under the provisions of the Income Tax Act (South Africa, 1962). The Taxation Laws Amendment Act (17 of 2017) (South Africa, 2017a) introduced a change to the limitation that the 12R incentive ceases to apply for years of assessment commencing the later of 1 January 2024 or ten years after the commencement of carrying on of a trade in an SEZ. The time limit may still have a negative impact when companies are considering long term investment in South Africa if their choices are based on the incentives offered under the SEZ regime.

Previously, there was ambiguity relating to the tax treatment of a small business corporations (SBC) situated within a SEZ. Since the 2016 National Treasury Budget Review it is resolved that a SBC operating in a SEZ would be subjected to a tax rate of 15% or the applicable tax rate per the tables for SBCs, whichever one of the two is the most beneficial (SARS, 2016). Highlighted by the Explanatory Memorandum to the Taxation Laws Amendment Bill (South Africa, 2013), the transactions between qualifying companies located in a SEZ with connected persons located outside the SEZ, even if those connected persons are South African residents, may pose a risk if subjected to transfer pricing considerations. This could deem a transaction as an affected transaction if the terms of the transactions are not at arm's length, creating transfer pricing risks, even if it is not an international transaction.

2.6.1.2 Section 12S: Accelerated wear and tear allowance

The second income tax incentive available under the South African SEZ regime is a section 12S accelerated wear and tear allowance on buildings in use by the taxpayer to produce taxable income within the SEZ (Gad & Radloff, 2013). A qualifying company can deduct an allowance equal to 10% of the cost of a new or unused building, as well as improvements to buildings owned by the qualifying company which are used to produce income in the course of trade (Clegg & Stretch, 2018).

Section 12S also contains a sunset clause that states that the allowance ceases to apply for years of assessment commencing on or after 1 January 2024 and in effect it only provides 8 years of benefits as the section 12S provision only came into force on 9 February 2016 (Saggers, 2015:32). This could demotivate investors from investing in infrastructure development especially with regards to constructing new buildings, because section 12S does not contain the same sunset clause provisions as section 12R to extend the benefits to the later years of assessment commencing on 1 January 2024 or 10 years after the commencement of operations within the SEZ.

As this allowance is only available to new and unused buildings or improvements, leasehold improvements would generally not qualify unless they are owned by the qualifying company in terms of section 12N of the Income Tax Act where depreciation allowances are granted for buildings owned by the government (SARS, 2016). The building or the improvements should therefore be physically located within the SEZ (Steenkamp, 2016:301). Based on the structure of the IDZs (which have now been converted into SEZs), the zones were owned by the IDZ operating company and leased to companies who wished to operate within the IDZ. Those leases would therefore be negotiated to ensure that the building on the leased land is indeed owned by the lessee before they would be entitled to qualify for the tax incentive (Saggers, 2015:31).

Section 12S(5) of the Income Tax Act (58 of 1962) states that no deduction will be allowed in respect of any building that has been disposed of by the qualifying company during any previous year of assessment. This section is vague and does not explicitly state if the provision also disqualifies other companies taking over the building when the first company ceases to be a qualifying company. It is unclear if the new company taking over the building will still be able to benefit from the tax allowance offered for buildings in use if the previous company disposed of the building prematurely before the provision ceases to apply in January 2024 (Chimbombi, 2016:40).

2.6.2 Section 12I: Investment and training allowance

The section 12I tax allowance was first introduced in 2011 with the objective to increase investment in manufacturing assets to motivate the expansion of the industrial sector within the economy (Smale, 2012:36). The section 12I Investment allowance also contains tax incentive benefits associated with SEZs. Even though the section is not primarily associated with SEZs, it allows for deductions based on investment in manufacturing assets associated with industrial policy projects (Saggers, 2015: 38). The provisions of section 12I grants a 100% deduction of the cost of acquiring a new and unused manufacturing asset if the industrial policy project has preferred status and is located within a SEZ compared to 55% for projects located outside the SEZ and 75% for projects without preferred status located within an SEZ, compared to 35% for projects located outside a SEZ (DTI, 2015:1).

According to section 12I(8) of the Income Tax Act (58 of 1962), the status of the projects is determined by the minister of Trade and Industry. This includes having a regard for the utilisation of innovative processes, using efficient and cleaner technology, the provision of business linkages, procuring from small and medium enterprises, creating employment and developing skills in the republic. Based on the aforementioned factors the project will be graded by the DTI to establish whether the project qualifies for "preferred status" or "other status" which will have an impact on the available deductions for investments in manufacturing assets (Smale, 2012:39).

2.6.3 Employment tax incentives

Employment tax incentives known as ETIs, are tax incentives that could be used by businesses operating in a SEZ as there is no limitation on the employee's age that would normally apply to qualify for an ETI (Warneke, 2014). The ETI reduces the employee tax that is deducted by the employer without affecting the remuneration paid to the employee. This serves as a cost-sharing incentive mechanism between the business (employer) and the government (Van der Zwan, 2014).

The employment tax incentives that are available to qualifying companies that operate in the SEZs are described in the Employment Tax Incentive Act (23 of 2013)(South Africa, 2013), hereafter referred to as the ETI Act. The mandate of the ETI Act is "to provide for an employment tax incentive in the form of an amount by which employees' tax may be reduced; to allow for a claim and payment of an amount where employees' tax cannot be reduced; and to provide for matters connected therewith".

The incentive is calculated with a formula that takes into consideration the number of eligible employees employed by the qualifying company (Warneke, 2014). A company will only be entitled to the incentive if they are a registered employer for employees' tax as required by paragraph 15 of the Fourth Schedule contained in the Income Tax Act. There are only two types of employees that are qualifying employees for the Employment Tax Incentive as per the ETI Act (Roux, 2015:9):

1) Employees between the ages of 18 and 29; or
2) Employees in employment by a qualifying company who renders services mainly for the operations of the business within the SEZ

There are certain requirements that need to be met for the employer to qualify for the incentive. The employee needs to be a South African citizen and may not be a connected person in relation to the employer. The employee will be disqualified if that employee is a domestic worker for the company and the employee needs to be employed after 1 October 2013 and receive remuneration of less than R6000 per month (Saggers, 2015:34).

The Employment Tax Incentive commenced on 1 January 2014 and will cease to apply on 28 February 2019 (Roux, 2015:8). With SEZs only becoming effective from 2016 there is a very limited time frame for foreign investors to benefit from the Employment Tax Incentives available under the SEZ regime. During the first 12 months of the employee's employment contract, the monthly ETI is determined by remuneration criteria as follows (Zulman *et al*., 2018):

- Remuneration below R2000 per month: 50% of monthly remuneration
- Remuneration is between R2000 and less than R4000: R1000
- Remuneration is more than R 4000 but less than R6000: apply the formula to calculate the ETI as R 1000 – (0.5 x (remuneration – R4000))
- Remuneration is more than R6000: No ETI available

During each of the following 12 months following the employee's initial employment, the monthly ETI is determined as follows (Saggers, 2015:35):

- Remuneration below R2000 per month: 25% of monthly remuneration
- Remuneration is between R2000 and less than R4000: R500
- Remuneration is more than R 4000 but less than R6000: apply the formula to calculate the ETI as R 500 – (0.25 x (remuneration – R4000))
- Remuneration is more than R6000: No ETI available

2.6.4 Indirect Tax Incentives

The Customs Rule amendment was published on 3 July 2015. It also amended section 21A of the Customs and Excise Act and the date that the SEZ Act will take effect was proclaimed as 9 February 2016. As defined in the Customs Control Act (31 of 2014) (South Africa, 2014), a “SEZ enterprise” is defined as an enterprise within a special economic zone or part of a special economic zone, designated in terms of section 43(2)(c) as a Customs Controlled Area (CCA). The Customs Control Act also defines the term “Special Economic Zone” as a designated area in terms of the SEZ Act.

Based on the SEZ Policy, all the previous IDZs will be converted to SEZs and the terms are interchangeable based on the available indirect tax incentives (Le Roux & Schoeman, 2016:753). The previous IDZ programme established that the zone would include a CCA, which could be defined as separate designated areas within the IDZ, or from 2016 the entire SEZ was a CCA approved enterprise in which business activities could be conducted. The CCA has its own separate entrance and exit points which are controlled by SARS Customs and the SEZ operator will only qualify within these areas for indirect tax incentives (Saggers, 2015:33).

The indirect tax incentives remain otherwise the same as the indirect tax incentives that were offered under the previous IDZ regime that were highlighted earlier in this chapter (see 2.5). The CCAs resulted in a number of issues that related to the VAT treatment of supplies to and from a SEZ operator located in a CCA of the SEZ. The practical issues were addressed by SARS by releasing interpretation note 40 in 2007, which had two subsequent issues which were released in 2012 and the latest version released in 2016 (SARS, 2016b).

Indirect tax incentives were made available for SEZ operators operating within the CCAs as per Interpretation Note 40 (issue 3) (SARS, 2016b). Movable goods imported by the SEZ operator for use in construction or maintenance of infrastructure in the CCA, are exempt from VAT and customs duties. Other movable goods imported by the SEZ operator, including raw materials for manufacturing, goods for storage and capital equipment used in the CAA, are also exempt from VAT and customs duties (Scheepers, 2012: 49). A major benefit of the indirect incentives was that the goods imported in the CAA are temporarily relieved from import customs and excise duties while being stored and undergoing manufacturing, processing, cleaning or repairs. Only when the goods are supplied to the local South African market will they be subjected to import customs and excise duties that were waived when the goods were imported to the CAA. These incentives assist the SEZ operator to improve the cash flow management of the business located within the SEZ (Erasmus, 2011:9).

The indirect tax benefits included VAT incentives which stipulated that goods which have been imported and then supplied to a licenced customs and excise storage warehouse, may be supplied at a zero rate (Le Roux & Schoeman, 2016:758). The physical supply of services located within the SEZ will also be at a zero rate and there is also no VAT payable on the rental payments made by the SEZ operator within the SEZ. The VAT incentive also stipulates that there shall be no VAT payable in terms of land supplied in the CCA and there are also VAT relief available in terms of electricity or water supplied within the SEZ (SARS, 2016b).

The normal VAT principles will still apply to the export of goods as it does for companies located outside the SEZ and therefore all goods exported outside the Republic will be at a zero rate. Where goods are supplied to a recipient within the Republic, no incentive is available as supply will be deemed to take place at a standard rate of 14%. If finished goods are directly exported from a SEZ then no levies are effectively collected by the revenue authorities (Saggers, 2015:34).

2.7 Chapter conclusion

The objective of this chapter was to determine what fundamental aspects are associated with SEZs globally while investigating which tax incentives are offered by the South African SEZ regime. It was established in this chapter that the SEZ programme can be seen as an important government tool. It strives to promote industrialisation, regional development and increase overall exports while addressing unemployment in South Africa and increasing the attractiveness of the country for foreign investment. FDI is seen as a growth generator, especially with regards to developing countries. By utilising SEZs as instruments, a country can establish a favourable investment climate that will promote FDI as productive capital that will support economic growth within the local economy.

SEZs act as experimental zones that enable governments to test new policies in a controlled environment while maintaining the status quo outside the zones for the rest of the country. Although SEZs have been implemented successfully, globally the derived benefits are not automatic but depend on whether the infrastructure, policies and favourable conditions have been created by the government. SEZs serve as instruments to achieve two types of benefits for a country namely, static and dynamic benefits (Nyakabawo, 2014:9).

The South African SEZ model has beneficial fiscal and other incentives that could reduce the tax burden for investors. It is allegedly most beneficial for companies to be located within an SEZ if the aim is to provide goods or services to other companies within the SEZ or for the export market which is in line with the South African export growth strategy. The current SEZ model might create barriers for foreign companies considering investment, as there are few incentives available for companies that aim to supply to the South African market (Saggers, 2015:44).

It can therefore be concluded that governments have various motivations to implement SEZs which explain the rationale behind the establishment of such zones. It was found that there are various entities classified as SEZs and for a zone to reflect the features of a SEZ in general, it needs to be administered through a policy framework which also contains specific identifiable characteristics. The conclusion reached in Chapter 2 is that there are four main tax incentives associated with the South African SEZ regime. This includes income tax concessions in the form of a reduced corporate tax rate, an accelerated building allowance, indirect tax incentives and ETIs. The remainder of the study will assess the incentives identified in Chapter 2 against a defined framework, to be established in Chapter 3, which will assist reaching a conclusion on the design of SEZs as a meaningful tax incentive in South Africa.

CHAPTER 3: TAX INCENTIVES AS INSTRUMENTS TO PROMOTE ECONOMIC GROWTH

3.1 Introduction to tax incentives

This chapter aims to explore the background and core principles associated with tax incentives. This includes the rationale behind the granting of an incentive, the different incentive options available for policy makers from which to choose and the design elements of a meaningful tax incentive. The focus of this chapter is to provide a backdrop against which the design of the South African SEZ can be evaluated, based on its design as a tax incentive. A tax incentive can be defined as a measure that allows tax treatment that is more favourable when compared with the same set of activities or industry sectors in the rest of the country (Klemm 2010:315).

Based on this definition a reduction in the corporate tax rate of the country as a whole is not an incentive even if it may increase corporate investment. If corporate taxes are lowered for firms relocating to a particular geographical area, or for the production of specific goods or services, it will be seen as an incentive scheme. If beneficial tax treatment is offered only for FDI instead of local investments, it will be deemed as an incentive to attract FDI (Moolman, 2012:22). The BEPS Action 5 suggests that if a regime provides even the slightest beneficial deviation from the tax laws in a country, then it is deemed to be preferential (OECD, 2015a:18). Preferential tax regimes are offered in different forms ranging from tax reductions, tax holidays or flexible tax payment terms which benefit the cash flows of the enterprise (Chimbombi, 2016: 25).

Internationally, countries choose tax competition models that would attract the mobile tax base by selecting favourable tax policies. The selected policy will depend on the mobility of the tax base as companies are then more flexible to establish themselves anywhere in the world (Easson and Zolt, 2002:15). This results in tax competition models which forecast lowered corporate tax rates because companies often prefer to locate or invest in countries with the lowest tax burden. It should however, be noted that companies also take into account non-tax factors when making their investment decisions (Wilson, 1999:269). This chapter aims to address the second research objective identified in 1.3.2 to identify the design characteristics associated with meaningful tax incentives.

Due to challenging circumstances in developing countries, special attention is drawn to how tax incentives may play a role to create a more favourable investment climate despite the challenges experienced from non-tax factors like market size, labour skills, infrastructure and political instability (Bird, 2008:24). The effect of these non-tax challenges is that developing countries are engaging in more aggressive and strategic tax incentives than developed countries. This results in a race to lower the corporate tax rates to compensate for an unfavourable investment climate (Asiedu, 2002: 108).

Developing countries prefer to offer tax incentives rather than financial incentives like government grants or favourable subsidized government loans. This may be because tax incentives do not require making use of upfront payments or constraining cash flows of government funds. The objective of the majority of tax incentives offered in developing countries are to lure foreign investment by reducing the tax burden for those investors (Asiedu, 2002: 109). The tax incentive models generally neglect to take into account the associated tax compliance costs and information costs. If the tax incentive is available discretionary depending on the engagement between the firm and the government, the costs incurred may increase and neutralise the original tax costs saved through the specific tax incentive (Klemm 2010:308).

A study done by Pouris (2003:196) found that South African tax incentives that form part of the country's innovation system have received unsatisfactory support from the government when being compared with global support. This has a negative impact on South Africa's investment climate as companies would find it more profitable to invest abroad. As South Africa aims to attract FDI and significant local investment, the incentives offered by SEZs need to compensate for the risks related to the local economy (Wilson, 1999:269). Commentators have conflicting opinions regarding the use and advantages and disadvantages of tax incentives when the balance between risk and rewards due to lower tax costs are being considered (European Commission, 2017:83). The next section will therefore explore the rationale behind the offering of tax incentives globally, despite conflicting views associated with tax incentives as an inducement for prospective investors.

3.2 Rationale for offering tax incentives

As identified in Chapter 3 (see 3.1) governments need to choose between government grants and tax incentives as inducement to lure FDI. The tax incentives form part of a strategic tax competition model and this section will take a closer look at the rationale behind the offered incentives and why policy makers would consider offering tax incentives to prospective investors. Tax incentives are used by governments as tools to serve as investment incentives in influencing investors' decisions favour certain countries (Moolman, 2012:22), or perhaps certain geographical regions in a country as is the case with SEZs. A reduction in the tax burden increases the anticipated profitability of projects which may lead to increased investment opportunities.

Investors may deem tax incentives as 'nice to have' benefits but not significant enough to be the sole influence of their investment decisions but still, tax incentives remain popular for developing, as well as developed countries. Companies make investment decisions based on a variety of factors, including government policies, inflation, interest rates and trends identified from competitors (Klemm, 2010:8). The processes and procedures which influence the design and implementation of tax incentives are imperative to establish their effectiveness (Barbour, 2005).

Different initiatives are launched as incentives including grants, subsidies, assistance programs and tax holidays promote certain behaviours. It has been debated that tax incentives are inferior to grants or subsidies due to them being less equitable because they often provide benefits to those requiring them the least. Although tax incentives may distort investment decisions and are sometimes labelled as inefficient and responsible for creating opportunities for abuse and corruption, they are still a key focus point for establishing policies globally (Easson and Zolt, 2002:23).

Tax benefits are sometimes a challenge to develop, maintain and administer because they are executed by tax committees who do not always possess the expertise and background information regarding non-tax social policies. Tax incentives are, however, more cost-effective than direct expenditure, which include grants, as they are available with lower transaction costs (Asiedu, 2002: 108). The cost may be lower due to easy introduction to the existing tax legislation and the tax incentives require no direct reductions in cash flow from government funds. Tax incentives have become very popular globally, specifically to attract FDI and to compensate for unfavourable investment climates or struggling economies (Pouris, 2003:195).

Tax incentives have become a more important role player in investment decision making over the past few years as they have evolved to become more generous (Moolman, 2012:23). This is illustrated through tax holiday periods increasing from two to ten years or where tax relief in SEZs have shifted focus from providing only indirect tax relief for VAT or customs duties, to offering additional trade and income tax relief. Due to the deterioration of non-tax barriers, the influence of tax incentives on investment decisions are increasing (Asiedu, 2002: 108). Over the past few years changes have been noted in the business environment. These are based on production and distribution activities which are becoming more mobile with fewer firms producing their products in a single country. Opportunities arise to out-contract activities of the value chain and it becomes more common for component parts to be produced elsewhere in the world (Easson and Zolt, 2002:3).

The main aim of tax incentives is to maximise investors' after-tax profits resulting in an increased need of tax competition to attract FDI (European Commission, 2017:62). Still, there is no recipe or one size fits all approach for tax incentives that will enable a country to achieve its development goals. It is therefore necessary to take into account a combination of policy instruments, including tax incentives, and country-specific characteristics to decide which incentives will be the most beneficial to offer for the host country (Pouris, 2003:195).

The income tax system is relatively easy to adjust in order to influence the desired behaviour of specific groups which the government has identified. Investors are often made more aware of the tax incentives rather than direct expenditure or grants (European Commission, 2017:62). This is the case because information is available to a large group of people like corporates or accountants, who acquired the information through either experience or their tuition. This information includes tax knowledge. The rationale for granting tax incentives is to stimulate investment and is based on the following characteristics (Moolman, 2012:24):

i. Tax incentives enable the private sector to retain autonomy as they require a reduced amount of state interference because, usually, in order to obtain grants, an investor would require assistance from the government.

ii. Tax incentives have fewer layers of bureaucracy which is a key role player in developing countries with limited administrative resources to their disposal. They are also more feasible from a political point of view as they are sometimes less challenging to impose and implement (Pouris, 2003:196).
iii. The qualifying criteria are transparent with less detailed upfront requirements in order to qualify for the benefits associated with the specific incentive (Bauer, 2010).
iv. Investors often prefer tax incentives as the favourable option compared to direct expenditure, and therefore they have the ability to induce the required industry reactions and activities.
v. They form an integral part of innovation in terms of drafting policies and complementing other fiscal and non-fiscal incentives already in place (European Commission, 2017:13).

3.3 Variety of tax incentives

There are a variety of tax incentives which are used globally to lure investment or to address socio-economic challenges, specifically with regards to using SEZs to obtain a competitive advantage by offering tax incentives. There are different options available through which legislation normally provides for a variety of possible tax incentives. These are known to attract foreign investors due to the financial benefits following the incentives, like reduced tax liabilities. This section will aim to explore the range of tax incentives which are often offered through SEZs (OECD, 2017: 17):

Tax holidays

Tax holidays are popular in developing countries and the most common category of tax incentive that targets investment. They offer good benefits on the short-term as it is usually only granted for a limited time and may include a full or partial exemption from relevant tax obligations. This includes exemptions from corporate and other forms of imposed taxes and could even relinquish the administration burden of submitting returns (OECD, 2017:17). A disadvantage of a tax holiday is that the revenue cost is not reliably estimated in advance and neither can the foregone cost compared to the investment benefits accrued to the host country, be calculated accurately (Klemm, 2010:14). This incentive is, however, easily administrated and the qualifying companies receive transitory benefits with the opportunity to terminate business operations once the tax holiday comes to an end, which is often referred to as the "sunset clause" (Jordaan, 2012:11).

Accelerated depreciation allowances and credits

This incentive is often offered as an alternative or in addition to tax holidays. The allowance reduces the taxable income when a particular percentage is applied to the capital expenditure or qualifying capital asset, which results in a taxable deduction. The tax credit is normally not influenced by the corporate tax percentage because the investment tax credit is net off against the tax liability (Klemm, 2010:14). These incentives can apply to different forms of capital investment or may sometimes be restricted to capital equipment or technology advanced assets. These incentives are often preferred by governments as the associated revenue cost is equal to the cost of the capital investment (Easson and Zolt, 2002:20).

These incentives distort the choice of investment assets as companies would prefer to invest in short-lived assets to claim additional allowances when those assets are replaced by new ones. This allows for a greater deduction against taxable profits over a shorter period of time. It leaves the total deductions over the period unchanged but fast forward them in time. In essence the main advantage to the business is the time value of money (Otto *et al*., 2006:11). Capital cost allowance incentives are more focused to incentivise capital investment and does not directly contribute towards creating employment opportunities like tax holidays (OECD, 2001:27).

Reduced corporate tax rates

This tax incentive generally benefits specific sectors of the economy. These rates are usually justified by economic factors which governments will take into account when lowering the tax rate (OECD, 2001:27). Some countries will reduce the corporate tax rate for investment in certain industries e.g., Ireland applied a reduced tax rate specifically for manufacturing activities. Some countries may elect to provide a reduced tax rate for specific locations such as the reduced tax rate for companies located within a SEZ in China (Easson and Zolt, 2002:19).

Special zones

The government will identify geographical areas where established businesses can operate at beneficial tax terms. Countries use these zones to attract investment and they are implemented either as duty free zones enjoying benefits from being exempt from customs duties and VAT, or as SEZs which offer unique tax privileges that differ from other regions in the host country (Klemm, 2010:15).

The SEZs normally reduce a portion of the tax liability of a company operating within such a zone by reducing the statutory corporate tax rate on all taxable profits generated within the zone. This incentive is also not complex to administer as the revenue losses are mostly transparent (Easson and Zolt, 2002:12). The incentive may cause the fiscus to face other obstacles such as tax avoidance or revenue leakage through profit shifting via high-tax enterprises to connected lower tax enterprises, while increasing the tax risks of transfer pricing (OECD, 2001:26).

Reinvestment incentives

Some countries will incentivise companies to reinvest their profits. Investment tax credits and investment allowances provide for a portion of an investment which could be deducted against payable taxes, or a deduction against taxable profits based on the value of reinvestment (OECD, 2001:27). There are different options available which generally include that the tax liability can be reduced with the reinvested amount, or the company is rewarded with a tax refund after filing the return and indicating the amount reinvested. Unless the host country has lavish depreciation allowances, this incentive is not as effective as the investment decisions of an enterprise which is based on actual business needs (Easson and Zolt, 2002:22).

Withholding tax incentives

This incentive may reduce the rate of withholding taxes such as dividends tax when profits are distributed to the shareholders. It may also provide relief for imputation of taxable profits from received dividends, or allow for deductions for dividends declared against taxable profits. Sometimes the applied rate for the withholding taxes may be lower than the applied rate outside the SEZ to increase the benefits of after-tax cash flows for the foreign investors (OECD, 2001:28).

Exemptions from Custom duties

Exemptions offered on the import of capital goods or raw materials can be beneficial for investors as these taxes are not easily recoverable and often increase the initial cost of investment for start-up operations (Klemm, 2010:16). Some investors deem this incentive to be one of the most favourable types of investment incentive as it is independent of profitability and result in immediate savings. The disadvantage of this type of incentive is that it promotes imports over local procurement. It therefore, increases the risk of goods being imported at lower costs and then being sold to the local market, rather than applying those goods for the production process which was the original intention of the incentive granted (OECD, 2017:17).

VAT refunds

VAT is generally claimed by the vendor at a later stage after the VAT was levied on the incurred expense or the purchase of goods or services. The majority of countries with SEZs, exempt the investors from VAT when importing goods or services within the zone (Scheepers, 2012:24). These incentives would have been subjected to VAT consequences if those goods or services were imported by the vendor outside the SEZ, resulting in cash-flow benefits for the investor (OECD, 2017:17).

Reduced property taxes

Property taxes relate to real estate and include taxes or levies collected by municipalities. Property tax exemptions are normally also only available for a limited period of time. This incentive is a cost saving incentive and is granted by a regional government authority (OECD, 2017:17).

Personal income taxes

Reduced personal income taxes or social security contributions aim to address unemployment in underdeveloped regions of the country. A reduction in personal income taxes have a positive impact on labour utilisation within the economy (European Commission, 2017:44). The impact of this type of incentive is not likely to be significant but it is easy to administrate. Overall, it will still contribute to creating a favourable investment environment for FDI (OECD, 2017:17).

3.4 Advantages and disadvantages of tax incentives

This section will take a closer look at the advantages and disadvantages associated with tax incentives in order to consider the overall impact of the incentive on the country. Every government incentive has its own set of benefits and limitations, the same applies to tax incentives. This contributes to the challenges of a country in considering which incentives are the best options with which to achieve certain economic outcomes in different investment circumstances (Buss, 2001:91). The criteria to establish which tax incentive should be preferred to the others will be influenced by the economic climate, the administration, the competence of the tax authorities, the type of investments being promoted and the financial limitations of the government (Jordaan, 2012:10).

When tax incentives are well designed and properly implemented they serve as effective measures to lure investments that would not have been achieved in the absence of the tax benefits provided by the incentive (European Commission, 2017:62). Tax incentives that are designed to be restricted may even successfully attract specific desired projects, particularly investment groups, or to promote advancement in certain industries. It is therefore often easier for governments to rather offer tax incentives than directly addressing economic challenges in the country. Tax incentives are also not challenging to endorse as they do not require direct expenditure of government funds. This render them the easy choice for both political and other economic reasons (Easson and Zolt, 2002:10).

According to Chen (2015:8), the cost of a tax incentive can be defined as “the direct revenue loss, efficiency loss and the increased administrative or compliance cost caused by a tax incentive program”. The benefit of a tax incentive can be defined Moolman (2012:22) as “the increased economic activities attributable to such an incentive program and the revenue gains generated by the increased economic activities”. Governments often perceive that the tax incentive benefits will exceed the costs and that the incentive will be compensated over a period of time through taxes paid, as profits increase due to an increase of investment activities, following the offered incentive (Buss, 2001:92).

3.4.1 Benefits of tax incentives

Examples can be provided of the possible benefits from tax incentives but the benefits are not always quantifiable with any degree of certainty (Moolman, 2012:23). Tax incentives do not require any expenditure from government and therefore are not capital intensive. Governments are willing to sometimes sacrifice the foregone tax in order to invest treasury funds in other projects from which the country as a whole may benefit. The tax incentives are less risky than grants offered to investors due to the risk of failure of their operations. If an investor makes a loss then no tax benefit would be obtained as no tax is payable, whereas with grants there is a risk that government funds are applied to support projects which may fail in the future (Trepelkov, 2018:26).

Some benefits may not be directly quantifiable but well-targeted tax incentives may solve specific needs in certain sectors or industries. The tax incentive may promote specific projects or attract specific investors and may be able to assist the government to achieve their goals (Klemm, 2010:19). One of the major benefits associated with tax incentives is the FDI that normally follows the offered incentives. The increased FDI may lead to increased capital investment, technology advancements, the transfer of valuable knowledge, new employment opportunities and a focus on improving underdeveloped areas (Jordaan, 2012:10).

Tax incentives are beneficial because they create spill over effects which could even influence investment decisions or the preferred geographical regions in which the investors would choose to operate. Firms are more responsive to tax incentives when these have a positive effect on their cash flow due to reduced indirect taxes or extended payment terms for tax liabilities (Easson and Zolt, 2002:11). This serves as a measure that solves financing constraints as more funds are then available to reinvest in the operations of the business. Once the investor is established in a country, it may be impractical and difficult for him/her to pack up the entire operations and leave the host country. This could subsequently lead to increased tax revenues from the foreign investors after the expiration of the tax holiday, as the tax benefits will terminate upon reaching the sunset clause (Trepelkov, 2018:27).

One of the general benefits includes economic growth which may be an overall result of the tax incentive. Economic growth will increase the spending power of residents of the host country which will lead to increased demand and supply which may increase future government tax revenues (Klemm 2010:12). Tax incentives serve as a measure for tax competition and enable policymakers to maintain or improve their country's natural competitive position when being compared to similar countries. The tax incentives can increase a country's attractiveness and make up for shortcomings like limited natural resources or perhaps poor location. Tax incentives are advantageous for countries because they serve as a measure to allow them to compensate for their inadequate tax systems which generally may include their own high corporate tax rates (Buss, 2001:98).

3.4.2 Disadvantages of tax incentives

The benefits flowing from the tax incentive will not assist policy makers if they are not aware of the possible accompanying costs. All tax incentive schemes are associated with certain costs which are generally classified in four categories:

3.4.2.1 Revenue costs

The incurred revenue costs relate to either revenue forfeited from projects accepted by investors that would have commenced irrespective of the existence of the offered incentive, or from revenue lost due to improper activities undertaken only to qualify for the incentive by shifting taxable income from connected persons, or other taxable activities to reduce the normal tax obligations (Moolman, 2012:25). It is challenging for governments to monitor all connected party transactions to prohibit income from being shifted from a taxable entity to another entity that qualifies for the benefits. The incentives often encourage investors whose investment decisions are not entirely influenced by the tax benefits, which results in foregone tax revenue by the government in exchange for non-marginal investment gains (Trepelkov, 2018:28).

The revenue costs result in the erosion of the tax base when the incentive leads to additional tax avoidance schemes where investors disguise their operations to obtain tax benefits. For example, tax incentives offered only to obtain foreign investment may encourage local taxpayers to incorporate foreign entities and reroute their investments into the country, only to qualify for the incentive benefits. Revenue costs are challenging to quantify and apart from revenue loss, the tax incentives lead to economic distortions due to the preferential tax treatment which might increase administrative costs to prevent abuse of the incentive schemes (Klemm 2010:11).

3.4.2.2 Resource allocation costs

The tax incentives may lure excessive investment in certain industries or activities which may result in investment shortcomings in other industries due to the influence of the tax incentives on the existing competitive market models. The cost-benefit analysis is almost impossible in developing countries if the incentive systematically excludes the effects of the market’s equilibrium, and if the incentive only aims to recuperate the economy of an underdeveloped area (Klemm 2010:13). Due to the increase in capital mobility, governments are competing to attract both local and foreign investment. This can result in investors having more bargaining power than the State as countries engage in aggressive tax competition to lower their corporate tax rates which could be harmful to the country’s tax base (European commission, 2017:120). This increases the risk that investors could abuse the tax incentive without properly compensating the country in return.

Aggressive tax competition often results in countries reducing their own gains from the investments which can impact negatively on a country’s income when compared to the period before the incentive was offered (Trepelkov, 2018:28). A country needs to generate certain levels of revenue to meet its social and economic objectives. By offering tax incentives a country may compromise a significant portion of its tax collection revenue which could bring about the liability to collect these taxes are shifted to the middle class and the poor to compensate for the tax revenue foregone. This emphasises that tax incentives are without value if the growth achieved in one area is at the expense of another group or sector in the economy (Buss, 2001:102).

3.4.2.3 Enforcement and compliance costs

The government spends additional costs to enforce tax incentives to ensure that the qualifying taxpayers are complying with the provisions of the law. The costs relate to the different phases of implementation of the incentive: from the original grant of the incentive and thereafter; also, costs in monitoring the compliance of the criteria to qualify for the incentive benefits (Buss, 2001:101). There is a correlation between the complexity and the cost of the tax regime as an increase in complexity would result in higher enforcement and compliance costs. Tax authorities would rather spend their resources to promote tax collection and it would not be worthwhile to investigate firms that are not fully taxable due to special tax incentives (Trepelkov, 2018:30).

3.4.2.4 Transparency costs

All tax incentives offered by the government is open to abuse and corruption when the incentive is not automatically available to all qualifying investors based on transparent requirement criteria (Jordaan, 2012:8). A tax regime is more prone to corruption if bureaucrats have freedom of choice in determining which projects receive beneficial tax treatment or where there is a deficiency in transparent guidelines for the qualifying criteria. The tax regime therefore needs to be proclaimed through a formal and transparent process (Easson and Zolt, 2002:12).

3.5 Design of an effective tax incentive

This section will identify the characteristics of meaningful tax incentives which are successful. The tax incentive needs to conform to certain design elements and desired characteristics. It was noted by Barbour (2005) that the design of a tax incentive is influenced by the economic circumstances of a country and there are no step-by-step guidelines that policy makers can follow when drafting a tax incentive policy. There are, however, some 'best practice guidelines' with which to avoid certain mistakes or evade general challenges. There are four distinct qualities that are perquisites for the design of an effective tax incentive which could optimise the benefits and minimise the limitations of the tax incentive. All tax incentives should therefore meet the four desired characteristics (Moolman, 2012:28):

3.5.1 Have an objective

The objective will set criteria for both eligible investors and projects that may qualify for the incentive benefits and will promote a fair balance between risks and rewards for both the private sector, as well as the government (Morisset & Pirnia, 2000:14). There is an increased risk if the tax incentive is only part of a short-term policy which could endanger the success of a country's long-term strategy or objectives because benefits accruing for a limited period of time often do not match the priorities of government's long term strategies (Klemm, 2009:14). The tax incentive will only be effective if it contains clear guidelines and a profound understanding of the proposed objectives and desired results, from inception to execution (Pouris, 2003:196).

A tax incentive should serve a specific purpose which will promote the objectives that a nation wants to achieve. It should be in line with the financial resources budgeted by the government to finance the incentive, instead of allowing the market to determine the extent of the obtained benefits. There are four primary objectives that may influence and motivate the government to offer tax incentives to stimulate investment (Zee *et al*., 2002:1499). These include:

a) Tax related objectives which include considerations that could provide relief to investment challenges due to tax burdens.
b) Economic related objectives which are aimed to influence either the macro-economic or structural environment.
c) Non-economic related objectives which affect the legal, regulatory and political environment (Buss, 2001:92).
d) Socio-economic objectives which are influenced by the demographics of the country, the geographical areas, the characteristics of the population or certain sectors or industries (Fisher & Peters, 1997:110).

In order to be effective the tax incentive should aim to produce beneficial tax related conditions because the incentive itself is not able to address fundamental challenges of the other objectives (Klemm, 2009:15). Zee *et al*. (2002:1500) noted that it is better to address deficiencies in each of the four objectives separately. This should be done with targeted solutions to address the specific objectives, rather than implementing a tax incentive with the aim to correct problems identified in all four categories (Moolman, 2012:29). The incentive will be most efficient when implemented to be a corrective measure for a tax-related environment.

3.5.2 Aim to be effective

The desired outcomes or primary objectives of the tax incentive will only be accomplished if the benefits of the incentive exceed the risks, disadvantages or costs associated with the offered incentive (Morisset & Pirnia, 2000:23). There are certain elements that are critical in the design of the incentive which could play a key role in promoting the overall effectiveness (Moolman, 2012:33):

3.5.2.1 Meet the objectives

The tax incentive should be designed carefully to address a specific goal. If reducing unemployment is a policy objective the incentive should not be focused on providing excessive benefits towards capital-intensive investments but rather to reward labour intensive operations (Jordaan, 2012:12). A tax incentive will be effective if the goals are met for all the parties involved which usually are the government and the investor. The incentive should create the optimal balance between risks and rewards in the regulatory environment in which the incentive is offered while creating the desired results (Easson and Zolt, 2002:15).

3.5.2.2 Increase after-tax returns of investments

Otto, *et al*. (2006:12) stated that tax incentives should aim to maximise the generated profits after taking into account the incurred costs to overcome the obstacles to qualify for the incentive. Meaningful tax incentives are the ones that increase a project’s after tax profitability as this will be a key consideration for investors’ investment decisions (Morisset & Pirnia, 2000:12).

3.5.2.3 Provide room for flexibility

The policies should be drafted in such a way to enable the tax incentive to support the investor in the different stages of the company or the project’s development (Moolman, 2012:39). The incentive policy should not only cover the basic provisions of the incentive but should also focus on other issues faced by newly established companies as flexibility is an imperative consideration for firms (Fisher & Peters, 1997:117). This includes changes in technology or concerns if no tax liability exists against which the benefits could be applied for tax relief. The policies should be reassessed on a continuous basis for possible amendments to the tax legislation to accommodate the companies when circumstances change, or in the occurrence of unforeseen events (Pouris, 2003: 197).

3.5.2.4 Focus on cost-effectiveness

The aim of the government might be focused towards attracting investors but the strategy of luring investment should never be at the expense of the host country’s economy (Otto, *et al*. (2006:13). Tax incentives are unquestionably costly due to a potential increase for revenue losses which may arise for the host country due to taxes foregone. All costs (direct and indirect), should be considered as they could be significant which could lead to a misguided strategy if the costs exceed the benefits of the incentive (Zee *et al*., 2002:1502).

It is impossible to implement any incentive cost-free and tax incentives are often less resource intensive to impose if the existing tax system already operates effectively (Jordaan, 2012:6). The omission of fiscal costs that does not show in direct state expenditure often leads to misguided cost-benefit ratios, resulting in policy makers selecting misguided economic development strategies that do not make provision to accurately measure the value added by fiscal and economic incentives (Fisher & Peters, 1997:135). Barbour (2005) pointed out that an effective and efficient incentive is designed to require minimal revenue to stimulate investment in the desired areas and limit possible abuse in the tax planning opportunities. Barbour (2005) highlighted the importance that an effective tax incentive should limit the additional administrative costs for government and investors and compliment other policies and strategies of all spheres of government.

Governments therefore, need to evaluate whether the new FDI would have occurred even in the absence of the granted incentives because in such cases "free riding" investors would benefit at the expense of the host country and resulting in harmful tax competition practices (Buss, 2001:20). The incentive should contain a limit of maximum foregone tax revenues by the tax authorities to limit the risks of eroding the tax base (Chen, 2015:9). Jordaan (2012:12) identified that a meaningful tax incentive should conform to offer incentives without significant revenue losses. Moderate tax incentives which are targeted towards new capital investment, like machinery, are often more cost effective because reductions in the corporate tax rate with more than 20%, could be more harmful for the country. Tax incentives should therefore not be harmful to the tax base of the host country (OECD, 1998:20) and additional factors will be considered in this chapter (see 3.6) to identify when a tax incentive may give rise to a harmful preferential tax regime.

Chapter 4 will evaluate the elements identified in 3.5.2 under separate headings. The first will continue to examine if the SEZs as tax incentive aims to meet its objectives as part of the requirements identified in 3.5.1. An evaluation will be performed to establish if the incentive aims to be effective by considering the cost-effectiveness of the incentive so that it is not harmful in terms of BEPS Action 5. The cost effectiveness will subsequently be explored under a separate heading to consider if the incentive compensates the host country adequately and to explore if it is perhaps harmful on a national level. Flexibility and increasing the after-tax returns of investments will be incorporated under one heading which will consider evaluating the effectiveness of the incentive for potential investors.

3.5.3 Contain stability

A prerequisite of an effective tax incentive is that it should preferably not change frequently to promote certainty in impact and longevity (Jordaan, 2012:5). It should, however, contain reasonable sunset clauses for the scheme itself and should identify the length of the available benefit period to the qualifying beneficiaries (Pouris, 2003:191). A study done by Staehr (2007:5) found that after assessing the growth in 17 OECD countries, growth was promoted when policies were put in place to reduce economic volatility.

Tax incentives should not change frequently as this could lead to higher investment uncertainty (Barbour, 2005). Companies need to assess if the projects in which they invest would provide favourable returns. If the incentives are amended frequently, this will prevent companies from forming a reliable expectation of the anticipated returns and to compare against the risks and costs before making an investment decision. A stable tax environment reduces the risks and uncertainty and assists in creating a more attractive economic climate for potential investors (Moolman, 2012:37).

It has been highlighted by investors that they appreciate transparency in a tax system as their confidence in making an investment increases when the application of the tax legislation could be regarded as simple, stable and certain. Reduced volatility in the tax regulation often has a more significant influence on the decisions made by investors, compared to the special tax incentives themselves (Brodzka, 2013:34). It is critical if government intends to make use of tax incentives to lure FDI, to ensure that they maintain a stable macro-economic environment with incentives that are transparent and easy to understand, as regimes that do not foster certainty with regards to the future application of tax legislation, could discourage prospective investors (Morisset, 2000:4).

The OECD (2018:36) defines fiscal stabilisation as a concept that is anticipated to preserve taxation provisions, or legislation that governs the state participation with regards to the application of tax laws at the time of a contract, and it entails three approaches. Fiscal stabilisation can be obtained by freezing the applicable legislation at the date of initial enforcement, or disregarding any future tax policy modifications that could increase a tax liability, or via agreements to negotiate the effects of adverse policy changes resulting in economic disequilibrium (Mausling, 2016:20).

3.5.4 Promote transparency

Zee *et al*. (2002:1502) highlighted that in order for a tax incentive to be transparent it should have structured qualifying criteria. The criteria should be simple, specific and contain an objective to reduce subjectivity when the incentive is interpreted and applied. A transparent tax incentive is less resource intensive as it requires less monitoring and enforcement assistance from the tax authorities. Improved transparency would avoid manipulation of the incentive which could lead to conflicts and inconsistencies of other existing tax legislation (Easson and Zolt, 2002:15).

Transparency has a significant impact on the view of the government, investors and the public (Moolman, 2012:37). The rationale behind the incentive should be communicated clearly by the government while disclosing the economic impact and associated costs of the incentive for public scrutiny in the budgetary process (Zee *et al*., 2002:1502). It was noted by Pouris (2003:190) that the tax incentive should be implemented, monitored and administrated by one authority to ensure that transparent criteria are met and that the provisions are not abused.

The incentive should therefore be non-discretionary and applied consistently against transparent predetermined criteria that provide certainty for the investor with regards to obtaining the rights for the incentive benefits offered by government (Mausling, 2016:35). The tax incentive should promote transparency and be easily understandable when information about the policy goals and legislation are obtained (Easson and Zolt, 2002:15).

The OECD has released best practise guidelines to assist developing countries in drafting and governing tax incentives that will assist to promote the transparency of the incentive policy (Zolt, 2015:32). The guidelines (evaluated in 4.2.4) propose that to enforce transparency, a public statement should be made with regards to the tax incentive and its objectives. The tax incentive should be offered exclusively through tax legislation while consolidating the governing responsibilities under the authority of a single governing body. The incentive should be administered in a transparent manner while being subjected to periodic reviews and calculations of foregone revenue to assess its effectiveness. It should, furthermore, preferably highlight the primary beneficiaries of the incentive through comprehensive reporting (OECD, 2015b:3-4).

3.6 Identifying a harmful tax regime

As noted in 3.5.2.4 of this chapter, an effective tax incentive is designed to require minimal revenue to stimulate investment while limiting the tax planning opportunities which could lead to possible abuse. The BEPS Action 5 is part of the OECD's Base Erosion and Profit Shifting (BEPS) Project which contains fifteen Actions focusing on several structures, computations and arrangements that may result in companies engaging in aggressive tax planning strategies.

This includes tax loopholes that may exploit the tax system and lead to profit shifting to lower tax jurisdictions and therefore give rise to erosion of the tax base due to profit shifting. The BEPS Action 5 is of key importance to identify possible harmful tax regimes (Chimbombi, 2016:6). Based on BEPS Action 5, a three tier analysis has to be executed to identify a harmful preferential tax regime. This includes the following steps (OECD, 2015a:22):

1) Consideration of whether the regime is preferential and if it falls within the scope of the work done by the Forum on Harmful Tax Practices (FHTP).

2) Determine, in light of five key factors and eight additional factors, whether the regime is possibly harmful.

3) Consideration of economic factors to establish if the regime is in effect harmful.

The first step includes evaluating if the regime is considered to be preferential but as identified in the introduction of this chapter, in light of BEPS Action 5, any regime offering preferential tax treatment that differs from the general tax treatment of a country is preferential and the benefit may occur in any possible form of tax incentive offered by the relevant country (OECD, 2015a:22). The work done by the FHTP specifically targets income generated through mobile activities like financial services and rendering of intangibles or intellectual property that are not restricted to a specific geographical area (Chimbombi, 2016:27).

The second step considers if the regime is potentially harmful and includes five key factors. The first factor, known as the gateway criterion, considers if the tax regime comprises of low or no effective tax rates from geographical mobile activities. Only when the first criterion is met, the other four would next be examined. The second key factor considers if the regime is ring-fenced from the country's economy and the third factor considers a lack of transparency which requires a more subjective assessment of the details, application and regulatory supervision of the tax regime (OECD, 1998:28). The fourth key factor considers the effectiveness of exchange of information within the regime and makes use of the tax treaty network established by the relevant country. The last key factor to consider is a substantial activity requirement examination which focuses on realigning the substantial activities of a regime with the generated profits that are subject to tax (OECD, 2015a:22).

The other eight factors include consideration of a possible artificial defined tax base, not adhering to international transfer pricing principles, exemptions of foreign source income in the country of residence, negotiable tax rates or tax bases and the existence of secrecy provisions. It also considers if the regime has access to a wide network of tax treaties, whether the regime serves primarily as a vehicle for tax minimisation or if the regime encourages arrangements that are tax driven without any substantial activities (OECD, 2015a:22). For the purpose of this study, only the first five key factors will be taken into account in chapter 4 to evaluate the South African SEZ regime as the OECD 1998 report placed particular emphasis on the last of the eight factors to consider if the regime promotes no substantial activities and is merely tax-driven (Chimbombi, 2016:20), which is already considered by the current BEPS Action 5 as part of the substantial activity requirement.

Step three is the last step in the three tier analysis and requires the consideration of common features of a tax regime to identify if it is actually harmful (Chimbombi, 2016:28). A regime that met the considerations of the two previous tiers in the analysis may have been identified as being potentially harmful but it will not be actually harmful if it does not seem to create harmful economic effects. There are three questions that need to be considered in making this assessment, which includes (OECD, 2015a:23):

i. Does the tax regime result in activities being shifted from one country to another, instead of generating significant new activities?
ii. Is the value of investments or generated income adequate in relation to the presence and level of activities in the host country?
iii. Is the motivation behind the location of a certain activity only due to the preferential tax regime?

If it is concluded that a preferential regime of a country is actually harmful, the country is granted the opportunity to bring the regime to an end or eliminate the features or characteristics that have given rise to the identified harmful effects of the specific regime. Other countries, which are independent of the regime, are also allowed to take defensive measures to limit the effects of the harmful regime and are allowed to encourage the country to modify or remove the regime (OECD, 1998:38).

3.7 Chapter Conclusion

As established by Barbour (2005), a tax incentive will only play a marginal role in the investor's decisions as other economic factors often play more significant roles. Governments should be aware that tax incentives are expenditures, even if it does not result in a direct outflow of funds because it removes the State's right to collect taxes. A well-designed tax incentive that is not properly implemented is just as ineffective as a poorly designed incentive. The benefits achieved through the tax incentive should complement the objectives (Moolman, 2012:32) and other government policies that have an impact on the economy of South Africa.

Chapter 3 established that specific characteristics and design elements need to be present in the design of a well-structured and meaningful tax incentive. This chapter identified the characteristics of well-structured tax incentives that could stimulate the economy over the long term without damaging the tax base of the host country. In terms of the BEPS Action 5 (OECD, 2015a:23), this study identified that a three tier analysis needs to take place in order to evaluate if the South African SEZ model gives rise to a regime that could possibly be classified as a harmful preferential tax regime.

The conclusion reached in this chapter is that the South African SEZ model will need to be evaluated in Chapter 4, based on the characteristics identified and discussed in Chapter 3. This will be done in order to conclude on the design of South African SEZs as a tax incentive. To provide a structured method for performing the evaluation, there is a need for clear and structured evaluation criteria. Chapter 4 will evaluate the design of the South African SEZ model as a tax incentive against the following summarised criteria from the content in Chapter 3:

i) Evaluate if the SEZ tax incentive has an objective while subsequently considering the presence of predetermined objectives and transparent qualifying criteria that stipulate the requirements in order for a company to be eligible to receive the tax benefits offered by the incentive.
ii) Evaluate if the SEZ tax incentive aims to be effective, based on the principles laid down in 3.5.2 of this chapter, by taking into account that in order for the incentive to be cost effective, it should not result in harmful tax practices and therefore considering if the incentive is harmful in terms of BEPS Action 5.
iii) Evaluate if the incentive aims to be effective, based on 3.5.2 of this chapter, by considering if the benefits that are accrued by the host country adequately compensate South Africa, as the incentive should never be offered at the expense of the host country. The cost effectiveness will subsequently need to be evaluated by considering the possible harmful effect(s) of the incentive on a national level.
iv) Evaluate whether the incentive provides room for flexibility, as identified in 3.5.2, to support companies through their different stages of development while considering if the incentive aspires to increase after tax returns. These aspects will be considered to establish if the incentive aims to be effective for potential investors.
v) Evaluate if the SEZ tax incentive contains stability, as considered in 3.5.3, with regards to the offered incentive benefits available under the SEZ regime, as well as the provisions contained in the legislation of the Income Tax Act.
vi) Evaluate if the SEZ tax incentive promotes transparency, as highlighted in 3.5.4, with regards to governance and monitoring requirements of the offered incentive.

CHAPTER 4: EVALUATING THE SOUTH AFRICAN SEZ MODEL AS A MEANINGFUL TAX INCENTIVE

4.1 Introduction

Ibi Ajayi (2006:29) established that FDI is driven by four motives that lead to investing abroad. These motives are identified as resource seeking, market seeking, strategic asset seeking and efficiency seeking. Resource seeking investors will relocate to a foreign country only to obtain critical inputs that are not available locally. The market seeking motive is driven by the opportunity of exploring new markets that originate in the foreign country. Research and development are key drivers for the strategic asset seeking investor who aims to take advantage of the benefits from the technological and scientific advancements. The efficiency seeking motive is influenced by optimisation of the value chain by limiting production to a few countries. Every country offers advantages which could include location, favourable financing opportunities or other government incentives (Moolman, 2012:41).

South Africa is not always the first choice for leading resource seeking investors and therefore needs to aim to be efficient through an appealing regulatory environment to stimulate FDI (Moolman, 2012:41). As per data from the World Bank (2017), South Africa is ranked 33rd out of 192 countries worldwide, based on gross domestic product (GDP) per capita. The ranking substantiates the fact that South Africa is globally one of the leading developing countries increasing the need to create investment opportunities which could lead to positive economic growth. Moolman (2012:41) also considers South Africa’s GDP ranking as an indication of an appealing investment environment due to South Africa being one of the top performing developing countries.

Since 2010 the South African Government introduced numerous policy incentives which started with the release of the Industrial Policy Action Plan (IPAP) in February 2010 by the DTI (Zarenda, 2013:3). The policy aimed to diversify and develop the local and global competitiveness of the South African industrial sector. In 2012/2013 the South African government adopted the NDP as a blueprint strategy for economic and socio-economic development which incorporates the IPAP in order to address the challenges identified in a South African economic context (Heirriss, 2017:11). This chapter aims to address the third research objective identified in 1.3.2 to perform an evaluation on the design of the South African SEZ model against the characteristics associated with a meaningful tax incentive.

In line with the IPAP and NDP, the DTI is committed to continue promoting their efforts to create employment opportunities and stimulate economic growth in South Africa through the establishment of a strong industrial base (Zarenda, 2013:4). The Policy on the Development of Special Economic Zones (South Africa, 2012:6) also stipulates that “the SEZ programme is one of the most critical instruments that can be used to advance government's strategic objectives of industrialisation, regional development and job creation. Moreover, the programme can assist in improving the attractiveness of South Africa as a destination for FDI”.

In the previous chapter tax incentives and their ability to attract FDI were explored and it can be concluded that SEZs could encourage FDI if it meets the design elements and characteristics of a meaningful tax incentive. The objective of this chapter is to evaluate the design of the South African SEZ model as a meaningful tax incentive. This will take into account that SEZs serve as a tool to promote the objectives of the NDP and the characteristics of a meaningful tax incentive will serve as a framework for the evaluation as established in Chapter 3 (see 3.7).

4.2 Evaluating the South African SEZ model against the design criteria of a meaningful tax incentive

In Chapter 3 it was established that a meaningful tax incentive should always conform to four specific design elements which includes: to have an objective, aim to be effective, contain stability and promote transparency. These four design elements will subsequently be used to consider possible shortcomings in the South African SEZ regime, as SEZs as a tax incentive should conform to:

4.2.1 Have an objective

As identified in Chapter 3 (see 3.5.1), a tax incentive should serve a specific purpose which will promote the objectives that a nation wants to achieve. The tax incentive should be designed carefully to address a specific goal as there are several motivations for government to offer the incentive to prospective investors.

4.2.1.1 Predetermined objectives

Chapter 3 (see 3.5.1) identified that a tax incentive can only be effective if it contains clear guidelines of the proposed objectives and desired results. SEZs have objectives identified by the government which are proclaimed in the Policy on Development of Special Economic Zones (South Africa, 2012:22). The general objective of SEZs in South Africa is defined as, "to support and accelerate industrial development in the targeted regions by the provision of special measures needed to develop targeted industrial capabilities and attract targeted foreign and domestic direct investment". The Specific objectives aim to support the development of foreign and direct investment, support the NDP, develop world-class infrastructure, promote growth in mineral and agricultural resources, contribute to job creation opportunities and to increase exports (South Africa, 2012:23).

Chapter 2 (see 2.6) established that SEZs are a useful tool that could be used to accelerate the country's development objectives by supporting macro-economic policies like the NDP (Vallie, 2017). SEZs were found not to be a "one size fits all" toolkit but need to be specifically designed to complement the needs, challenges and economic objectives of the host country. In the Policy on the Development of SEZs (South Africa, 2012:7) it states that SEZs is a critical instrument to promote strategic government objectives of industrialisation, regional development, and job creation, in line with the NDP. However the SEZ policy does not explicitly state the focus areas contained in the NDP that it aims to support or precisely how SEZs intend to support the objectives and resolve the challenges contained in the NDP. This section considers if the South African SEZ model addresses the focus areas identified in Chapter 1 (see 1.1.5) of the developmental capabilities recognised by the NDP:

(i) Creating jobs and livelihoods

The NDP aims to promote a more labour-absorptive economy that will create 5 million new jobs by 2020 through enabling a supportive environment for growth and development. The NDP further elaborates that the first step that requires action is the fact that South Africa has millions of unemployed and low-skilled citizens who are desperately in need of job opportunities (South African Government, 2011:26).

From a tax perspective it can be concluded that the ETIs offered in the SEZs (refer to Chapter 2.6.3) are in line with the NDP as this incentive is available for all employees of all ages in SEZs. This recognises the fact that South Africa has unemployed citizens of all ages desperately in need of job opportunities and not just youths between 18 and 29, which are the normal age criteria for ETIs outside the SEZs. As the ETI is only available to employees receiving a salary below R6000 per month, it can be concluded that the incentive is aimed towards encouraging investors to employ low-skilled citizens within these zones as the salary scales will need to increase significantly for highly-skilled employees (Roux, 2015:9).

Different types of taxes have different effects on GDP. According to a study by the OECD, taxes on personal income are distortive and could have a direct negative impact on labour utilisation (Johansson *et al*., 2009:54). The ETI offered within the zones has the opposite effect as taxes levied on personal income. Although the employee will be below the tax threshold, the employer is entitled to deduct the amount of the ETI incentive from their total gross PAYE liability for a month and therefor the PAYE reduction supports the promotion of a more labour-absorptive economy. Investors will think twice before automating manual production activities in order to rather qualify for the ETI than purchasing expensive machinery. The following examples from the implementation of the SEZs highlights the success in the design of the SEZ model as it achieved the aimed objective of creating jobs and livelihoods:

Apart from the ETIs, Coega spent R776 million during 2017 on small and medium enterprises which created 16 500 new jobs and benefited 5 886 individuals from its training and skills development programme (Matavire, 2017b). This supports the NDP’s vision to create an environment for growth and development. Chapter 1 identified that the OR Tambo SEZ has already created 110 temporary jobs, even though it is not yet fully operational, with the potential of creating another 1000 jobs in the future developmental phases of the project. The new Maluti-A-Phofung SEZ has also brought hope to the people of the Free State with an additional 22 000 new jobs in the pipeline (Mashigo, 2017).

Statistics SA concluded that 3 435 jobs existed within the East London SEZ in 2017 and that four new investors signed contracts with a total investment value of R1.06 billion. These new investors contributed to a job creation potential of another 1 422 direct manufacturing jobs (Ramncwana, 2017:11). The minister of the DTI, Rob Davies, highlighted the job-creating potential and the importance of SEZs when he announced that during 2017, SEZs created 23 351 new job opportunities and retained 38 192 existing jobs (Ensor, 2018). It can therefore be concluded that SEZs contributed to creating jobs and livelihoods as envisioned by the NDP.

(ii) Transforming urban and rural spaces

The NDP underpins the importance that by 2030, South Africa's rural communities should have greater prospects to participate in the economic, social and political dimensions of the country in order to contribute to the development of an all-inclusive rural economy. The Commission proposes a national focus on spatial transformation across all geographic scales (South African Government, 2011:28).

According to Rob Davies (2018), economic activity had originally been concentrated in the three regional industrial hubs of Gauteng, eThekwini-Pietermaritzburg and the Cape Peninsula, which accounted for about 70% of the nation’s gross value. He emphasized that the spread of economic opportunities is key to the creation of an inclusive economy that benefits all South Africans. By establishing new industrial centres through the SEZ tax incentive programme, the government is promoting balanced growth and industrial development. The established zones identified in Chapter 2 all fall outside the economic hubs identified above and the designation of new zones are located within developing geographical areas.

The Western Cape has recently been instructed by parliament to accelerate industrialisation in the West Coast and to specifically focus on promoting green technology. The Maluti-A-Phofung SEZ located near Harrismith in the Free State is proposed to offer exporting investors a logistics base while the latest proposed Musina-Makhado SEZ in Limpopo will focus on cross-border trade with South Africa’s neighbouring countries (Mashigo, 2017). The aim is for government to finalise two more zones during 2019 in Bojanala in the North West and Nkomazi in Mpumalanga.

Based on the performances of the SEZs, Rob Davies (2018) is convinced that SEZs have become growth engines that stimulate regional economic activity to create new job opportunities. They also improve local communities by empowering themselves to create jobs and foster a spirit of entrepreneurship. The location of the first SEZs was aligned to the Spatial Development Initiative (SDI) Programme which is committed to decentralise development through the promotion of investment activities in remote areas that had potential for economic growth (Chinguno, 2011:3). It can therefore be concluded that SEZs as tax incentives are contributing to the transformation of urban, and specifically rural spaces, in South Africa.

(iii) Expanding infrastructure

The NDP aims to raise competiveness and export earnings through improved infrastructure that also strengthens key areas such as commercial transport, energy, telecommunications and water supply. The infrastructure is essential for economic growth and to provide citizens with the opportunity to increase their income earning possibilities (South African Government, 2011:28).

The zones provide for the infrastructural needs of investors as they are strategically located. The ORTIA SEZ is located close to an international airport; Coega is located on the east-west trade route to service both world and African markets adjoined by the Port of Ngqura, a modern multi-user deep-water harbour developed by the National Ports Authority of South Africa as a gateway to global markets; Richards Bay SEZ is linked to the international sea port of Richards Bay; and East London is located in Buffalo City which contains South Africa's only remaining river port. Dube Tradeport is the only facility in Africa that brings together an international airport, a cargo terminal, warehousing, offices, a retail sector, hotels, and an agricultural area. It is also positioned between the two biggest sea ports in Southern Africa, and linked to the rest of Africa by road and rail (DTI, 2017).

From a tax perspective the SEZ model as tax incentive also supports the vision of the NDP to improve infrastructure as section 12S offers an accelerated depreciation allowance for new and unused buildings. This incentive will encourage investors to construct new buildings to improve infrastructure located in the SEZs in order to qualify for the 10% depreciable allowance, see 2.6.1.2, based on the cost price of new buildings acquired by the qualifying company (Saggers, 2015:28). The increased deduction available for preferred status industrial projects qualifying under section 12I, also emphasises that the incentives offered within the SEZ regime aim to improve infrastructure by acquiring new manufacturing technologies which could be applied more efficiently in innovative business processes (Smale, 2012:36). The following examples from the implementation of the SEZs highlights the success in the design of the SEZ model as it achieved the aimed objective of expanding infrastructure:

The South African Government News Agency (2016) reported that the Dube Tradeport SEZ signed an agreement with Cipla Biotech for a R1.3 billion investment in Cipla's new manufacturing facility. This will be South Africa's first biotech manufacturing facility for the production of affordable cancer treatments and treatments for auto-immune diseases. This investment would enable government to promote the distribution of more affordable medication for South African citizens. Coega received environmental-impact assessment approval to develop a 440 hectares land-based aquaculture development and a desalination plant. The plant will help to address the severe water shortages that were experienced in the Nelson Mandela Bay region (Burger, 2018).

In the past South Africa failed to manufacture sufficient electronic products and had to rely on imports. The DTI invested R350 million from the SEZ fund for the construction of an information and communication technology (ICT) manufacturing factory in the East London SEZ. The factory will be operated by Yekani Manufacturing, a 100% black-owned ICT manufacturing company, which will enable the South African ICT sector to be a pioneer of new technology (South African Government News Agency, 2018b). Rob Davies (2018) announced that the government has set aside R4.9 billion for industrial infrastructure projects to invest over the next three years in SEZs and it can therefore be concluded that South African SEZs are aimed at improving and expanding local infrastructure through investment projects hosted within the SEZs.

(iv) Transforming society and building a capable state

The NDP defines that transforming the economy means to change the form of ownership and control to promote social cohesion and support one of the key objectives to build a state that is a capable role-player to accelerate development and transformation (Heiriss, 2017:11). The NDP admits that, "if South Africa moves forward in transforming ownership and control of the economy without reducing poverty and inequality, transformation will be superficial. Similarly, if poverty and inequality are reduced without demonstrably changed ownership patterns, the country's progress will be turbulent and tenuous" (South African Government, 2011:30).

The SEZ tax incentive forms part of the DTI's programmes with the main purpose to drive economic transformation and increase participation in industrialisation. As part of the SEZ programme there are three sub-programmes which specifically include the equity and empowerment programme (DTI, 2017). This program is focused to promote B-BBEE and economic growth through the Black Industrialists Programme. As per the DTI'S Black Industrialists Policy, the programme is focussed to stimulate growth and global competitiveness of black-owned businesses and to transform the demographic composition of the industrial sector (South Africa, 2015:12). The following examples from the implementation of the SEZs highlights the success in the design of the SEZ model as it has achieved the aimed objective of Transforming society and building a capable state:

Coega SEZ is regarded as a pioneer in the Black Industrialist Programme as the Kenako Concrete manufacturer is the first black industrialists in Port Elizabeth to receive funding of R71 million from the DTI's Black Industrialists Programme. The Dube Tradeport's transformational goals include a B-BBEE strategy that impacts the national transformation agenda through the procurement of goods and services. The East London SEZ also supports the Black Industrialists Programme as the Yekani ICT Manufacturing Company located in the East London SEZ is also a beneficiary of the Black Industrialists Programme (Sathekge, 2017).

The Maluti-A-Phofung SEZ is the first to be developed in one of Apartheid's Bantustan industrial parks. Former President Jacob Zuma said that "this development forms part of our conscious efforts of creating economic development and growth opportunities close to where our people are. This we do through promoting industrialisation and also the development of the township and rural economy". He also emphasized that SEZs contributes to a balanced regional economy that is critical to radical economic transformation (Mngadi, 2017). During the SEZ Roadshow attended by more than 100 Chinese companies and South African representatives, the Deputy Minister of the DTI, Bulelani Magwanishe said that "the SEZ Roadshow marks the significance of the relationship with the Chinese government. This collaboration will accelerate the implementation of industrial development and radical economic transformation agendas" (South African Government News Agency, 2018c).

By revitalising rural communities, urbanisation could be prevented as new growth opportunities are created to spread the economic activities across the country. SEZs have transformed the nation into a global competitive industrial economy which enables the government to realise the economic potentials of different geographic regions that allow more South Africans to actively participate in economic activities (Davies, 2018). It can therefore be concluded that the South African SEZ regime supports the NDP to unite the nation in transforming society while building a capable state that could be competitive globally.

4.2.1.2 Qualifying criteria

In addition to having an objective, Chapter 3 (see 3.5.1) identified that the tax incentive needs to set a criteria for eligible investors or projects which will support the predetermined objectives. The European Commission (2017:75) describes tax incentives as expenditures that target specific taxpayers or activities. Targeting is consequently an inherent design feature of a tax incentive and is achieved through an explicitly restricted and eligibility criteria that sets out the qualifying factors.

Chapter 2 (see 2.6.1.1) identified that, as required by section 12R, a company is a "qualifying company" if its place of effective management is in South Africa and the fixed place of business is physically located within the SEZ. The company needs to carry on a trade that is not specifically excluded from the list of disallowed sectors under the SIC Codes. The company is also required to generate at least 90% of its income within the SEZ and is not allowed to incur more than 20% of expenditure or generate more than 20% of its revenue with 'connected persons' as defined in section 1 of the Income Tax Act. Section 12S also specifically states that the privilege to qualify for the accelerated building allowance is that the allowance is only available to new and unused buildings or improvements owned by the qualifying company.

It can therefore be concluded that SEZs as a tax incentive serve a specific purpose that promotes certain objectives that the country aspire to achieve. The South African SEZs tax incentive has specific objectives and contains definite criteria of prerequisites that are regulated by the Income Tax Act. The qualifying criteria reflected under this heading of 4.2.1.2 refer to the requirements of the Income Tax Act and do not consider the criteria of obtaining the rights to operate within a SEZ, as that will be considered as part of transparency discussed in 4.2.4.

4.2.2 Aim to be effective

As established in Chapter 3 (see 3.5.2), the desired outcomes of the predetermined objectives will only be met if the benefits of the incentive exceeds the risks and costs and the incentive will only be effective if the objectives are met for all parties involved. The parties include the direct investor, the host country and also the international tax environment, as the investor may prefer one country above another due to the offered incentive. The incentive should therefore create an optimal balance between risks and rewards in the regulatory environment without establishing a harmful tax competition regime globally in terms of BEPS 5.

The incentive should not be offered at the expense of the host country without it being sufficiently compensated (Otto *et al*. 2006:13). It is the duty of the policy makers to focus on the cost-effectiveness of the incentive to ensure that the benefits generated through the incentive do not lead to a harmful regime on a national level. Lastly, the incentive will only aim to be effective if the incentive itself provides room for flexibility for the investee company during its life cycle of development while maximising after-tax returns for the relevant investors.

4.2.2.1 Is the SEZ tax incentive harmful in terms of BEPS Action 5?

Chapter 3 (see 3.5.2.4) identified that an effective tax incentive should limit the opportunities that could lead to possible abuse if “free riding” investors only invest in the country due to the tax incentive. This might give rise to possible harmful international tax competition. It is recognised that SEZs may contain similar characteristics which are associated with low tax jurisdictions and therefore commentators are prudent when dealing with state-sponsored tax incentives as they are liable to cause global economic distortions while resulting in harmful tax competition. It is therefore established that a narrow interpretation of harmful tax competition should be followed as all practices (including SEZs) that have the possibility to amount to harmful tax competition should be evaluated in terms of BEPS Action 5 (Chimbombi, 2016:24).

The place of establishment of the investee company is a critical component in tax incentive schemes because all forgone taxes should lead to economic growth in the host country. This is often ensured through a permanent establishment requirement in the country offering the tax incentive to enable policy makers to protect the national tax base from being exploited without being economically compensated for offering the tax incentive (European Commission, 2017:78).

The South African SEZ regime limits the exposure to risks through the provisions of section 12R of the Income Tax Act. Section 12R states that only incorporated companies or companies with their place of effective management in South Africa are allowed to qualify for the tax incentives offered through the SEZ regime. This excludes foreign incorporated companies and companies incorporated in “tax havens” without having places of effective management in South Africa. These companies cannot claim the income tax benefits as this increases the risk of value stripping from the South African tax base. The limitation of the 20% of expenditure incurred, or not more than 20% of the income may be generated between connected persons, limits the risk of profit shifting from taxable connected persons outside the SEZ to the company that qualifies for the tax benefits offered within the SEZ (National Treasury, 2015:36).

An important characteristic is that the tax incentive itself should not be harmful to the international tax base and this chapter will therefore focus on identifying a harmful tax regime (OECD, 2015a:23). Under this heading the three-tier analysis, in terms of BEPS Action 5 to identify a harmful preferential tax regime, will be applied to the South African SEZ model. The first tier requires the identification of a preferential regime while the other tiers are considered to evaluate the vital issue of considering if such a regime is indeed potentially or actually harmful in terms of BEPS Action 5.

(i) Step one: Is the South African SEZ model a preferential regime?

As identified in chapter 3 (see 3.6), SEZs often provide preferential tax treatment for investors or companies located within a SEZ, resulting in classification as a preferential tax regime. The South African SEZ regime, regulated by the SEZ Act (16 of 2014), offers income tax benefits through the introduction of section 12R and 12S to the Income Tax Act. Section 12R grants qualifying companies located in the SEZ, a reduced corporate tax rate of 15% instead of the standard rate of 28%. Section 12S offers these companies an additional accelerated tax allowance for qualifying commercial buildings at a rate of 10% instead of the standard rate of 5% available under section 13quin. Based on the special income tax incentives only available in SEZs, the SEZ regime will be classified as a preferential tax regime.

The area of uncertainty is to establish if the preferential tax regime could possibly be harmful. This is established through an analysis of whether the regime falls within the scope of work done by the FHTP, which relates to geographical mobile services that specifically include the provision of financial services and intangibles. Palazzi (2011:16) notes that a business sector criterion is used to target certain sectors or prohibit participation in certain sectors when the tax incentive is made available. The motivation of targeting particular sectors is to simulate macro-economic outcomes or innovation in sectors that lack the ability to perform on their own. Alternatively, the targeting can explicitly exclude certain activities or sectors from the scope of the tax incentive as an anti-abuse provision to limit tax planning opportunities that can lead to profit shifting structures (European Commission, 2011:78).

The current South African SEZ regime does not make use of specific business sector targeting as there is no prerequisite for certain activities that are compulsory to be conducted within the zones. There is, however, an exclusion of certain activities that are not permitted to be conducted within these zones which include distilling of spirits and the manufacturing of wine, malt liquors, tobacco products, weapons, ammunition or bio-fuels that may negatively impact food security (Clegg & Stretch, 2018). However, none of the exclusions refer to intellectual property or financial services.

Although no express notion of the provision of financial services or intangibles were noted in the South African SEZ regime, the SEZ Act (16 of 2014) includes “tradable services” under section 4 as part of the purpose of SEZs to create a national strategic economic advantage. The Policy on the Development of Special Economic Zones (South Africa, 2012:13) defines the eligibility criteria for SEZ designation and specifically includes that access to SEZs will be permitted for the provision of internationally traded services. The policy (South Africa, 2012:14) defines eligible tradable services to include computer software services, data processing, database services support services, website services and research and development services.

As identified in Chapter 2 (see 2.6.1.1), some activities are specifically excluded from the eligible activities that a qualifying company may conduct in order to obtain the tax benefits offered through section 12R and 12S. A company will not be deemed a qualifying company if that company conducts a disqualified activity designated by the minister of finance through a government Gazette. A government Gazette published on 15 April 2016 stated that in terms of section 12R, all activities classified under section K: financial and insurance activities and section J: information and communication were excluded from the list of eligible activities that could be conducted by a qualifying company located within a SEZ. Section J specifically includes all activities related to telecommunications, computer programming, consulting, data processing and related activities (South Africa, 2016b). It can be concluded that although some of these activities are defined as eligible tradable services to be conducted within a SEZ, the provisions of section 12R disqualifies any company conducting such activities from being eligible for the tax benefits offered by section 12R and 12S.

The revisions to chapter VI of the Transfer Pricing Guidelines that were adopted by the OECD under its BEPS mandate, provide for a broader definition for intangibles. This includes anything that is neither corporeal nor a financial asset which is capable of being subjected to ownership or control. The transfer of its right to ownership would normally be compensated if it occurred between non-related parties and could include (but is not limited to) “intellectual property” (Deloitte, 2015:1). A decision of the South Gauteng Tax Court in the case of TML Consultancy CC v CSARS (ITC 12860) has proven that words need to be interpreted based on their ordinary meaning. Judge Mbha emphasised that “the basic rule of interpretation is that the meaning must be taken to be the ordinary meaning of the word which can be found in a dictionary of established authority” (Klue, 2012). This underlines that words should receive their ordinary meaning within the context of being used.

Considering the services listed as disqualifying activities classified as “section J: information and communication” of the SIC codes in the government Gazette, it can be deduced that if those services are interpreted within an ordinary context that some could possibly exclude the provision of intangibles or intellectual property. The activities excluded by the minister of finance from eligible activities to be conducted by a qualifying company operating within a SEZ, can be deemed as an anti-avoidance measure. The excluded activities under section J (information and communication) and section K (financial and insurance activities) of the SIC codes limit the exposure of the SEZ regime from income generated through mobile activities that are not geographically restricted as set out in Chapter 3 (see 3.6).

It can therefore be concluded that there is not a reasonable risk that the South African SEZ regime will fall within the scope of the work done by the FHTP, which relates to income generated through mobile activities. The first tier of the three tier analysis has not been met as the SEZ regime does not contain a risk with regards to the provision of financial services, intangibles or intellectual property. It has however been noted that the anti-avoidance measure could be improved if it was expanded to also explicitly exclude under section J, the provision of intangibles and intellectual property.

(ii) Step 2: Is the South African SEZ regime potentially harmful

As identified in Chapter 3 (see 3.6) five key factors need to be taken into account to identify a potentially harmful tax regime. The first factor entails a regime that contains a low or zero effective corporate tax rate. As section 12R lowers the corporate tax rate of a qualifying company below the standard rate for companies of 28% to 15%, the gateway criterion have been met. The second factor considers if the regime is ring-fenced from the country's economy. The SEZs are defined in the Policy on the Development of Special Economic Zones (South Africa, 2012:6) as "geographically designated areas of a country set aside for specifically targeted economic activities", and the tax incentive benefits are only available to companies located within these zones. It can therefore be concluded that the South African SEZs are indeed a ring-fenced regime from the rest of the South African economy (Chimbombi, 2016:44).

The third factor considers a lack of transparency in the application and regulation of the regime. The Income Tax Act provides clear provisions in terms of the associated section 12R and 12S SEZ benefits with a comprehensive definition of a "qualifying company". The term 'place of effective management' is commonly known in an international tax context due to the Model Tax Convention (MTC) drafted by the OECD (Du Plessis, 2012). The requirements of the SEZ regime are transparent and can be found in either the Policy on Development of Special Economic Zones in South Africa, the SEZ Act, or the Income Tax Act, and therefore the third key factor is not met.

The fourth factor focuses on the effectiveness of information exchanges, specifically with regards to the tax treaty network. South Africa is party to more than 70 bilateral tax treaties to avoid double taxation, and the majority of the treaties are also based on the OECD MTC (Du Plessis, 2012). It is therefore reasonable to conclude that there is an effective exchange of information that relates to the SEZs in South Africa.

As part of the key factors to consider under step 2, the fifth key factor to consider is the substantial activity requirement which considers the linkage between taxable profits that qualify for the tax incentive benefits and the primary business activities that are responsible for generating the profit. The South African SEZ model has the requirement of “carries on a trade” within the SEZ and specifies that the income earned should be attributable to operations within the SEZ (Clegg & Stretch, 2018). However, this would not be able to satisfy the substantial activity test in full when Intellectual property is provided within the SEZ, due to a possible absence of expenditure carried on within the zone to promote profits generated from the zone.

In defence of the South African SEZ regime, section 12R specifically requires that the place of effective management of the company should be in South Africa and there is a limitation that not more than 20% of transactions may be incurred between a company and their connected person. The disqualified activities in step one, serve as an anti-abuse provision that protects the SEZ regime from mobile profits such as the provision of intellectual property and intangibles. The evaluation performed on the five key factors, indicated only a slight possibility of being potentially harmful based on the substantial activity examination. In order to conclude if the regime is indeed potentially harmful the other eight additional factors are also considered to identify a possible harmful regime.

There is no indication of a possible artificial tax base or secrecy provisions as the regime is transparent (Chimbombi, 2016:46). The regime does not promote arrangements that lack economic substance to obtain tax benefits. As the entities located in the SEZ have their place of effective management in South Africa, they have access to all the South African tax treaties, resulting in the absence of not adhering to international transfer pricing principles (National Treasury, 2015:36). There are also no specific exemptions noted in the South African SEZ regime that exempts foreign source income generated by the SEZ and no negotiable tax rates exist as the qualifying company located in the zone will pay tax based on the defined corporate tax rate of 15%. It can therefore be concluded that the South African SEZ regime is not deemed to be potentially harmful.

(iii) Step 3: Is the South African SEZ regime actually harmful

The last step in the three tier analysis considers if the regime creates harmful economic effects and as established in 3.6 there are three questions that require consideration. The first question considers if the regime shifts activities between countries, instead of creating significant new activities. South African SEZs only contain provisions to exclude certain activities but does not require any specific activities that need to be conducted within the zone. This may indicate a red-flag as there is no real requirement for significant new activities and this may create the opportunity of shifting existing income-generating activities to the SEZ.

The second question identified in Chapter 3 (see 3.6) considers if the generated investment income is adequate in relation to the level of activities (OECD, 2015a:23). The only way to answer this question is to collect additional data over a period of time, since the zones become operative. The statistics of income generated, compared to the level of activities, will be the only way to truly establish if the host country is appropriately rewarded for granting the incentive. This data is not easily accessible to the general public and therefore poses a challenge in answering the second question. It is known, however, that during 2016-2017 the DTI spent R12.8 billion in grants. Also, the tax allowance scheme and loans generated R39.4 billion in return in projected investment and R7.1 billion export revenue (Ensor, 2018). This data derived from the implementation of SEZs, substantiates that the investment income generated could be adequate in relation to the level of activities and that the design of the SEZ aims to compensate South Africa as the host country.

The last question considers the motivation behind the location of the activities and the tax incentive which may not be the only reason for locating within the SEZ. The SEZs also provide business support services, top-class infrastructure, streamlined administrative processes and preferential physical locations as they are often located close to export points, including harbours or airports (Le Roux & Schoeman, 2016:763). This substantiates that tax incentives may not be the only or main motivation for a company to locate their operations within a SEZ. It can therefore be concluded that the South African SEZ regime is not deemed to be actually harmful.

4.2.2.2 Is the SEZ tax incentive harmful on a national level?

Chapter 3 (see 3.5.2.4) highlighted that luring investment through tax incentives should never be at the expense of the host country's economy. The rewards for the country include the FDI or local investments which generate state revenue to assist reaching the country's objectives as a whole. Systematic monitoring enhances the design of tax incentives to promote the attainment of value for money and to ensure that incremental costs associated with the incentive justifies the economic and social effects generated (European Commission, 2017:7).

As identified in Chapter 3 (see 3.5.4) the OECD proclaimed some best practice guidelines to provide developing countries with a foundation to promote transparency and governance of tax incentives which are aimed to attract FDI. Some of the principles that require action from government also concentrate on monitoring requirements that need to be in place in order to assess the effectiveness of the incentive in the long run. As part of the public statement that government needs to make to introduce their objectives of the incentive, they should also publically disclose the anticipated costs and associated benefits. These statements should be communicated regularly to provide a basis for assessing the performance and effectiveness of the incentive while holding government responsible for the incentives granted OECD (2015b:3).

The incentive should be administered in a transparent manner which includes the periodic disclosure of the financial results. Government should embed estimated figures of foregone tax revenue due to the incentive to assist the decisions of policy makers in the annual budgetary process in support of fiscal planning (Zolt, 2015:32). The projection should also take into account the number of years that it would require in order for the benefits to exceed the costs or foregone revenue as some incentives may take years to realise financial benefits for the country. The OECD (2015b:3) emphasises that the performance of the incentive should be subjected to regular performance reviews and a tax expenditure report should be part of the reporting requirements to assess if the tax incentive has reached the predetermined objectives. A review criterion should be published to assess all behavioural reactions of the incentive, including the positive (incremental investment lured) and the negative (aggressive tax planning and revenue foregone).

A suggested monitoring requirement should also include evaluating the beneficiaries of the incentive on a regular basis as it is probable that only a few investors actually benefit from the incentive (Zolt, 2015:33). The tax expenditure statement should contain adequate detail for reporting purposes to identify the extent to which certain sectors and beneficiaries benefit from the incentive. Public disclosure of this information will enhance the validity of government's decisions in the eyes of citizens and prospective investors. To enable government to analyse the performance of a tax incentive, data should be collected systematically over a period of time to assess the actual behavioural responses produced by the incentive (OECD, 2015b:3).

There is a lack of government disclosure with regards to tax expenditure statements and the beneficiaries benefiting from the incentive within the South African SEZ regime. There are no detailed public disclosures available that reflect the costs and benefits associated holistically with the incentive, which result in a lack of data and financial information in determining an accurate conclusion regarding the effect of the incentive on a national level. There is also no indication that government regularly reflect on the performance of the incentive to determine the impact of the offered incentive on South Africa. The following examples from the implementation, however, highlight the rewards generated through the design of the SEZ model in South Africa:

The South African Government News Agency (2018a) reported that President Cyril Ramaphosa confirmed a decision made by Mercedes-Benz to increase their investment in South Africa in their Eastern Cape plant located within the East-London SEZ. The investment entails an additional R10 billion to produce the latest range of luxury C-Class models locally. The President stated in a report that "through the development of SEZs and industrial parks, we are putting in place the necessary infrastructure and support for a manufacturing boom. We are working to ensure it is easier to invest and do business in South Africa".

According to the Eastern Cape Development Corporation (2018) the Coega SEZ is currently considered as the most successful SEZ in Africa with more than forty operational investments with a cumulative value of R6.9 billion and another 22 potential investments underway. Rob Davies reported that in 2016-17 R12.8 billion was spent on SEZs in grants, while the tax allowance scheme and loans generated in return R39.4 billion investments, and R7.1 billion export revenue (Ensor, 2018).

Although the rewards of the SEZ regime are directly linked to investment generated by the zones, the only approach to effectively consider if the rewards exceed the risks or costs is an economic analysis. This requires that a substantial volume of historical data needs to be collected from the inception date of the SEZ regime and to analyse the data over the period of time (Chimbombi, 2016:47). Based on the information known to the general public with regards to investment and revenue generated by the zones, it can still reasonably be concluded that the benefits could exceed the cost of the incentive for South Africa.

4.2.2.3 Is the SEZ incentive effective for potential investors?

Chapter 3 (see 3.5.1.2) noted that it is essential that the tax incentive needs to increase the after tax returns for the investor in order to be effective. As per the SEZ Programme Planning Guidelines (South Africa, 2018a:7) the application process to apply for a SEZ operating permit entails several critical phases. These phases include different steps to be initiated by the investor including a concept note, pre-feasibility study, a feasibility study, business plans and a presentation to the SEZ Advisory Board (Saggers, 2015:78). It could be possible that these steps require significant financial inputs in order to obtain an SEZ operating permit and would have to be evaluated for each individual investor to establish if after-tax returns will be maximised.

To register as an SEZ operator to qualify for the tax benefits, the company has to file its application with SARS on the DA185 form and the registration is completely free of charge (SARS, 2018). In principle, the tax incentive will enable the investor to increase after-tax returns, as taxable profits are only subjected to a corporate tax rate of 15% instead of 28% for companies located outside of the SEZ.

In addition to increasing the after-tax returns for the investor, the tax incentive also needs to provide room for flexibility to support the company in the different life stages of its development (Moolman, 2012:39). During the initial set-up phase a company often incurs more expenses than income generated, resulting in an assessed loss. The tax incentive benefits can therefore only be utilised when profits are generated. It was underlined by Chapter 2 (see 2.6.1.1 and 2.6.1.2) that there is a time limitation, or sunset clause, associated with the incentive benefits of section 12R and 12S. This causes doubt on whether the SEZ model provides room for flexibility to support the investee during the different life stages of the company.

The only difference is that section 12R has extended the provision to cease to apply years after the commencement date of the SEZ operations or years of assessment commencing on 1 January 2024, whereas section 12S states the provision to seize for years of assessments commences on 1 January 2024. In effect section 12S only provides 8 years of benefits instead of ten, as it only became effective on 9 February 2016 (Saggers, 2015:32). In reality the investor will not be able to fully utilise the benefits from the SEZ regime if the company experiences losses within the first few years of operations because no tax benefit is obtained in the absence of taxable profits. Once the company starts to generate taxable profits to be subjected to 15% tax, the company may be close to reaching the sunset clauses and not be able to fully utilise the offered benefits as was intended from inception.

In a submission to National Treasury on behalf of SAIT, Newman highlighted these concerns to emphasise that start-up companies experience tax losses for extensive periods before they are profitable (Visser, 2018). The majority of these companies located in the SEZs will be entitled to accelerated capital allowances under section 12C, additional investment tax allowances under section 12I, and an accelerated building allowance under section 12S. All these taxable deductions could result in an assessed tax loss position for a few years and the benefit is only obtained from the incentive once they start paying taxes at the reduced rate of 15%. The time constraint under section 12R could therefore fundamentally negate the benefit (SAIT, 2017a:2).

Another challenge arises for the incentive to provide room for flexibility for the prospective investor due to the 90% prohibition rule as explicated in 2.6.1.1. This requirement obliges the company located within the SEZ to generate at least 90% of its income from the rendering of services or the sale of goods resulting from business activities located within the zone (Visser, 2018). The requirement limits the flexibility of structure of the company or group located within the zone because as identified by Saggers (2015:29), the requirement may force a company to incorporate a separate subsidiary for the purpose of conducting business in the SEZ if the investor has other businesses free-standing from the SEZ.

Newman (2015), who is also chairman of the tax incentives work group at the South African Institute of Tax Professionals (SAIT), is of the opinion that this will increase uncertainty if the investor could possibly fail to qualify for the tax incentive in the first few years of operating in the SEZ if the revenue generated from other business activities outside the SEZ exceeds the acceptable quota of 10%. This could cause a practical concern of the incentive being able to support an investor during the different stages of the company's life cycle, as the part of the operations located in the SEZ may not meet the 90% requirement. The results may be problematic when the revenue for the SEZ operations is compared to revenue figures generated through other operations of the investor located outside the SEZ as the qualifying company may find it challenging to generate substantial revenue within the first few years of establishing its operations within the SEZ.

As per the SEZ Guide (South Africa, 2016:11), the DTI is also in the process of rolling out a "One-Stop-Shop" concept with the aim to facilitate investors with all the required permits and informational requirements to provide support during the stages of development. The One-Stop-Shop will also assist investors with the planning and development, simplifying the process of obtaining business licences and facilitating access to direct or indirect financial assistance to start business in the zones. This will be a non-tax measure to assist the investor during the different life cycles of the company.

4.2.3 Contain stability

Chapter 3 (see 3.5.3) identified that a tax incentive that changes regularly leads to increased investment uncertainty. The European Commission (2017:6) identified that a good practice guideline for stability is that the tax incentive needs to have fixed design features with upfront announcements if changes occur and states that it is not recommended that the design features of the incentive are frequently changed. The tax policy should stabilise over time to reduce uncertainty for prospective investors as it is important for investors to make long-term investment decisions.

Fiscal stabilisation is a solution identified in Chapter 3 (see 3.5.3) to provide for consistency. It preserves the tax law to not be subjected to future changes in tax policies and although most sectors in the economy will be subjected to tax law changes, it is common for mining, oil and gas sectors to contain fiscal stabilisation clauses due to the long-term nature of the proposed investment (OECD, 2018:36). The Tenth Schedule of the South African Income Tax Act (58 of 1962) is an example of how the tax legislation could provide for a stable tax environment. It contains a fiscal stabilisation clause that has a provision that if any changes occur in the price of oil, investors will not be subjected to any adverse tax consequences in the form of higher corporate tax liabilities. This provision results in increased stability for investors which is imperative in their investment decision making process (Mausling, 2016:21).

Due to the time period of projects and the costs for investors to relocate their operations to South Africa and in specific the SEZs, they will require an investment environment that contains stability and certainty. The design of the South African SEZ model as tax incentive does not contain any fiscal stabilisation clauses and imbedded stability in the regime is therefore not implicitly guaranteed at inception of operations when the investor relocates to a SEZ to obtain the tax incentive benefits. Since inception, the provisions of section 12R and 12S have been subjected to amendments which could adversely impact the tax position of the company located in the SEZ.

The incentives offered by SEZs were introduced by section 12R and 12S through the Taxation Laws Amendment Act No. 39 of 2013 (Saggers, 2015:28). As indicated in Chapter 1, the SEZ incentive scheme was inactive until the effective date was proclaimed on 9 February 2016. The tax incentive benefits offered under section 12R and 12S have remained relatively constant from the date of inception, however, the requirements to qualify for those benefits have been subjected to changes since it became effective.

Section 12R was initially amended by the Taxation Laws Amendment Act (25 of 2015) (South Africa, 2015) before it became effective to add an exception that a company is not a qualifying company if more than 20% of its deductible expenditure or more than 20% of its income, results from activities between the company and any connected person. The Taxation Laws Amendment Act (17 of 2017) (South Africa, 2017a) introduced three additional requirements to be classified as a “qualifying company”. Paragraph (b) to (c) were added to section 12R requiring that the company had to carry on a trade in the SEZ, from a fixed place of business in the SEZ and at least 90% of the income should be derived from the trade activities located within the SEZs.

Newman, on behalf of SAIT, stated that the South African SEZ model predominantly falls short in the statutory principles regulating the trading activities of companies located in SEZs (SAIT, 2017a:2). As highlighted in Chapter 2 (see 2.6.1) the reduced tax rate of 15% will be denied from the company operating in the SEZ if more than 20% of the business income or expenditure occurred between connected parties. The connected person restriction could be a major stumbling block for the future success of the SEZs due to the reality of integrated supply chains of investors (Visser, 2018).

In a submission made to National Treasury, Newman (SAIT, 2017a:2) also pointed out that although the 20% benchmark allows for some space to transact with connected parties, it should not be a fixed percentage. He highlights the fact that uncertainty could be created when companies need to analyse measurements to evaluate the percentages of connected party transactions over the tax incentive period, which could deter potential investors. Investors who regularly transact within their own supply chains to add value within their group of operations, would be unwilling to relocate their operations to a SEZ.

Investors would therefore have to incorporate a new legal entity to benefit from section 12R without being subjected to the connected person restrictions which also increases the compliance costs to qualify for the incentive. This raises a concern that if investors do not obtain exhaustive tax advice upfront they could possibly not realise the impact of transacting with connected parties and subsequently be disqualified from obtaining the tax incentive benefits offered under section 12R. On behalf of SAIT, Newman also points out that it has been experienced practically that the investment promotion agencies and the DTI administrators of the SEZ programme are not always fully aware of the tax provisions as they are more focused on the economic side of the regime to attract investors (SAIT, 2017a:2).

Although the primary tax incentive benefits associated with the SEZ regime have remained consistent, the requirements have changed in order to qualify for the benefits associated with section 12R and 12S. In order to be viewed as stable the tax incentive should not change regularly but there should also not be any uncertainty. The changes were added as anti-avoidance measures to counter potential profit shifting by connected persons to benefit from the incentive only accessible to companies operating within the SEZ. These changes result in some uncertainty for investors and prohibit transacting in integrated supply chains on a firm level which could result in in instability if an investor starts transacting with connected parties and does not realise that he/she will no longer qualify for the incentive benefits.

The core issue is therefore that initial investors could have set up their operations with the aim of transacting within an integrated supply chain and due to the changes to section 12R, they could now be disqualified from meeting the requirements of a qualifying company. This signals uncertainty to prospective investors as future tax modifications could also have an adverse impact on their operations after the incorporation of businesses within a SEZ. As the regime does not contain any fiscal stabilisation clauses, it provides no definite certainty and stability to potential investors. This disables the regime from ensuring that future tax changes will not result in higher tax liabilities or that investors will not be disqualified form meeting the requirements.

4.2.4 Promote transparency

Chapter 3 (see 3.5.4) highlighted the best practise guidelines released by the OECD to assist developing countries like South Africa to draft tax incentives with the aim of increasing transparency. The initial requirement of the best practice guidelines suggests that a public statement should be made with regards to the tax incentive and its objectives. As identified in 4.2.1.1 the objectives associated with SEZs are publicly known as they are contained in the Policy on Development of Special Economic Zones with a primary objective to accelerate industrial development and attract investment.

The OECD (2015b:3-4) proposes that the tax incentive should be offered exclusively through tax legislation while consolidating the governing responsibilities under the authority of a single governing body. The South African SEZ model lacks transparency compared to this requirement as the incentive is governed by both the DTI in the form of the SEZ Act (16 of 2014), as well as the receiver of revenue (SARS) via the Income Tax Act (58 of 1962). In order to achieve transparent administration of the incentive it should be subjected to periodic reviews and calculations of the revenue foregone to assess its effectiveness. Bird (2008) supports this guideline and suggests that tax incentives should be monitored and assessed frequently in the interests of transparency, efficiency and fiscal control.

Bird (2008) further notes that only a few developing countries keep records and evaluate the results associated with the offered tax incentive because often the "political advantages of ambiguity seem to outweigh the potential social gains from transparency". James (2009) accentuates that tax expenditure statements should be published by governments to measure the costs and assess the effectiveness of the incentive to accurately measure investment return in order to conclude if the rewards exceeded the associated costs and risks. Transparency also requires clear government communication for public scrutiny in the budgetary process.

Chapter 1 (see 1.1.4) noted that during the 2018 budget speech the finance minister, Malusi Gigaba, allocated R 4.9 billion of the incentives budget for industrial infrastructure projects over the medium term for Special Economic Zones. There is, however, no direct evidence that the government reviews the performance of SEZs as tax incentive as there are no publically available statistics to communicate the revenue sacrificed compared to the returns generated by lured investment.

The last best practice guideline (Zolt, 2015:32) encourages government to disclose the primary beneficiaries that qualified for the obtained benefits through the tax incentive. Chapter 3 (see 3.5.4) also recognised that for a tax incentive to be transparent it should have structured qualifying criteria. The evaluation done on the objectives of a meaningful tax incentive established that the South African SEZ regime does contain a specific criterion within section 12R which reduces a degree of subjectivity, stipulating when a company will qualify for the tax incentive benefits. There is, however, some uncertainty whether the criteria to qualify as an operating company within a SEZ are sufficiently transparent from a tax perspective.

The application process for the individual businesses considering to commence operations within a SEZ, is regulated by section 38 of the SEZ Act (16 of 2014). Any person who intends to locate their operations or businesses within a SEZ, needs to apply to the SEZ board in the manner prescribed in 4.2.2.3. The applicant needs to provide information to prove that the intended business activities are not excluded from the list of disallowed activities as prescribed by the minister and set out in 2.6.1.1 of this study. The SEZ Board will then approve the application and allow the company to locate their operation within the SEZ. In a submission made to National Treasury on behalf of SAIT, Newman explains that the application process to receive section

12R benefits is not yet transparent. It emphasises that National Treasury needs to issue regulations to clarify how an investor will qualify for the benefits to be able to locate within a SEZ (SAIT, 2017b:6).

It can therefore be concluded that by communicating a portion of the budget allocated to the incentive, verifies that the South African SEZ model aims to achieve some of the basic transparency requirements of a tax incentive but it currently lacks in terms of achieving some of the other basic best practice guidelines released by the OECD. The absence of releasing detailed financial results of the performance of the SEZ tax incentive and not clarifying a transparent qualification criterion in terms of the requirements to locate within an SEZ, and not disclosing the beneficiaries benefiting from the zones, are transparency shortcomings that should be addressed by government.

4.3 Chapter Conclusion

This chapter considered the different aspects to conclude whether the South African SEZ regime could serve as a meaningful tax incentive by evaluating its design by comparing it to the design elements of a meaningful tax incentive as part of the evaluation criteria identified in Chapter 3. It also considered the theory and development of SEZs globally to establish if the South African SEZs supports existing macro-economic policies in place, specifically referring to the NDP.

In order for SEZs to accelerate economic growth it needs to support the macro-economic policies of the country, contain specific objectives and a qualifying criteria. The findings in this Chapter highlighted the importance of SEZs in South Africa and indicated that the SEZs promoted some of the developmental capabilities of the NDP. It can be concluded that the South African SEZ model conforms to meet the required characteristic of having an objective and supporting other government policies in place, such as the NDP. It was however highlighted that the objective of the SEZs to support the NDP should be more specific as to which explicit aspects within the NDP it aims to support. The study concluded that the tax incentive benefits regulated through section 12R and 12S have clear stipulated qualifying criteria that sets out the requirements to qualify for the benefits. It has however been noted that there is a lack in transparency regarding the initial application process for a business to qualify and locate within a SEZ.

The research performed in this Chapter established that a harmful tax regime could be identified through the application of a three tier-analysis in terms of BEPS Action 5. The SEZ regime was established in the first tier as a preferential regime, due to preferential tax treatment for companies located within a SEZ. The regime however fell outside the scope of the work done by the FHTP due to the list of excluded activities that were published in the government Gazette. Despite the list of specific excluded activities, an area of improvement has been identified to strengthen the anti-abuse provision. This entails to also specifically exclude the provision of intellectual property and intangibles from the list of disallowed activities within the SEZs.

The SEZ regime will not be able to fully satisfy the substantial activity test when intellectual property is supplied due to the absence of a clear link between profits generated and expenditure incurred. The list of excluded activities under section J and section K of the SIC codes, however excludes the provision of mobile activities that could relate to intellectual property, intangibles and financial services. These excluded activities ensure that the primary business activities conducted within the regime do not relate to mobile services. The last tier of the analysis considered three questions to establish if the regime is actually harmful and it can be concluded that the SEZ regime as a tax incentive was not found to be harmful on a national level or within the context of BEPS Action 5.

It was established that although the SEZ incentive benefits enables the investor to maximise after tax returns, some issues were noted with regards to the regime being able to provide room for flexibility to support the company during its life cycle of development. This poses a real challenge for the regime to aspire to be effective for the potential investor. Section 12R and 12S both contain sunset clauses that limit the tax benefits for a relative short period of time as start-up companies make tax losses for extensive periods before they become profitable. It was also highlighted that the 90% income constraint may limit the flexibility of the group structure. It may therefore become necessary to incorporate another company to mitigate the risk of not meeting the 90% income requirement.

It was concluded that shortcomings within the South African SEZ regime have been identified with regards to stability of the incentive itself and the uncertainty caused by the limitation of transacting with connected parties. Due to the regime being administrated by both SARS and the DTI, it results in uncertainty when the DTI promotes investment opportunities without having proper regards to the tax implications. Investors may plan to transact with their connected parties within an integrated supply chain and may not realise they could be disqualified from being eligible for the tax incentives if they transgress the 20% limitation. Additionally some uncertainty is also created where companies need to analyse measurements during a tax period. This would be the case as the onus is on the company to demonstrate that less than 20% of total transactions took place between connected parties.

It was concluded that some weaknesses have been identified with regards to the SEZ regime promoting transparency. The governing responsibilities do not fall under one single governing authority as the regime is administrated by both SARS and the DTI. The performance of the SEZ regime is also not disclosed holistically through detailed tax expenditure statements and also lacks the disclosure of the primary beneficiaries benefiting from the regime. The application process to locate within a SEZ is also not clear and it can be concluded that the design did not conform to meet the majority of the best practice transparency guidelines that were released by the OECD.

To summarise the findings of the research performed, it can be concluded that the South African SEZ regime could qualify to be deemed as a meaningful tax incentive once the shortcomings identified in of 4.2 of this chapter are addressed by government and policy makers. It has however been noted in 4.2.1.1 that although SEZs provide support for the focus areas identified in this study, the current model does not contain any detailed link or connection between the SEZs and the specific objectives and challenges identified by the vision of the NDP. The objective of SEZs to provide a clear planning framework to support the NDP is too extensive and it does not highlight specific key focus areas that it intends to support within the NDP.

It can however still be concluded that the SEZs as tax incentive conformed in some areas to meet the required characteristics and design elements of a meaningful tax incentive. As the regime is relatively new to South Africa and only became effective in 2016, it is therefore reasonable that some shortcomings and weaknesses would have been identified through the research performed. These deficiencies noted in in the design of SEZs as tax incentive, will be addressed in Chapter 5 as possible improvements.

CHAPTER 5: CONCLUSIONS AND FUNDAMENTAL FINDINGS

5.1 Introduction

Chapter 1 emphasised the importance of SEZs as a key role player to contribute to the country's economic performance as a tool to drive industrial and economic development (DTI, 2018:4). It was noted in chapter 1 that SEZs should be designed specifically to complement the objectives contained in other government policies and cannot be adopted as a "one size fits all" development tool (Bernstein, 2012:4). South Africa experiences a number of challenges across economic and socio-economic levels. The government's solution to address these challenges was the implementation of the NDP which broadly identifies the way forward for South Africa to solve the economic challenges by 2030 (Heiriss, 2017:11).

The Policy on the Development of SEZs (South Africa, 2012:6) identifies SEZs as critical instruments for government to promote strategic objectives of industrialisation, regional development and job creation while improving the attractiveness of South Africa to lure FDI. Chapter 4 identified that one of the specific objectives of the Policy on Development of SEZs, is for SEZs to support the NDP in order to assist the government with developing infrastructure, promote growth, increase exports and contribute to creating employment opportunities (South Africa, 2012:23).

Chapter 3 defined a tax incentive as any provision allowing for beneficial tax treatment when the tax treatment is compared to the general tax rules for an identical set of activities performed, or operations conducted within the same industry in a specific country (Klemm 2010:315). In terms of BEPS Action 5, it was further noted in this study that if a regime provides even the slightest beneficial deviation from the tax laws in a country, then that regime is deemed to be preferential (OECD, 2015a:18). It was outlined that tax incentives could be offered in various forms but irrespective of the nature of the offered incentive, there were some 'best practice guidelines' to follow when policy makers adopt a new tax incentive. The requirement for a tax incentive to be categorised as a meaningful incentive is a prerequisite that it should be designed to comply with four specific desired characteristics known as design elements within this study (Moolman, 2012:28).

The tax concessions offered through SEZs were delineated and it was established that these provisions could be regarded as mechanisms used by the South African government to solve the economic challenges contained in the NDP as highlighted in Chapter 1 of this study (see 1.1.5). The SEZs were found to address the issues and reach the objectives of creating jobs, expand on infrastructure, transform rural spaces, and building a capable state while transforming society and uniting the nation. The SEZ regime offered income tax relief in the form of section 12R, also a lower income tax rate of 15%, and section 12S offered an accelerated depreciation allowance and indirect tax incentives which includes ETIs, VAT and customs concessions. As a result of the direct and indirect tax concessions offered by the South African SEZ regime as identified in Chapter 2 (see 2.6.1- 2.6.4), it could be concluded that the SEZs were offered by government as a tax incentive motivated by economic objectives.

It was established that the South African SEZ model could be classified as a tax incentive after outlining the incentive benefits offered under the regime. A critical evaluation was performed to consider whether the design of the South African SEZ regime as tax incentive conformed to the design elements of a meaningful tax incentive highlighted by the evaluation framework established in Chapter 3. The aim of the study was to obtain a detailed understanding of both the structure and design of the implemented SEZ model as a tax incentive in South Africa while considering whether the design enables the SEZ model to serve as a meaningful tax incentive. The purpose of obtaining an in-depth understanding of SEZs and the design elements of meaningful tax incentives was to enable the study to critically compare the South African SEZ model as tax incentive against structured criteria. This enabled the study to evaluate the overall design of SEZs as a tax incentive while identifying limitations and recommendations.

A literature review was selected as the research method to perform a review of available existing literature that relates to both SEZs and tax incentives to perform a subsequent critical evaluation of the design of SEZs as a tax incentive in South Africa, while taking into account the respective tax legislation contained in the Income Tax Act. The purpose of Chapter 5 is to reflect on the findings, shortcomings and conclusions reached in the preceding chapters 1 - 4. The core purpose of chapter 5 is to provide significant findings and recommendations, and provide an overall conclusion for the research.

5.2 Research objectives

The objectives behind this study are contained in Chapter 1 (see 1.3.2) and are divided between one primary objective and three secondary objectives that will assist the study to reach the primary objective. The primary objective was to evaluate whether the design of the SEZ model applied in South Africa enables it to serve as an effective tax incentive. A literature review was conducted which included the critical evaluation of the design of the SEZ model as tax incentive in South Africa and the findings have been used to meet each of the secondary objectives below:

1. Exploring the development of SEZs locally and globally, while subsequently considering the tax incentives available to South African companies operating within such a zone. This objective was addressed in Chapter 2 where it was established that SEZs are a critical tool used to address economic challenges and stimulate FDI. It was concluded that South African SEZs offer investors primarily income tax incentives, through section 12R and 12S, as well as other indirect tax concessions that relate to VAT, customs duties and ETIs.
2. Identify the characteristics of well-structured tax incentives that stimulate the economy over the long term without damaging the tax base of the host country. This objective was addressed in Chapter 3 where it was concluded that a poorly designed tax incentive will not be effective to meet its objectives. It was concluded that there is a distinct criteria of characteristics that should be incorporated in the design of a meaningful tax incentive.
3. Evaluate the design of the SEZ model against the design elements and characteristics identified of a well-structured tax incentive while taking into account existing government policies in place, specifically referring to the NDP.

   This objective was addressed in Chapter 4, where it was concluded that there is a deficiency in the coordination between the objective of SEZs to support the NDP and the vision of the NDP. The objective of the SEZs is not specific as it did not identify explicit aspects which it aimed to support within the NDP. It was concluded that although the SEZ model reflected some of the desired characteristics of meaningful tax incentives, there were weaknesses and areas for improvement identified within the current design structure.

5.3 Recommendations for improvement

Based on the literature review conducted with the aim of reaching the objectives identified in Chapter 1 (see 1.3), recommendations are provided in pursuit of improving the design of SEZs as a tax incentive for sustainable investment activities within the SEZs. The research question posed aimed to critically consider if the design of the SEZ model in South Africa enables it to serve as a meaningful tax incentive. The research question was answered by performing a literature review. It has been established that the SEZ model is able to serve as a meaningful tax incentive, although it lacked some of the required characteristics in its design.

The research highlighted that there could be recommendations for improvements with regard to some of the provisions contained in section 12S. As identified in 2.6.1.2, there is some uncertainty regarding the application of section 12S. Section 12S should clarify the implications if a building that previously qualified for the accelerated wear and tear allowance is then disposed by a qualifying company. Section 12S should therefore be amended to remove the ambiguity currently associated with the provision, to clarify if the allowance will still be available for the new qualifying company acquiring the building from the previous qualifying company.

Another area of improvement within section 12S relates to the sunset clause provision which indicates that the benefits of the accelerated wear and tear allowance, which terminates for years of assessment commencing on 1 January 2024, and therefore only allowed for 8 years of benefits, although the 10% allowance was supposed to provide accelerated wear and tear write offs over a period of 10 years. The sunset clause of section 12R has already been amended as identified in 2.6.1.1 to terminate for years of assessment commencing on 1 January 2024 or ten years after the commencement of carrying on a trade within a SEZ. The sunset clause of section 12S should also be amended to offer benefits for at least a period of ten years as section 12R, especially as the SEZs only became effective on 9 February 2016.

As identified in 2.6.3, ETIs became effective 1 January 2014 and ceases to apply on 28 February 2019. The sunset clauses contained in section 12S, 12R and ETIs provide limited time frames for investors who base their investment decisions solely on the tax incentive benefits. As highlighted in 4.2.2.3 the time constraint associated with section 12S and 12R could fundamentally negate the incentive benefits as start-up companies are known to make tax losses in their initial years of operations, and as they do not have access to the benefits, no tax would in any case be payable. It is recommended that the provisions should be reassessed and consider extending the length of the available time periods before reaching the sunset clause to provide more room for flexibility for potential investors.

It has been established in 4.2.2.1 that the SEZ regime contains an anti-abuse provision to specifically exclude certain activities from being conducted by a qualifying company within a SEZ. Based on the list of excluded activities, it was concluded that the regime was not at risk of falling within the scope of the work done by the FHTP. Participation in any of the prohibited activities published in a government Gazette will result in disqualification of the tax concessions available under section 12R and 12S. These excluded activities refer to section J (information and communication) and section K (financial and insurance activities) of the SIC codes, which protects the SEZ regime from mobile activities that are not geographically restricted. It is recommended that the list of excluded activities under section J of the SIC codes should also explicitly state that the provision of intangibles and intellectual property are also prohibited. This will strengthen the requirements contained in section 12R to be classified as a "qualifying company" and limit potential harmful tax planning opportunities.

As part of the considerations undertook in 4.2.2.1 to establish if the SEZ regime resulted in a harmful tax regime, it was highlighted that there is a red flag indication due to no real requirements for significant new activities to be conducted within the zones. The regime will create harmful economic effects if it shifts activities between countries instead of creating significant new activities. It is recommended that in addition to the SIC codes disqualifying certain activities to be conducted within the SEZs, there should be a similar provision that requires a company to conduct a list of preferred activities within the zone to promote the objectives of the SEZs and to avoid harmful effects.

It was established in 4.2.2.2 that the South African SEZ regime experiences a lack of government disclosure and it is proposed that in order to enhance the transparency of the incentive, regular tax expenditure statements, including the beneficiaries benefiting from the regime, should be disclosed publically. There is also no indication that government regularly reflects on the performance of the regime and it is recommended that public disclosure should include releasing detailed financial results and comparisons of generated benefits in return for foregone tax revenue to disclose the true performance of the SEZ incentive.

Some other deficiencies have also been noted with regards to the best practice guidelines relating to transparency which was issued by the OECD. The tax incentive should be governed by one regulating authority but, as noted under 4.2.4, the South African SEZ incentive is administered by both SARS and the DTI. As instances have occurred in the past (see 4.2.3) where the investment promotion agencies and the DTI administrators were not fully aware of the tax provisions as they are focussed on the economic side of the SEZ regime, it is proposed that the regulation and governance of the SEZ as a tax incentive should be centralised within the control of one regulating authority. It was pointed out by SAIT that the initial qualifying criteria for investors to locate within a SEZ is not clear or transparent and it is recommended that there should be an improvement with regards to the application process.

As identified in 4.2.2.3, the requirement that 90% of the businesses' income should be derived from operations conducted within the SEZ, possibly limits the flexibility of the structure of the group. It is proposed that the revenue authorities should rather require additional information when a qualifying company submits their returns to disclose the locations of their revenue generating business activities 12R, instead of prescribing a fixed benchmark of 90%. This will enable SARS to identify taxpayers that should be subjected to tax audits, as the submitted returns will identify which companies are possibly abusing the provisions of section 12S. This will avoid increasing the compliance burden of the investors which places them at risk of disqualifying themselves from the benefits by not meeting the 90% requirement in the early stages of setting up operations within a SEZ.

The revenue authorities should consider the effect of BEPS Action 5 extensively for drafting anti-profit shifting provisions for their SEZ legislation. The current section 12R excludes companies located within the SEZ of transacting more than 20% with connected residents or the permanent establishment of non-residents located within the SEZ but it does not exclude non-residents of transacting more than 20% with their connected non-resident persons. The connected persons' 20% anti-profit shifting provision should be updated in order for the same provision to apply for both resident and non-resident companies as connected persons.

It was also identified in 4.2.3 that the 20% benchmark should not be a fixed percentage as it creates uncertainty and discourages stability of the tax incentive when taxpayers need to analyse measurements to evaluate percentages of connected party transactions over a tax period. The 20% restriction was found to be a potential stumbling block for the success of SEZs as tax incentives, as investors often utilise integrated supply chains. It is recommended that there should be no restriction placed on the purchases made from SEZs companies from connected parties located outside the zones as long as the produce is exported. This will mitigate the risk that goods or services cannot be supplied to the local market while shifting taxable profits to entities located within the SEZ. In order to promote stability it is recommended that policy makers should consider the possibility of adding fiscal stabilisation clauses to the SEZ regime to provide investors with certainty due to some projects operating for an extensive period of time.

The current SEZ regime in South Africa does not contain a linkage between the tax incentives and skills development or B-BBEE. Outside of the SEZs, B-BBEE have economic incentives which can assist businesses in doing business with other local companies or the South African government, based on a point scoring system that incorporates ownership, skills development and demographics at the workplace. There is no direct incentive for export orientated companies to achieve higher B-BBEE points as they are unlikely to generate significant business activities in South Africa resulting in an irrelevant B-BBEE status. It is recommended that a similar B-BBEE strategy is to be implemented for companies located within a SEZ where they could receive additional tax incentives for investing in skills development and employing people from a previously disadvantaged background to include them in the country's transformational objectives.

5.4 Summary of findings

In order to evaluate SEZs as tax incentives, criteria serving as backdrop of information regarding the associated characteristics of a meaningful tax incentive were identified. The following significant characteristics or design elements have been identified in Chapter 3 as a requirement for the design of SEZs as a tax incentive to serve a meaningful purpose in the South African economy:

i. All tax incentives should have defined objectives which pose qualifying criteria for eligible investors and projects. In 3.5.1 it was established that the tax incentive should complement the country's long-term strategies and objectives, and the incentive will only be effective if it contains clear linkages of the objectives to be achieved.

ii. For a tax incentive to be effective it needs to meet the set objectives, increase after-tax returns of investments and focus on cost-effectiveness. In 3.5.2 it was established that the policy regulating the incentive should be focused on achieving the specific goals identified in 3.5.1. The costs of investment for investors should be compensated with increased after tax returns to deliver improved project profitability. The focus on cost-effectiveness, highlighted in 3.5.2.4, not only focuses on the cost effectiveness for the host country that needs to be sufficiently compensated, but also takes into account harmful tax practises that could lead to a harmful tax regime in terms of BEPS Action 5.

iii. As part of the aim to be effective, it has been identified in 3.5.2.3 that the incentive needs to incorporate an element of flexibility as companies undergo various stages during their developmental life cycle where losses are often experienced within the first few years of operations.

iv. As identified in 3.5.3, long term investors require stability, and a volatile tax environment will increase the investment risks resulting in sacrificing possible FDI that would have occurred in the absence of regular changes to the incentives.

v. The last required characteristic of a meaningful tax incentive is recognised in 3.5.4 as transparency. The incentive should be easy to comprehend to reduce the risk of possible abuse and require regular government communication regarding the objectives and associated costs for public scrutiny.

The findings can conclude that a tax incentive that is poorly designed and not conforming to the desired characteristics of a meaningful tax incentive as identified above, is just as ineffective as a well-designed incentive that is not properly implemented or governed by the revenue authorities. Incentives that conform to the desired characteristics of a meaningful tax incentive have the potential to promote investment and stimulate economic growth.

5.5 Limitations of the study

This study focussed on evaluating the design of SEZs as a tax incentive in South Africa to offer recommendations on possible improvements to the income tax incentives offered by the SEZ regime. Some limitations have been encountered during the research performed as the focus was placed on the taxation characteristics and design of the South African SEZ regime, rather than the general compilation characteristics of SEZs globally.

The Policy on Development of SEZs identified one of the specific objectives for SEZs is to support the NDP. However, no specific areas within the NDP were identified by the policy which limited the study to self-identified areas within the NDP that could be supported by the SEZs, based on the structure and nature of SEZs proclaimed in South Africa. Unfortunately, no comparative analysis was used to directly compare the design and tax benefits available in South African SEZs to other SEZs offered globally as the emphasis of the study was placed to rather evaluate the design of the South African SEZ model as a meaningful tax incentive.

Furthermore, the research did not aim to gather large volumes of data regarding the performance of SEZs in South Africa to evaluate their impact on the economy or to conduct an in-depth analysis of the economic performance of SEZs, as the focus of the study would have shifted from the evaluation of the design to the implementation of SEZs in South Africa.

5.6 Contribution of the research performed

The research aimed to determine whether the design of SEZs in South Africa enabled it to serve as a meaningful tax incentive while luring FDI to promote investment in South Africa and address socio-economic challenges experienced by the country and identified in the NDP. This study should benefit policy makers of any country, National Treasury and SARS to obtain an understanding of the linkage between SEZs and the concept known as “tax incentives” which are entwined within tax legislation. The research performed should assist the revenue collecting authorities to establish the motives for offering tax incentives and to identify benefits and objectives that are aimed to be achieved with the offered incentive, specifically when implementing SEZs.

This mini-dissertation provides a backdrop for revenue authorities to obtain an understanding of the characteristics and design elements on which future tax incentives should be based in order to be categorised as “meaningful”. The study had the intention to consciously alert revenue authorities that although incentives as SEZs do not always result in a direct outflow of government funds, there are associated costs such as the foregone tax revenue. Revenue authorities need to be entirely aware that all costs (direct and indirect) should be taken into account to evaluate if the benefits exceed the costs of the proposed incentive when drafting new tax incentive policies.

5.7 Recommendations for future study

The aim of this study was not to perform in-depth research on every aspect associated with the concept known as SEZs. There is a gap for future studies to expand on the research in this study regarding the required design element identified for tax incentives in 3.5.2 as “Aim to be effective”.

Further studies could endeavour to assist potential foreign investors with determining the required return on their investments before investment should be undertaken within a SEZ in South Africa. Forthcoming research could also expand on considering if the rewards of the SEZ as tax incentive exceed the risks or costs on a national level by performing an economic analysis. Future studies could aim to gather a substantial volume of historical data from the inception date of the SEZ regime and to analyse the data over the period of time to effectively establish if the SEZs as tax incentive are not harmful to the South African tax base on a national level (see 4.2.2.2).

Prospective studies could analyse the impact of the requirement that 90% of the income should be derived from carrying on a trade within a SEZ. This will assist to determine whether the provision inherently excludes certain business activities from the SEZ regime, such as service organisations which regularly provide services at the premises of their clients. Future studies could also investigate the impact of disqualifying a company as a “qualifying company” if more than 20% of the tax deductible expenditure is incurred between connected persons. Companies often buy from connected persons as it provides them with a competitive advantage if goods could be sourced at lower prices rather than obtaining them at higher prices from competitors in the local market. Future studies could evaluate if this requirement could discourage companies from locating in SEZs as their products will not be globally competitive with higher prices due to being unable to source production inputs locally at cheaper prices from their South African connected parties.

5.8 Overall conclusion

The research have been conducted with the aim to determine if design of the SEZ model applied in South Africa, enables it to serve as a tax incentive as identified in 1.3 of this study. Based on the literature review performed to meet both the primary and secondary objectives identified in Chapter, it can be concluded that the design of South African SEZ model enables it to serve as a tax incentive although some areas for improvements have been identified to ensure that the SEZ model is enabled to also serve as a meaningful tax incentive.

The South African SEZ model contains different tax incentives ranging from direct corporate tax inducements which include section 12R, a lowered corporate income tax rate of 15%, and section 12S which is an accelerated building allowance for a 10% tax deduction of the cost per year. The SEZs also contain tax concessions for indirect taxes including VAT, customs relief and the employment tax incentive known as an ETI.

As part of the requirements of a meaningful tax incentive, it was identified that the incentive should meet its specified objectives. This study focused on areas with a direct linkage between SEZs and the NDP and it was found that the SEZs complied with the objective of supporting the vision of the NDP as noted in 4.2.1.1. It was established that the SEZs as tax incentive did not completely conform to all requirements to be effective as some weaknesses have been identified with regards to providing room for flexibility and focusing on the cost effectiveness. Weaknesses have been identified within the area of focussing on cost effectiveness on a national level due to the lack of government monitoring of the actual performance of the offered incentive.

Some flaws have also been identified in the South African SEZ regime as tax incentive which relates to the characteristics of containing stability and promoting transparency. It can therefore be concluded that although the SEZ regime could be classified as a tax incentive, it requires that some improvements should be made to the current regime in order to enable it to fully serve as a meaningful tax incentive within a South African context, based on the evaluation performed.

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