



# **Making an impact that matters**

Budget 2019/2020

Pre-budget commentary

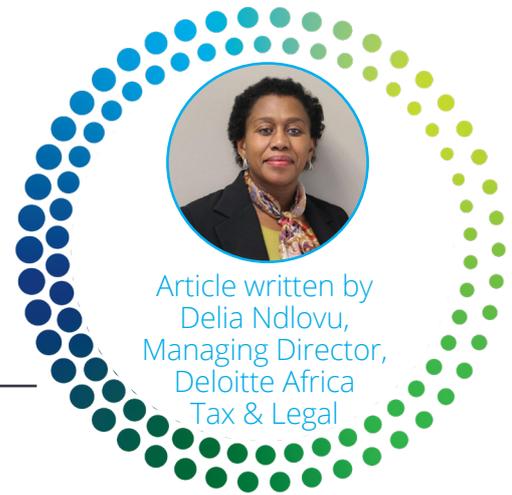
South Africa

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# An interesting Budget for an interesting year



## Finance Minister Tito Mboweni has a tough task ahead of him as he seeks to present a Budget which will meet with public approval ahead of the national election, while also coming to terms with the pressing need to grow South Africa's economy.

At last year's Medium Term Budget Policy Statement, delivered in October, the minister spoke of the need to reform and stabilise state-owned enterprises. The state faced a R27.4 billion revenue shortfall for 2018/2019, and an R85 billion shortfall over three years. Debt service costs are expected to grow by almost 11% every year, from R181 billion in 2018 / 2019, to R247 billion in 2021 / 2022, according to the MTBPS.

South Africa's GDP is expected to grow 1.3% this year, higher than last year, but still a concerning rate. There are also fears that Moody's, the only agency to rate South Africa above junk status, may drop its rating and the Budget speech will be a key factor Moody's will weigh up, as it gives direction on government priorities and spending plans.

We expect that the long-term priority areas of the National Development Plan will continue to guide this year's Budget. With the economy still weak, we hope that Minister Mboweni and his colleagues at the National Treasury will be prioritising growth and investment.

Eskom has asked for a R100-billion bailout from government so that it can stabilise its finances, and is being pushed to deliver a turnaround plan ahead of the Budget presentation on 20 February, according to reports. Eskom's role in the economy is a critical one, with the World Bank warning recently that it is too big to fail. It's likely, then, that funding Eskom will occupy a central position in the Budget.

In addition, former President Jacob Zuma last year committed government to funding tertiary education for students with a household income of R350 000 or less, costing the fiscus R57 billion – a decision which will continue to impact this year's Budget despite concerns that this is not sustainable.

In this climate, it is hard to see how National Treasury will be able to prioritise the National Health Insurance (NHI) scheme, despite the years of planning and political will which have gone into this initiative.

South Africa's economy has seen low growth over the past few years and ordinary consumers are feeling the pinch. Since raising taxes will be difficult, one way of bringing in additional revenue is by increasing collections and building capacity at SARS. We expect that this will be a priority, as the MTBPS already allocated R1.4 billion to this task in October.

While government will find it difficult to raise taxes so close to an election period, and with local taxes already relatively high, we can expect to see some adjustment of tax brackets so as to tax high income earners more and give relief to lower-income taxpayers.

We also do not expect another VAT increase, particularly so close to the elections, but further clarity and guidance is needed on certain aspects of VAT regulations, for example the treatment of educational services, electronic services, and VAT deductions and crypto-currency.

# Growing South Africa inclusively - Is there room to manoeuvre in the tax system?



On 20 February 2019 all eyes will be on the Minister of Finance Tito Mboweni as he presents the 2019/20 annual National Budget in Parliament.

The National Budget speech has over the years given South Africans a credible sense of the economic outlook of the country and this year, once again, it will be presented against a challenging global and South African fiscal and economic backdrop.

During a year in which South Africans head to the polls, Minister Mboweni will need to articulate a careful balancing act between both "spending" and "revenue-generating" activities to ensure fiscal growth in the country whilst at the same time ensuring that our critical social and economic programmes are protected. This year's budget will need to ensure that spending and policy formation is aligned to the president's stimulus package, which seeks to revive our ailing economy, while also ensuring that the South African citizens are not unduly burdened with further tax hikes.

In the recent "Global Economic Prospects" report issued earlier this month by the World Bank Group, it was noted that South Africa's growth is likely to expand by 1.3% in 2019 (a downward revision from the previous projected amount of 1.8%), which is lower than the 3.4% projected average for Sub-Saharan countries. Key reasons for this modest growth include continued high unemployment levels, policy uncertainty and low business confidence.

Thus, whilst South Africa (SA) is growing, we are not growing fast enough; importantly, we are also not growing inclusively enough and as a result poverty and income inequality remain key challenges on SA's agenda. We thus need a buoyant revenue base to address these and other key challenges in SA. Over the last few years, various legislative changes and initiatives have been introduced to sustain and

improve tax collections and broaden the tax base (admittedly, some of these changes, such as the increase in the VAT rate have received notable backlash).

Thus, given our growth expectations, one of the key questions is: What further measures could be introduced by the Minister to generate the required additional revenues?

## South African taxpayers – Who is currently paying what?

Tax is one of the main source of revenue collection for the government. The 2018 Tax Statistics report (which was published during December 2018), noted that tax collections in SA have increased to R1 216.5 billion in the 2017/18 fiscal year (this represents a 6.3% increase (R72.4 billion) over the prior fiscal year).

In SA, personal income taxes, value-added tax (VAT) and corporate income taxes collectively account for approximately 80.7% of the total tax revenues of the country. Of the R1 216.5 billion revenue collected during the 2017/18 fiscal year, personal income taxes continue to be the main contributor to our country's tax coffers, contributing a total of 38.1% of the total tax revenues. VAT contributed 24.5% and CIT contributed approximately 18.1% to the total tax revenue (this has not increased from the prior fiscal year). Other taxes (e.g. transfer duty, capital gains tax etc.) account for the balance of the revenue collected in 2017/18 fiscal year.

It is clear from these statistics, that the man on the street is paying a significant amount of tax (both direct taxes such as personal income tax and indirect taxes, such as VAT). A revenue budget that supports SA's future should therefore go further than just tax increases and alternative avenues should be considered to generate additional revenues.

## Alternative avenues for generating additional revenues

SARS, when announcing its preliminary results in April 2018, noted that *"revenue collection is driven by the state of the economy, the fiscal policy choices, administrative efficiency and taxpayer compliance or tax morality."*

The Medium-Term Budget Policy Statement (MTBPS) which was presented in October last year, the President's stimulus package and the outcomes of the recent Job and Investment summits, provide us with slight hints as to the areas which could potentially be used to contribute additional revenue to the fiscus. We explore some of these below:

### Returning SARS to its former glory

SARS was once the crown jewel of revenue authorities on the continent. However, due to the tax administration and governance issues at SARS in recent years, revenue collections were below targets and inefficiencies crept in. SARS is now on a mission to restore itself to its former glory.

SARS has re-established its Large Business Centre (LBC) unit which seeks to achieve, amongst others, an enhanced customer experience, compliance and revenue focus for large businesses and high net worth individuals. Increasing the ease with which taxpayers can liaise with SARS, targeting specific sectors, freeing up capacity in other divisions (such as Enforcements) to focus on service delivery, will go a long way in increasing revenue generation and tax morality.

In addition, SARS' recent announcement to impose administrative non-compliance penalties for non-compliant corporate taxpayers will encourage tax compliance and result in increased revenue collections and also sends a clear message that SARS is adopting a "no nonsense" attitude to non-compliance.

### **Increasing revenue through policy decisions that encourage investment**

As announced by Minister Mboweni during the MTBPS, the Mineral and Petroleum Resources Development Amendment Bill will be withdrawn. This should provide more certainty to the energy industry and should encourage investment and increased activity, which in turn will result in additional taxes from taxpayers operating in this sector.

### **Increasing revenue through a clamp down on profit-shifting and the misuse of transfer pricing**

A continuing debate is how to effectively combat the significant financial leakages in the South African economy through the erosion of the tax base, profit-shifting and illicit money outflows. The use of tax havens by taxpayers whereby profits are shifted to no-tax or low tax jurisdictions where the taxpayer has no or very little economic presence, remains a significant concern to the fiscus. It is however also a significant potential pool of revenue, if SA manages to get its fair share of these taxes.

Judge Dennis Davis has called for further investigations into this matter as the country is losing an estimate of R7 billion annually, due to base-erosion and profit shifting. He has also called for the transfer pricing unit at SARS to be reconstituted in order to increase enforcement.

The re-building of the transfer pricing unit at SARS will ensure that targeted audits are conducted and that shifting profits through transfer pricing schemes is clamped down.

It appears that steps are underway at SARS to focus on this matter as part of the LBC's enforcement role is to focus on to base-erosion and profit shifting. Attempts to stop this leakage will add significantly to the revenue collection efforts.

### **Increasing revenue through an increase in personal tax rates?**

SA has a progressive income tax system which is based on the premise that the wealthy should contribute a greater proportion towards supporting the state

than the poor. In other words, the more you earn, the higher tax you should pay.

In line with this premise, we saw an increase in the maximum marginal tax rate from 41% to 45% for the 2018 tax year and annual tax deductions in respect of retirement contributions being capped at R350 000 per annum.

Whilst it is unlikely, given the current economic environment, that the maximum marginal tax rate would be further increased, we do anticipate that the tax brackets at the higher marginal tax rates will have lower than inflationary adjustments, whilst continued tax relief will still be granted for low income earners.

### **Increasing revenue through other sources of personal income tax?**

An analysis of the 2017 tax assessments raised by SARS as detailed in the "2018 Tax Statistics" report reveals the following key information:

- Income from salaries, wages and remuneration accounted for 76.0% of total taxable income assessed;
- Travel allowances amounting to R27.4 billion in total was assessed and this allowance remains the largest of the total allowances assessed, comprising 24.5% of the total allowances assessed;
- Share options exercised amounting to R11.9 billion in total was assessed, comprising 10.7% of the total allowances assessed;
- Contributions to retirement funding amounting to R182.6 billion (85.7%) constituted the largest tax deduction claimed by taxpayers, whilst travel expenses constituted 9.7% of tax deductions claimed.

The above statistics do provide Treasury with guidance on what the "high" ticket items are in our personal tax system and hence, where collection efforts could potentially be focused to increase tax revenues, without increasing the tax rates.

### **Funding the NHI and medical scheme fees tax credits?**

Government is seeking to address the urgent matters in our health care system and has indicated that it will be working with the National Department of Health to ensure that the phasing in of the National Health Insurance (NHI) is adequately financed.

It has been mooted that the medical scheme fees tax credits will be utilised to fund the NHI in part. Whilst we do not anticipate a complete withdrawal of the medical scheme fees tax credits regime, we anticipate lower than inflationary adjustments to the amounts taxpayers may claim as a credit against their normal tax liability.

### **Infrastructure spending**

Infrastructure spending is one of the main components of President Ramaphosa's stimulus package.

In the MTBPS, Minister Mboweni indicated that R15.9 billion will be allocated towards infrastructure programmes. This allocation may be used (in part) to fund the various grants and incentive applications which have come to a halt due to the lack of funding. Since this is a critical focus of the government, we would hope that we see some tax reforms and incentives to encourage infrastructure spend in the private sector.

### **Conclusion**

Whilst the main component of our revenue base will as always be tax revenues, tax is certainly not the only solution to raise additional revenues. Key parts of the solution must also include expenditure cuts, curbing the size of the civil service, reducing policy uncertainty, restore investor confidence, creating jobs etc.

It is clear is that there are tough times ahead and South Africans need to start tightening their fiscal belts, come 1 March 2019.

# Optimising tax recovery through digital innovation



Article written by  
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The South African Revenue Service (“SARS”) was once recognised not only as the best working state organ but also as one of the best revenue authorities in the world in terms of adopting guidance from the OECD on tax matters and in being at the forefront of technology advances. We saw this through the introduction of a world class e-filing system, requests for detailed reconciliations of various taxes to financial statements and analytics audits, among others. In my opinion one of the key factors that propelled SARS to greatness was its embrace of technology.

If we look at the example of the e-filing system, SARS was able to improve the user experience of taxpayers in filing returns and improve communication with them. These are fundamental aspects to consider in any changes SARS makes. If it reduces the administration burden carried by taxpayers, by providing a better experience, SARS can expect greater responsiveness from taxpayers and in turn it will improve compliance to increase revenue collection. What emerging technologies it is exploring to improve its operations and how it interacts with taxpayers?

The fourth industrial revolution (Industry 4.0) is upon us, forcing us to adopt or be left behind. This revolution appears to be changing the way businesses function and, by extension, the stakes by which they are forced to compete. For business leaders accustomed to traditional linear data and communications, the shift to real-time access to data and intelligence enabled by Industry 4.0 would fundamentally transform the way they conduct business. This inadvertently will change how tax authorities administer regulation of this changing business landscape. We are already seeing the introduction of real-time reporting to tax authorities:

- Brazil - disclose full invoice details before obtaining valid invoice number,
- Hungary - online connection established between invoice invoicing software and the tax authorities’ system,
- Tanzania, Malawi, Zambia, etc. – use of fiscal device which transmit data real-time to revenue authority at point of sale.
- Various European countries - requests for standard audit file for tax (SAF-T)

These are examples of how tax authorities are trying to introduce more efficient processes for tax collection, gain greater visibility and more real-time access to taxpayer data. One of the items for SARS to take into account, which multinationals are certainly already considering, is obtaining better data granularity, that is standardised across various taxes and accessible more easily and quickly to respond to the greater demands of data being put on them by revenue authorities. This single source of truth approach which can leverage technologies such as blockchain is definitely a must for consideration.

Our revenue authority now has a great opportunity to leapfrog ahead by being bold in how it uses digital innovation to change how it enforces the tax regulation and collects revenue. We hope that in the upcoming budget speech there will be an announcement around how it will invest in these digital advances.

# Transfer Pricing: Taxpayers should brace for attention from SARS



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In recent years South African taxpayers which form part of multi-national enterprises (MNE's) have been burdened with a significantly increased compliance obligation in relation to transfer pricing (TP). For many years South Africa had TP rules but their actual enforcement by SARS was somehow inconsistent. For one thing, TP adjustments previously could only be made by SARS and SARS could not get to all affected taxpayers. In addition, the preparation of TP documentation was optional for taxpayers.

The landscape has since changed dramatically. The first fundamental shift occurred in 2012, when the onus to make TP adjustments was shifted to taxpayers themselves. This means that, if such adjustments are not made by a taxpayer at year-end, the taxpayer is potentially liable for interest plus the full range of penalties imposed by the Tax Administration Act (including secondary TP adjustments). The second key change was that the annual submission of TP documentation has become compulsory for many taxpayers. SA's documentation rules follow those of the OECD, and include the preparation of the following – in terms of the OECD's so-called 3 tier approach:

- Tier 1: The preparation and submission of a country-by-country (CbC) report by: 1) a South African based MNE (i.e. a South African ultimate holding entity) with an annual consolidated turnover exceeding R10 billion; and 2) a South African taxpayer that is part of a MNE group (i.e. ultimate holding entity is in a foreign jurisdiction) with an annual consolidated turnover exceeding EUR750 million and specific exceptions do not apply. This report is usually submitted by the ultimate holding company in the group and is then exchanged by the revenue

authority in that country with all the other revenue authorities in countries where the group has operations.

- Tier 2: A masterfile – consistent for the whole group. This document, which describes various aspects of the group's operations, is prepared centrally but submitted separately by the various group operating companies together with their respective local files.
- Tier 3: Local file – a document which is specific to the operations of the relevant operating company. The preparation of local files is usually co-ordinated centrally by the group (with significant input from the center) but the local file is specific to each operating company.

In addition to the OECD documentation requirements, SARS also issued certain transfer pricing record keeping requirements of its own.

The result of these new rules is that:

- SARS will have received numerous CbC reports from other revenue authorities relating to SA subsidiaries of foreign based MNE's.
- SARS will also have received CbC reports submitted by SA-based MNE's.
- In addition, SARS is now receiving a deluge of master files and local files, which are required to be submitted via e-filing (CbC01 form) by no later than 12 months after the financial year-end (provided that taxpayers meet certain thresholds with respect to the value of their foreign related party transactions).
- Taxpayers are holding additional information available to be reviewed by SARS in terms of its additional TP record keeping requirements.

There are clearly considerable challenges for SARS associated with processing this vast volume of information. Like taxpayers, SARS is faced with capacity constraints as TP specialists are in short supply. It therefore seems likely that SARS will invest heavily in technology to help with processing and analysing TP information. Such technology might, for example, enable SARS to do initial risk profiling of taxpayers based on information received. The taxpayers identified as a result of this step might be subject to further analysis and even targeted for audits.

Therefore, while many taxpayers are sighing with relief having succeeded in submitting their TP documentation for the first time, this feeling of wellbeing is likely to be short lived. It is likely that TP will continue to be an area of focus for SARS going into the future.

It is important for taxpayers to remain as close as possible to the ongoing developments in this area. Specifically, taxpayers should try to understand the approach taken by SARS (and the technological tools used) in processing the information received.

Since TP documentation now needs to be submitted annually there also needs to be a robust process to ensure that it is updated timeously and with a view to mitigating risks which are identified.

# Unpacking our import activity



The 2018 Tax Statistics publication is compiled from the latest available data from National Treasury and the South African Revenue Service (SARS) and was published in December 2018. Apart from providing valuable insight into tax collections across the three main types, Personal Income Tax, Corporate Income Tax and Value-Added Tax the publication also provides valuable information on customs collections and emerging trade patterns. Increased levels of import activity are also a good sign of a flourishing economy.

In summary, the publication reveals the following for the 2017/2018 fiscal year:

- Total tax revenue collected – R1 216.5 billion (6.33% increase)
- Number of registered importers - 310 784 (3% increase)
- Import VAT contribution to total revenue – R152.8 billion or 12.6% (2.36% increase)
- Customs duties contribution to total revenue – R49.2 billion or 4.0% (7.84% increase)
- Main contributor to import VAT – machinery and electronics 26.6%
- Main contributor to customs duties – vehicles, aircrafts and vessels 26.8%
- Main contributor by world trade zone to total import tax – Asia R96.7 billion or 47.2%
- Main contributor by Port of Entry to total import tax – Durban harbour R88.1 billion or 43.0%

Customs duties are imposed in accordance with the Customs and Excise Act, 1964 with the aim of raising revenue and providing a level of protection to the domestic market. The term 'customs duties' as reflected in the above statistics comprises the general customs duties imposed on imported goods as well as any specific excise duties and ad valorem duties collected on such goods. General customs duties are either levied on an ad valorem basis (i.e. as a percentage of the customs value of the imported goods) or on a specific duty basis (i.e. at a rate of cents per unit for example per kilogram, metre or litre). The customs value is based on

the 'free-on-board' price and includes the actual transaction value (the price actually paid or payable) plus all costs, charges and expenses up to the point where the goods are loaded onto a ship (or other vehicle) at the port of export.

VAT is levied in accordance with the Value-Added Tax Act, 1991 at either the standard rate or, in certain instances, the zero rate. The statistics above do not reflect the impact of the increase in the standard rate from 14% to 15% with effect from 1 April 2018. The import VAT is based on the customs value of the imported goods plus an upliftment of 10% thereof to cover assumed costs such as insurance and freight (the upliftment does not apply to goods imported from Botswana, Lesotho, Namibia and Eswatini).

Main import suppliers and contributors to the customs value of imported goods by trade zone were as follows:

- Asia - 37.1%
- Africa – 26.2%
- Europe – 25.8%

The European Union, as a trade bloc, remained South Africa's main supplier of imported goods contributing 24.5% of the customs value followed by the African Union and BRICS contributing 24.3% and 20.6% respectively.

The main contributors to total import tax by country of origin were as follows:

- China – R52.9 billion (mainly machinery and electronics, textile and clothing, and footwear and accessories)
- Germany – R24.8 billion (mainly automotive parts and vehicles, aircraft and vessels)
- United States – R14.1 billion (mainly machinery and electronics, and chemical products)
- United Kingdom – R8.8 billion
- India – R8.7 billion
- Japan - R7.8 billion.

The Port of Durban, which is the largest and busiest shipping terminal in sub-saharan Africa, contributed R88.1 billion of the total import tax by customs port of entry (mainly from mineral products, machinery and electronics, and vehicles, aircraft and vessels) to the economy followed by O.R. Tambo International Airport with a contribution of R33.1 billion (mainly from machinery and electronics).

Looking forward, the estimated collections for the 2019 fiscal year, after the mid-term revision, are as follows:

- Total tax revenue – R1 317.6 billion i.e. an increase of some 8.31%
- Customs duties – R54.025 billion i.e. an increase of some 9.81%
- Import VAT – R170.712 billion i.e. an increase of some 11.723%.

Considering that the 1% increase in the VAT rate could yield an additional 7% in VAT collections, it would seem that the import VAT collections might be realised. However, the low growth in our domestic economy and depressed demand from consumers and businesses for imported goods will place this year's collections of import taxes under significant pressure.

In conclusion, the above statistics are a useful measure of how our country has performed from an import trade perspective. No doubt, our 2019 performance will be judged in a similar way. We should, however, remain mindful of the following comment made by the Minister of Finance in his October 2018 Medium Term Budget Policy Statement:

***'However, it is more than a set of numbers, reams of data, charts, graphs or words. Our performance should be measured by whether people are gainfully employed, whether our children are learning in decent schools, and whether we have health care facilities that are up to standard.'***

# National Health Insurance predictions



## In a year of elections and economic uncertainty, is National Health Insurance a priority for National Treasury?

The February 2019 Budget speech is again likely to be underpinned by the long-term priority areas outlined in the National Development Plan. With the country moving out of a technical recession but still forecasting weak growth, it is uncertain whether Finance Minister Tito Mboweni will prioritise the funding and implementation of the NHI.

Due to the forthcoming national elections, any meaningful reforms and budget cuts are likely to be postponed to after May. While the ruling party's election manifesto states that the implementation of NHI remains a central priority, much of the budget is expected to focus on economic stimulus as outlined in the October medium term budget policy statement.

This is in addition to the focus on education and the growing cost of free higher education, while the efforts to support infrastructure development, the growing debt burden of state-owned enterprises and the 2018 tax shortfall of R27.4 billion are likely to limit the allocation of funds for NHI.

Updates on sugar tax collections, as well as projected revenue of the incoming carbon emissions tax which will begin collection on 1 June 2019 could be provided. However, it is unclear as to the use of these funds and extent of their allocation to NHI.

At the Presidential Health Summit in October, the removal of medical aid tax credits and the use of the resulting tax proceeds to fund NHI was proposed again. This was not reiterated in the October budget speech following the summit, and it appears unlikely that it will materialise in the upcoming budget. This follows the Davis Tax Committee's finding to National

Treasury in 2017 that "the phasing-out of the medical tax credits can only happen once the NHI is fully operational" due to its impact on the poorest medical scheme members.

Further, the need for a complementary and supplementary role of private insurance as well as cooperation between the public and private health systems was raised at the summit. This was illustrated by example of the major under-utilisation of capacity in the private sector that could accommodate the needs of an additional 7.7 million people.

The Medical Schemes Amendment Bill was published and presented by Health Minister Dr Aaron Motsoaledi in June 2018. Proposed changes include the abolishment of co-payments, meaning that medical schemes pay in full for health services. According to Motsoaledi, members paid R29 billion in co-payments in the last financial year. Further, the cross-subsidisation of high-claiming members with low-claiming members is also proposed. This parallels NHI in which young and healthy members will subsidise the old and sick.

The Bill also aims to create a central beneficiary register which will be used by government to identify trends and assess risks within medical schemes. Furthermore, it proposes to replace prescribed minimum benefits with comprehensive service benefits which include vaccinations, screening and family planning.

While the Bill is unlikely to heavily impact the budget allocation to NHI, it represents an alignment of the private medical schemes industry with NHI.

Both the proposals of the Presidential Health Summit as well as the Medical Schemes Amendment Bill continue to build on the proposed Hybrid NHI model, wherein advantage is taken of existing infrastructure, skills and systems within the current healthcare system. This approach suggests that the employed and wealthy continue to fund themselves, with minimal support from the taxpayer and therefore directs more funding to poor and unemployed.

The consideration of the hybrid model will serve to reduce anticipated costs of implementing NHI as it leverages off existing infrastructure. This may support government in balancing the need to focus on NHI while also meeting additional budgetary requirements.

# Mergers and acquisitions in South Africa – No light at the end of the tunnel for now

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The landscape for mergers and acquisitions has been bleak in South Africa in the recent past. A weak economy offering with low growth, coupled with political and policy uncertainty has provided little incentive for prospective buyers in the market.

Finance Minister Tito Mboweni has a difficult juggling act to perform in the upcoming Budget speech, as on the one hand, a more prosperous economic environment needs to be created within which businesses can invest, whilst at the same time, various other expenditure mandates need to be taken into consideration. Given this context, it is not likely that the Budget will propose any major changes in respect of tax policies that are specifically aimed at attracting investment and expanding the economy.

However, it would be reasonable to expect that even given the difficult situation, some initiatives need to be put in place to foster growth in the economy and increase business confidence.

Globally, the trend recently has been for countries to reduce its corporate tax rates. In South Africa, this rate has remained constant at 28% for some time now, and is out of sync with the global trend. A decrease in the corporate tax rate may provide companies with greater cash resources with which to expand their business and could also enhance profitability for the economy as a whole, eventually with more taxes flowing into the State's coffers as a consequence.

Another option is also to provide greater tax incentives to businesses looking to invest and expand their operations. For example, the rules around deductibility of interest incurred on loan funding used to acquire shares could be relaxed so as to decrease the after-tax cost of equity investments. The complex tax rules that currently prevent certain forms of funding from being guaranteed or secured by a third party could also be relaxed, and thus create easier access to sources of funding for potential buyers. Such tweaks to the tax laws could be small steps in contributing to creating the scale of investment activity that our economy so urgently needs.

Whilst the 2019 Budget is unlikely to contain significant tax incentives/changes to tax laws to promote investment and expansion by businesses in our economy, some minor changes would go a long way.

# Update: Carbon Tax Bill

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## Who is liable?

Combustion emissions: 10 MW (th) input\*

- Threshold determined at entity level (i.e. the sum of all controlled facilities)
- Based on installed capacity of fuel input

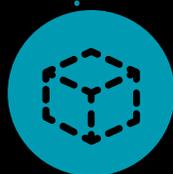
Fuel	Approximate threshold (annual)
Other bituminous coal	16 400 tonnes
Natural gas	8 300 000 Nm <sup>3</sup>
Paraffin	9 100 000 liters
Heavy fuel oil	8 100 000 liters

Fugitive and process emissions: None\*\*

- No threshold for fugitive and process emissions
- All emitters will pay
- Carbon Tax will not apply to emissions for agriculture, forestry and land use, except for stationary combustion emissions

Agriculture, forestry and other land use, waste: NA

\* Except for aviation, rail and naval fuel use (100 000 liters/year) and brick-making (4 million bricks a month)  
\*\* Except for CO<sub>2</sub> transport and storage (10 000 tCO<sub>2</sub>/year) and Other Carbonate use (100 t/year)



## Design of Carbon Tax

- Carbon Tax base of R120 per tonne of Carbon Dioxide equivalent (tCO<sub>2</sub>e) emissions, based on fuel combustion, process and fugitive emission sources
- Basic 60% allowance (70% for process and fugitive emissions and 75% for transport emissions)
- Additional allowance mechanisms:
  - Trade exposure (up to 10%)
  - Performance (up to 5%)
  - Carbon Budget participation (5%)
  - Offsets (Up to either 5% or 10%)
- Effective Carbon Tax rate will fall between R6 and R48 per tCO<sub>2</sub>e depending on allowances
- A Carbon Tax for petrol and diesel will be incorporated into the fuel levy system, and not be taxed directly
- Annual payment must be done by 30 June and will be administered through the Customs and Excise Act

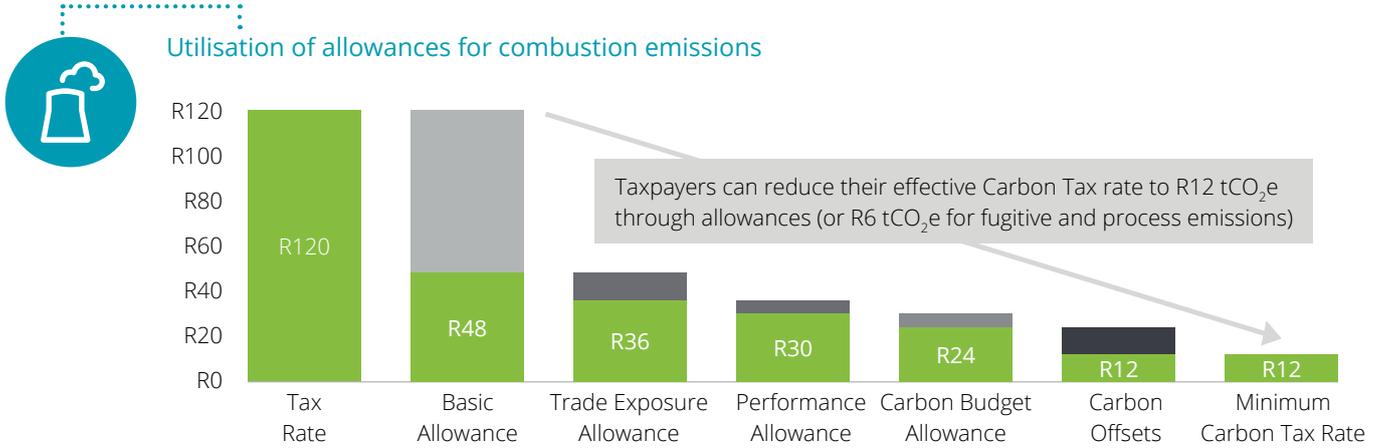


## Highlights of the Carbon Tax Bill

- Scope and thresholds have been aligned with the Department of Environmental Affairs' mandatory Greenhouse Gas Emissions Reporting
- Tax rate will increase by CPI + 2% annually until 2022, and CPI thereafter
- Trade exposure allowance now determined by ratio between production and imports and exports in sector
- DEA responsible for approval of emission factors, sequestration and Carbon Budget system participation
- Carbon Tax liability for fossil fuel based electricity producers will be reduced by environmental levy payments (3.5 c/kWh), as well as a renewable energy premium to be announced by the Minister of Finance
- Sectors covered that may previously not have expected to pay Carbon Tax: food, beverages, tobacco, clothing, machine manufacturers, domestic aviation and navigation
- Persons subject to the tax is expanded to include municipalities and public entities

The honourable Minister of Finance, Mr Tito Mboweni, introduced the Carbon Tax Bill to the National Assembly on 20 November 2018. This brings the carbon tax closer to being enacted, with an anticipated start date being 1 June 2019

Carbon tax will be levied on the sum of greenhouse gases from fuel combustion, industrial processes and fugitive emissions in accordance with a reporting methodology approved by the Department of Environmental Affairs



The regulations surrounding the following parts of the Carbon Tax are still outstanding:

- Performance allowance
- Trade exposure allowance
- Licencing and rules from SARS

### Carbon offsets

- Carbon offsets involve specific projects or activities that reduce, avoid, or sequester emissions, and are developed and evaluated under specific methodologies and standards, which enable the issuance of carbon credits
- Demand for carbon offsets is anticipated to exceed the supply thereof
- The expected value is in the region of R80 per offset

#### Eligible project activities

- Renewable energy projects with generation capacity less than 50MW
- REIPPPP bids signed after 9 May 2013
- Energy efficiency outside the carbon tax net and not claiming 12L
- Transport energy efficiency and municipal waste projects
- AFOLU e.g. restoration of forests and grasslands, small scale afforestation and anaerobic biogas digesters

### Calculation of tax payable

$$X = \{[(E-S) \times (1 - C)] - [D \times (1 - M)]\} + \{P \times (1 - J)\} + \{F \times (1 - K)\} \times R$$

**Where:**

- X = Carbon tax payable
- E = Combustion emissions
- S = Sequestered emissions
- C = Sum of allowances for combustions emissions
- D = Diesel and petrol emissions
- M = Sum of allowances for diesel and petrol emissions
- P = Process emissions
- J = Sum of allowances for process emissions
- F = Fugitive emissions
- K = Sum of allowances for fugitive emissions
- R = Rate of tax

Proposed that entities exceeding their carbon budget will pay R600/tCO<sub>2</sub>e

### How we can help you get ready

- Determine your liability for mandatory GHG reporting and Carbon Tax
- Implement verifiable GHG reporting structures (different from regular sustainability, CDP or GRI reporting)
- Determine a performance allowance benchmark for your sector to submit to National Treasury
- Facilitate participation in the Carbon Budget programme
- Investigate Tier 3 emission factors for your low emission technologies
- Evaluation and registration of carbon offsets through CDM, VCS and GS

# Oil and gas industry – tax considerations



The health of the energy sector in South Africa is critical to the local and wider regional economy.

**The oil and gas (O&G) industry has a particularly important role to play in ensuring that, in line with key government objectives set out in the National Development Plan and elsewhere, there is energy security, and growth in economic activity and employment opportunities.**

It is essential that South Africa give renewed focus to encouraging investment in all spheres of the O&G industry, taking in the entire O&G value chain from upstream exploration and extraction and oilfield services, through refining and petrochemical production, to transport and infrastructure and marketing and distribution.

Some areas which we believe require attention from government are mentioned below.

The Tenth Schedule to our Income Tax Act was introduced in 2006 as part of an attempt to provide a set of clear tax rules and incentives that would encourage O&G companies to invest in exploration for hydrocarbons on land and off the coast of South Africa, taking into account that the country had very limited O&G exploration to date and that exploration is typically very expensive and has a high risk of failure. One of the tax incentives provided in the Tenth Schedule is an additional tax deduction (or uplift) that an O&G exploration company may claim in relation to expenditure that is of a “capital” nature and is incurred in respect of exploration

or post-exploration in terms of an O&G right. The additional tax deduction is 100% during exploration and 50% during post-exploration.

However, it is not entirely clear what qualifies as expenditure of a capital nature that will benefit from the special tax deduction. Uncertainty on this issue is currently having a negative impact on investment decisions. We hope that an appropriate interpretation as to what constitutes “capital” will be agreed to with the tax authorities in the near future, taking into account the imperative to incentivize exploration activity in South Africa and that the term “capital” should accordingly be interpreted broadly.

The Tenth Schedule to Income Tax Act and the Mineral and Petroleum Resources Royalty Act provide that an O&G company may enter into fiscal stability agreements with government, which guarantee that the terms of the respective pieces of legislation as at the date that the relevant fiscal stability agreement was entered into will apply, regardless of any subsequent change to that legislation. The purpose of a fiscal stability agreement is to ‘stabilize’ the tax regime applicable at a certain point in time and hence to create certainty for the taxpayer entity as to what its tax consequences will be for the foreseeable future.

In addition to there being potential deficiencies in the manner in which the fiscal stability provisions are worded in the Mineral and Petroleum Resources Royalty Act (only the provisions of section 4 of that Act are stabilized and no other inputs into the calculation of the royalty), which warrant amendment to ensure that the provisions operate as intended, there is currently an urgent need for government to re-commence the processing of fiscal stability agreement applications for approval after a long period of no

applications being processed. It is hoped that this will be addressed by government soon as a matter of extreme importance.

Other matters which warrant attention from government include the following:

- It is imperative that amendments to the overriding legislative framework for extractive industries, the Mineral and Petroleum Resources Development Act, including provisions in this Act that are specifically applicable to the O&G sector, or the carve-out of rules for the O&G sector into a separate piece of legislation, be finalised soon after many years of delays.
- Government support (for example, by way of grants and/or tax incentives) for the upgrades that our oil refineries have to make in order to meet new fuel specification standards has long been a matter of contention. Some progress on this is needed.
- The draft Integrated Resource Plan (IRP) 2018 envisages a much greater role for gas in our future energy mix. This will require significant resources being spent on infrastructure, and a suitable regulatory and tax incentive framework to encourage investment in this area is required.
- There are currently inconsistencies in the rules contained in tax laws and other pieces of legislation that regulate environmental rehabilitation and provisioning. The alignment of these provisions to function as a consistent rule-set would be most welcome.

There are many challenges that the O&G industry is facing both locally and globally. What is clear, is that a stable and fair regulatory (including tax) framework, with appropriate incentives, is needed in order to ensure continued investment and growth in the sector.

# The tax compliance burden for small and medium term enterprises (SMEs)



SMEs have long been recognized as a priority sector for growth and development in South Africa as they play a critical role in achieving our country's targeted rates for economic growth and employment figures.

Over the years, South Africa has achieved steady successes in broadening its tax base amongst small businesses and various legislative measures were enacted to provide preferential tax treatment to them.

In the South African "2018 Tax Statistics" report, an annual report which is issued jointly by National Treasury and the South African Revenue Service (SARS) and which was published in December 2018, it was noted that as at 30 June 2018, 768 687 companies (714 422 as at 30 June 2017) were assessed for tax, of which 143 768 companies (129 867 as at 30 June 2017) assessed were small business corporations who paid tax at the preferential graduated income tax rate, instead of the fixed corporate tax rate of 28%. This does seem to indicate that an increased amount of small businesses are making use of the preferential tax regime available to them.

However, despite this progress, taxpayer education and the cost of tax compliance remains a significant challenge for SMEs as they often simply do not have the necessary staff resources and skills to timeously and fully comply with all their tax obligations. The cost of tax compliance can add significantly to the cost of doing business for SMEs (e.g. additional resources that have to be employed to comply with tax rules, significant penalties imposed for non-compliance with tax rules etc.).

SARS has also recently announced that it will impose administrative non-compliance penalties for non-compliant corporates (including SMEs) whose tax returns are long outstanding. This could potentially impact a number of SMEs as SARS, in collaboration with the Companies and Intellectual

Property Commission ("CIPC"), will be able to easily obtain a list of non-compliant SMEs. Given the cost of the tax compliance burden on SMEs and how key this sector is to the South African economy, SARS could encourage non-compliant SMEs to regularize their affairs by encouraging voluntary disclosure applications for a limited timeframe before it imposes non-compliance penalties.

It remains imperative that government continues to commit to tax incentives that benefit this small business sector. This could include reducing the tax compliance burden for these entities, simplified tax laws, granting tax incentives, and easier access to finance. When this is done, the contribution SMEs will make towards our country's economic prosperity could be significant.

As many of these small businesses operate within the informal sector, incentives and regulatory changes are critical to ensure the transition from the informal sector to the formal. The 2018 Medium Term Budget Policy Statement (MTBPS) cited barriers to entry as being one of the key reasons why small businesses find it difficult to compete in SA and indicated that the Small Business and Innovation Fund would assist small businesses to *"navigate the pre-start-up phase and provide support as they scale up their enterprises"*. It is expected that R500 million will be committed for the debt and equity investments of SMEs in the first quarter. It will however be interesting to see whether the application process for SMEs to obtain this funding will not in itself be too onerous.



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