

Incentives for small business corporations: Company qualifying criteria in South Africa and Australia

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Mini-dissertation submitted in partial fulfilment of the requirements for the degree *Masters of Commerce in South African and International Taxation* at the North West University

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Graduation May 2018

Student number: 23407034

SUMMARY/ABSTRACT

Title: Incentives for small business corporations: Company qualifying criteria in South Africa and Australia

Key terms: Small business corporation; small business entity; tax incentives, South Africa, Australia, Section 12E, Division 328.

South Africa is a country facing numerous economic and other challenges, such as high rates of unemployment and rampant inequality. One solution to these challenges is to ensure that South Africa has a growing and vibrant economy, capable of creating sustainable jobs that address the systemic inequality in the country. Small businesses can play a vital role in the future of the South African economy, as they are the engines powering growth, job creation and innovation. Small businesses should, therefore, be assisted as far as possible – the use of small business tax incentives can be viewed as a form of assistance. These small business tax incentives can be the “turbo fuel” used to kick-start small businesses and power up the South African economy.

Currently, South Africa provides small businesses with tax incentives in the form of Section 12E of the Income Tax Act (58 of 1962). Entities that meet the definition of a “small business corporation” in terms of this section, are provided with tax relief in the form of reduced corporate tax rates and accelerated wear and tear allowances. This relief is, however, often criticised for being overly onerous and complex.

Other countries also offer small businesses tax relief as a form of assistance. One such country is Australia where small businesses that meet the definition of a “small business entity” – per Australian tax legislation – qualify for tax relief in the form of reduced corporate tax rates and preferential wear and tear rules. Previous studies have noted that South African small business tax legislation can learn from Australian legislation on how to standardise and expand small business tax relief.

The purpose of this study was, therefore, to perform firstly an in-depth analysis of both the South African small business corporation and Australian small business entity tax relief. A critical comparison was secondly performed in order to identify the shortcomings

of the South African small business corporation qualifying criteria and tax relief when compared to the Australian small business entity qualifying criteria and concessions. Recommendations were made in this study on how to possibly improve or enhance the South African small business tax relief, specifically with regard to Section 12E. This study was, therefore, performed through a detailed literature review of previous research concerning the respective small business tax concessions of South Africa and Australia. This research methodology was a post-structural or doctrinal research design.

The study found several shortcomings in the South African small business corporation eligibility criteria and tax concessions when compared with the Australian small business entity system, including the fact that the anti-avoidance measures in Section 12E are overly onerous and that South African small business tax incentives ensure a mismatch between providing relief to incorporated and unincorporated small businesses. Moreover, it was noted that the form of corporate tax relief in South African tax legislation is narrow when compared to the Australian system.

Several recommendations were made on how to possibly improve Section 12E tax relief, especially in terms of the aforementioned shortcomings. Recommendations were also made with regard to future areas of research that can even further improve Section 12E tax relief. The value this study created was, therefore, to assist Section 12E tax relief in becoming as effective as possible – adding a bit more turbo to the fuel needed to power small businesses in South Africa.

ACKNOWLEDGEMENTS

I am extremely grateful for the opportunity I was granted through this mini-dissertation and indeed in my master's studies in taxation as a whole. It has been an enriching journey of learning, self-discovery and growth.

I am also grateful for the ability to have written a mini-dissertation on small business tax - a topic which I hold very close to my heart. I hope that through this study one or two small businesses could perhaps benefit through the recommendations suggested. I truly believe that developing small businesses is fundamental if we want to unlock the full potential that this great country has to offer. I believe in South Africa. I love this place I call home and I refuse to be negative about its future.

Of course one does not undertake a monumental task such as a master's study without the support of some specific individuals, who rightly deserve a special mention:

- Firstly, thank you to God for granting me the opportunity to pursue a master's degree and further, for the talent and strength to see it through.
- Thank you to my mom, Mitzi Heiriss for being my rock, my counsellor and for always believing in me. Thank you to my dad, Gerhard Vosloo and sister, Karla Heiriss for all the words of encouragement and support along the way.
- Thank you to my special friends: Ivan Kuit; Buddy Muundjua; Rizaan Olivier; Roüa Pienaar; Jimmy Pressly, Susan Pressly; Lebona Sello; Bianca van Rooyen and Xanthe Wittmann. Thank you for all the support and motivation along this journey. I have the most amazing friends anyone could ask for and I appreciate each and every one of you.
- Thank you to my supervisor, Erica Derbyshire and co-supervisor, Prof. Pieter van der Zwan for the extremely valuable contributions made to this mini-dissertation and for guiding me every step of the way.
- Thank you to Mari Grobler for the language editing of this study.
- To every other family member or friend not mentioned, thank you for keeping up with me through the best and worst times during the course of this study. I appreciate it immensely.

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LIST OF ABBREVIATIONS AND ACRONYMS

ATO	Australian Taxation Office
CGT	Capital Gains Tax
DTC	Davis Tax Committee
FBT	Fringe Benefit Tax
GDP	Gross Domestic Product
GST	Goods and Services Tax
NDP	National Development Plan
PPP	Purchasing Power Parity
SARS	South African Revenue Service
SBE	Small Business Entity
SBC	Small Business Corporation
SME	Small and Medium-sized Enterprises
SMME	Small, Medium and Micro Enterprises
STS	Simplified Tax System
VAT	Value-Added Tax
VCC	Venture Capital Company

CHAPTER 1: INTRODUCTION

1.1 Introduction

South Africa is a country that currently faces several severe economic and socioeconomic challenges, such as high rates of unemployment and rampant inequality (Motsamai, 2011:3-4). In order to address these challenges, the South African government has initiated and implemented several programmes and policies – the most notable the National Development Plan (NDP). This plan broadly sets out the methods which will be used to restructure the economy and address other socioeconomic challenges to ensure that South Africa is a more prosperous and equal society by the year 2030 (Department: The Presidency, 2012:140-144).

The NDP specifically lists small businesses as a critical factor for the plan to be a success. Small and expanding businesses are highlighted as the method used to generate the vast majority of new employment opportunities leading up to 2030, seeing as that from a historical perspective, most new employment opportunities do not come from existing businesses. The NDP foresees that by the year 2030, small and medium businesses will contribute to approximately 90% of South Africa's gross domestic product (GDP). According to the NDP, these small businesses can be transformed into hubs of innovation to offer solutions to several challenges faced within South Africa, including the important task of aiding the transformation of the economy into a more inclusive one that offers opportunities to previously disadvantaged individuals (Department: The Presidency, 2012:140-144).

Even though the NDP highlights the importance of small businesses to improve the future of South Africa, it does not negate their importance to the current economic structure of the country. A report released by the South African Department of Trade and Industry estimates that small businesses currently make up approximately 27-34% of the South African GDP (Department of Trade and Industry, 2008:94).

Small businesses have also historically been known as employment creators, not just in South Africa but throughout the world (Singh *et al.*, 2015:150). Small businesses are often described as the seed of big businesses and the fuel of national economic engines, evident by the fact that in the most developed countries, the small business sector rather than large multinational companies are the largest employers of workers (Abor & Quartey, 2010:1).

A small business survey released by FinScope also revealed that small businesses created more than 11.6 million employment opportunities in 2010 (FinScope, 2010:15). When one looks at the current unemployment rate of South Africa (27,7% in the first quarter of 2017) (Statistics South Africa, 2017), it is clear that it is critical to ensure that small businesses succeed in order to help address this high unemployment rate by continuing their contribution towards employment creation within the country.

The small business sector in South Africa is in itself confronted by a range of problems and challenges. According to a paper released by Luiz (2002:24), these problem areas can be summed up into several main factors, such as access to finance for small businesses; inadequate infrastructure; and complying with tough labour laws and taxation. The NDP offers some solutions to the problems small businesses face, including the use of venture capital companies to assist businesses with acquiring financing and restructuring and easing restrictive legislation of which tax legislation forms a major part (Department: The Presidency, 2012:140-144).

1.1.1 South African tax legislation relating to small business concessions

Currently, from a South African Income Tax Act (58 of 1962) perspective, the government has aimed to aid small businesses through the use of legislation, such as Section 12E: “deductions in respect of small business corporations”. The main focus of this Section has been to ease the tax legislative burden on small businesses by offering them reduced rates of taxation payable (as opposed to the otherwise flat corporate tax rate of 28%) and by offering greater capital allowance write-off rates on plant and machinery used in the

trade of small business corporations than would otherwise normally be allowed in a specific year of assessment.

The Section 12E concessions are, however, only available to entities that meet all the criteria as set out by this section – quite often viewed as overly complex and onerous (Davis Tax Committee, 2014:19). Statistics regarding the application of the Section 12E allowance show that many businesses may have a problem in applying this section. Statistics available from the website of the South African Revenue Service (SARS) regarding corporate tax payments in 2014 show that approximately 127,735 companies with positive taxable income exceeding just over R5,000,000 were assessed for tax purposes in total whilst companies assessed under the small business corporation (SBC) tax rates within the same tax bracket totalled just 42,912 companies. Only about a third (33,59%) of potential SBCs are, therefore, applying the special taxation rates (South African Revenue Services, 2015b).

It was with the aim of simplifying the complex criteria and analysing the effect that the tax system can have on the promotion of small businesses that government approved the launch of the Davis Tax Committee study in 2013 into various forms of legislation governing small business tax, such as the Section 12E allowance and turnover tax (Department of Finance, 2013b:2)

1.1.2 Australian tax legislation in respect of small business concessions

Globally, small businesses are also of significant importance in other countries. In these countries, small businesses contribute a major portion of both employment creation and to the GDP (Singh *et al.*, 2015:150). In 2012, a report released by the Australian government indicated that more than 45,7% of all private sector employment in that country was created by small businesses. Approximately 95,9% of all businesses in Australia across a wide-range of industries are classified as small (Department of Industry Innovation, Science, Research and Tertiary Education, 2012:31, 36).

From an Australian tax perspective, much emphasis has been placed on supporting concessions for small businesses. This process started in 2001 by the introduction of a simplified tax system (STS) that provided small businesses with simplified trading stock and capital allowance rules amongst other concessions (Tretola, 2007:1). In 2007, these concessions were modified when the small business entity (SBE) concessions were written into Division 328 of the Australian Income Tax Assessment Act (38 of 1997). The SBE concessions provided small businesses with an annual aggregated turnover of less than AUD2 million – approximately R21,1million as per the exchange rate available from Bloomberg (2017) on 2 October¹ - with wide-ranging tax relief.

These SBE concessions are continually expanded. During the 2016 Australian budget speech, Treasurer Scott Morrison announced a ten year enterprise tax plan to boost new investments and create new jobs. In terms of this tax plan, the SBE concessions have been extended to provide relief to all small businesses with an annual aggregated turnover of less than AUD10 million (R106,4 million) with reduced rates of corporate tax. Treasurer Morrison estimated in his budget speech that over 800,000 small businesses in Australia qualify for the lower corporate tax rates (Australian Budget, 2016:4).

1.1.3 Past research into South African and Australian small business tax concessions

Over the years, quite a few studies have focused on South African and Australian small business tax concessions, including studies in which comparative analyses were performed. Smulders (2006) completed a study on the tax compliance burden that small businesses in South Africa face. The objective was to identify all research already done with a focus on the compliance burden and to identify additional areas of research regarding this topic. This study concluded by acknowledging that tax compliance is a significant burden for most small businesses but that more empirical research is needed

^[1] With reference to exchange rates on 2 October 2017 per the Bloomberg website. These rates are applicable throughout this study.

in order to quantify the overall and exact problems that small businesses face when complying with tax laws.

Sieberhagen (2008) also performed research on the compliance costs that small businesses in South Africa face and completed a qualitative analysis of the various forms of tax concessions available in South Africa, including Section 12E and turnover tax and examined the impact these concessions have had in addressing the aforementioned compliance costs. The study found that there is a lack of evidence to suggest that the current South African small business tax legislation is effective in addressing the compliance cost burden of small businesses.

Two studies, respectively done by Aucamp (2010) and Du Toit (2012), executed a comparative analysis of the South African and Australian small business tax concessions. Aucamp (2010) critically compared all South African and Australian small business tax legislation and found that there are several Australian small business tax concessions not currently available in South Africa. This study was, however, broad in nature and did not focus specifically on Section 12E legislation. Du Toit (2012) performed a comparative analysis of South Africa and Australia but included Canadian small business tax legislation. Similar to Aucamp (2010), Du Toit (2012) found that there were several small business tax incentives applied in Canada and Australia not being implemented in South Africa. Du Toit (2012) was, however, also broad in nature by only focusing on all forms of small business tax relief within the chosen countries.

Stols (2013) performed a quantitative study focusing on small business tax concessions available in South Africa, including Section 12E concessions and turnover tax. By making use of a detailed analysis and questionnaires, Stols (2013) tried to obtain an in-depth understanding of the current perception of small business tax relief in South Africa, including understanding whether these tax concessions met their stated objectives. Stols (2013) found that the current contribution of small business tax relief to the growth of small businesses in South Africa is limited and that tax relief can be improved to ensure that all objectives are met and that benefits for small businesses are increased.

Within Australia, Tretola (2007) researched the STS in order to determine whether this system has simplified tax for Australian taxpayers and whether any of its relief should be extended. Tretola (2007) found that although the STS rules had some merit in them, the inconsistency within the STS eligibility criteria actually worked against the intention of simplifying Australian small business tax.

As previously mentioned, the STS rules were replaced by the SBE concessions in 2007. Kenny (2008) investigated the evolution of Australian small business tax from the STS rules to the SBE concessions currently in place in order to determine whether the SBE system adequately addresses the criticisms the STS system faced. Kenny (2008) found that the SBE concessions significantly streamlined the definition of a small business for tax purposes but these concessions still do not provide an appropriate universal definition.

Certain Australian studies made use of questionnaires in order to obtain information about Australian small business tax. Lignier & Evans (2012) examined the perceptions that the small business sector in Australia have of small business tax concessions. This study found that small business owners continue to believe that they face a high degree of tax compliance costs. Ingraham *et al* (2005) conducted questionnaires amongst tax advisers in Australia and the United States of America in order to determine what they perceive as the complex areas of tax legislation that small businesses face. This study found that more research can be conducted into the method of tax simplification for small businesses.

Freudenberg *et al* (2012) also used questionnaires aimed at tax advisers in order to determine what their perception is of tax law, specifically applicable to small businesses. This study focused on Australia, the United States of America and New Zealand and identified several similarities in the issues facing tax advisers regarding small business tax. The study concluded by stating that when a comparative analysis is used, jurisdictions can learn from each other and strive for tax systems with less complexity.

The last study examined for the purpose of the literature review was McKerchar & Drever (2008). This study examined the effect that tax reform has on entrepreneurship and the tax practices of small businesses, as it is often argued that less regulation of small businesses would increase their ability to be entrepreneurial. This study concluded by stating that more research is needed to determine the needs of small businesses concerning the reduction of tax compliance costs and the improvement of tax legislation coordination.

From the above discussion, it is clear that significant research has been done in both Australia and South Africa regarding small business tax. Some studies have involved comparative analyses of the small business tax systems of the two countries. However, no previous study has been found that focuses specifically on the comparison of the criteria by which Section 12E in South Africa and Division 328 in Australia operate.

With this background in mind, this mini-dissertation aimed to critically investigate and compare Section 12E allowances available within South Africa with its Australian counterpart. Australia has been chosen for this comparative analysis due to the fact that these two countries have similar taxation laws (Marchbank, 2012:12-13). Both countries also offer similar tax relief to small businesses. In Australia, small businesses that meet the criteria of Division 328 of the Australian Income Tax Assessment Act (38 of 1997) qualify for a simplified capital allowance, trading stock rules and reduced corporate tax rates. In South Africa, small businesses that meet the requirements of Section 12E of the Income Tax Act (58 of 1962) qualify for accelerated wear and tear allowances and reduced corporate tax rates. It is, therefore, evident that there are several similarities with regard to the manner and form of small business tax relief provided by the two selected countries.

Furthermore, in previous studies it has been noted that South Africa can learn from Australia regarding the method Australia undertook in order to standardise criteria for small businesses to qualify for tax relief (Aucamp, 2010:8). In South Africa, the lack of a consistent definition of small, media and micro enterprises (SMME) for both tax and other

legislative purposes, is often mentioned as one of the challenges that small businesses face (Smulders, 2006:33).

South Africa is generally regarded as a developing country in terms of economic and infrastructure development (Abor & Quartey, 2010:218-228). Information is easily available in terms of small business tax legislation in South Africa through the use of the South African Income Tax Act (58 of 1962), as well as previous studies undertaken in terms of small business legislation highlighted within the literature review. However, tax legislation in developing countries is generally regarded of poor quality (Tanzi & Zee, 2000:299) and would, therefore, make comparisons with the South African small business tax legislation difficult. This further supports the selection of Australian legislation as a comparative.

1.2 Problem Statement

Small businesses are important to the future of the South African economy and emphasis should, therefore, be placed on how to assist with their development. The Section 12E allowance for SBCs provides tax relief for all small businesses that meet the set criteria of the section. Currently, this tax relief is criticised as being overly complex and strict. In Australia, it is noted that a more standardised criteria for providing small business tax relief exists. Small businesses that meet certain criteria in terms of Division 328 of the Australian tax law, qualify for this tax relief. This research aims to analyse, when compared to Australia, whether there are any shortcomings regarding the form of tax relief and criteria used to apply small business tax incentives within South Africa and subsequently, based on findings, identify possible improvements available to the form of tax relief and current criteria used to apply Section 12E.

1.3 Objectives

1.3.1 Primary objective

The primary objective of this study would be to critically compare the small business tax incentives available in South Africa under Section 12E of the South African Income Tax Act (58 of 1962) with the incentives available to small businesses in Australia under Division 328 of the Australian Income Tax Assessment Act (38 of 1997). This critical comparison will be done in order to identify any shortcomings regarding the criteria and the tax relief provided by the small business tax incentive within the South African legislation and further, to recommend improvements to the South African Section 12E legislation.

1.3.2 Secondary objectives

Within this study, multiple secondary objectives will be met in order to ultimately achieve the primary objective, namely:

1. Determining the definition of small businesses within South African and Australian legislation and evaluating, relative to the small business definition per tax legislation, which definition of small businesses can be used for the purpose of a critical analysis in this study.
2. Exploring and evaluating the small business tax relief found within Section 12E in South African tax legislation.
3. Exploring and evaluating the small business tax relief found within Division 328 of the Australian Income Tax Assessment Act 38 of 1997).
4. Performing a critical comparison of the South African small business tax relief in terms of Section 12E of the Income Tax Act (58 of 1962) with Division 328 of the Australian Income Tax Assessment Act (38 of 1997) in order to make recommendations for a possibly improved or revised Section 12E based on the shortcomings identified in the critical comparison.

1.4 Research methodology

Before commencing with this study, a detailed literature review was performed in order to identify previous relevant research performed in this area and to gain a comprehensive understanding of knowledge that has already been accumulated. Only literature that included research on small business tax in Australia and South Africa and previous comparisons between the two systems have been considered for the purpose of this review.

This study will be completed through the use of a comparative analysis of the existing literature available on the Section 12E small business allowance in South Africa with the equivalent Australian small business tax incentive literature. The source of this literature will be the relevant legislation governing these incentives in the above-mentioned countries, information supplied by each country's relevant tax authority and previous research performed regarding small business tax.

The various guidelines applied by the Australian Taxation Office and published for small businesses and the Interpretation Note number 9 issued by SARS (South African Revenue Service, 2016b) were also used. Available literature was analysed in detail in order to determine the similarities and the differences between the South African and Australian small business tax incentives in order to reach conclusions regarding possible shortcomings the South African small business tax incentive criteria may have based on the identification of successes in the Australian legislation relating to small business concessions.

Firstly, a detailed understanding will be obtained of the definitions of small businesses within South African and Australian legislation. The reason for obtaining an understanding of the definitions was to ensure the refinement of this study to such an extent that it primarily focuses on the definitions of small businesses in Australia and South Africa for tax purposes. Conclusions will thereafter be drawn regarding the comparability of the

definitions, as well as on the nature and number of definitions available within both countries.

A detailed examination of the Section 12E relief available within South Africa will thereafter be undertaken by using the Income Tax Act, Interpretation note 9, the findings of the Davis Tax Committee as well as available literature on the topic (as mentioned within the literature review). This detailed examination aims to track the development of Section 12E, explore the definitions used to apply the relief in this section and identify any criticisms directed towards Section 12E.

Thereafter, an examination will be performed on the tax relief available within the Australian Income Tax Assessment Act (38 of 1997) in terms of Division 328. This examination will explore the development of the current system of tax relief applied to small businesses in Australia and identify criticisms directed towards the Australian method of tax relief as well as virtues. This will be achieved through the use of literature identified within the literature review, as well as by exploring the mechanisms and definitions available within Division 328.

Lastly, this study will use the detailed examinations made of South African and Australian legislation to make several recommendations towards the improvement of the South African legislation. The study will also make several recommendations towards future research regarding small business taxation in South Africa.

This study falls within the post-structural or doctrinal research methodology. Amongst other things, the post-structural or doctrinal research methodology is one that provides a systematic exposition of the rules governing a particular legal category and explains areas of difficulty (McKerchar, 2008: 14-15). As this study will analyse the different legal doctrine governing each country's small business tax incentives and will investigate how these legal doctrines are applied, it falls within this research methodology. This type of research is also referred to as "black letter" law as the research will be carried out using purely

documentary data, this data being the South African Income Tax Act (58 of 1962) and the Australian Income Tax Assessment Act (38 of 1997). (McKerchar, 2008:14).

A post-structural or doctrinal research methodology forms part of an interpretivist research paradigm. Within an interpretivist research paradigm, research is undertaken to gain an understanding of certain phenomena – this research paradigm starts with a specific observation from which certain conclusions are drawn (Mouton, 2001:118). This mini-dissertation falls within this research paradigm because this research is undertaken to gain an understanding of unexplored dimensions of the Section 12E small business tax incentives criteria by performing a critical analysis of existing literature on the allowance.

An interpretivist research paradigm falls within a relativist view of the world and knowledge (Coetzee *et al.*, 2014: 29) and this makes out the ontology and epistemology of this study. In broad terms, ontology is the manner in which the researcher views the world (Harper, 2011:85) and epistemology is what the researcher regards to be knowledge (Mason, 2002:16). When researchers have a relativist view of the world, they believe that knowledge is influenced by various facts and circumstances (Coetzee *et al.*, 2014:27). This fits in with the research into the Section 12E small business allowance as the problem statement stems from various facts and circumstances currently guiding the small business tax incentive.

1.5 Chapter overview

Chapter 1: Introduction to the mini-dissertation

This chapter sets out the background to the study and includes a description of the importance of small businesses in the South African economy, and details of tax legislation relating to small business concessions in South Africa and Australia. Background is provided of past research studies conducted with regard to small business concessions in South Africa and Australia. The chapter outlines the problem statement,

primary and secondary objectives of the study, that will be achieved throughout this mini-dissertation.

Chapter 2: Definitions of a small business in South Africa and Australia

This chapter explores the definitions of small business corporations in South Africa and Australia from a tax and other legislative points of view. Definitions were determined for use in this study and these definitions are compared to other definitions of small businesses found within legislation in South Africa and Australia.

Chapter 3: South African small business tax relief in terms of Section 12E

This chapter will critically explore and evaluate the small business tax relief available to small businesses in South Africa in terms of Section 12E of the Income Tax Act (58 of 1962). This will include an analysis of the SBC definition and tax relief provided through this Income Tax Act section, in addition to determining any criticism against Section 12E.

Chapter 4: Australian small business tax relief

The small business tax relief available to small businesses in Australia in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997) will be explored and evaluated. Similar to Chapter 3, an analysis of the SBE definition and an evaluation of the tax relief is provided. This evaluation of the small business tax relief offered to small businesses in Australia is used in Chapter 5 as the basis of the comparison in the analysis of the South African tax relief provided per Section 12E and Division 328 of the Australian Income Tax Assessment Act (39 of 1997).

Chapter 5: Critical comparison of South African and Australian small business tax relief

This chapter critically compares the evaluation of South African and Australian small business tax relief in order to identify the shortcomings within the South African small business tax relief that is provided in Section 12E of the Income Tax Act (59 of 1962) of South Africa.

Chapter 6: Summary, recommendations and conclusion

This chapter concludes the study by providing a summary and the key findings. Recommendations are provided to address the shortcomings identified within Section 12E tax relief in South Africa. Future research recommendations and a final conclusion are highlighted.

CHAPTER 2 – DEFINITIONS OF A SMALL BUSINESS IN SOUTH AFRICA AND AUSTRALIA

2.1 Introduction

As this study focuses on the tax relief available to qualifying small businesses, it is necessary to define what a small business is. An entity needs to meet the definition of a small business in both Australia and South Africa (by applying certain criteria) before it can qualify for certain forms of tax relief. This chapter will therefore aim to define a small business within both South Africa and Australia by paying particular attention to the definition of a small business within these countries for tax purposes.

There are differing views on what constitutes a small business from both an economic and a tax perspective. According to Chamberlain and Smith (2006:44), South Africa lacks a coordinated SMME policy, a state of affairs which is very visible in a simple problem such as a lack of a consistent SMME definition. This lack of a consistent SMME definition adds to the compliance costs which small businesses face (Smulders, 2006:33).

In Australia, the lack of a single definition for the term “small business” for tax law purposes has also been acknowledged as a significant source of compliance burdens faced by small businesses (McKerchar & Drever, 2008:4).

As this study will focus on a very specific range of small business relief, it is necessary to define what the term “small business” means for the purposes of this study.

2.2 Defining small businesses within a South African context

Numerous attempts have been made within South Africa to define a small business. Within a South African context, the terms “small business”, “small business corporation” and “SMME” are often used interchangeably (Smulders, 2006:7). It should be noted, however, that the definitions of each of the above terms may differ. The following section

of the study attempts to shed light on the various definitions applied in a South African context.

2.2.1 The National Small Business Amendment Act

One of the most comprehensive guides for the definition of SMMEs within a South African context is the National Small Business Amendment Act (26 of 2003). This Act aims to provide guidelines for organs of state to promote small businesses in South Africa. In terms of this Act, a small business in South Africa can either be classified as “micro”, “very small”, “small” or “medium”. (National Small Business Amendment Act, 26 of 2003).

The official definition of a small business enterprise in terms of this Act is as follows:

“Small enterprise means a separate and distinct business entity, together with its branches or subsidiaries, if any, including cooperative enterprises (and non-governmental organisations) managed by one owner or more (which, including its branches or subsidiaries, if any, is) predominately carried on in any sector or subsector of the economy mentioned in column 1 of the Schedule and (which can be) classified as micro-, a very small, a small or a medium enterprise by satisfying the criteria mentioned in columns 3, 4 and 5 of the Schedule (opposite the smallest relevant size or class mentioned in column 2 of the Schedule)” (National Small Business Amendment Act, 26 of 2003).

This Act states, therefore, that a small business can vary in size depending on the sector of the economy in which it operates. The Act categorises small businesses based on a comprehensive schedule including criteria, such as the number of employees employed within the small business, the turnover of the small enterprise and the total gross asset value (fixed property excluded) of the small enterprise.

The following is an extract of the above-mentioned schedule used by the National Small Business Amendment Act (26 of 2003):

Table 2.1 Characteristics of small and micro businesses based on the schedule

Column 1	Column 2	Column 3	Column 4	Column 5
Sectors or sub-sectors in accordance with the Standard Industrial Classification	Size or class	Total full-time equivalent of paid employees	Total annual turnover	Total gross asset value (fixed property excluded)
		<i>Less than:</i>	<i>Less than:</i>	<i>Less than:</i>
Mining and quarrying	Medium	200	R39m	R23m
	Small	50	R10m	R6m
	Very small	20	R4m	R2m
	Micro	5	R0.2m	R0.1m
Manufacturing	Medium	200	R51m	R19m
	Small	50	R13m	R5m
	Very small	20	R5m	R2m
	Micro	5	R0.2m	R0.1m
Electricity, gas and water	Medium	200	R51m	R19m
	Small	50	R13m	R5m
	Very small	20	R5.1m	R1.9m
	Micro	5	R0.2m	R0.1m
Construction	Medium	200	R26m	R5m
	Small	50	R6m	R1m
	Very small	20	R3m	R0.5m
	Micro	5	R0.2m	R0.1m
Wholesale trade, commercial agents and allied services	Medium	200	R64m	R10m
	Small	50	R32m	R5m
	Very small	20	R6m	R0.6m
	Micro	5	R0.2m	R0.1m

Sectors or sub-sectors in accordance with the Standard Industrial Classification	Size or class	Total full-time equivalent of paid employees	Total annual turnover	Total gross asset value (fixed property excluded)
		<i>Less than:</i>	<i>Less than:</i>	<i>Less than:</i>
Finance and business services	Medium	200	R26m	R5m
	Small	50	R13m	R3m
	Very small	20	R3m	R0.5m
	Micro	5	R0.2m	R0.1m

Source: National Small Business Amendment Act (26 of 2003)

In summary, the above definition of small businesses within the National Small Business Amendment Act (26 of 2003) characterises small businesses in terms of sector and range in size. Employment ranges from employing a minimum of five (micro business) to a maximum of 200 (medium business) employees across various industries. Further, turnover ranges from as low as R200 000 (micro business) to an absolute maximum of R64 million (medium business) – again depending on the sector in which the business operates. Lastly, the total gross asset value of a business can range between R100 000 (small business) to a maximum of R23 million (medium business).

2.2.2 The Broad-Based Black Economic Empowerment Act

However, the National Small Business Amendment Act (26 of 2003) does not provide the only small business definition available within a South African legislative context. Another Act that sets out criteria for the classification of a small or a micro business is the Broad-Based Black Economic Empowerment Act (53 of 2003). In terms of the Codes of Good Practice under Section 9 of this Act, an enterprise has to meet certain criteria to be classified as either a micro or a small business. Any enterprise with a total annual revenue

of R10 million or less is classified as a micro business while any enterprise with a total annual revenue of between R10 million and R50 million is classified as a small enterprise (Broad-Based Black Economic Empowerment Act 53 of 2003). However, no reference is made to the number of employees of an enterprise in order to be classified in terms of this Act.

2.2.3 The Department of Trade and Industry

The White Paper on the national strategy for the development and promotion of small businesses also contains definitions of SMME. In March 1995, this White Paper was published by the Department of Trade and Industry and in terms thereof, different definitions are provided to survivalist micro, small and medium enterprises. Survivalist enterprises are activities performed by individuals unable to find a paid job or get into an economic sector of their choice. Micro enterprises are identified as very small businesses, often only involving the owner, some family members and at the most, one or two paid employees. Small enterprises are defined as constituting the bulk of established businesses with employment ranging between 5 to 50 people. The last category defined by the White Paper is medium enterprises where the upper limit of employment is described as 200 people with a limit of capital assets set at R5 million (White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995:7-8).

2.2.4 South African tax legislation

Within South African tax legislation, a small business is also defined. There are, however, numerous definitions available for a “small business”, a “micro business” and “small business corporations”. These definitions are explained in the following section.

2.2.4.1 The Value-Added Tax Act (89 of 1991)

This Act allows for every individual that does not have taxable supplies in excess of R1 million within a 12 month period to be exempted from registering for value-added tax (VAT). Any individual who has taxable supplies in a 12 month period that exceed R1 million is obliged to register for VAT. This R1 million threshold is applicable to all enterprises, regardless of the sector in which they operate. This definition differs significantly from the previous definitions discussed under the National Small Business Amendment Act (26 of 2003), as the turnover threshold differs according to the industry in which the enterprise operates. It also differs from the definition under the Broad-Based Black Economic Empowerment Act (53 of 2003), as the R1 million threshold for the purpose of VAT is considerably lower than the R10-R50 million threshold for black economic empowerment purposes (Value-Added Tax Act 89 of 1991). Furthermore, it should be noted that there is also no limit placed on the number of employees the small enterprise may have before it no longer qualifies for VAT registration exemption (Value-Added Tax Act, 89 of 1991).

Although the VAT Act does not explicitly refer to this registration threshold as an exemption for small businesses, it should be noted that an enterprise with a turnover of less than R1 million meets the definition of a “micro” business within the Income Tax Act (58 of 1962) – see section 2.2.4.2. It is, therefore, assumed that entities that do not meet the registration requirement for VAT purposes, will undoubtedly be classified as a micro business elsewhere within tax legislation.

2.2.4.2 The 2006 small business tax amnesty

The tax amnesty programme ran from 1 August 2006 and was scheduled to end on 31 May 2007. This programme allowed small businesses to register for tax purposes without having to be concerned that tax liabilities would arise due to previous non-compliance. With regard to this programme, the qualifying criteria used to define a small business was

an annual turnover of less than R10 million for the 2006 year of assessment (South African Revenue Service, 2006).

2.2.4.3 Skills Development Levies Act (97 of 1998)

All entities are required to pay a skills development levy of 1% on the total remuneration paid by an employer to its employees in terms of Section 3 of the Skills Development Levies Act (97 of 1998). This levy is, however, not applicable to a small business with an annual payroll expense of less than R500 000. A small business with an annual payroll expense of less than R500 000 is thus exempt from paying the levy (South African Revenue Service, 2015a).

2.2.4.4 Section 12E of the Income Tax Act – Small Business Corporations

Section 12E of the Income Tax Act (58 of 1962) provides tax relief for entities meeting the definition of a SBC. A SBC is defined within this Section 12E as an entity with less than R20 million gross income in a year of assessment. In addition to this, the holder(s) of shares in a SBC may not hold an interest in any other company with certain exceptions applicable. A SBC may also not derive more than 20% of its income from providing “personal services” or from “investment income” (Income Tax Act of South Africa, 58 of 1962). The criteria used to apply the SBC relief will be discussed in more detail in Chapter 3.

2.2.4.5 The 6th schedule of the Income Tax Act (58 of 1962) – turnover tax

The 6th schedule of the Income Tax Act (58 of 1962) sets out the relief available to micro enterprises that meet certain criteria: The annual turnover of a micro business must be less than R1 million and must be a sole proprietor, a partnership, a close corporation, a company or a cooperative (Income Tax Act of South Africa, 58 of 1962).

Once again this R1 million threshold is applicable to all companies, regardless of the economic sector in which they operate and, therefore, is similar to the requirements of the VAT Act (89 of 1991).

2.2.4.6 The 8th schedule of the Income Tax Act (58 of 1962) – capital gains tax

The 8th schedule of the Income Tax Act (58 of 1962) provides relief to certain small business regarding the capital gains tax payable upon the disposal of small business assets. In paragraph 57 of this schedule, a small business is defined as “a business of which the market value of all its assets, as at the date of the disposal of the asset or interest contemplated in subparagraph (2), does not exceed R10 million” (Income Tax Act, 58 of 1962).

The relief found within this schedule means that a natural person can disregard the first R1,8 million capital gain made on the disposal of small business assets or interest in a partnership or company if that person held the interest for a continuous period of at least 5 years prior to the disposal. In addition, the person who makes the disposal must have attained the minimum age of 55 years or the disposal must have been made in consequence of ill-health, or another infirmity, superannuation or death of the person making the disposal (Income Tax Act of South Africa, 58 of 1962).

2.2.4.7 Section 12J of the Income Tax Act (58 of 1962) – venture capital companies

Section 12J of the Income Tax Act (58 of 1962) was introduced in order to promote the increased access of equity finance by small and medium-sized businesses and junior mining exploration companies, as this was one of the most serious challenges small businesses face. Section 12J aims to address this challenge by allowing for the creation of so-called “venture capital companies” (VCCs) in which qualifying investors can invest in order to gain a tax deduction for the amount they invested (Income Tax Act, 58 of 1962).

A qualifying small business (investee) needs to meet certain criteria in terms of Section 12J, namely that an investee needs to be a resident company that is not a controlled group company in relation to a group of companies; an investee must have its tax affairs in order; an investee may not be listed as a company on the Johannesburg Securities Exchange (except for junior mining exploration companies, which may be listed on the Alternative Exchange Division of the Johannesburg Securities Exchange); and not more than 20% of the gross income of the company may be derived from investment income and the investee may not carry on certain impermissible trades. In addition to this – after the VCC has invested in the investee – the book value of the assets of the investee may not exceed R500 million (in the case of a junior qualifying mining company) and R50 million (in the case of any other qualifying company) (Income Tax Act, 58 of 1962).

2.3 Defining small businesses within an Australian context

Australia, much like South Africa, does not have one single definition of what constitutes a small business (McKerchar & Drever, 2008:4). Australian legislation was used as a starting point in order to determine whether an entity can be classified as a small business. However, even within certain aspects of Australian legislation (such as Australian Tax legislation, which is discussed below) no consensus exists on what the definition of a small business is.

2.3.1 The Australian Fair Work Act (28 of 2009)

The Australian Fair Work Act of 2009 provides a definition of what a small business is. In terms of Section 23 of this Act, a “small business employer” is one in which an entity employs fewer than 15 employees at any particular point in time (Fair Work Act of Australia, 28 of 2009).

2.3.2 The Australian Bureau of Statistics

The Australian Bureau of Statistics defines a small business as an entity employing fewer than 20 people. The bureau further breaks down the classification of a small business into three sub-categories, namely non-employing businesses (sole proprietorships and partnerships without employees); micro businesses (businesses employing between one and four people, including non-employing businesses); and small businesses (businesses that employ between five and nineteen employees) (Parliament of Australia, 2015).

2.3.3 The Australian Privacy Act (119 of 1988)

Yet another definition of a “small business” is found in the Australian Privacy Act of 1988 (119 of 1988). In terms of Section 6D of this Act, a small business is any entity in which the annual turnover for the previous financial year is less than AUD3 million (R31,92 million). If the business is a newly incorporated entity (it does not have a “previous financial year”), then it still qualifies as a small business should its turnover for the current financial year be less than AUD3 million (R31,92 million) (Privacy Act of Australia, 119 of 1988).

2.3.4 The Australian Income Tax Assessment Act (38 of 1997)

The Australian Income Tax Assessment Act (38 of 1997) also has its own set of criteria provided in Division 328 in order to determine whether an entity can be classified as a “small business”. This Act uses turnover as its main basis to determine the classification of a business (much like the Australian Privacy Act) and unlike the criteria used for the actual number of employees employed within a business, which is used by the Fair Work Act and the Australian Bureau of Statistics (Australian Income Tax Assessment Act Division 328, 1997).

Entities in Australia qualify for a range of income tax concessions should they meet the definition of a SBE. These income tax concessions include lower corporate tax rates, simplified trading stock and prepaid expenditure rules and numerous other concessions (Australian Taxation Office, 2017c), discussed in more detail in Chapter 4 of this study.

A small business in Australia is classified as a SBE if the annual aggregated turnover is less than AUD10 million (R106,4 million) in an income year for reduced corporate tax rates and for income tax concessions, such as preferential prepaid expenditure rules, simplified trading stock and wear and tear allowances (Australian Taxation Office, 2017b). An entity that meets this criteria automatically qualifies for the small business tax concessions. However, there are two notable exceptions.

The first examined exception is the capital gains tax (CGT) SBE concession. In order to qualify for small business CGT relief in Australia, the aggregated annual turnover of a SBE has to be lower than AUD2 million (R21,28 million) in an income year. In addition to this, the total maximum asset value of this small business may not exceed AUD6 million (R63,84 million) (Australian Taxation Office, 2017b).

The second examined exception is the small business income tax offset for unincorporated SBEs. In order to qualify for this concession, a small business may not have turnover exceeding AUD5 million (R53,2 million) in an income year (Australian Taxation Office, 2017b).

2.4 Summary and chapter conclusion

This chapter aimed to determine the definition of a small business within South African and Australian legislation. It was established that within both Australia and South Africa, numerous definitions exist for small businesses from a legal perspective.

Within South Africa, the National Small Business Amendment Act (26 of 2003), the Broad-Based Black Economic Empowerment Act (53 of 2003) and various tax legislation all have

different definitions of what a small business is. Some of the legislation, such as the Broad-Based Black Economic Empowerment Act (53 of 2003) and most forms of tax legislation use company turnover to classify an entity as a small business. The National Small Business Amendment Act (26 of 2003) uses a combination of turnover, the number of employees an entity has, the asset value of the entity and the sector in which the entity operates in order to classify a small business.

Within South African tax legislation, at least seven definitions of a small business exist and inconsistencies are evident amongst them all due to none of them having the same eligibility criteria, although one would expect the same definition to be applied at least within the same Act. These small business definitions referred to includes one for VAT purposes, the business definition of the Skills Development Levies Act (97 of 1998), the definition used for small business tax amnesty and the definitions of a small business as defined in the Income Tax Act (58 of 1962) in Section 12E, Section 12J and the 6th and 8th schedule of the Act.

Each of the aforementioned definitions of the Income Tax Act and VAT Act vary to some degree or form. Section 12E defines a small business as one with less than a set turnover amount and which meets certain income and ownership requirements. The 6th schedule and the tax amnesty programme define small businesses as entities that earn less than a certain amount of turnover. However, the turnover/gross income requirement of the 6th schedule, the tax amnesty programme and of Section 12E all differ in this regard. The turnover requirement for small businesses in the 6th schedule is, however, similar to the turnover requirement for the compulsory registration of businesses in terms of the VAT Act (R1 million).

In contrast, the 8th schedule defines a small business as an entity in which the assets do not exceed a certain set amount (in addition to other owner-specific criteria). The asset value definition correlates with the main defining criteria of Section 12J (Section 12J does, however, impose additional income requirements for small businesses), although the maximum asset value in terms of the 8th schedule and Section 12J differs substantially.

It is, therefore, evident that even the definitions of a small business contained within the same tax legislation (the South African Income Tax Act, 58 of 1962) do not correlate with one another. As stated within the introduction, the lack of a coherent definition for SMME in South Africa adds to the compliance costs that small businesses face (Smulders, 2006:33).

Australia has at least four legal definitions of a small business, found within the Australian Fair Work Act (28 of 2009); the Australian Bureau of Statistics; the Privacy Act (119 of 1988) and the Australian Income Tax Assessment Act 39 of 1997). The criteria within each of these differ, ranging between using turnover and the number of employees in order to classify a small business. Within Australian tax legislation, the single term “small business entity” (SBE) is used to define a small business. However, at least three alternative definitions of a SBE exist depending on the type of tax relief the small business wishes to apply for.

It should be noted that for the remainder of the study, when reference is made to a small business within a South African context, the researcher is referring to a small business aiming to meet the definition of a “small business corporation” (SBC) in terms of Section 12E of the South African Income Tax Act (58 of 1962). When reference is made to a small business within an Australian context, the researcher is referring to an entity aiming to meet the definition of a “small business entity” (SBE) in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997).

The adopted definitions for the remainder of this study, namely a SBC and SBE, are examined and explored respectively in Chapters 3 and 4 of this study.

CHAPTER 3 – SOUTH AFRICAN SMALL BUSINESS TAX RELIEF IN TERMS OF SECTION 12E

3.1 Introduction

In Chapter 2, definitions of small businesses within South African and Australian legislation were determined and a definition of a small business was adopted for the remainder of the study. This chapter aims to explore the definition adopted and tax relief provided from South African legislation, as defined in Chapter 2, for SBCs in order to address the objective of exploring and evaluating small business tax relief in terms of Section 12E as per secondary objective number 2 in Section 1.3.2.

In 2001, Section 12E was introduced in the Income Tax Act (58 of 1962) as a means to offer support to small businesses. The support offered is structured around the use of the term SBC, which is defined within Section 12E and any entity that meets this definition, is able to apply for certain tax relief (Income Tax Act, 58 of 1962).

Since 2000, SBCs have been an important discussion point for the development and growth of the South African economy. In this year, former finance minister, Trevor Manuel, introduced in his budget speech the SBC concessions, stating that the “development of small and medium sized enterprises is fundamentally important to the employment and growth potential of our economy” (Department of Finance, 2000:20).

Small businesses continue to be of importance in the discussion concerning the growth of the South African economy. As was mentioned in Chapter 1, the NDP focuses particularly on small businesses as a catalyst for economic change within South Africa (Department: The Presidency, 2012:140-144). In a study on tax compliance costs facing small businesses, Chamberlain and Smith (2006:3) state that the economic importance of the small business sector is nested in its demand-generating ability, its income-generating potential and ability to act as an employment driver.

The Davis Tax Committee (DTC) report on small and medium enterprises states that Section 12E was introduced as an incentive to the “missing middle” sector of businesses. This sector contains small and medium businesses of a formal nature (incorporated) and which have entrepreneurial growth potential (Davis Tax Committee, 2014:9).

This chapter analyses the Section 12E small business concessions. Particular attention is paid to the criteria used to define a SBC. Available statistics on Section 12E were also analysed to determine whether it was effective in providing the “missing middle” sector with an incentive in the form of concessions, as the DTC claims it should. Any criticisms against Section 12E are explored and documented.

3.2 Mechanisms and workings of Section 12E

Any entity that meets the definition of a SBC can apply for the Section 12E concessions. The definition of a small business corporation is provided in Section 12E(4)(a) of the Income Tax Act (58 of 1962).

As described in Chapter 2, a SBC is defined as a private company, a close corporation or a cooperative in which all the shareholders of the company or members of the close corporation or cooperative are natural persons and the gross income of that entity may not exceed R20 million for a year of assessment. These natural persons may not hold any shareholding in any other company with limited exceptions as indicated in Section 12E(4)(a)(ii) (Income Tax Act, 58 of 1962).

The remaining requirements for an entity to be classified as a SBC, include that no more than 20% of the income of a SBC may be derived from investment income or income from the rendering of a personal service. A SBC may also not be a personal service provider as defined within the 4th schedule of the Income Tax Act (58 of 1962).

In order to gain a better grasp of what these criteria actually mean, how these measures should be applied and the reason for the inclusion of these criteria in Section 12E(4)(a), the study investigated each criterion in detail.

3.2.1 The gross income requirements of an SBC

The starting point of the Section 12E concessions is that an entity may not have a gross income in excess of R20 million during a year of assessment (Income Tax Act, 58 of 1962). If a SBC trades during a particular year of assessment for a period of less than 12 months, the gross income requirement available to that business must be calculated based on a pro rata method. The ratio used to calculate a pro rata gross income is the number of months the SBC traded during the year of assessment in proportion to the full 12 months of a year (South African Revenue Service, 2016b:9-10).

The DTC has suggested that the gross income requirement should be increased from R20 million to R50 million, based upon “carefully considered considerations”. However, the committee’s paper does not mention what these considerations are (Davis Tax Committee, 2014:19).

Stols (2013:21) mentions that if the current gross income requirement is not regularly increased, the criteria would not be able to keep up with inflation increases in the turnover of an entity. The last increase in the gross income requirement (from R14 million to R20 million) was announced in the 2013 budget speech of former finance minister, Pravin Gordhan (Department of Finance, 2013a:12). Stols (2013:21) further highlights that if the gross income requirement is increased, more small businesses will be able to apply for this tax relief.

In addition, as mentioned earlier in Chapter 2, the gross income threshold requirement of Section 12E of the Income Tax Act (58 of 1962) also differs from the definition of a small business found within legislation, such as the National Small Business Amendment Act (26 of 2003), and the gross income threshold requirements in other sections of the Income

Tax Act (58 of 1962), such as the R1 million turnover definition for micro businesses found within the 6th schedule.

3.2.2 A SBC must be a private company, a close corporation or a cooperative

A SBC must be a private company, a close corporation or a cooperative, as defined in Section 1 of the Companies Act (71 of 2008). It is, therefore, clear that a SBC has to be a juristic person, as all three forms of entities that qualify to be classified as a SBC are juristic persons (Companies Act, 71 of 2008). Furthermore, all three of these forms bear the status of being incorporated. What is notable from this requirement is that the definition of a SBC specifically excludes any sole proprietorships, partnerships or trusts. However, from Interpretation Note 9, it is clear that trusts do qualify as SBCs provided that the beneficiaries hold a vested interest in the trust income and are all natural persons (South African Revenue Service, 2016b:6).

Information obtained from the SARS website indicates that neither a sole proprietor (South African Revenue Service, 2016d) nor a partnership (South African Revenue Service, 2016c) is a legal entity or a separate person for tax purposes. The legal form of these businesses bears, therefore, the status of “unincorporated”. The relief available to SBCs in terms of Section 12E is, therefore, only available to incorporated entities.

The reason for excluding unincorporated entities is that with the SBC concessions, the government wants to encourage the growth of specifically only small incorporated businesses (South African Revenue Services, 2012b:6). Smulders and Oberholzer (2006:10) are of the opinion that this was the reason for only including incorporated small businesses by stating that: “to encourage small business to incorporate so that they can reap the benefits of a more formal approach to business, Section 12E was inserted into the Income Tax Act”.

It can, therefore, be stated that the government is encouraging small businesses to formally incorporate by offering them an award in the form of lower taxes and increased

wear and tear allowances. In research conducted by Bornman and Stack (2015:815) on small business owners in the South African metropolitan area of Ekurhuleni, it was found that taxpayers generally viewed programmes by the government to reward tax compliance positively. These taxpayers felt that these schemes can have a positive effect on the tax behaviour of other small businesses due to the fact that these schemes have motivational value. From a South African perspective, there appears to be some merit in the government offering awards to formally incorporated small businesses.

Worldwide, there are, however, criticisms against countries only providing tax relief to formally incorporated small business entities. In a paper by Freedman and Crawford (2008:28), it was determined that there may be several advantages for small owner-managed businesses within the United Kingdom to achieve incorporation status. However, it was also acknowledged that accessing incorporation benefits alone will not necessarily lead to growth in entrepreneurship and that this form of relief can lead to distortion amongst incorporated and unincorporated small owner-owned businesses.

The above-mentioned notion has been supported within a South African context in a study by Chamberlain and Smith (2006: 34) with the assumption that “small businesses will not live or die by SARS intervention alone”. Chamberlain and Smith (2006:4) highlight that small businesses in South Africa face numerous challenges that can inhibit entrepreneurship, including access to finance and the quality and availability of entrepreneurship education. However, the study states that compliance with tax regulation is viewed as a high burden to small businesses and that lowering tax compliance costs can contribute towards an enabling environment for businesses (Chamberlain & Smith, 2006:4).

The rationale for providing tax relief only to incorporated small businesses in South Africa is, however, still lacking. When reference is made to the importance of small businesses to the future of the South African economy in the NDP, no distinction is made between the importance of incorporated and unincorporated entities (Department: The Presidency, 2012:140-144). The need to support and develop small businesses in general is, however

mentioned by reducing regulatory burdens and improved access to finance) (Department: The Presidency, 2012:140-144). It is, therefore, evident that the emphasis placed by Section 12E on the incorporation status of businesses may be unwarranted.

3.2.3 The shareholders of a private company or members of a close corporation or cooperative should be all natural persons.

In this section, attention is given to the reasons why the criterion of only natural person(s) is included with a specific focus on the anti-avoidance mechanisms the government has built into Section 12E.

This criterion specifically states that only natural persons may be the holders of shares of a company which wants to comply with the criteria set for a SBC (Income Tax Act, 58 of 1962). This requirement, therefore, excludes any juristic person from being a holder of shares in a SBC. Any company, close corporation, cooperative or similar juristic person is, therefore, disqualified from applying for the tax relief available in Section 12E for any entity it has an interest in – even if that entity should otherwise meet all the requirements necessary to apply for the SBC concessions.

This requirement further states that all the holders of shares of an incorporated entity must be natural persons throughout the entire year of assessment under consideration in order to qualify for the relief provided for in this section. The SARS Interpretation Note No. 9 provides some guidance on the application of this requirement. Where any juristic person – even if for just one day – holds an interest in a SBC during a year of assessment, that SBC will not be allowed to apply for the concessions available even if the SBC meets all of the other requirements necessary to apply for this tax relief (South Africa Revenue Service, 2016b:6).

The reason for only allowing natural persons to be the holders of shares in an SBC is to build an anti-avoidance mechanism into Section 12E. By including this criterion, larger entities cannot split their income into smaller portions and then have these smaller

portions of income taxed at a reduced rate instead of the full tax rate for normal entities (Arendse *et al.*, 2006:9).

Another reason for the inclusion of this requirement may be to advance the government's vision of more entrepreneurial activities in South Africa. Rogerson (2004:767) found that the government's policies in a post-apartheid South Africa are focused heavily on the promotion of small business development in order to drive job creation and poverty alleviation. It would, therefore, make sense that if the government is offering tax incentives to small businesses, these incentives should be directed towards individuals who are able to set up thriving enterprises rather than supporting already existing larger companies. The DTC supports this viewpoint by highlighting that tax relief should be provided to the "missing middle", namely those small enterprises that have growth potential in creating jobs. By assisting larger, more formal enterprises with incentives, this will not necessarily achieve a thriving economy (Davis Tax Committee, 2014:9).

However, the DTC criticises the requirement that 100% of the holders of shares or members of a SBC must be natural persons. The potential problem this criterion creates is that if an SBC seeks an investor in the form of another company in order to finance the small business, the SBC will be disqualified from applying for tax relief in terms of Section 12E as the SBC no longer meets the requirement that all of the holders of shares or members of the SBC are natural persons (Davis Tax Committee, 2014:19).

As mentioned in Chapter 1, Luiz (2002:24) highlights access to finance as one of the most significant constraints facing small businesses within South Africa. This view is further highlighted by Smit and Watkins (2012:6326) who mention that finance is one of the primary problems faced by SMMEs. From a tax perspective, the government has tried to alleviate this problem by the introduction of Section 12J in the Income Tax Act (58 of 1962). This section was specifically introduced in order to alleviate the problem small enterprises face in terms of a lack of access to finance (Sieberhagen, 2008:51). The study further investigated how a 100% natural person requirement may be working against

Section 12J (venture capital financing) when the criticisms relating to the information obtained in this chapter are discussed in a later section.

3.2.4 Shareholding and membership restrictions

The natural person members or holders of shares of a SBC may not have an interest in any other company – with a few exceptions applicable. These exceptions are contained in Section 12E(4)(a)(ii) (Income Tax Act, 58 of 1962). According to these exceptions, natural person shareholders or members are allowed to hold an interest in any listed company or a portfolio in a collective investment scheme. The natural person is also allowed to hold interests in or be a member of body corporates, share block companies or any friendly society, as defined within the Friendly Societies Act (25 of 1956). Furthermore, a natural person may hold an interest of less than 5% in a social or consumer cooperative, a cooperative burial society, a primary savings cooperative or a primary savings and loans cooperative bank. Natural persons who hold interests or are members of or in SBCs are also allowed holding an interest in a venture company, as defined in Section 12J.

Lastly, the natural person is allowed to hold an interest in or be a member of another close corporation, cooperative or company if they have not carried on any trade during a year of assessment; if they own assets of which the market value does not exceed R5,000 or if that specific company, close corporation or cooperative has taken steps to liquidate (Income Tax Act, 58 of 1962).

From the above-mentioned discussion, it is clear that the exceptions provide natural persons with a significant number of entities in which they are allowed to have an interest. What is also clear, however, is that the natural person is not allowed to hold an interest or be a member of another SBC. The next section of the chapter examines the reasons why these exceptions are in place.

The SARS Interpretation Note No. 9 provides the logic behind this criteria put in place by stating that: “The reason for the limitation is to prohibit multiple shareholdings or arrangements which may be used to split income between various qualifying entities, thus providing taxpayers with an undue tax benefit” (South African Revenue Service, 2016b:7). It is, therefore, clear that the main reason for the inclusion of these criteria is to ensure that no tax evasion takes place. Criticism can be directed towards this safety mechanism, as it may possibly work against some of the elements of entrepreneurship that the government is trying so hard to promote.

As has already been stated, taxes are a significant and complicated cost for most small businesses (Luiz, 2002:24). Worldwide, there are several arguments for and against significant levels of anti-avoidance mechanisms being built into small business tax legislation, evident from studies, such as Nam and Radulescu (2007:1-27), where the investment decisions of small and medium-sized enterprises (SMEs) within the European Union were explored. In this study, Nam and Radulescu (2007:2) argue that taxes are one of the important elements of the cost structure of SMEs, because SMEs do not have the financial and human capacity to develop sophisticated tax avoidance strategies. The first form of criticism, therefore, that can be levelled against the inclusion of this part of the criteria is that it is unfair to build a significant level of anti-avoidance mechanisms within Section 12E as it may prohibit small businesses that do not have the capacity to actually partake in tax avoidance schemes, from applying tax relief due to the onerous nature of the Section 12E anti-avoidance mechanisms.

The argument that anti-avoidance and evasion mechanisms should be built into relief mechanisms provided to small businesses is supported by Chen *et al.* (2002:11). This study examined the effect that tax policies have on the growth of SMEs in countries belonging to the Organisation for Economic Cooperation and Development. Chen *et al.* (2002:11) argues governments should reduce opportunities for tax avoidance and tax evasion by the self-employed. These self-employed are those natural persons that establish small businesses in order to earn an income.

The study supports the viewpoint that a balance should be found between incorporating anti-avoidance mechanisms into South African legislation whilst still providing deserving natural person entrepreneurs the opportunity to qualify for tax relief. This is called a “smart regulation” and is defined by within Chamberlain and Smith (2006:34) as a move away from deregulation towards monitoring and controlling regulations that SMEs face. This study focused on possible smart regulation to be implemented within Section 12E in Chapter 5 of this study.

Section 12E requires taxpayers to meet all of the criteria in order to obtain tax relief. What this essentially means is that if there are taxpayers who meet all of the criteria of Section 12E – except for one part – taxpayers are unable to apply for tax relief. If one natural person is, therefore, a holder of shares or a member of two otherwise totally compliant SBCs, neither of the two small businesses are able to apply for any form of tax relief. This is true even if the combined gross income of the two SBCs is less than R20 million (if the two SBCs are a single company). This appears unfair given the fact that the small businesses may have benefitted from the tax relief provided to them.

According to the *Oxford Dictionary* (2016), the definition of an entrepreneur is “a person who sets up a business or businesses, taking on financial risks in the hope of profit”. What is clear from this definition is that a person regarded as an entrepreneur may have an interest in more than one entity at a time. A natural person, having an interest in more than one small business at a time in an environment where tax relief is provided to small businesses will not always mean it is to access the tax relief or because the natural person is participating in a tax avoidance scheme. There can be a very real situation in which the natural person is participating in various small business endeavours because they are hoping to make a profit.

Stols (2013:12) supports the view that the restriction of the shareholding rights of natural person with regard to Section 12E may be a disadvantage. Stols (2013:12) mentions that “some small business owners own more than one business to diversify their business risk

and increase opportunities for growth”. This view, therefore, supports the notion that the Section 12E natural person ownership requirements may be overly onerous.

3.2.5 No more than 20% of income may be derived from investments or personal service income

In order to determine whether a small business is a SBC, it should be verified if the small business derives more than 20% of their gross income from rendering investments or personal services. Both an investment income and personal service income are defined in Section 12E (Income Tax Act, 58 of 1962).

In terms of Section 12E (c)(i)-(iii), “investment income” has a very wide-ranging definition and includes income in the form of dividends, royalties, rental derived from immovable property and interest, amongst other types of investment income. SARS Interpretation Note No. 9 states that rental income obtained from immovable properties exclude rental income received from serviced accommodation, such as hotels, guesthouses and other similar types of accommodation (South African Revenue Service, 2016b:11).

The above-mentioned viewpoint is important, because it means that small businesses within the tourism sector are able to apply for Section 12E tax relief. The tourism sector is of particular importance to the South African economy and more specifically to the creation of future employment opportunities. Binns and Nel (2002:236) highlights the importance of tourism for economic development and for redressing inequality caused by previous apartheid policies. Ensuring small businesses that fall within the tourism sector can apply tax relief is important because it ensures that one of the key constraints that small businesses face is removed, affording them better opportunities to grow.

The next important definition is “personal service income”. Personal service income entails any income derived from the rendering of a “personal service”. Personal services are defined in Section 12E(d) as services falling into the field of auditing, real estate, broking and law, amongst other services (Income Tax Act, 58 of 1962).

Small businesses that provide any of the above-mentioned services, can be viewed as providing “personal services” and the income they receive is, therefore, viewed as a personal service income. However, there are two more requirements to be met in order to be classified as a SBC. The first is that the service that falls into the list of services named above should be performed personally by any person who holds an interest in the SBC and that SBC does not throughout the year employ three or more full-time employees (other than a holder of shares or member of an SBC or any person connected to that holder of shares or member) (Income Tax Act of South Africa, 58 of 1962).

This means that if a small business employs three or more full-time employees who are not connected to the members or holders of shares of the small business, the entity will still be able to apply the SBC concessions even if the services it is providing fall into the “personal service” list as described above. Also, if the entity does not throughout the year of assessment employ three or more unconnected persons, but the personal service this entity provides is not performed personally by any person who holds an interest in the entity, it will also not meet this part of the exclusionary criteria. The entity will still be able to apply the SBC concessions (Income Tax Act, 58 of 1962; South African Revenue Service, 2016b:13).

If a small business does not employ more than three full-time employees in a year of assessment and if the personal service is personally provided by a holder of shares or a member of the business, then it should be determined whether or not more than 20% of the gross income of the SBC is derived from “personal service” income. In this circumstance, if the amount of gross income earned by a person who is a holder of shares or member of the SBC by rendering a personal service exceeds 20% of the total gross income of the small business, then the entity will not be able to apply the tax relief available (Income Tax Act, 58 of 1962; South African Revenue Service, 2016b:10).

The reasons for the inclusion of both the investment income and personal service income criteria is to ensure that relief is given to enterprises with entrepreneurial growth potential, namely, enterprises that are capable of growing and providing employment opportunities.

The government's intention should not be to fund an SMME that is not creating jobs or contributing to a country's GDP (Arendse *et al.*, 2006:13). Small businesses that are providing personal services are still able to apply the tax relief if they employ three or more full-time employees throughout the year of assessment. This measure was included in order to encourage the creation of full-time employment in qualifying entities (South African Revenue Services, 2016b:14).

3.2.6 SBCs may not be personal service providers

The last requirement set out by Section 12E(4)(a)(iv) is that a SBC may not be a personal service provider, as defined within the 4th Schedule of the Income Tax Act (58 of 1962). What this definition essentially entails is that an SBC that derives income through a connected person shareholder rendering a service to another company, where that connected person would have been seen as an employee or under the control of that other company in any regular business circumstance, then that SBC is providing personal services through its connected person shareholder (Income Tax Act, 58 of 1962).

Any business that meets this definition of a personal service provider will be disqualified as a SBC and will, therefore, not be able to apply for any form of Section 12E small business tax relief. There are, however, certain exemptions available, such as if the personal service provider SBC throughout the year employs three or more unconnected persons in its trade (4th Schedule of the Income Tax Act of South Africa, 58 of 1962). Although there are similarities to this requirement with the personal service income requirement, they are not exactly the same. An entity wishing to be classified as an SBC would need to ensure that it is neither a personal service provider nor does it derive more than 20% of its gross income from personal service income (South African Revenue Service, 2016b:10).

Arendse *et al.* (2006:13) provide the reason for the inclusion of this requirement – to avoid providing tax benefits to small businesses not capable of creating new jobs. The DTC (2014:22) state that there is doubt as to whether it was the intention of the legislature to

ever provide taxpayers who render a professional service with limited entrepreneurial potential with tax relief.

3.3 Section 12E tax relief

The study examined in detail what kind of small businesses qualify for SBC concessions. Subsequently, an examination follows of the form of tax relief available to entities in South Africa that meet the definition of a SBC.

3.3.1 Accelerated wear and tear allowances

The first form of tax relief available to a SBC is accelerated wear and tear allowances. The reason these wear and tear allowances are labelled as “accelerated” is because they offer faster write-off periods on the cost of assets for a small business than the normal deduction periods available in Section 12C and Section 11(e) of the Income Tax Act (58 of 1962) (Stols, 2013:16). Accelerated wear and tear allowances were first introduced along with the inception of the SBC concessions in 2001 and were extended in 2005 (Sieberhagen, 2008:15).

Wear and tear allowances available to a SBC are governed in terms of Section 12E(1) and (1A) of the Income Tax Act (58 of 1962). Any asset acquired by a SBC and used in a process of manufacturing can be entirely claimed as a deduction from income tax in the year in which it is brought into use (Income Tax Act, 58 of 1962). This contrasts significantly with relief available to non-SBC entities within Section 12C. Within Section 12C, an asset used in a process of manufacturing qualifies for a 40% deduction in the year in which the asset is brought into use and 20% in each of the subsequent three years after the asset is brought into use (Income Tax Act, 58 of 1962).

The Section 12E manufacturing asset allowance matches the total cost of the item in the year that the purchase is made. Thus one can see that there is significant tax advantage in being an SBC when acquiring manufacturing plant and machinery. This accelerated wear and tear allowance can have a positive impact on the cash flow of a small business,

as it will lead to less tax being paid in the year the machinery is bought. It appears as though there is significant focus on the manufacturing industry (evident by the greatly increased write-off periods provided for assets used in a process of manufacturing). The reason for this is that this industry is more likely to create additional jobs within South Africa, and thus the tax relief should be directed here (Aucamp, 2010:16).

The second accelerated wear and tear allowance available to a SBC is in terms of Section 12E(1A). The cost of any non-manufacturing asset can be claimed as a deduction from a taxpayer's taxable income as 50% of the cost of the asset in the year in which it was first brought into use, 30% in the first succeeding year of assessment and 20% in the second succeeding year of assessment (Income Tax Act, 58 of 1962).

Entities that do not qualify for the Section 12E small business tax relief would otherwise have to claim wear and tear allowances on non-manufacturing assets in terms of Section 11(e) of the Income Tax Act (58 of 1962). This Section allows taxpayers a wear and tear allowance based on the type of asset being depreciated. This is set out within SARS Interpretation Note 47, with the shortest write-off period being one year (for wire line rods) and the longest write-off period being 25 years (for various assets such as portable safes) (South African Revenue Services, 2012a). A small business can, therefore, obtain significant value from claiming the accelerated three year write-off period on non-manufacturing assets in terms of Section 12E for income tax purposes.

3.3.2 Reduced taxation rates

The second significant form of tax relief that Section 12E provides is substantially lower rates of tax payable by entities that meet the definition of an SBC (Stols, 2013:17). The latest available tax rates for a SBC are as follows (South African Revenue Service, 2017b):

Table 3.1 – SBC tax rates 2018

Taxable income (R)	Rate of tax (R)
0-75 750	0%
75 751-365 000	7% of taxable income above 75 750
365 001-550 000	20 248 + 21% of taxable income above 365 000
550 001 and above	59 098 + 28% of taxable income above 550 000

Source: South African Revenue Service (2017b)

It should be examined how these tax rates compare with other tax rates in order to determine the level of relief provided to SBCs. As was previously stated, SBCs have to be incorporated entities. These incorporated entities would be taxed under the corporate tax rate if they were not classified as SBC's. The current corporate tax rate for South African companies is 28% from the first Rand of taxable income (South African Revenue Service, 2016a).

As was also previously discussed, one reason why SBC tax relief is structured around incorporated entities is to encourage the incorporation of entities. A taxpayer that carries on a small business that is not incorporated would usually bear the status of a sole proprietorship or partnership. These two forms of business are not recognised as separate taxpayers and therefore the taxable income accruing to them is taxed in the hands of the natural person taxpayer who is the owner of the sole proprietorship or a partner in the partnership. Natural persons in South Africa are taxed against the individual tax rates (South African Revenue Services, 2017a).

Individual tax rates are currently as follows:

Table 3.2 – Individuals tax rates

Taxable income (R)	Rates of tax (R)
0-189 880	18% of taxable income
189 881-296 540	34 178 + 26% of taxable income above 189 880
296 541-410 460	61 910 + 31% of the taxable income above 296 540
410 461-555 600	97 225 + 36% of taxable income above 410 460
555 601-708 310	149 475 + 39% of taxable income above 555 600
708 311-1 500 000	209 032 + 41% of taxable income above 708 310
1 500 001 and above	533 625 + 45% of taxable income above 1 500 000

Source: South African Revenue Services (2017a).

Trusts qualify for a reduced corporate tax rate if all of the beneficiaries hold a vested interest in the trust income and if they are all natural persons (South African Revenue Service, 2016b:6). If trusts do not meet these requirements, their income is either taxed according to the natural person tax rate (if beneficiaries hold a vested interest in the trust income) or at the trust rate of 45% (if trusts are taxed themselves) (South African Revenue Service, 2017c).

It is, therefore, evident that significant tax savings are available for SBCs when these corporations comply with the criteria set for obtaining tax relief. Incorporated SBCs that fall within the top tax bracket are taxed at marginal rate of 28% compared to a marginal rate of 41% if the SBC was unincorporated or a flat-out rate of 28% if the incorporated

entity was not an SBC. If small businesses are trusts that do not qualify for SBC concessions, they are taxed at a flat-out rate of 45%. The benefit these reduced tax rates have on SBCs is that it increases their after-tax earnings that can possibly have an influence on the investment and financing decisions of SBCs (Chen *et al.*, 2002:12). However, there are criticisms against the tax relief provided to SBCs in the form of reduced tax rates. These criticisms are examined in more detail later on in this chapter.

3.4 Section 12E statistics

Since Section 12E has been in implementation since 2001, there are various statistics available regarding the scale of its implementation. In this part of the chapter the statistics available will be laid out in tabular format and will be examined. These tables can be found within Annexure A and B of this study. These statistics are available from the SARS website (South African Revenue Service, 2015b).

From Annexure A, it is clear that just over 81 000 SBCs have applied for relief in 2014. Of these SBCs, only 42 912 had a positive taxable income, meaning they yielded some form of income for the *fiscus*. Only 53% of all the entities meeting the definition of a SBC actually have positive taxable income (South African Revenue Service, 2015b). This is a concern, as SBC tax concessions are not useful to SBCs if the corporations do not reflect a positive taxable income. The DTC argues that SBCs not receiving tax relief are in just as much need of financial intervention as SBCs receiving concessions (Davis Tax Committee, 2014: 17).

The second important thing noted is that the number of entities applying the relief appears to be declining over the past two years. The number of SBCs (81 000) that applied for tax relief in 2014 has shown a 28.78% decrease from the SBCs (113 926) that applied for relief in 2013. In 2012, approximately 121 511 SBCs have applied for tax relief. In the 2012-2013 financial year, 6.24% fewer SBCs have, therefore, applied for tax relief. No possible reasons accompanied the statistics as to why fewer SBCs are applying for tax relief (South African Revenue Service, 2015b). Stols (2013:41) states that many small

businesses in South Africa may be forced to close due to the current economic climate. This can be one of the reasons for the declining use of tax relief provided in Section 12E.

The table provided in Annexure B breaks down in which sector of the economy SBCs operate that are applying the tax relief. From the table it is evident that SBCs are found in the primary, secondary and tertiary sector of the economy (South African Revenue Service, 2015b). The primary sector refers to the extraction of raw materials, such as minerals and agricultural produce. The secondary sector refers to the production of finished goods (manufacturing sector) and the tertiary sector refers to the provision of services to consumers (EconomicsHelp, 2017). This table is useful as it can be used to analyse whether the SBC concessions are reaching the targeted enterprises, namely, whether the tax relief is funding what the DTC calls the “missing middle”, that is, those small enterprises which have high levels of entrepreneurial growth potential (Davis Tax Committee, 2014:9).

In 2014, the largest user of tax relief was the tertiary sector. 63.2% of all the SBCs applying for tax relief are located within this sector and this sector delivers 62.5% of all the revenue collected through the SBC system. In contrast, the primary sector is the smallest user of SBC tax relief, as only about 4.5% of the entities are located within this sector and delivers about 7.1% of all the tax assessed by the SBC system (South African Revenue Service, 2015b).

A concern is the amount of entities making use of SBC tax relief that falls within the “financial intermediation, insurance, real-estate and business service” category and entities that fall within the “community, social and personal services” category. Entities in these two categories provide real estate services, business services, medical, dental and other health-related and veterinary services (South African Revenue Service, 2015b). All of these services fall within the definition of “personal services” – one of the exclusions applied within the Section 12E relief (no more than 20% of the income can be derived from rendering a personal service). The entities that are able to apply the SBC relief are those that met have the exception to this exclusion, for example, those entities that

employ 3 or more full-time employees who are unconnected to the member(s) or holder(s) of shares of the SBC (Income Tax Act, 58 of 1962).

It should be taken into consideration that the reason this personal service exclusion was introduced in Section 12E in the first place was because the government did not want to provide relief to entities that do not show a high entrepreneurial growth potential. The intention was, therefore, not to fund SMMEs that are not able to create jobs (Arendse *et al.*, 2006:13). Similarly, the DTC doubts whether the intention of the legislature ever was to provide tax relief to small professional businesses (Davis Tax Committee, 2014:17). The amount of entities that falls within these two categories providing personal services and where the entrepreneurial growth potential may be limited totalled 31.7% of all the SBCs applying for tax relief in 2014 (South African Revenue Services, 2015b).

As was previously stated, one of the sectors that should receive SBC relief is manufacturing, as this sector is capable of producing additional jobs (Aucamp, 2010:16). From the statistics provided, it is evident that only about 15.9% of all the SBCs assessed were from the manufacturing sector in 2014. This is a figure that has held steady for both 2013 and 2014, although it represents a slight increase from the 14.9% of all entities in 2012 (South African Revenue Service, 2015b). It is doubtful whether the SBC tax concessions are reaching the manufacturing entities intended by the government. It is also unclear whether there are any manufacturing entities trying to apply for Section 12E tax relief but due to criteria constraints, are unable to do so.

3.5 Section 12E criticisms

The criticisms against Section 12E are examined in this section – directed specifically at Section 12E and towards small business tax relief in general. Some of these criticisms have already been mentioned but receive more attention in this section.

3.5.1 Section 12E tax relief is only available to formally incorporated entities

The first criticism is against tax relief only directed towards formally incorporated entities. As previously mentioned, in a United Kingdom-based paper by Freedman and Crawford (2008:6), several criticisms are directed against the difference of how incorporated and unincorporated companies are treated with regard to tax consequences. This paper argues that incorporation may significantly alter the tax consequences of taxpayers without altering the economic activities of these taxpayers. This may also be true from a South African perspective, as incorporation may mean that small businesses suddenly qualify for vastly reduced tax rates without changing their entrepreneurial activities.

Freedman and Crawford (2008:18) further reject the notion that incorporation can be used as a tool to encourage entrepreneurship. The paper argues that neutrality between different forms of ownership is desirable so that decisions between being incorporated and unincorporated are made purely on commercial grounds. Tax assistance to small businesses, in the opinion of this paper, should be achieved by encouraging tax simplicity and a system that is as far as possible neutral.

3.5.2 Shareholding of SBCs may only be held by natural persons

The second criticism is directed against the fact that 100% of the shareholding or membership composition of SBCs must be held by natural persons. As was mentioned before, this leaves the SBC unable to apply the tax relief should it attract an investor in the form of another company. The DTC suggests that this requirement should be changed in order to allow for at least 33,3% of the shareholding of an SBC to be held by another company – allowing that small business to qualify as a SBC (Davis Tax Committee, 2014:19).

Even though this study focused on the requirements of Section 12E, a worthwhile note is how the above-mentioned natural person requirement may be working against legislation

supposed to assist small businesses, namely Section 12J: venture capital companies (VCCs).

Section 12J was introduced to the Income Tax Act (58 of 1962) in order to alleviate the problem small enterprises face in terms of lack of access to finance (Sieberhagen, 2008:51). In terms of the relief available in Section 12J, a qualifying investor can invest in a VCC. This investment that is made will then qualify as a deduction for tax purposes in the hands of the investor. The VCC can then use the funds it receives to invest in qualifying small business investees (as mentioned in Chapter 2). One way in which a VCC can invest in a qualifying investee is through the subscription of shares in that investee. However, the VCC must be an incorporated company that is approved by the commissioner (Income Tax Act, 58 of 1962).

What is immediately evident from this information is that although the government is actively trying to promote greater access to finance for small businesses, the tax relief it provides in terms of Section 12J is in the hands of the person who provided the funds to the VCC (the investor) and not in the hands of the small business acquiring the funds. Furthermore, should a VCC invest in a small business, it will mean that not all the holders of shares or members of the small business are natural persons, making that entity incapable of meeting the definition of an SBC. It will therefore not qualify for any relief in terms of Section 12E.

Although the government is addressing one of the constraints facing small businesses in Section 12J (access to finance), it appears as though the government is actually prohibiting another constraint (relief from taxation) from being eliminated as well. Luiz (2002:24) identified taxation as another constraint facing small businesses. It appears as though, at least from a tax perspective, small businesses in South Africa are faced with a choice of either electing to have greater access to finance and paying higher taxes (opting to make use of a VCC) or for not having access to venture capital but receiving significant tax relief (complying with Section 12E). It should be noted that if the DTC recommendations are implemented regarding ownership requirements (specifically the

suggestion that up to 33,3% of a SBC can be held by another company) (Davis Tax Committee, 2014:19), this can afford small businesses the opportunity to benefit from both Section 12E and Section 12J.

3.5.3 Other criteria and the general complexity of the tax code

In addition, the DTC has stated that it views the criteria on which tax relief is based as too complex. The committee further suggested that the gross income limit should be increased from its current R20 million to R50 million. The DTC has also raised objections to the criteria that natural person may not hold an interest in any other entity, believing this to be onerous. The committee believes that this requirement can be simplified by changing the wording of the Act to state that the relief excludes any SBC where “any shareholder holds any interest in any other SBC” (Davis Tax Committee, 2014:19).

Stols (2013:16) also agrees with the above-mentioned viewpoint regarding the complexity of small business tax incentives. Specifically, Stols (2013:16) states that:

“...the current definitions of a small business in the Income Tax Act are quite strict which could contribute toward small businesses not complying with these definitions and not benefitting from the reduced tax rates included in the section of the Income Tax Act pertaining to small businesses.”

The view that complexity is one of the problems small businesses face was also highlighted by Chamberlain and Smith (2006:25). In their review of the report “SBP: Counting the cost of red tape for business in South Africa”, one of the main findings noted by Chamberlain and Smith (2006:25) was that the complexity of tax forms and other paperwork form a large part of the tax compliance cost faced by small businesses.

3.5.4 The form of tax relief provided to SBCs

The form of tax relief provided to SBCs has also been criticised. Firstly, it is doubtful whether the accelerated wear and tear allowances provide any meaningful relief to SBCs. Secondly, the DTC is of the opinion that accelerated wear and tear allowances are merely a timing difference and that its impact on the growth of SBCs is minimal (Davis Tax Committee, 2014:18). This view is shared in a study by Margalioth (2007:494-517) in which research was conducted on the impact of accelerated wear and tear allowances on entities in the United States of America.

Stols (2013:21) is also of the opinion that wear and tear allowances are merely a timing difference for SBCs. However, Stols (2013:23) states that accelerated wear and tear allowances can be beneficial in improving the cash flow of SBCs in their formative years, helping them to become well established. An improved cash flow will come from the fact that the small business will save money from the reduced amounts of tax payable.

Margalioth (2007:510) criticises the notion that accelerated wear and tear allowances can be used to increase investments in assets by reducing tax costs and is of the opinion that entities do not consider the tax cost of an asset when deciding whether or not to purchase an asset but rather the liquidity of the entity.

Stols (2013:23), agrees with the above-mentioned notion that accelerated wear and tear allowances do not necessarily contribute towards an increased investment in fixed assets by SBCs. The impact that accelerated wear and tear allowances has on SBCs is minimal given the fact that these entities do not necessarily have fixed asset expenses on which to claim a deduction (Stols, 2013:50). Given that access to finance is another constraint facing small businesses (Luiz 2002:24) in South Africa, these businesses are not able to claim wear and tear allowances as they do not initially have the means to spend vast amounts of capital on fixed assets.

The second form of relief provided by Section 12E is reduced tax rates applicable to SBCs. Chen *et al.* (2002:12) argue that one disadvantage of using reduced tax rates for SMEs is that it can encourage underreporting of income by entities wishing to apply for tax relief. It can also induce business owners to divide their business into separate corporations for tax purposes, ensuring they qualify for tax relief. However, it should be noted that within Section 12E, significant levels of anti-avoidance measures exist (as previously mentioned). Another disadvantage that Chen *et al.* (2002:19) mentions regarding lower tax rates is the viewpoint that these reduced rates may discourage the growth of small businesses. Small business owners may strive to keep their reported income low enough in order to still qualify for reduced tax rates.

In contrast, in a survey done amongst accountants who deal with small businesses in Pretoria, Stols (2013:48) asserts that one of the criticisms against the small business tax relief found in Section 12E is that the reduced tax rates are not sufficient. Stols (2013:48) further asserts that one of the ways in which Section 12E can be improved is by offering further reduced tax rates applicable to SBCs.

3.6 Summary and chapter conclusion

As stated within the introduction, the purpose of this chapter was to explore and evaluate small business tax relief available in terms of Section 12E of the Income Tax Act (58 of 1962). In order to achieve this, this chapter critically examined tax relief available to small businesses within South Africa. This critical examination included an analysis of the definition of a SBC; an examination of the relief available in terms of Section 12E and lastly, by examining the criticisms currently levied against Section 12E.

The definition of an SBC in terms of Section 12E was examined, because an entity that meets all of the criteria of this definition is able to apply for small business tax relief. Each criterion was examined individually, particularly paying attention to the reason each criterion was included in the definition.

The first observation is that SBC concessions are only available to incorporated businesses. A SBC has to be a company, a close corporation or a cooperative and this criterion was included to encourage small businesses to formally incorporate.

The second observation is that all of the holders of shares or members of an SBC must be natural persons. This measure was included as an anti-avoidance mechanism to ensure that incorporated entities do not split their income by setting up a SBC subsidiary that qualifies for the reduced tax rates available in terms of Section 12E. Another possible reason for this inclusion was to encourage entrepreneurship within South Africa by providing tax relief to entrepreneurs who own small businesses.

This part of the criteria may, however, discourage a SBC to seek external finance from an investment company. If an SBC allows an external company to invest in the SBC through a share subscription, it will have the consequence that not all its holders of shares or members will be natural persons. The SBC will thus forfeit the relief it receives in terms of Section 12E. Small businesses thus face a choice between seeking external finance and applying tax relief.

The third observation is that natural person holders of shares or members of a SBC may not hold an interest in any other entity with exceptions applicable. These exceptions essentially disallow natural persons from holding an interest in another SBC. This is another anti-avoidance mechanism, as it disallows a natural person from splitting gross income between numerous entities in order to qualify for reduced corporate tax rates.

This chapter also discussed the requirement that no more than 20% of the gross income of a SBC may be derived from investment or personal service income. Both investment and personal service income are defined within Section 12E and the reason for the inclusion of this requirement is to ensure that SBCs with a limited entrepreneurial growth potential do not qualify for tax relief. However, this requirement can be overcome if a SBC employs three or more employees on a full-time basis who are not connected to the holders of shares or members of the SBC.

The last requirement examined was that a SBC may not be a personal service provider. According to this requirement, an SBC may not meet the definition of a personal service provider as set out within the 4th schedule of the Income Tax Act (58 of 1962). After examining the definition of a SBC, the tax relief these entities qualify for was examined. Entities that meet the definition of an SBC may apply for both accelerated wear and tear allowances and reduced corporate tax rates.

There are several criticisms against the relief provided in Section 12E. Some critics argue that the wear and tear allowances are merely a timing difference and that these allowances will not encourage small businesses to invest in assets as businesses do not always consider the tax cost of an asset when taking the decision to invest. Other critics argue that by allowing small businesses to benefit from reduced corporate tax rates, the tax system is distorted and the growth of small businesses is discouraged, as they seek to remain eligible for reduced tax rates.

The DTC argues that the definition of a SBC is too complex, essentially only providing relief to a small number of businesses (Davis Tax Committee, 2014:17) Given the fact that only 81 000 entities applied for small business tax relief in 2014, there may be some evidence supporting this statement. The 81 000 entities that applied for relief in 2014 represent a 28.78% decrease in comparison with the 113 926 entities that applied for relief in 2013.

This chapter has, therefore, met its objective of exploring and evaluating the tax relief found in Section 12E, evidenced by the observations and criticisms mentioned above. These observations and criticisms are compared to tax relief available to small businesses in Australia in Chapter 4. In Chapter 5, recommendations and conclusions are made concerning the tax relief structure currently available in South Africa.

CHAPTER 4 – AUSTRALIAN SMALL BUSINESS TAX RELIEF

4.1 Introduction

In Chapter 2, attention is paid to businesses in Australia that meet the definition of a SBE in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997). Chapter 4 aims to examine the SBE definition comprehensively, including the qualifying criteria and tax relief provided to small businesses in Australia. This examination will lead to the achievement of the secondary objective number 3 as per section 1.3.2, to explore and evaluate small business tax relief, mentioned within Chapter 1 of this study.

As mentioned in Chapter 1, Australia was chosen for the critical comparison, as South Africa and Australia share similar taxation laws (Marchbank, 2012:12-13). Specifically, in terms of small business tax relief, both Australia and South Africa provide reduced corporate tax rates and differentiated wear and tear allowances to qualifying small businesses. Moreover, it appears that Australia is successful in providing small business tax relief, evident by the fact that in the 2014/2015 Australian tax year, 768,033 businesses were classified as either micro or small, enabling them to access SBE tax concessions. This represents 84% of the 914,508 entities assessed for income tax purposes in total (Australian Taxation Office, 2015). This contrasts severely with only 33,59% of eligible small businesses applying for SBC tax relief in South Africa (South African Revenue Service, 2015b).

Australian small businesses play a major part in both employment generation and economic contribution (McKerchar & Drever, 2008:129). Apart from contributing significantly towards the output of GDP, small businesses are also viewed as important in the future economic performance of Australia, as these businesses are viewed as the “seed bed” for future economic growth (Freudenberg *et al.*, 2012:678). It is, therefore, no wonder why many Australian research studies focus on understanding and creating an environment supportive of entrepreneurship (McKerchar & Drever, 2008:130). Reducing the tax compliance burden for small businesses is often viewed as a way in which to

support increased entrepreneurship. It has been noted that small businesses face a high degree of compliance costs when compared to other taxpayers (Lignier & Evans, 2012:616). Compliance costs of taxes are defined by Tran-Nam *et al* (2000:229) as the value of resources expended by taxpayers in meeting their tax obligations. Small businesses are facing high compliance costs due to the limited resources with which they have to navigate vast amounts of tax regulations and record keeping requirements (Kenny, 2008:227).

The Australian government aimed to address high tax compliance costs facing these entities by implementing small business tax concessions. In 2001, this process first started when Australia introduced the simplified tax system (STS) – a system of taxation designed to respond to the regressive tax compliance burden faced by small businesses (Tretola, 2007:1).

STS concessions faced their first reform in 2005 when some of the requirements were abandoned. In 2007, small business tax concessions in Australia were further reformed when the STS was replaced by SBE rules. The reason for the replacement of the STS was, ironically, because the rules within the system were viewed as overly complex and only benefitted a minority of small businesses (Kenny, 2008:234-235). This chapter aimed, therefore, to explore and examine Australian small business tax relief, including the evolution from the STS to the current SBE system in place. Particular attention was paid to the criteria that are used to apply the SBE tax relief, the form of concessions available, the criticisms the SBE system face and any indicators of its success. The analysed Australian SBE system is critically compared to the South African SBC system in Chapter 5 in order to identify any shortcomings within the South African SBE system.

4.2 The Simplified tax system

The STS was introduced in Australia through the New Business Tax System (simplified tax system) Act (76 of 2001). This Act was introduced in order to promote a simpler and more certain system of taxation (Tretola, 2007:1). The need for a simplification of

Australian tax legislation was due to the fact that it was viewed as overly voluminous and extremely complex with the burden of this complexity falling disproportionately on small businesses (McKerchar & Drever, 2008:132). This study examined the STS as these rules eventually developed into the SBE rules, which are discussed later in this chapter. The STS was replaced entirely by SBE concessions in 2007 (Kenny, 2008:235). The STS was, therefore, an early form of the SBE concessions.

Firstly, the STS made certain concessions for small businesses. Small businesses were allowed to apply cash accounting principles for taxation instead of making use of the accrual accounting principle (Tretola, 2007:4). Secondly, the pooling of depreciable assets for capital allowance calculations was also allowed (Ingraham *et al.*, 2005:326). Thirdly, the STS allowed taxpayers to deduct all prepaid expenses that have been paid up until 12 months in advance (Tretola, 2007:6). Lastly, the STS allowed taxpayers a choice of not having to undertake stocktaking if the value of their opening and closing inventory did not differ by more than AUD5,000 (R53,200) (Tretola, 2007:5; Ingraham *et al.*, 2005:297).

In order to apply the STS, small businesses had to comply with certain criteria. The first criterion was that the entity had to carry on a business in the year of income (Tretola, 2007:2). Determining whether an entity had carried on a business during a year was very difficult – there was no outright definition available of what constituted a “business”. This lack of clarity led to a number of court cases with regard to business activity and various taxation rulings by the ATO (Kenny, 2008:231).

The second criterion was that the average annual turnover of an STS taxpayer must have been less than AUD1 million (R10,64 million) (Kenny, 2008:231). This average annual turnover was the sum of the taxpayer’s group turnover for any three of the previous four income years divided by three. The formula was adjusted if the taxpayer did not carry on business in each of the previous four years. The reason the average annual turnover was used was to ensure that a small business did not fail the criteria simply because it experienced an unusually high turnover in any one particular year (Tretola, 2007:2).

The STS average annual turnover requirement also required that entities group their turnover with other entities that they control and with entities that they are affiliates of (Tretola, 2007:3). This anti-avoidance mechanism – known as the STS “grouping rules” – prevented larger businesses from artificially splitting their income or restructuring their business in such a way that they qualified for STS tax concessions (Kenny, 2008:232).

These grouping rules were criticised for being overly complex and not in line with other grouping rules found within the Australian income tax law, such as the grouping rules applicable to the goods and services tax (GST) (Tretola, 2007:3). The detailed grouping rules found within the STS were thought to actually impose additional compliance costs on small businesses working against the initial mandate of the STS (Kenny, 2008:232).

The last criterion concerning the STS rules was that the sum of all the written down values of depreciating assets held by a taxpayer had to be less than AUD3 million (R31,92 million) (Tretola, 2007:4). Once again, the total value of depreciating assets was determined by applying the previously mentioned grouping rules of connected or affiliated small businesses in order to derive a depreciating asset value of all assets held by grouped entities (Kenny, 2008:232).

The STS rules faced numerous criticisms during the period in which it was in operation. One criticism the STS rules faced, was the lack of flexibility in applying STS concessions. Although the STS was optional for small businesses, these entities were obliged to apply almost all the concessions once they had elected to adopt the STS concessions. The cash accounting, simplified capital expenditure and prepaid expenses concessions were all compulsory. Only the simplified trading stock rules were optional (Kenny, 2008:231).

The STS system was also criticised for being inflexible in terms of opting in and out of the system. Taxpayers who had been in the STS system, but had then chosen to leave, could not re-apply the STS concessions for a period of five full years after opting out of the

system (Tretola, 2007:6). Small businesses had to perform detailed analyses about the benefits of joining the STS.

Joining the STS, meant that small businesses were obliged to convert to a cash accounting basis instead of an accrual accounting principle for tax purposes. If small businesses left the STS, they had to convert back to an accrual accounting system for normal tax purposes, as the use of a cash accounting system was disallowed according to the normal income rules. The analyses that small business had to perform imposed significant compliance costs on them (Kenny, 2008:233-234).

Lastly, the STS was criticised for being overly complex in its application. A high level of detail was found within its eligibility criteria (for example, the average annual turnover requirement and grouping rules discussed above), which worked against the STS mandate of simplifying tax legislation for small businesses (Kenny, 2008:234). Furthermore, the STS did not determine a universal definition for a “small business” and, as previously mentioned, applied different grouping rules than for businesses found in the CGT legislation (Kenny, 2008:230-231). The overly complex rules of STS actually increased the level of compliance costs small businesses faced (Ingraham *et al.*, 2005:312).

However, the STS criticisms mentioned above did have a high degree of merit behind them. When the STS concessions were first introduced in 2001, the federal government of Australia estimated that 95% of businesses would be eligible for the concessions available (Kenny, 2008:230). Unfortunately, by the end of the 2002 financial year, only 4% of eligible small businesses elected to apply STS concessions (McKerchar & Drever, 2008:134). This low application figure was indicative of the complexity and inflexibility of the STS and most small businesses were not prepared to commit.

4.3 SBE rules

Owing to the high amount of criticism the STS faced, the government of Australia decided to reform the system in 2005 by relaxing the compulsory use of cash accounting for income tax purposes and by introducing other taxation concessions for entities with a turnover of less than AUD75,000 (R798,000) (McKerchar & Drever, 2008:134). In 2007, these concessions proved ill-fated and the system was completely overhauled and replaced when SBE rules were introduced (Kenny, 2008:235).

The previous STS regime was, therefore, renamed and modified. Consequently, SBE rules were introduced in Division 328 of the Australian Income Tax Assessment Act (38 of 1997), effective on 1 April 2007 (Kenny, 2008:235; Small Business Bill Explanatory Memorandum, 2007:3).

In terms of initial SBE rules published in 2007, a small business was defined as any entity that is doing business where the aggregated annual turnover was less than AUD2 million (R21,28 million). This particular criterion increased from the AUD1 million (R10,64 million) aggregated annual turnover requirement previously applicable in the STS system. Moreover, under the SBE concessions, the AUD3 million (R31,92 million) disposable asset limit previously applied under the STS system was discarded (Small Business Bill Explanatory Memorandum, 2007:7). Significant changes have, therefore, been made to the eligibility criterion in the transition from the STS to SBE concessions.

SBE rules were further amended at the start of the 2016/2017 tax year. In terms of this amendment, an entity now needs to have an annual turnover of less than AUD10 million (R106 million) in order to qualify for SBE concessions (Australian Taxation Office, 2017e). By increasing the turnover requirement to AUD 10 million (R106 million) from the AUD2 million (R21,28 million), an additional 90,000 to 100,000 small businesses have access to small business concessions whilst also allowing for greater reinvestment in small businesses to take place (Enterprise Tax Plan Explanatory Memorandum, 2016:7).

Apart from altering the eligibility criterion for small businesses, the SBE rules also align the definition of small business, so as to have the effect that a single definition applies to numerous pieces of tax legislation. Consequently, the SBE test applies to various small business concessions (Kenny, 2008:236), including, amongst others:

- The option of managing accounting on a cash basis.
- Paying GST in quarterly instalments.
- A 15 year asset exemption with regard to GST.
- 50% active asset reduction with regard to GST.
- (FBT) car parking exemption.
- Small business income tax exemptions

Previously, a small business had to satisfy eligibility criterion of various tax laws in order to qualify for the different tax concessions. For example, in order to apply the GST small business concessions a small business had to carry on an enterprise with an aggregated annual turnover of less than AUD2 million (R21,28 million), with the grouping rules applicable in determining aggregated turnover for GST similar but technically different from those previously applied in the STS system (Small Business Bill Explanatory Memorandum, 2007:17).

However, it should be noted that despite the above-mentioned alignment of the definition for a small business, in order to be eligible for certain concessions, small businesses may need to comply with additional criteria to determine whether an entity can be classified as a small business (Small Business Bill Explanatory Memorandum, 2007:41). For example, in order to access the CGT small business concessions mentioned above, an entity needs to satisfy the definition of a small business and further may not have net assets exceeding AUD6 million (R63,84 million) in carrying value (Kenny, 2008:237).

Despite the annual turnover requirement that was increased to AUD10 million (R106 million) in order to define a small business for receiving tax concessions, the annual turnover requirement remained AUD2 million (R21,28 million) in order to determine whether an entity meets the definition of a small business for the purposes of applying

small business CGT concessions (Small Business Bill Explanatory Memorandum, 2007:47).

The above-mentioned mismatches undermine the potential benefit that could have been achieved from having only one single definition of what constitutes a small business (Kenny, 2008:237). However, it must be noted that significant improvement in the alignment of small business definitions has been achieved. The lack of alignment in the definition of small businesses has been highlighted in previous papers as an aspect of concern (McKerchar & Drever, 2008:131).

It should be noted that for the purposes of this chapter, the focus will mainly be on the small business entity concessions available for corporate tax purposes and the criterion needed to be able to access these concessions. The criteria for GST, CGT and FBT were, therefore, not examined in detail. However, it is acknowledged that by aligning the definition of a small business for tax purposes (as was mentioned above) an important step is taken towards the reduction of compliance costs faced by small businesses (McKerchar & Drever, 2008:131).

4.3.1 Annual aggregated turnover

The AUD10 million (R106 million) annual aggregated turnover requirement needs to be calculated separately by each small business entity. In terms of the “aggregated turnover” test, an entity satisfies the AUD10 million (R106 million) turnover test if it meets any of the following three tests (Small Business Bill Explanatory Memorandum, 2007:8; Kenny, 2008:237):

1. The entity’s aggregated turnover for the previous income year was less than AUD10 million (R106 million).
2. The entity’s aggregated turnover for the current income year, worked out on the first day of the income year, is likely to be less than AUD10 million (R106 million).
3. The entity’s aggregated turnover for the current income year, worked out at the end of the current income year, is actually less than AUD10 million (R106 million).

The reason for structuring the aggregated turnover mechanism in this way, is to ensure that small businesses easily qualify for SBE concessions. Most small business only need to consider whether their aggregated turnover in the previous year was less than AUD10 million (R106 million) because this is the applicable scenario in most cases (Small Business Bill Explanatory Memorandum, 2007:10).

An important rule to note is that entities may not use an aggregated turnover if their taxable income in each of the previous two taxable income years was greater than AUD10 million (R106 million) (Small Business Bill Explanatory Memorandum, 2007:13). The above rule ensures the integrity of small business tax concessions and avoids a scenario where entities annually expect taxable income for a particular year to meet the eligibility criteria and apply, therefore, small business tax concessions even though their turnover clearly does not meet the requirement of being below AUD10 million (R106 million).

The last aspect to take note of regarding the annual turnover determination is that if entities have been in operation for only part of an income tax year, entities must use a reasonable estimate to determine what their annual turnover would have been if they had been in operation throughout the income year (Small Business Bill Explanatory Memorandum, 2007:13, 20). This provision was included in the annual turnover determination to ensure that entities calculate an annual turnover that is truly representative of the size of their business. The effect is, therefore, avoided when entities only did business for a part of the year and their annual turnover is distorted) (Small Business Bill Explanatory Memorandum, 2007:13).

4.3.2 Carrying on a business

In order for a SBE to qualify for tax concessions offered in terms of SBE rules, the annual turnover of an entity derived in an income tax year needs to be from the carrying on of a business (Kenny, 2008:239). The term “carrying on a business” is not defined within Australian tax law and should, therefore, be viewed according to its ordinary meaning

(Small Business Bill Explanatory Memorandum, 2007:20). The Small Business Bill Explanatory Memorandum (2007:21) states that the term “carrying on a business” should include any activity that the entity regularly or customarily carries on.

4.3.3 The grouping rules

Any SBE wishing to qualify for the SBE concessions needs to apply the grouping rules to determine their annual turnover. These grouping rules entail that the annual turnover of a small business needs to be aggregated with an entity if it is affiliated to that other entity or if it is connected with that other entity (Kenny, 2008:239-240). Therefore, the small business entity would need to apply the definitions found within Section 328 of the Australian Income Tax Assessment Act (38 of 1997) in order to determine whether it should include the turnover of any other entity in its aggregated annual turnover.

An affiliate is defined as any individual or company that in relation to their business affairs acts or could reasonably be expected to act according to the directions or wishes of the SBE or act in concert with the SBE (Kenny, 2008:239).

The Small Business Bill Explanatory Memorandum (2007:24-25) provides guidance in determining whether one entity is affiliated with another. In terms of this, being affiliated with another entity generally entails determining whether some form of interdependence or close connection between the two parties exists on either a personal or business level. The affiliated rules can, therefore, be applied in order to determine whether the annual turnover of two sole proprietors needs to be aggregated, as there may be some close personal or business relationship between the two sole proprietors.

An entity is connected to a SBE if either entity controls the other or if both entities are controlled by the same third entity (Australian Taxation Office, 2017a). Determining whether one entity controls another is quite complex and requires consideration of the rules set out in Section 328-125 of the Australian Income Tax Assessment Act (38 of 1997) (Kenny, 2008:240).

For any entity other than a discretionary trust, an entity controls another entity when the first entity or its affiliates or the first entity and its affiliates between them own or have the right to acquire the beneficial ownership of interests in the other entity that between them give the right to receive at least 40% of any distribution of either income or capital. For control of companies, another test applies. Where an entity alone or together with affiliates beneficially own or has the right to acquire beneficial ownership of interests in the company with at least 40% of the voting power in the company, then the entity will control the company (Australian Taxation Office, 2017a; Kenny, 2008:240).

In addition, special rules apply where the interest of one entity in another entity is at least 40% but less than 50%. If this occurs, the Commissioner may exercise discretion to determine whether that entity or a third entity actually controls the other entity (Kenny, 2008:240). In determining whether an entity has control of a discretionary trust, two possible tests need to be considered (Small Business Bill Explanatory Memorandum, 2007:25-31). The first test is to determine whether the trustee of a discretionary trust paid at least 40% of the income or capital to an entity, its affiliates or the entity and its affiliates for any of the four income years before that income year in which control is being determined (Kenny, 2008:240). The second possible test to apply in determining control of a discretionary trust is to determine whether the trustee of the trust acts or can be expected to act in accordance with the directions or wishes of the entity (Kenny, 2008:240).

4.3.4 Eligibility criteria amendments: the result

It appears as though using the aggregation rules to determine the aggregated annual turnover of a small business can be rather complex. In a 2012 survey conducted by Lignier and Evans (2012:615-672), small business owner participants were asked to rate how complex they perceive SBE concessions to be. The vast majority of respondents felt that SBE concessions were either overly complex (33%) or felt that they were unsure about SBE concessions and the complexities involved (66%) (Lignier & Evans, 2012:653).

However, despite the perceived complexities involved, it must be noted that considerable effort has been made to simplify small business concessions available in Australia, especially when the STS was changed to the SBE system. As mentioned before, a single small business definition now covers a wide variety of small business concessions and, therefore, this definition is not as restricted to corporate tax as it previously was (Kenny, 2008:236). Furthermore, previously all STS concessions were compulsory when an entity decided to apply STS rules. However, the new SBE system allows for a voluntary application of any or all of the small business tax concessions (Kenny, 2008:236).

Significant improvement has also been made to the flexibility of small business concessions. For example, the five year entry and exit rules applied under the STS have been removed, as these rules are unnecessary under the optional provisions in the SBE system (Kenny, 2008:237). The only concession in which a five year waiting period for re-entry to the system is applicable, is the pooling of assets for capital allowance purposes (Kenny, 2008:247). This concession is discussed in section 4.4.

It also seems as though there is considerable evidence to prove that the complexities of small business tax concessions are not as high as perceived to be by small business owners. Another survey, conducted by Freudenberg *et al.* (2012:678-718), asked small business tax advisers to rank the complexities of certain taxes facing small businesses. Small business entity concessions were only ranked the 10th most complex tax item faced by small businesses (out of 15 tax areas in total). Non-resident trusts were ranked 1st, franchise tax was ranked 6th and capital gains tax applicable to businesses was ranked 8th (Freudenberg *et al.*, 2012:691).

The above results point to a scenario where small business tax concessions are perceived as quite complex by small business owners themselves (Lignier & Evans, 2012:653) yet are only perceived as moderately complex when ranked by tax advisers who assist small businesses (Freudenberg *et al.*, 2012:691). This is significant when considering the fact

that approximately 93% of business taxpayers in Australia use a tax adviser in order to help them prepare and lodge their income tax returns (McKerchar & Drever, 2008:135).

When examining the statistics regarding the classification of businesses in Australia for income tax purposes, it appears as though there has been some success regarding the introduction of SBE rules. As mentioned within the introduction of this chapter, in the 2014/2015 Australian tax year, 768,033 businesses were classified as either micro or small, enabling them to access SBE tax concessions. This represents 84% of the 914,508 entities assessed for income tax purposes in total (Australian Taxation Office, 2015).

4.4 The benefits of applying SBE concessions

The SBE concessions provides small businesses with various forms of tax relief in terms of corporate tax. The first of these benefits is the treatment of prepaid expenditure. Small businesses can immediately deduct an amount of prepaid expenditure where the payment covers a period of 12 months or less, regardless of the amount (Australian Taxation Office, 2017c).

The next concession is the simplified capital allowance rules. In terms of these rules, a small business can combine depreciable assets into certain pools based on the effective life of the depreciable assets. Depreciable assets with a useful life of less than 25 years are allocated to the general pool. To these assets, a capital allowance rate of 30% per taxable year is applicable. This capital allowance rate works according to the diminishing balance method (Australian Taxation Office, 2017c). There is, however, criticism directed towards the use of a diminishing balance method of wear and tear, as this does not necessarily reflect the accounting of these assets where depreciation is often based on the period in which the income related to those assets is earned (Kenny, 2008:248).

Depreciable assets with a useful life of more than 25 years are allocated to the long life pool and make use of an accelerated diminishing value capital allowance of 5% per year (Kenny, 2008:241). Certain depreciable assets, such as film expenditure and horticultural

plants, do not qualify for capital allowance pooling (Kenny, 2008:242). The benefit of applying depreciable asset pooling is that it avoids the need to calculate capital allowances on individual assets by eliminating the need to keep detailed capital allowance schedules for each asset (Tretola, 2007:5). This benefit is, however, eroded by the fact that small businesses would still need to keep detailed schedules of the depreciation of assets for accounting purposes, which may not necessarily reflect the same method of depreciation as those applied in the pooling of assets for tax purposes (Kenny, 2008:248).

SBE concessions also offer simplified trading stock rules. These simplified trading stock rules allow taxpayers the option of not having to undertake a stock take if there is a difference of AUD5,000 (R53,200) or less between the value of the stock of a business at the beginning of the income year and a reasonable estimate of the value of stock at the end of the year. In order to apply the simplified trading stock rules, the ATO requires taxpayers to record how they estimated the value of their trading stock (Australian Taxation Office, 2017c).

From the above-mentioned discussion, it is clear that many of the small business tax concessions were retained from the STS. One major difference, as previously discussed, is that the application of SBE concessions is completely voluntary whereas the concessions available under the STS were all compulsory (Kenny, 2008:236).

4.5 Recent amendments to SBE concessions

In recent years, a number of amendments to SBE concessions took place. SBE concessions were increased and the pool of small businesses to which the concessions can potentially apply was extended.

The first such amendment was the increasing of the annual aggregated turnover requirement for small business concessions to AUD10 million (R106 million) from the AUD2 million (R21,28 million) that was previously applicable (Australian Taxation Office, 2017e). As previously discussed, more small businesses are able to qualify for small

business concessions due to the increasing of the annual aggregated turnover requirement (Enterprise Tax Plan Explanatory Memorandum, 2016:7).

The second amendment is reduced corporate tax rates that came into effect during the 2015/2016 income year. A flat tax rate of 28.5% is applicable to small businesses as opposed to the 30% applicable to all other companies (Australian Taxation Office, 2017d). More recently, the corporate tax rate has been reduced to a flat rate of 27.5% for the 2016/2017 income year (Enterprise Tax Plan Explanatory Memorandum, 2016:2). The Enterprise Tax Plan Explanatory Memorandum (2016:3) on the reduced corporate tax rate explains that this lower tax rate applicable to small businesses will increase investments in the small business sector, encourage enhanced productivity and boost the level of economic activity in Australia.

It should be noted, however, that the reduced corporate tax rate policy is a progressive policy currently applied by the Australian government, which will have the effect of gradually reducing the corporate tax rate while at the same time extending it to all corporate tax entities by the 2023/2024 income year (Enterprise Tax Plan Explanatory Memorandum, 2016:2). Therefore, eventually the corporate tax rate will not only be extended to small business entities. The corporate tax rate will be reduced to 27 per cent by 2024/2025; 26 per cent by 2025/2026 and will eventually reach a low of 25 per cent in the 2026/2027 income year (Australian Taxation Office, 2017d). While the above policy will reduce the corporate tax rate payable by incorporated small businesses, unincorporated small businesses will not be able to access these concessions as they are not liable for corporate income tax.

To counter this above-mentioned mismatch, the Australian government introduced a tax discount for unincorporated small businesses. This discount allows small business entities who are liable to pay income tax on a share of income of a small business entity to a tax offset equal to 5% of the basic income tax liability, capped at a value of AUD1,000 (R10,640) (Enterprise Tax Plan Explanatory Memorandum, 2016:4). This discount was introduced in the 2015/2016 income tax year, much like the reduced corporate tax rate.

This tax offset discount will be progressively increased until the 2026/2027 income year – in line with proposed decreases in the corporate tax rate. From the 2016/2017 income year an 8% discount will be offered. From the 2024/2025 income year this discount will be increased to 10% and from the 2025/2026 income year a discount of 13% will apply. This unincorporated tax offset discount will reach a peak of 16% of a basic income tax liability in the 2026/2027 income year (Enterprise Tax Plan Explanatory Memorandum, 2016:4).

In order for unincorporated small businesses to access the tax offset discount, their annual aggregated turnover must be less than AUD5 million (R53,2 million) (Australian Taxation Office, 2017b). This turnover requirement differs, therefore, from the AUD10 million (R106 million) necessary to access the rest of the SBE concessions discussed above.

4.6 Summary and chapter conclusion

In 2001, small business tax concessions were introduced for the first time in Australia in the form of the STS system. In terms of this system, any entity with an aggregated annual turnover of less than AUD1 million (R10,64 million) and with depreciable assets of less than AUD3 million (R31,92 million) was entitled to certain tax concessions. The aggregated turnover of a small business had to be calculated by including the turnover of affiliated and controlled entities to the turnover of the small business. The tax concessions available through the STS included the use of a cash accounting system, simplified trading stock rules, the pooling of depreciable assets and the simplified treatment of prepaid expenses.

Although the STS provided the above benefits to small businesses, the system was criticised for being overly complex and inflexible. The definition of a small business in the STS legislation differed from those within other areas of Australian tax legislation, such as the definition of small business for CGT and GST purposes. Although the STS was

optional, once a small business opted into using the concessions, they were obliged to make use of all but the simplified trading stock concessions.

The criticisms facing the STS led to its eventual replacement by the SBE system in 2007. In terms of the SBE system, various definitions of a “small business” across all areas of the Australian tax legislation were consolidated into one definition. This had the effect that any entity with a turnover of less than AUD2 million (R21,28 million) could qualify for income tax, CGT, GST and various other concessions.

With regard to income tax, the SBE system allows small businesses the use of a cash accounting system, simplified trading stock, preferential prepaid expense rules and the pooling of assets for capital allowance purposes. Unlike the STS rules, all of these small business concessions are voluntary, affording the small business the choice of which concessions to apply.

In recent years, the SBE system has been amended. The turnover requirement was increased to AUD10 million (R106 million) from the previously applicable AUD2 million (R21,28 million). Furthermore, incorporated small businesses now qualify for reduced corporate tax rates (a 27.5% corporate tax rate instead of the 30% applicable to other entities). Unincorporated small businesses qualify for a 5% reduction of taxable income if their annual turnover is less than AUD5 million (R53,2 million).

Although the SBE system has also been criticised for being complex, it appears as though significant effort has been made by the Australian government in consolidating the definitions of small businesses for income tax purposes. Furthermore, the amount of small businesses eligible for concessions has also increased in recent years through the raising of the SBE turnover requirement – evident by the fact that within the 2014/2015 Australian income tax year, over 84% of all the assessed entities were classified as either micro or small businesses and enabled them to access SBE concessions. The Australian government appears committed to continually develop and extend small business tax relief.

As stated within the introduction, the purpose of this chapter was to examine the definition of SBEs comprehensively. The tax relief provided to small businesses in terms of this definition was closely examined. The exploration conducted within this chapter included an understanding of the criteria used to apply for Australian small business tax relief and the forms of tax relief available to SBEs. This chapter has, therefore, met secondary objective 3 in terms of Chapter 1.3.2. The analysed and examined Australian SBE tax system will be used to form a critical comparison against the analysed South African SBC tax relief system (this South African analysis was performed within Chapter 3 of this study). This critical comparison of the Australian SBE system and South African SBC concessions will be performed within Chapter 5 of this study.

CHAPTER 5 – CRITICAL COMPARISON OF THE SOUTH AFRICAN AND AUSTRALIAN SMALL BUSINESS TAX RELIEF

5.1 Introduction

In Chapter 3, the study explored and examined South African small business tax relief in terms of Section 12E of the Income Tax Act (58 of 1962) in order to draw certain conclusions on available tax relief. In Chapter 4, Australian small business tax relief in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997) were investigated and certain conclusions were reached with regard to tax concessions.

The objective of this chapter is to use the South African and Australian small business tax relief data from Chapters 3 and 4 to do a critical analysis of the differences in small business tax relief of these two countries. After the critical analysis, the fourth secondary objective of this study, as stated in section 1.3.2 of Chapter 1, is achieved. The critical analysis performed will be used in order to identify any shortcomings regarding the criteria used to apply small business tax incentives in South African legislation.

These shortcomings will be used in order to form certain recommendations for the possible improvement of the South African small business tax relief, presented in Chapter 6. After the presentation of recommendations, the fourth secondary objective of this study is achieved.

This chapter focuses on a critical comparison analysis between the eligibility criteria of the South African and Australian small business tax relief. A comparison is presented of the actual tax relief provided by the Australian SBE system and the South African SBC concessions.

5.2 Definition of a small business

In Chapter 2, the absence of a uniform definition for the term “small business” within South African and Australian legislation was highlighted. However, in the Australian Income Tax Assessment Act (38 of 1997), a consistent definition is applied, as entities only need to comply with the definition of an SBE. In contrast with Australian legislation, the South African Income Tax Act (58 of 1962) offers at least four definitions for the term “small business”. It is, therefore, clear that the Australian tax legislation provides a more standardised definition for the term “small business” when compared to South African tax legislation.

5.3 Critical comparison of the eligibility criteria

In both South Africa and Australia, entities that meet the requirement of a specific definition can apply for small business tax relief. In South Africa, the SBC definition is of concern while in Australia an entity needs to comply with the definition for a SBE. Complying with the definition for a SBE in Australia, allows an entity to access small business corporate tax relief, CGT concessions, GST concessions and FBT exemptions (Kenny, 2008:236). It should be noted, however, that for some of the concessions an Australian small business needs to comply with further requirements, such as the previously mentioned AUD6 million (R63,84 million) asset limit for CGT relief (Small Business Bill Explanatory Memorandum, 2007:41).

In South Africa, an entity needs to comply with multiple definitions in order to fully access small business tax relief. Corporate income tax relief is governed by the SBC definition provided in Section 12E while CGT relief is governed by the definition available in the 8th schedule. These definitions have been examined in more detail in Chapter 2.

In the following section, the South African Section 12E eligibility criteria were compared to the eligibility criteria of the Australian Division 328. Each segment of the tax relief found

in Section 12E was compared to the tax relief provided in terms of Division 328. The comparison is presented in the form of seven points.

5.3.1 Gross income or turnover requirements

In both the SBC and SBE definitions, turnover or gross income is used to determine whether an entity qualifies for corporate income tax relief. In Australia, this turnover requirement is currently AUD10 million (R106 million) for reduced corporate tax rates and other income tax concessions (Enterprise Tax Plan Explanatory Memorandum, 2016:7).

In South Africa, the SBC rules are only applicable to an entity that does not have gross income in excess of R20 million during a year of assessment (Income Tax Act, 58 of 1962). The South African gross income amount appears, therefore, quite low when compared to the Australian turnover requirement. It is, therefore, clear that that there is some merit in the DTC's recommendations to increase the South African gross income requirement from R20 million to R50 million in order for more enterprises to benefit from available tax relief (Davis Tax Committee, 2014:19).

In 2016, the South African economy was valued at approximately US\$739.4 billion in terms of purchasing power parity (CIA World Factbook, 2017b) whereas the Australian economy for the same period was valued at approximately US\$1.259 trillion (CIA World Factbook, 2017a). The reason for the difference in the value of the turnover requirement between South Africa and Australia may be due to economic differences in each respective country. However, the South African gross income requirement was last updated in 2013 (Department of Finance, 2013a:12) and there is, therefore, some merit in increasing the South African gross income requirement from its current R20 million value.

In Australia, a small business needs to determine its annual aggregated turnover by considering either the turnover of the previous year, an estimated turnover for the current year or the actual turnover of the current year. Then a small business must determine

whether any of these three turnover options falls below the AUD10 million (R106,4 million) threshold (Small Business Bill Explanatory Memorandum, 2007:10). In South Africa, an entity can only consider whether its actual gross income for the current tax year is less than R20 million (Income Tax Act of South Africa, 58 of 1962). No option is available to make use of the gross income of the previous year or an estimated current gross income in order to apply for SBC provisions.

If a South African entity is only operating for a portion of a particular year of assessment, the gross income attributable to that entity for the purposes of complying with Section 12E is calculated using a pro rata method – the gross income of the entity is estimated as if the entity has been in operation for a full 12 months (South African Revenue Service, 2016b:9-10). The Australian requirement is similar – if an entity has only been in operation for a portion of the income tax year, the entity must use a reasonable estimate to determine what the annual turnover would have been if the entity has been in operation for a full 12 months (Small Business Bill Explanatory Memorandum, 2007:13, 20).

5.3.2 Relief is only provided to small incorporated businesses

In South Africa, small business tax relief is only provided to SBCs classified as companies, close corporations or cooperatives, as defined in Section 1 of the Income Tax Act (58 of 1962). As mentioned in Chapter 3, SBC tax relief is, therefore, only available to juristic or incorporated small businesses (Income Tax Act of South Africa, 58 of 1962).

In terms of incorporated businesses, Australian small business tax legislation compares well with South African legislation, as Australian entities wishing to qualify for SBE tax relief need to be incorporated entities (Australian Income Tax Assessment Act, 38 of 1997). However, in Australia, unincorporated small businesses may qualify for a reduction in their income tax should their turnover be less than AUD5 million (R53,2 million) (Enterprise Tax Plan Explanatory Memorandum, 2016:4). In South Africa, no relief is provided to unincorporated small businesses in terms of Section 12E. In South Africa, it

seems as if there is a distortion regarding relief provided to incorporated and unincorporated businesses.

In Chapter 3, the mismatch between relief provided to incorporated and unincorporated businesses was criticised, as this leads to a scenario where the tax consequences of an entity is altered without necessarily affecting the economic activity of taxpayers (Freedman & Crawford, 2008:6).

5.3.3 Restrictions on who can hold shares within a SBC/SBE

In South Africa, only natural persons may be the holders of shares of a company which wants to comply with the requirements of a SBC (Income Tax Act, 58 of 1962). As mentioned in Chapter 3, this effectively disallows any juristic person from being a holder of shares in a SBC. The reason for including this criterion, as previously mentioned, is to ensure that large entities do not split their income into smaller portions and then have these smaller portions pay income tax at a reduced rate instead of the full tax rate for normal entities (Arendse, *et al.*, 2006:9). This natural person limitation can, therefore, be viewed as an anti-avoidance mechanism (South African Revenue Service, 2016b:7).

In contrast with South Africa, no limitation exists in Australia on who may hold the shares of the entity wishing to comply with the requirements of a SBE (Australian Income Tax Assessment Act, 38 of 1997). Instead, Australia has built in aggregation rules in Division 328 as an anti-avoidance mechanism (Kenny, 2008:232). Australian SBE rules require that entities must determine their annual aggregated turnover. An aggregated annual turnover is determined by aggregating the turnover of entities with that of their affiliates and connected persons (Kenny, 2008:239-240). These aggregation rules are examined in detail in Chapter 4. If the aggregated turnover (turnover considered together with the turnover of affiliates or connected persons) of an entity is less than AUD10 million (R106,4 million), the SBE will qualify for relief (Kenny, 2008:239-240).

In South Africa, when a juristic person holds an interest in another SBC, the SBC is disqualified from applying for tax relief even if that juristic person holds that interest for reasons other than possible tax avoidance. If a SBC with a juristic person as holder of shares was assessed under the Australian SBE aggregation rules, the SBC may have qualified for tax relief.

5.3.4 Shareholding and membership restrictions

According to the South African Section 12E requirements, the natural person holders of shares of the SBC may not hold an interest in any other company, with the exception of those listed in Section 12E(4)(a)(ii) (Income Tax Act, 58 of 1962). These rules essentially disallow a natural person from holding an interest in any other SBC.

This limitation is to ensure that natural persons are not provided with an undue tax benefit, where income is split between various qualifying SBCs (South African Revenue Service, 2016b:7). This limitation can, therefore, be viewed as an anti-avoidance mechanism. As previously stated in Chapter 3, this limitation may work against the idea of entrepreneurship, as some small business owners may own more than one business in order to diversify risks and to increase growth opportunities (Stols, 2013:12).

In contrast with South Africa, Australian SBE rules do not place any limitation on the type of entities in which the holders of shares of a SBE may have an interest in (Australian Income Tax Assessment Act, 38 of 1997). Instead, Australian tax legislation ensures the integrity of their small business relief by applying aggregation rules.

The South African anti-avoidance rules can, therefore, be criticised, as these rules appear to be overly onerous (Davis Tax Committee, 2014:19). According to the South African SBC rules, if natural person shareholder hold two SBCs, they are automatically disqualified from applying for tax relief even if the combined gross income of the entities is below the R20 million threshold. However, if these entities had been assessed according to the Australian SBE aggregation rules, tax relief may still have been provided.

5.3.5 Small business income restrictions

According to the South African SBC restrictions, no more than 20% of the gross income of a SBC may be derived from the rendering of personal services or from investment income (Income Tax Act, 58 of 1962). The definitions of personal service and investment income are provided in Chapter 3. Personal service income, includes income derived in the fields of accounting, auditing and any other professional service field. Investment income, includes income derived from royalties, dividends and other types of passive investments (Income Tax Act, 58 of 1962).

As stated in Chapter 3, the reason for this restriction is to ensure that SBC relief does not fund entities with a limited entrepreneurial growth potential (Arendse *et al.*, 2006:13). The above requirement strongly contrasts with Australian SBE concessions, as no such limitation on the nature of the income of a SBE exists (Australian Income Tax Assessment Act, 38 of 1997). It appears, therefore, as though Australian legislation is less onerous with regard to the type of entities that may apply for small business tax relief concerning the nature of income.

5.3.6 Personal service providers

In South Africa, an entity that wishes to obtain the benefits of the Section 12E small business tax concessions, may not be a personal service provider. A personal service provider is defined within the 4th schedule of the South African Income Tax Act (58 of 1962). As previously mentioned in Chapter 3, the definition of a personal service provider essentially entails is that if a SBC derives income through a connected person holder of shares rendering a service to another company and where that connected person is viewed as an employee or under the control of company in any regular business circumstance, then that SBC is providing personal services through its connected person shareholder (Income Tax Act, 58 of 1962).

In terms of the relief provided by the Australian SBE concessions, there is no similar requirement to consider. It does not matter whether the small business is a personal service provider or a similar entity (Australian Income Tax Assessment Act, 38 of 1997). It therefore appears as though companies in South Africa who would meet the definition of a PSP (and therefore not qualify for any SBC tax relief) may have qualified for tax relief in terms of the SBE rules in Australia, as there is no similar limitation on the nature of entities applying for small business tax relief.

5.3.7 Carrying on a business

In Australia, any small business that wishes to qualify for tax concessions in terms of the SBE rules, needs to ensure that its annual turnover is derived from the carrying on of a business (Kenny, 2008:239). As mentioned in Chapter 4, the term “carrying on a business” is not defined in Australian tax law and should be taken to include any activity that the entity regularly or customarily carries on (The Small Business Bill Explanatory Memorandum, 2007:21).

In contrast, South African tax legislation requires an entity that wishes to apply for SBC tax relief, to carry on a trade (Income Tax Act, 58 of 1962). Section 12E does not provide any guidance regarding when an entity is carrying on a trade. However, SARS Interpretation Note 9 states that for detailed discussions on the trade requirement, a small business owner should consult Interpretation Note 33: “Assessed losses: Companies: The Trade and Income from Trade Requirements” (South African Revenue Service, e:7). Trade is, therefore, defined in Section 1 of the Income Tax Act as, amongst others, any profession, business, employment, the letting of any property and the grant of permission to use a patent (Income Tax Act, 58 of 1962).

5.4 The nature of tax relief provided by small business tax concessions

Once a small business has met the definition of either a SBC in South Africa or a SBE in Australia, it qualifies for various forms of tax relief within both countries. The following

section of the chapter focuses on a critical comparison of the various types of tax relief provided to small businesses in both South Africa and Australia.

5.4.1 Reduced corporate tax rates

A common form of tax relief provided in both countries is reduced corporate tax rates for small businesses. In South Africa, a SBC qualifies for reduced corporate tax rates on a sliding scale where the maximum tax charged is a marginal 28% tax rate as opposed to a flat rate of 28% for corporate tax purposes (South African Revenue Service, 2016a; 2017b). In Australia, qualifying SBEs are taxed at a flat rate of 27.5% as opposed to the 30% flat rate for corporate tax purposes (Australian Taxation Office, 2017d).

There, one can see that the reduced corporate tax rate relief provided by both countries is fairly similar. In Australia, qualifying small businesses are taxed at a flat rate of 27.5% whereas South African qualifying small businesses are taxed at the maximum marginal tax rate of 28%.

5.4.2 Differentiated wear and tear allowances

Both South Africa and Australia offer wear and tear provisions different from normal wear and tear allowances provided within other areas of tax legislation. In South Africa, a SBC can immediately write the value of a capital asset for income tax purposes off should that capital asset be used in a process of manufacturing. Capital assets not used in a process of manufacturing qualify for accelerated wear and tear allowances on the cost of the asset (Income Tax Act, 58 of 1962).

In Australia, SBEs can pool capital assets in order to simplify wear and tear calculations. Capital assets categorised in a long-life pool (assets with useful lives of longer than 25 years), qualify for a wear and tear allowance of 5% per annum on the pool value. Capital assets categorised in the short-life pool (assets with useful lives of less than 25 years),

qualify for a wear and tear allowance of 30% per annum on the pool value using the diminishing value method (Australian Taxation Office, 2017c).

As previously mentioned in Chapter 3, emphasis is often placed on wear and tear allowances as a form of small business tax relief but in actual fact, these benefits are merely timing differences (Davis Tax Committee, 2014:18).

5.4.3 Prepaid expenditure benefits

Australian small businesses may qualify for prepaid expense benefits in terms of the SBE provisions. Australian provisions allow an SBE to immediately deduct prepaid expenses (of any amount) if the period in question is not longer than 12 months and if the expense item ends in the following financial year (Australian Taxation Office, 2017c).

Although there is no similar provision found in the South African SBC rules, it should be noted that all South African entities may qualify for prepaid expense benefits in terms of Section 23H. According to Section 23H, any entity may immediately deduct prepaid expenses if the period in question does not extend six months after the year of assessment, if the expense is less than R100,000 or if the expense is imposed by legislation (Income Tax Act, 58 of 1962). South African prepaid expenditure rules do, however, appear less generous than those provided in Australia, as there is no cap placed on the value of prepaid expenditure deductions in Australia. Moreover, Australian legislation allows expenses for up to 12 months to be deducted, as opposed to the six months provided in South Africa.

5.4.4 Other forms of small business tax relief

In addition to the above-mentioned prepaid expenditure benefits and wear and tear allowances, the Australian SBE rules provide additional provisions that cannot be compared with the provisions available in South African legislation. This includes an optional choice in Australia to apply for cash accounting principles for taxation purposes

rather than the regular application of accrual accounting (Australian Taxation Office, 2017c). Australian small businesses may also choose not to undertake a stock count for inventory valuation purposes if the value of the opening inventory stock and a reasonable estimate of the closing value of inventory does not differ with more than AUD5,000 (R53,200) (Australian Taxation Office, 2017c).

Furthermore, entities in Australia that meet the definition of a SBE, may also qualify for additional forms of tax relief with no connection to corporate income tax. Australian SBEs qualify for capital gains tax relief (if the entities do not have assets exceeding AUD6 million in carrying value), GST benefits and FBT car parking exemptions (Kenny, 2008:236). In contrast, South African entities that meet the definition of a SBC do not qualify for any other tax relief except reduced corporate tax rates and accelerated wear and tear allowances. Small businesses in South Africa that wish to obtain other forms of tax relief (such as CGT relief), need to meet other small business definitions specifically relating to that form of tax relief. This dilemma is discussed in Chapter 2.

5.5 Summary and chapter conclusion

The aim of this chapter was to critically compare the small business tax relief in Australia and South Africa under Section 12E of the Income Tax Act (58 of 1962). The purpose of this comparison was to fulfil the fourth secondary objective listed in section 1.3.2 of Chapter 1, namely to critically compare Section 12E of South Africa with the Australian Division 328 concerning small business tax relief, specifically to identify any shortcomings regarding the criteria used to apply the small business tax incentive within the South African legislation. The shortcomings identified will be used to make recommendations as to possible improvements to the South African Section 12E legislation. These improvements are presented in the final chapter of the study.

It was established that a more standardised definition of the term “small business” exists in the Australian Income Tax Assessment Act (38 of 1997) than the South African Income Tax Act (58 of 1962). Small businesses in Australia that meet the definition of a SBE,

qualify for tax relief outside the ambit of corporate income tax. This tax relief includes CGT, GST and FBT exemptions. It was noted that small businesses in South Africa that would like to obtain additional tax relief, have to meet the criteria of additional definitions, such as the definition contained within the 8th schedule of the Income Tax Act (58 of 1962). The existence of numerous definitions of the term “small business” in South Africa is a shortcoming as it may compromise the application of Section 12E tax relief as it may create confusion regarding whether an entity is eligible for applying the tax relief or not.

It is evident from the critical analysis performed, that both the Australian and South African small business tax concessions make use of turnover in order to determine whether an entity qualifies for any tax relief. The South African gross income requirement is lower than the Australian turnover requirement, especially when comparing the turnover requirement for reduced corporate tax in Australia of AUD10 million (R106 million) with the R20 million requirement in South Africa. The low South African gross income requirement is a shortcoming regarding the Section 12E eligibility criteria.

Comparisons were also made between the anti-avoidance rules contained in the South African and Australian small business tax legislation. Australia makes use of certain aggregation rules as anti-avoidance mechanisms within Division 328. However, South Africa does not make use of aggregation rules as anti-avoidance mechanisms. South African SBCs are only allowed natural person holders of shares or members and, in turn those natural persons may not hold shares or be members of any other SBC. South African legislation appears more onerous, as certain disqualified South African entities may have qualified for tax relief according to the Australian aggregation rules. The South African anti-avoidance rules were, therefore, identified as another shortcoming in the provision of South African small business tax relief.

The gross income restrictions placed on South African SBCs were also analysed – not more than 20% of the gross income of a SBC may be derived from personal service or investment income. South African SBCs may not be personal service providers, as defined in the 4th schedule of the Income Tax Act (58 of 1962). This measure contrasts

directly with Australia where there are no restrictions placed on the nature of the turnover of a SBE. There are also no restrictions in place prohibiting Australian small businesses from being classified as personal service providers or other similar entities. This restriction in place on the derivation of gross income of SBCs in South Africa represents, therefore, a shortcoming when compared to Australian turnover derivation criteria.

It was further noted that both South African SBCs and Australian SBEs must be incorporated small businesses in order to qualify for the small business tax relief provided in each country. However, it was noted that unincorporated small businesses in Australia can still qualify for SBE tax relief if their turnover is less than AUD5 million (R53,2 million) in a year of assessment. Unincorporated South African small businesses do not qualify for similar tax relief in terms of Section 12E. This mismatch between incorporated and unincorporated tax benefits represents, therefore, a shortcoming in the provision of South African small business tax relief.

After critically comparing the South African and Australian eligibility criteria, a comparison was made of the small business tax relief provided in each country. It was noted that both countries provide qualifying small businesses with reduced corporate tax rates and differentiated wear and tear allowances. In addition, Australian tax legislation provides qualifying SBEs with the option of applying cash accounting, differentiated trading stock and prepaid expenditure benefits.

This chapter successfully compared the eligibility criteria of and tax relief applicable to South African SBCs with its SBE counterparts in Australia. This critical comparison led to the identification of several shortcomings in Section 12E regarding small business tax relief. The identified shortcomings in this chapter and other shortcomings identified in the study, were used to form recommendations to possibly improve South African Section 12E relief. These recommendations are presented in Chapter 6 along with future possible areas of research concerning South African small business tax legislation.

CHAPTER 6 – SUMMARY, RECOMMENDATIONS AND CONCLUSION

6.1 Introduction

In Chapter 1, the study highlighted the importance of small businesses in the future economic performance of the country and to achievements of the NDP (Department: The Presidency, 2012:140-144). It was noted, however, that small businesses currently face numerous challenges, including high levels of tax compliance costs with regard to current tax legislation (Luiz, 2002:24).

The SBC tax concessions in terms of Section 12E were delineated and found to be a mechanism through which the South African government has aimed to reduce the tax compliance costs faced by small businesses (Income Tax Act. 58 of 1962). The SBC tax concessions are, however, often criticised for being overly onerous and complex (Davis Tax Committee, 2014:19). The position of small businesses in a more global perspective was subsequently explored, detailing the importance of small businesses in Australia where more than 45.7% of all private sector employment is derived from small businesses (Department of Industry Innovation, Science, Research and Tertiary Education, 2012:31, 36). Small businesses in Australia also qualify for certain tax concessions, such as a reduced corporate tax rate and simplified trading stock rules in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997).

A critical analysis was performed in which the South African Section 12E small business eligibility criteria and tax relief were compared with the eligibility criteria applied and relief provided to Australian small businesses in terms of Division 328. This comparative analysis was performed in order to identify possible shortcomings in the South African small business tax legislation in light of the importance of small businesses in the South African economy.

This study was, therefore, conducted with the aim of obtaining an in-depth understanding of the eligibility criteria and tax relief provided to small businesses in South Africa in terms of Section 12E and in Australia in terms of Division 328. The aim of obtaining a comprehensive understanding was to be able to critically compare the South African small business legislation with Australia in order to identify any shortcomings within South African SBC concessions. These shortcomings can be used to make recommendations to possibly improve Section 12E relief, specifically with regard to its eligibility criteria and tax relief provided. Recommendations made within this chapter do not only relate to those identified in the critical comparison, as shortcomings were also identified by examining the definition of small businesses in South African legislation and in an analysis of Section 12E. However, more emphasis is placed on the shortcomings identified during the critical comparison.

The research method used in this study was a literature review of previous research performed with regard to South African and Australian small business tax relief. A literature review falls within the post-structural or doctrinal research methodology and a subsequent comparative analysis of South African Section 12E legislation with Division 328 of the Australian Income Tax Assessment Act (38 of 1997) was performed. This comparative analysis was carried out by making use of each country's respective small business tax legislation, information supplied by each country's relevant tax authority (such as Interpretation Note 9 published by SARS and guidelines published by the ATO), and previous research in terms of small business tax.

The purpose of the last chapter is to reflect on the research findings of Chapters 1-5. The research performed in these chapters has uncovered several shortcomings identified in the South African SBC small business tax relief. This chapter provides a summary of key findings of the research, suggests recommendations to address the identified shortcomings and identifies future areas of research concerning SBC tax relief.

6.2 Research objectives

The study included a primary objective and several secondary objectives. In broad terms, the primary objective of this study was to critically compare South African small business eligibility criteria and tax relief in terms of Section 12E of the Income Tax Act (58 of 1962) with tax relief available to qualifying small businesses in Australia under Division 328 of the Income Tax Assessment Act (38 of 1997). The aim of this analysis was to identify any shortcomings in the South African small business tax legislation when compared to its Australian counterpart in order to make recommendations to possibly improve South African Section 12E legislation.

The primary objective was achieved by addressing the secondary objectives. The secondary objectives of this study (and details of where they have been achieved) were as follows:

1. Determining the definition of small businesses in South African and Australian legislation and evaluating – relative to the small businesses definition per tax legislation – which definitions can be used for the purpose of examining each country's tax legislation and performing a comparative analysis. This objective was addressed in Chapter 2.
2. Exploring and evaluating the South African small business tax relief in terms of Section 12E of the Income Tax Act (58 of 1962), investigating the history of Section 12E relief, examining its eligibility criteria, the form of tax relief it provides and the criticism of relief available. This objective was addressed in Chapter 3.
3. Exploring and evaluating the Australian small business tax relief in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997), investigating its evolution from the STS to the SBE concessions, examining the SBE concessions eligibility criteria and investigating the tax relief that Division 328 provides. This objective was addressed in Chapter 4.
4. Performing a critical comparison between the South African small business tax relief in terms of Section 12E and the Income Tax Act (58 of 1962) and Division

328 of the Australian Income Tax Assessment Act (38 of 1997) in order to make recommendations for a possibly improved or revised Section 12E based on the shortcomings identified in the critical comparison. This objective was addressed in Chapters 5 and 6 with Chapters 2 and 3 as the foundation.

6.3 Summary of research results

The summarised results of the study are discussed in the following section. This summary specifically focuses on the achievement of the secondary objectives of the study.

6.3.1 Definitions of “small business”

This study examined the different definitions of the term “small business” in both South Africa and Australia. It was determined that in South Africa, various definitions of the term exist with at least seven different definitions used for South African tax purposes. These definitions include one used in the VAT Act (89 of 1991), the skills development levy, in terms of Section 12E, Section 12J, and the 6th and 8th schedule of the Income Tax Act (58 of 1962). It was found that all the definitions of small business within South African tax legislation differ. These definitions also contradict definitions found in other areas of legislation, such as the Broad-Based Black Economic Empowerment Act (53 of 2003).

After the definitions of small businesses were considered, a definition for the purpose of this study was adopted for a South African purpose: small businesses who meet the definition of a “small business corporation” (SBC) in terms of Section 12E of the South African Income Tax Act (58 of 1962). A SBC is defined within this section as an entity with less than R20 million gross income in a year of assessment. In addition to this, the holder(s) of shares in the SBC may not hold an interest in any other company, with certain exceptions applicable. A SBC may also not derive more than 20% of its income from providing “personal services” or from “investment income” (Income Tax Act, 58 of 1962).

In Australia, various definitions of the term “small business” also exist, including definitions in terms of the Australian Privacy Act (119 of 1988), the Australian Fair Work Act (28 of 2009), the Australian Bureau of Statistics and the Australian Income Tax Assessment Act (38 of 1997). The Australian small business definition adopted for the purpose of this study was small businesses meeting the definition of a “small business entity” (SBE) in terms of the Australian Income Tax Assessment Act (38 of 1997). Small businesses in terms of Division 328 are classified as SBEs if their annual aggregated turnover is less than AUD10 million (R106,4 million) in an income year.

6.3.2 Analysis of Section 12E: SBCs

In Chapter 3, the tax relief available in South Africa to entities that meet the definition of a SBC was investigated. It was identified that the benefits that entities derive from applying SBC concessions, include both reduced rates of corporate tax and accelerated wear and tear allowances (Income Tax Act, 58 of 1962).

The SBC concessions have been criticised for being overly onerous and complex (Stols, 2013:12). These criticisms were investigated in detail and were found to be mainly directed at the criteria used to apply the SBC concessions. The gross income requirements, the ownership structure, and restrictions placed on natural persons from undertaking more than one SBC were all requirements that were criticised.

The current SBC gross income requirement of R20 million was criticised as being too low, especially in light of the fact that an increased gross income requirement may provide more small businesses with tax relief (Davis Tax Committee, 2014:19). The ownership criteria criticism relates to the fact that only natural persons may be the holders of shares or members of an SBC. This was criticised as it can lead to scenario in which a SBC has to face a choice between qualifying for tax relief in terms of Section 12E or possibly attracting an investor in the form of another company (Davis Tax Committee, 2014:19).

The restriction on the natural person holders of shares or members of the SBC relates to the fact that these natural persons are disqualified from holding shares in other SBC's

(Income Tax Act, 58 of 1962). This was criticised because natural person entrepreneurs often own more than one business in order to diversify risk and increase growth opportunities (Stols, 2013:12).

Available statistics on the application of Section 12E examined in Chapter 3 found that a very low number of entities that potentially qualify for Section 12E tax relief are actually applying the SBC concessions. Based on the latest available statistics, only 33,49% of potential SBCs in 2014 applied for reduced corporate tax rates. What is of greater concern than the above-mentioned statistics, is that the number of entities applying for tax relief appears to diminish over time (South African Revenue Service, 2015b).

6.3.3 Analysis of Division 328: SBEs

Chapter 4 examined the tax relief available to small businesses in Australia, specifically small businesses that meet the definition of a SBE in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997). The findings showed that the tax relief available to SBEs include reduced corporate tax rates, simplified trading stock and prepaid expenditure rules, the optional use of cash accounting and the pooling of capital assets for depreciation purposes (Australian Income Tax Assessment Act, 38 of 1997).

It was also determined that the tax relief available in Australia progressed from the STS system first implemented in 2001. In the STS, all of the tax relief in terms of the system was compulsory and was eventually replaced by the SBE system in 2007. It was discovered that the SBE system is a far more flexible system than its predecessor (Kenny, 2008:226), as the tax relief options in terms of the SBE concessions are not compulsory. The SBE system also increased the scope of entities qualifying for tax relief, as the turnover threshold was increased from AUD1 million (R10,64 million) under the STS to AUD2 million (R21,28 million) under the SBE system. Moreover, over 84% of the 914,508 entities assessed during the 2014/2015 Australian tax year were classified as either micro or small businesses that enabled them to access SBE tax concessions (Australian Taxation Office, 2015). In 2016, the turnover requirement for qualifying SBEs was

increased once again from AUD2 million (R21,28 million) to AUD10 million (R106 million) (Australian Taxation Office, 2017e).

6.4 A critical comparative analysis between Section 12E and Division 328 and recommendations

6.4.1 Critical comparative analysis findings

Chapter 5 critically compared the small business tax relief available in South Africa with its Australian counterpart. The critical comparison determined that both countries use turnover/gross income as a mechanism in determining whether an entity qualifies for small business tax relief. In Australia, the concept of aggregated turnover is used, meaning that an entity should include the turnover of affiliates and other connected individuals/persons in order to determine whether it meets the SBE turnover requirement. This was identified as an anti-avoidance mechanism built into the Australian small business tax legislation (Kenny, 2008:232). Entities that meet the definition of a SBE in Australia, qualify for corporate tax, FBT, GST and CGT tax relief.

The shortcomings identified with regard to Section 12E in the comparative analysis are set out below.

6.4.1.1 Definition of a small business

A more standardised definition of the term “small business” exists within the Australian Income Tax Assessment Act (38 of 1997) when compared to the South African Income Tax Act (58 of 1962). Australian entities only need to comply with the definition of a SBE for tax legislative purposes in order to access tax relief. In South Africa, there are at least four definitions provided respectively in the Income Tax Act (58 of 1962), Section 12E, Section 12J, and the 6th and 8th schedule. The lack of a consistent small business definition for tax purposes adds to compliance costs small business face in South Africa

(Smulders, 2006:33). Aligning the definition of a small business for tax purposes is an important step towards the reduction of these costs (McKerchar & Drever, 2008:131).

It should be noted, however, that some of the benefits require SBEs to consider additional requirements in order to determine whether they meet the appropriate criteria. A SBE wishing to apply for the CGT benefit may not have assets exceeding AUD6 million (R63,84 million) (Australian Taxation Office, 2017b). The shortcoming regarding the definition of small businesses in South Africa were discussed within Chapter 5.2.

6.4.1.2 The low South African gross income requirement

The South African gross income requirement of R20 million to qualify as a SBC, according to Section 12E, is low when compared to the Australian turnover requirement used for corporate tax concessions of AUD10 million (R106 million) for a SBE in terms of the Australian Income Tax Assessment Act (38 of 1997). This was discussed within Chapter 5.3.1.

6.4.1.3 The South African anti-avoidance mechanisms

In Australia, a SBE must determine its annual aggregated turnover, and if this annual aggregated turnover is less than AUD10 million (R106,4 million), the SBE qualifies for tax relief (Australian Income Tax Assessment Act, 38 of 1997). These aggregation rules entail that a SBE must consider its own turnover, and that of its affiliates or entities connected to the entity (Kenny, 2008:239-240) in order to derive “aggregated turnover”.

In South Africa, no aggregation rules exist to determine gross income. Instead, Section 12E specifically disallows certain entities from qualifying for SBC tax relief – entities that do not only have natural person holders of shares and those where its natural person holders of shares hold more than one SBC are disqualified (Income Tax Act, 58 of 1962). These disqualifications serve as Section 12E anti-avoidance mechanisms, but have been criticised for being overly onerous (Davis Tax Committee, 2014:19; Stols 2013:12). In

Australia, there are no similar restrictions placed on the holders of shares of a SBE. The scope of small businesses that may qualify for SBE concessions is, therefore, widened. The limitations of South Africa anti-avoidance mechanisms for small business tax relief when compared to its Australian counterpart was discussed within Chapters 5.3.3 and 5.3.4 of this study.

6.4.1.4 The nature of gross income in South Africa

In South African tax legislation, no more than 20% of the gross income of a SBC may be derived from personal services or investment income. However, no restrictions are placed on the nature of the turnover of a SBE in Australian tax legislation. This shortcoming was identified within Chapter 5.3.5 of this study.

6.4.1.5 The mismatch between incorporated and unincorporated businesses in South Africa

The study also determined that South African SBC concessions provide tax relief strictly to incorporated small businesses. This fixation on the incorporation status of entities may be unwarranted given the fact that an entity formally incorporating will not necessarily lead to growth in entrepreneurship (Chamberlain & Smith, 2006:4). Australian SBE concessions provide relief to incorporated entities and unincorporated entities if unincorporated entities have an aggregated annual turnover of less than AUD5 million in a year of assessment. (Enterprise Tax Plan Explanatory Memorandum, 2016:4). Unincorporated SBE entities in Australia qualify for relief where 5% of their basic income tax liability can be offset. This benefit is capped at AUD1,000 (approximately R10,640) per income tax year (Enterprise Tax Plan Explanatory Memorandum, 2016:4). This shortcoming in South African small business tax relief was discussed within Chapter 5.3.2 of this study.

The criticism against only providing tax relief to incorporated entities has also been mentioned in Chapter 3. Incorporated owner-managed businesses may achieve

significant benefits from incorporating without changing their level of economic activity (Freedman & Crawford, 2008:28).

6.4.1.6 The forms of tax relief available in South Africa

South African entities that meet the definition of a SBC only qualify for corporate tax relief in the form of reduced corporate tax rates and accelerated wear and tear allowances (Income Tax Act, 58 of 1962). In Australia, entities that meet the definition of a SBE qualify for corporate tax, reduced corporate tax rates, differentiated prepaid expenditure, wear and tear allowances and trading stock rules.

Although South African entities qualify for prepaid expenditure concessions in terms of Section 23H, this relief is not specifically aimed at small businesses and is less generous due to a value limitation and only applies to expenses prepaid in advance of six months. In contrast, the prepaid expenditure concession offered to Australian small businesses has no value limit and is applicable to expenses paid one year in advance.

The comparison of the different forms of tax relief provided to South African and Australian small business was made within Chapter 5.4 of this study.

6.4.2 Recommendations

There have been several suggestions on how to extend the scope of Section 12E tax relief. The DTC suggests that small business tax relief should be replaced by a rebate offered to qualifying small businesses (Davis Tax Committee, 2014:20).

Chamberlain and Smith (2006:34) are of the opinion that in order to minimise the deadweight burden that compliance costs impose on businesses, it is necessary to embrace a process of smart regulation – rather than focusing on deregulation. Chamberlain and Smith (2006:34) further define “smart regulation” as a move away from deregulation towards monitoring and controlling regulations that SMEs face.

Based on the outcomes of this study, the following recommendations are made:

6.4.2.1 Consistent use of the small business definition in tax legislation

It is recommended that South African tax legislation should include a more standardised definition for the term “small business”. This will ensure that the selected definition does not add to the tax compliance costs of small businesses. One consistent definition of a small business should be used in legislation to determine whether entities meet the requirements for turnover tax, capital gains tax, Section 12E and Section 12J relief.

6.4.2.2 Increasing the turnover/gross income requirement

It was noted in Chapter 3 that the gross income requirement of Section 12E was last increased in the 2013 budget from R14 million to the current R20 million gross income requirement (Department of Finance, 2013a:12). It is, therefore, recommended that the gross income threshold should be increased. As previously mentioned, the DTC recommends increasing the gross income requirement from R20 million to R50 million (Davis Tax Committee, 2014:19). However, this study recommends that the gross income should at least be increased to R64 million to align with the maximum turnover threshold applied by the National Small Business Amendment Act (26 of 2003), as discussed within Chapter 2.2.1 of this study.

6.4.2.3 The aggregation rules

It is recommended that South Africa explores the use of aggregation rules as an anti-avoidance mechanism rather than the current integrity rules in place. Specifically, the rules pertaining to the shareholding of a SBC that may only be held by natural persons and the restrictions on the shareholdings of these natural person holder of shares of the SBC is recommended to be changed. The anti-avoidance mechanisms built into Section 12E relating to ownership requirements should not be ignored. However, smart regulation

can be utilised, ensuring that anti-avoidance mechanisms still exist whilst still providing relief to SBCs that genuinely should qualify for tax relief.

The change this study recommends is that the definition of “connected person” within Section 1 of the Income Tax Act is utilised to determine the total amount of gross income of a SBC. A SBC can, therefore, consider the gross income of the entity together with that of its connected person entity in order to determine its total gross income. This change can easily be implemented given the fact that “connected persons” are already defined in detail (Income Tax Act, 58 of 1962) and that a similar process of aggregating gross income already exists within the VAT Tax Act (89 of 1991).

Currently, the aggregation rules in the VAT Act (89 of 1991) are used to determine when individuals are liable to register as VAT vendors. In terms of Section 23(1)(a)-(b) of the VAT Act (89 of 1991), any individual who delivers total taxable supplies exceeding R1 million in a 12 month period is obliged to register as a VAT vendor (Value-Added Tax Act, 89 of 1991). Individuals who carry on several businesses or who operate a business in several branches and divisions, cannot avoid registering for VAT by considering the taxable supply of each business separately. Instead, the taxable supplies of all the separate businesses and branches are “aggregated” to determine whether the R1 million registration threshold has been met (South African Revenue Service, 2016e:14).

What aggregation rules within Section 12E would possibly entail is that, should a natural person hold shares within two small entities, the gross income of these two entities may be aggregated in order to determine whether it is below R20 million and, therefore, whether the entities would qualify for tax relief. The gross income of these two entities would be aggregated by virtue of them meeting the definition of “connected persons” within Section 1 of the Income Tax Act (58 of 1962).

Similarly, aggregation rules may be used if a SBC does not exclusively have natural person holders of shares. Should a portion of the shareholding of a SBC be held by another incorporated entity, the gross income of these two entities could be aggregated

by virtue of them meeting the definition of “connected persons” in Section 1 of the Income Tax Act (58 of 1962). If the aggregated gross income is less than the R20 million threshold, a SBC should be able to qualify for tax relief.

6.4.2.4 The holders of shares of the SBC

Another recommendation for the SBC definition is that the requirement that all the holders of shares of the SBC be natural persons possibly be changed. Although the previous section mentioned aggregation rules as a possible mechanism to change this requirement, this section focuses on yet another recommended change.

The limitation that all the holders of shares of the SBC should be natural persons has faced certain amounts of criticism (Davis Tax Committee, 2014:19), especially against the requirement that 100% of the shareholding of the SBC must be held by natural persons. In Chapter 3, it was examined how the above-mentioned requirement may be working against other legislation, such as the Section 12J venture capital financing relief and how small businesses face a choice between qualifying for tax relief in terms of Section 12E or for increased finance in terms of Section 12J.

It is, therefore, recommended that the requirement stating that 100% of the holders of shares of the SBC must be natural persons be changed. The DTC has recommended changing this requirement so that at least 33,3% of the shareholding of a SBC may be held by another company (Davis Tax Committee, 2014:19).

6.4.2.5 Relief for both incorporated and unincorporated entities

It is recommended that in order to address the mismatch in relief provided to incorporated or unincorporated small businesses in South Africa in terms of SBC concessions, relief should be extended under Section 12E to include unincorporated small businesses. This relief can be structured in a similar manner to the Australian unincorporated SBE relief, namely by making use of a tax offset percentage.

6.4.2.6 Recommendations for future research concerning South African small business tax legislation

Throughout the study, various areas of possible future research have been identified and are presented in the following section.

The first recommended area of possible future research is the possibility of increasing the scope of small business tax relief available in terms of Section 12E. Currently, tax relief is limited to accelerated wear and tear allowances and reduced corporate tax rates (Income Tax Act, 58 of 1962). In Australia, entities that meet the definition of a SBE qualify for tax relief, such as the optional use of cash accounting, differentiated trading stock and prepaid expenditure rules (Australian Income Tax Assessment Act, 38 of 1997). Research can, therefore, be conducted to determine whether or not small businesses in South Africa may benefit from similar differentiated forms of tax relief.

It is also recommended that research should be performed on the fact that no more than 20% of the gross income of a SBC may be derived from personal service and investment income. Moreover, a SBC may not be a personal service provider (Income Tax Act of South Africa, 58 of 1962). It was noted in Chapter 4 that no comparable limitation on turnover or the nature of than entity is applicable to SBEs in Australia (Australian Income Tax Assessment Act of 1997). Research can, therefore, be conducted to determine whether or not these requirements are overly onerous when compared to other systems of small business tax relief, including whether there is scope to relax these requirements.

As mentioned in Chapter 3, no tax relief is provided to unincorporated small businesses. This has faced criticism as it is argued that focusing tax relief on incorporated small businesses ensures that the tax consequence of the taxpayer is altered significantly without necessarily altering the economic activity of that taxpayer (Freedman & Crawford, 2008:6). As mentioned previously in Chapter 4, in Australia relief is provided to both incorporated and unincorporated small businesses in terms of the SBE rules, albeit

different forms of tax relief provided to the two forms of business. It is, therefore, recommended that research should be performed into the possible provision of tax relief to unincorporated entities in South Africa in terms of Section 12E provision.

Research should also be undertaken to determine whether use should be made of “averaging” in order to determine the gross income of a SBC. As mentioned within Chapter 4.2, small businesses in Australia originally applied an “average turnover” threshold, meaning that small business averaged their income over a three year period to determine whether they qualified for the small business tax relief (Kenny, 2008:231). This ensured that small businesses did not disqualify for relief if their turnover was unusually high in a specific tax year (Tretola, 2007:2). Research can therefore be performed to determine whether applying an average gross income requirement in South Africa could potentially increase the scope of SBC tax relief.

Further research is required regarding other recommendations made in terms of this study. Research should determine the optimal gross income level of a SBC, as it has been noted that the current R20 million threshold is deemed too low in value. Research is needed concerning the structuring of the connected person rules as an alternative to the current anti-avoidance mechanisms in Section 12E, including any limitations to these connected person rules. Research should focus on the optimal interest that a juristic person holder of shares may have in a SBC for it to still qualify for small business tax relief.

6.5 Concluding remarks

In order for South Africa to achieve the developmental objectives it has set for itself in terms of the NDP, support should be offered for small businesses, including support in terms of the tax compliance costs facing small businesses. Currently, the South African government aims to assist small businesses with tax compliance costs through the offering of Section 12E income tax relief.

Section 12E, however, does not adequately achieve the easing of the tax compliance burden, as the eligibility criteria are overly complex and onerous. When compared to the small business tax relief provided in terms of Division 328 of the Australian Income Tax Assessment Act (38 of 1997), several shortcomings in the South African Section 12E legislation are noted. This is especially true with regard to the definitions of small business in South African tax legislation and the anti-avoidance measures used within Section 12E. Criticism was voiced against the form of tax relief provided by Section 12E.

In order to assist small businesses with tax relief, a standardised and more coherent definition of the term “small business” should be built into the Income Tax Act (58 of 1962). Moreover, it should also be ensured that the criteria used for the classification of a business entity as a SBC and anti-avoidance measures built into Section 12E should not unnecessarily disqualify entities from applying for corporate tax relief. Several recommendations to improve the current Section 12E were therefore proposed.

6.6 Limitations of the study

This study focused on a comparison between Section 12E of the South African Income Tax Act (58 of 1962) and Division 328 of the Australian Income Tax Assessment Act (38 of 1997) to offer recommendations on how to improve corporate income tax relief offered to SBCs. Unfortunately, no comparison was made between the CGT, VAT/GST and other tax benefits applicable to small businesses in South Africa and Australia. This study only compared the South African Section 12E small business tax relief to the tax system of the Australian Division 328 income tax concessions, as these concessions were found to be less onerous and more standardised than the South African Section 12E system. Furthermore, the research presented is not a study or comparison of the tax compliance burden facing small businesses in South Africa or Australia.

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ANNEXURES

Annexure A - The number of SBC's assessed by taxable income group

Tax Year	2011			2012			2013			2014		
Taxable Income Group	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)
A: < -25 000 000	2	-81	–	4	-179	–	2	-124	–	1	-28	–
B: - 10 000 001 to -25 000 000	42	-602	–	36	-524	–	34	-492	–	31	-435	–
C: -5 000 001 to -10 000 000	80	-532	–	101	-660	0	118	-780	–	104	-702	–
D: -1 000 001 to -5 000 000	2,396	-4,228	0	2,694	-4,818	0	2,704	-4,784	0	2,143	-3,907	0
E: -100 001 to -1 000 000	21,512	-7,083	1	20,367	-6,880	1	18,030	-6,162	1	13,512	-4,684	0
F: -1 to -100 000	23,421	-828	0	20,986	-744	0	17,858	-635	1	11,904	-424	0
G = 0	10 235	–	2	18,656	–	1	19,619	–	1	10,535	–	0
H: 1 to 100 000	36,142	1,304	16	34,675	1,320	15	30,918	1,223	9	21,541	895	7
I: 100 001 to 250 000	10,779	1,757	117	10,912	1,785	114	10,648	1,738	76	8,429	1,379	59
J: 250 001 to 500 000	7,521	2,566	283	7,830	2,684	288	8,328	2,921	216	6,916	2,476	172

K: 500 001 to 750 000	2,142	1,307	241	2,292	1,394	251	2,536	1,533	232	2,716	1,634	208
L: 750 001 to 1 000 000	1,070	929	199	1,186	1,031	217	1,298	1,136	216	1,315	1,143	197
M: 1 000 001 to 2 500 000	1,386	2,006	496	1,513	2,246	548	1,559	2,291	530	1,616	2,445	546
N: 2 500 001 to 5 000 000	221	719	199	235	764	207	245	796	208	326	1,068	273
O: 5 000 001 +	22	151	50	24	141	40	29	188	52	53	377	102
Total	116,971		1,606	121,511		1,683	113,926		1,542	81,142		1,564

Source: SARS Tax Statistics, 2015.

Annexure B - The number of SBC's assessed by economic activity

Tax Year	2011			2012			2013			2014		
Economic Activity (1)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)
Primary Sector	4,256	-958	68	4,474	-979	85	4,604	-982	95	3,684	-797	111
Agriculture, Forestry and fishing	4,064	-943	65	4,270	-969	79	4,324	-988	88	3,443	-806	104
Mining and Quarrying	192	-15	4	204	-10	6	280	6	8	241	10	8
Secondary Sector	33,916	-1,220	438	38,070	-1,201	478	38,121	-771	480	26,156	91	476
Manufacturing (2)	17,081	-562	265	18,083	-533	290	18,146	-257	293	12,925	167	289

Electricity, gas and water	730	15	15	864	-20	15	966	13	13	679	23	15
Construction	16,105	-673	158	19,123	-647	173	19,009	-528	175	12,552	-99	171
Tertiary Sector	78,705	-438	1,097	78,914	-260	1,120	71,186	602	966	51,294	1,943	977
Wholesale and retail trade, catering and accommodation (3)	34,822	-852	361	33,917	-780	345	29,754	-537	278	21,532	1	286
Transport, storage and communication	6,288	-252	88	6,321	-300	79	5,965	-211	69	4,062	-24	71
Financial intermediation, insurance, real-estate and business services (4)	28,731	383	477	28,977	605	507	25,460	724	398	18,320	1,304	421
Community, social and personal services (5)	8,864	283	171	9,699	215	189	10,007	627	220	7,380	662	200
Other (6)	94	1	2	53	-1	0	15	-0	0	8	-0	0
Total	116,971		1,606	121,511		1,683	113,926		1,542	81,142		1,564
Percentage of Total												
Primary Sector	3.6%		4.3%	3.7%		5.1%	4.0%		6.2%	4.5%		7.1%
Agriculture, Forestry and fishing	3.5%		4.0%	3.5%		4.7%	3.8%		5.7%	4.2%		6.6%

Mining and Quarrying	0.2%		0.2%	0.2%		0.3%	0.2%		0.5%	0.3%		0.5%
Secondary Sector	29.0%		27.3%	31.3%		28.4%	33.5%		31.1%	32.2%		30.4%
Manufacturing	14.6%		16.5%	14.9%		17.3%	15.9%		19.0%	15.9%		18.5%
Electricity, gas and water	0.6%		0.9%	0.7%		0.9%	0.8%		0.8%	0.8%		0.9%
Construction	13.8%		9.8%	15.7%		10.3%	16.7%		11.3%	15.5%		11.0%
Tertiary Sector	67.3%		68.3%	64.9%		66.5%	62.5%		62.7%	63.2%		62.5%
Wholesale and retail trade, catering and accommodation	29.8%		22.5%	27.9%		20.5%	26.1%		18.1%	26.5%		18.3%
Transport, storage and communication	5.4%		5.4%	5.2%		4.7%	5.2%		4.5%	5.0%		4.5%
Financial intermediation, insurance, real-estate and business services	24.6%		29.7%	23.8%		30.1%	22.3%		25.8%	22.6%		26.9%
Community, social and personal services	7.6%		10.7%	8.0%		11.2%	8.8%		14.3%	9.1%		12.8%
Other	0.1%		0.1%	0.0%		0.0%	0.0%		0.0%	0.0%		0.0%
Total	100.0%		100.0%	100.0%		100.0%	100.0%		100.0%	100.0%		100.0%

Source: SARS Tax Statistics 2015

(1) SARS' source of income code is used to classify according to the Standard Industrial Classification (SIC) system. SARS' source of income code is not fully aligned with the SIC system that Statistics South Africa uses.

- (2) *Includes the following SARS sectors – Bricks, ceramic, glass, cement and similar products; Chemicals and chemical, rubber and plastic products; Clothing and footwear; Coal and petroleum products; Food, drink and tobacco; Leather, leather goods and fur (excl. footwear & clothing); Machinery and related items; Metal (including metal products); Other manufacturing industries; Paper, printing and publishing; Scientific, optical and similar equipment; Textiles; Transport equipment; and Wood, wood products and furniture.*
- (3) *Includes the following SARS sectors – Catering and accommodation; Retail Trade; Specialised Repair Services; Vehicles, parts and accessories; and Wholesale Trade.*
- (4) *Includes the following SARS sectors – Agencies and other services; Financing, insurance, real estate and business services; Long Term insurance; and Research and Scientific Institutes.*
- (5) *Includes the following SARS sectors - Educational services; Medical, dental and other health and veterinary services; Personal and household services; Recreation and cultural services; and Social and related community services.*
- (6) *Includes where the source of income was indicated as Other (as per SARS source code) or where the source of income was left blank on the return.*