‘It is time for us to sow the seed of renewal and growth.’ These were the words of Finance Minister Tito Mboweni on 20 February 2019 in the opening paragraphs of his budget speech. This theme was followed throughout his speech, in which the Minister referred to setting South Africa ‘on a track to renewal’ with interventions to putting our country on a ‘bold new path’ and ‘sowing the seeds for renewal and growth’. The question is whether the planned interventions would result in the New Dawn that we so desperately need to achieve a better South Africa for all.

UNDERSTANDING THE BUDGET PROCESS

The annual budget debate creates a large misconception that by getting the Finance Minister and Treasury on the right path will solve all our fiscal problems. The National Treasury does not create all the problems and it will not solve them all. People should also be mindful that the Minister does not prepare the budget on his own. The budget starts halfway through the previous year when the Budget Technical Committee (departmental DGs) prepares recommendations based on the institutional budgets which in turn is submitted to the Ministers’ Committee on Budget and Cabinet. In a nutshell, the whole executive arm of Government from accounting officers to the President form part of the process, not just the Finance Ministry.

NO DEBATING THE OBVIOUS – THE PROBLEMS

Much time is usually spent determining if we are in agreement with what the problems are and if this meeting of minds is apparent. So, let’s look at the positions of the various role-players.

The Minister of Finance was clear what the problems were, namely:

- Low economic growth
- Declining tax morality and tax collections
- Public spending inefficiency
- Public sector debt burden and debt costs
- Financially burdensome SOEs
- The public sector wage bill

The CEO Initiative echoed this sentiment even before the budget speech and identified the following areas that needed attention:

- Improving growth and investment environment including fiscal policy
- Revenue collection including SARS capacity
- Spending discipline
- Reducing fiscal debt
- The public sector wage bill

To avoid the risks and negative consequences of ethical gaps, there needs to be an alignment between what is said and done within the organisation. Saying and doing need to be focused on what’s right for the business, its people and its stakeholders.

Words Pieter Faber
• Contingent liabilities at SOEs
• Public sector worker accountability
• Improving accountability of institutions like the National Prosecuting Authority (NPA) to address wrongdoing
• Improving education

SAICA in the 2018 Budget Review parliamentary debate the year before identified:
• The debt burden
• Unsustainably low economic growth
• Low tax morality
• Public sector accountability
• The education system
• Unknown and unquantified liabilities including SOEs, National Health Insurance (NHI), and failing water and sanitation infrastructure

Even President Cyril Ramaphosa is under no illusion as to what the main problems are. In his maiden SONA 2018 he stated that tough decisions have to be made on:
• Closing the fiscal gap
• Stabilising debt, and
• Restoring the health of SOEs

The reality is that we as a country are very aligned as to what our main problems are, and this area deserves little debate. The differences lie in the tough decision-making to solve them.

TOUGH DECISION-MAKING

South Africans have the habit of scoring own goals, and in many instances, it relates to us being harsher on ourselves than our peers in respect of the decisions we make. We see this in our sports and even more so in emotive national interest debates on land reform and safety and security. We seem to care less about the facts on the one hand than exercising our bias in favour of our beloved country on the other. I travelled to and met private sector and public officials in eight countries in the last four years and specifically enquired on their thoughts about South Africa, and it became quite apparent that the negatives are all that they know, having read those in the populist media (including social media) generated mainly by South Africans from all walks of life, inside and outside South Africa. Very few actually know any of our good attributes like our good banking sector, extraordinary landscape and mineral riches, stable political environment, transparent fiscal system and, yes, our friendly and beautifully diverse people.

It should be clear from the outset that the decisions the Minister and we a country have to make are not between good and bad or easy and difficult, but rather a choice between the lesser of two evils. When you cut public expenditure, you may impact service delivery; when you reduce headcount, you increase unemployment and skills loss; when you increase revenue, you decrease tax morality. These are not easy choices and though we may disagree with some of the choices and priorities, we have to acknowledge the burden in making them.

Furthermore, taking tough decisions is not a perfect numbers game. The chairperson of the Standing Committee on Finance, Yunus Carrim, has on numerous occasions, including a recent debate on South African Customs Union payments, reiterated that perfect budget numbers can’t be the only consideration when making tough decisions, especially if it imposes a burden too high on the people to bear.

There is a fine line between the ‘absolute truth’ of the numbers and the burden to be imposed on the people. The ‘how’ is critical in informing this tough balancing act.

The ‘how’ therefore seems to be the biggest problem, as this is part justification of the choice. It is also, unfortunately, the ‘how’ that is clearly missing from the Minister’s budget speech. Owing to the lack of ‘how’, the Minister has proposed the same solutions as the previous four (practically three) Finance Ministers before him since 2008, namely increase debt, increase expenditure, and announce an incremental proposal to address the wage bill. This is a far cry from 2005 when former Finance Minister Trevor Manuel tabled a budget seeking to reduce debt to 10% of GDP.

Kicking the can down the road again and hoping for a miracle is not a ‘how’ but deferring the responsibility of us as a country to take our future in our own hands.

So, what are the stakes in this poker-faced decision-making-deferral game?

GAMBLING WITH THE THIRD STRIKE – DOWNGRADE

A credit-rating agency assigns a debtor a credit rating based on the debtor’s ability to pay back debt by making timely payments of principal and interest and estimating the likelihood of default. There are a few rating agencies of which Moody’s, S&P and Fitch are the main ones. The table on page 40 explains the ratings of each of the three.¹
For most investors to withdraw foreign direct investment, they mainly rely on all three rating agencies to give a unanimous non-investment grade rating, that is, junk status. A country therefore has three strikes before it is out of the investment grade circle, and therefore should be heeding the early calls. Where are we?

- Strike ONE – Fitch downgrades SA to BB+ on 7 April 2017
- Strike TWO – S&P downgrades SA to BB+ on 17 April 2017
- Strike THREE – Moody’s downgrades SA to Ba1 on 29 March 2019 (or will it?)

We are therefore ONE strike (downgrade) from junk and Moody’s may not be very impressed with Budget 2019. So, are they just thumb sucking the risk of default and are we bean-counting and criticising too much?

Tin the table on the right is a study on default rate vs rating in quantifying risk.2

![Estimated spreads and default rates by rating grade](https://www.accountancysa.org.za/)

For the data above, two levels above investment grade-rated creditors (that is, Baa2, where South Africa’s was just below its best in 2009) is four times more likely not to default than Ba2-level sub-investment grade creditors to levels below sub-investment grade (that is, where South Africa started in 1994), or one level below where we may be going on 29 March 2019. That says a lot about how rating agencies see South Africa’s creditworthiness. It also shows us the huge slide, with South Africa having worked so hard to receive its highest rating of an A3 stable outlook in July 2009 and then downwards from there with not much to show for the debt incurred. Our debt costs in 1999 were 5,6% of GDP, by 2005 it was down to 3,5%, and now we are back at 5%. In 2005, Finance Minister Trevor Manual commented on this progress:
Members of the House will recall that debt service accounted for 5.6 per cent of GDP six years ago, and I know you will share my firm intent not to reverse this progress.

Looking back, it is a pity that he was wrong in that the succeeding Parliament elected in 2009 rejected this path, approving a perilous path down memory lane. We should also not forget that to make these tough decisions, in the 15 years from 1994 Government had to defer many of our people’s dreams of a better life to settle debt, much of it not even of its own making. The lesser of two evils was chosen on the promise that their children and grandchildren would have a better and more secure life. A promise now not only deferred but becoming less of an option.

So, are the consequences of a downgrade really that dire?

On 10 April 2017, after our first downgrade by Fitch, economist Dawie Roodt noted that a downgrade would mean less investment but not dramatically so and that South Africa would not go into an immediate recession. Not even 12 months and one more downgrade later, and South Africa had already gone into a technical recession. It is estimated that when South Africa is relegated to junk status, all foreign pension funds will be forced to exit South Africa’s bond market, thus exiting $18 billion in FDI and undoing all the gains the President lobbied for.

ACE UP THE SLEEVE OF TAX INCREASES, OR IS IT?

I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle − Winston S Churchill

Countries have one advantage over companies when it comes to improving the revenue side of credit-worthiness − they can to some degree increase revenue by the stroke of a pen, by increasing taxes. There is, however, a limit and it may come to bite you if you go beyond it.

Many ‘tests’ have been formulated as persuasive canaries in the mine for this ‘overtaxed’ position. The first macro indicator that was commonly used was formulated by the Katz Commission in the early 1990s, namely the upper threshold of 25% of tax to GDP. This ceiling was breached in 2012 and has since climbed steadily with it expected by Treasury to be 26.7% or more in 2021/22. Treasury in 2017 rejected this threshold as arbitrary but has not proposed an alternative.

Much has been made of the Laffer Curve in South Africa, which proposed a theory that the more productivity is taxed, the more people tend to want to work less and therefore less tax revenue will result. This is not perfect science, but as was noted in Budget 2019, tax buoyancy (the ratio of growth in tax compared to GDP) has been decreasing notwithstanding several tax increases in the last few years, indicating a decrease in the reliance of our taxes in the current economy.

In South Africa, it would seem that decreased tax morality rather than reduced production has been the response to a perceived over-taxing and badly spending fiscal policy. Tax increases are therefore having the opposite effect in a depressed economy characterised by a lack of public spending discipline, which means that answers will have to be found in limiting spending in the short term and substantial economic growth in the medium to long term.

GETTING THE FUNDAMENTALS RIGHT FOR ECONOMIC GROWTH

In February 2018, the then Minister asked how we should increase economic growth. On analysing this, the SAICA National Tax Committee concluded that policy certainty remains a major challenge and that ad hoc interventions seemed counterproductive. They compiled what was presented to Parliament as the SAICA Seven:

- Agreement of Government’s role in the economy as player and facilitator
- Agreement on stable and peaceful labour relations
- Currency stability
- Quality and fit-for-purpose education
- Policy stability and accountability enforcement
- Reduction in crime
- Agreement on infrastructure build priorities

Many of the above questions, as well as the fundamentals and risks to growing our economy, have been reiterated by ratings agencies. The market also cares if South Africa balances its books by securing long-term revenue growth and efficient spending. The confidence in our country and its ability to pay its debts is seeming followed by both foreign direct investment (FDI) and the currency, as reflected below.

[Graph showing FDI inflows as a percentage of GDP]

[Graph showing ZAR to USD exchange rate]
As our debt grew worse and our economy slowed, investors started losing their appetite to invest. The President’s interventions in the last few years in speaking about driving change have resulted in an upturn, but without the fundamentals being fixed, this upswing is just a dead cat bouncing.

So, for Budget 2019, where have we decided to go and how?

**BUDGET 2019 OVERVIEW**

**Narrowing the budget deficit and stabilising debt**

The current economic growth situation continues to look bleak, with the GDP growth revised downwards from the Medium-term Budget Policy Statement (MTBPS) to 1.5%. The debt-to-GDP level has also deteriorated slightly compared to the medium-term budget estimates. Therefore the focus remains on narrowing the budget deficit and stabilising the debt-to-GDP ratio. In addition to this, addressing the electricity crisis (and growing Eskom debt) and the state of our state-owned entities, as well as stimulating the economy, remain at the heart of the Budget.

The public sector wage bill continues to grow at nearly twice CPI, at 9.3%. Not just the annual increases but the overall burden of the wage bill, even compared to that of other countries, is cause for concern, and this disparity has grown significantly since 2015 as reflected in the graph below:

Much concern is also appropriate given the Minister’s proposals of normal attrition and early retirement as the only containment measures. These are usually the most skilled staff and having five young PAs and no older engineers is a recipe for disaster – like what happened at Eskom and municipalities who have followed similar practices.

However, the numbers don’t lie and kicking the can down the road has been retained as policy with the budget deficit again adjusted upwards and 2020 expenditure being revised upward by R14 billion from 2018. This does not bode well for the country, as we are either going to begin making the necessary hard decisions ourselves or have them imposed on us when we start borrowing from the IMF and suffer junk status downgrades.

**Poor revenue collection**

Revenue collection in relation to estimates continues to decline. As per the 2018/19 MTBPS, the initial revenue shortfall for 2018/19 was estimated at R27.4 billion as compared to the 2018 Budget estimate.

The revenue collections shortfall has now increased to R42.8 billion compared to the 2018 Budget estimate – which represents an increase of R15.4 billion in the expected shortfall between October and now.

National Treasury has attributed the shortfall to economic weakness, which resulted in lower than estimated
corporate and personal income tax collections, as well as poor tax administration. It is interesting to note that approximately half of the additional R15.4 billion shortfall has been attributed to higher than expected VAT refunds. Taxpayers and tax practitioners will no doubt feel vindicated for the complaints that they have consistently raised in this regard over the last few years. However, the promised R20 billion reduction in the VAT debt book (that is, delayed refunds) in MTBPS 2018 did not occur. Only half of that happened, which means there is probably some explaining to do.

The ongoing revenue shortfalls, as well as additional expenditure like the free higher education plan, resulted in significant tax increases over the last few years. We have seen increases in personal income tax rates, the VAT rate and dividends tax, capital gains tax (CGT), donations tax, and estate duty (over certain limits). Despite these measures raising an additional R99 billion in collective revenue over the last four years, tax revenue as a proportion of GDP has continued to decline. In order to limit the negative impact on economic growth, a decision was taken not to increase tax rates in any category. Instead, collections will be increased by not adjusting for inflation. It is felt that the improved efficiency of tax administration will go a long way to improving collections overall. In this regard, it is estimated that revenue growth will increase from 6.6% this year to 8.4%, which is quite optimistic given the minimal increase projected in GDP growth.

This budget essentially requires a Hail Mary pass for the new SARS Commissioner, as the Minister believes much revenue ground can be recovered with an effective SARS. This pressure may, however, continue incentivising the wrong behaviour of SARS officials in relation to compliant taxpayers.

2019/20 tax proposals and beyond

The 2019/20 tax proposals are designed to address at least part of the revenue collections shortfall and are expected to result in an overall increase in collections that will raise an additional R15 billion in revenue. This is mainly attributable to R13.8 billion gained from not giving inflationary relief on salary increases (bracket creep) and medical credits.

There is also a new carbon fuel tax, which is estimated to raise R1.8 billion, and this will continue to place a growing burden on transport costs where we have a rising fuel price and a depreciating rand. In total, the fuel price will be increased by 29c for petrol and 30c for diesel.

Saving drowning SOEs

SOEs continue to plague the Budget with Eskom getting some relief, but not nearly as much as it asked for. The Minister’s conclusion that this is Eskom’s debt problem is oversimplifying the challenge we face. There is also an expectation that other SOEs and municipalities will need help, with the contingency reserve being expanded to R13 billion to cover claims for assistance. This seems in addition to the Road Accident Fund (RAF), which now sits with a R215 billion liability. Farmers in particular will be concerned that the contingency reserve has been turned into an SOE rescue fund, as it means not much will be allocated for drought relief or other natural disasters. The Minister did, however, infer a backup plan to fund critical SOEs with the sale of others.

New taxes for future years

There are also new taxes waiting in the wings which include the carbon emissions tax, gambling tax, and expanding the fuel levy to other fossil fuels like paraffin, LPG and biofuels. In respect of the latter, it is unclear how the poor will be protected who use these fuels for cooking and heating. Proposals will also be made for a host of new environmental taxes, water taxes and waste taxes. A possible tax as a disincentive for exporting scrap metal would be positive, but banning exports would probably bring a much more immediate end to the butchering of South Africa’s infrastructure for cheap scrap exports and will incentivise local industry.

CONCLUDING REMARKS – IS IT POSSIBLE TO TURN THE TIDE?

‘We are a nation that regularly performs miracles and we have been doing so from the day of our peaceful transformation to democracy when the world thought that we could not do it. But like every other country, we also have our share of problems. And we all know those problems intimately, because we are confronted with them in our daily lives’ – Nelson Mandela to Nelson Mandela Scholarship Recipients, October 2002

South Africa does have its challenges as Madiba said, but we are at least honest what they are, and we have performed other miracles before. We also not only judge ourselves harshly but also score the most own goals. Unlike many other countries with problems, we have the power and capacity to fix them; it is merely our willingness to work together in doing so that seems lacking. Budget 2019 did not usher in a New Dawn, but positive signs are already indicating that things may change in the rest of 2019, including a substantial increase in our collaborative efforts in defining and implementing the missing ‘how’ that we so desperately need.

AUTHOR | Pieter Faber, SAICA Senior Executive: Tax

NOTES
BUDGET IMPLICATIONS FOR SMMEs: BUSINESS AND CHALLENGES AS USUAL?

YOUNG WORKFORCE TO INCREASE IN NUMBERS

BUDGET SPEECH 2019: EXPECT CHANGES TO THE WAY WE DO TRANSFER PRICING

ATTEMPT TO REDUCE ILLICIT FUND FLOWS

ANTI-DIVIDEND STRIPPING RULES: THE DILEMMA WITH THE PROPOSED CHANGES TO ANTI-DIVIDEND STRIPPING RULES
BUDGET IMPLICATIONS FOR SMMEs
BUSINESS AND CHALLENGES AS USUAL?

Although the challenges are big, they are not insurmountable, and this country can once again rise to become the economic powerhouse of Africa – give the small businesses a chance.

Although most of the focus on the 2019 budget was on rescuing Eskom and trying to curb expenditure and reduce debt in order to appease rating agencies, Minister Tito Mboweni did provide some support for small, micro and medium enterprises (SMMEs). He allocated R481.6 million to the Small Enterprise Development Agency (SEDA) to expand its small business incubation programme. This three-year programme is designed to strengthen technology commercialisation and harness the entrepreneurship of the technology community in South Africa. Any registered SMME that is struggling to grow qualifies for incubation at one of the 54 SEDA-supported incubators, although each incubator has its own recruitment/selection process that is unique to their sector.

Through incubation, SMMEs can develop skills, knowledge and expand their markets which in turn should lead to increased profitability and growth and ultimately to an increase in jobs. The budgetary allocation is welcome especially because, in the words of Ms Mandisa Tshikwatamba, CEO of SEDA, ‘in the South African context, they also drive the transformation agenda and promote economic inclusion to undo the legacy of our past’.

Over the next three years, R1.8 billion will also be allocated for the implementation of 262 priority land-reform projects and R3.7 billion has been set aside to assist emerging farmers seeking to acquire land to farm. The Land Bank has also been allocated R3 billion to disburse in support of smallholders and to leverage partnerships with other financial institutions.
Industrial incentives will also be bolstered by R19.8 billion, of which R600 million is going to the clothing and textile competitive programme. Mr Mboweni stated that this should support 35,500 existing jobs and create about 25,000 new jobs over the next three years – hopefully boosting small business development.

The Jobs Fund, whose role is to co-finance projects (within enterprise development, infrastructure investment, support for work seekers and institutional capacity-building) that will significantly contribute to job creation, will receive R1,1 billion over the next three years due to its success of creating over 200,000 jobs since its inception in 2011 and its disbursement of R4,6 billion in grant funding.

SMMEs should hopefully also benefit from the Infrastructure Fund initiative. This initiative was announced by the President in 2018 to encourage collaboration between the public and private sector to transform public infrastructure delivery. The Government has confirmed its commitment to contribute R100 billion over 10 years to this initiative. Encouraging small businesses to do business with the state is one of Government’s aims. In light of this (and as a result of complaints raised by SMMEs) a new Public Procurement Bill, which will consolidate various procurement laws into a single framework, is being finalised by Government. This new Bill will allow for greater participation of black-, youth- and women-owned businesses in state procurement, again, hopefully also benefiting the SMME sector.

With regard to doing business with Government and in general, the World Bank has compiled a series of annual reports (entitled the Doing Business reports) investigating the regulations that enhance business activity and those that constrain it. The Doing Business report provides objective measures of business regulations and their enforcement across 190 economies and selected cities for a small and medium-sized company through its life cycle. This report indicates that South Africa has dropped from an overall ranking of 32 in 2008 to 82 (out of 190 countries) in 2019. In respect of the ease of doing
business, South Africa has a score of 66.03 out of 100. To put this score into context, other African and developing countries such as Mauritius, Thailand and Turkey all outperform South Africa on this ranking (79.58, 78.45 and 74.33 respectively). This report has caught the Presidency’s eye and Invest SA has been mandated by the Presidency to introduce reforms to address and manage South Africa’s Investment Climate Reform Programme with a view to creating an enabling business environment and augmenting the Presidential Investment Drive. The purpose of the reform initiative is to improve South Africa’s ranking on the World Bank’s Ease of Doing Business survey, to substantively improve South Africa’s business environment, and to influence investor perception positively in view of President Cyril Ramaphosa’s investment drive to bring R1 trillion in investment to the South African economy. Despite the methodological concerns with the Doing Business rankings, the steps taken by the Presidency to improve the ease of doing business in South Africa are most definitely welcomed and we look forward to the findings and reform suggestions stemming from Invest SA’s investigation.

From a tax perspective, a review of the SMME tax incentives was mentioned in the 2018 budget speech, but no further details about this review have been forthcoming other than the statement that the venture capital company regime will be evaluated in line with its objectives during 2019/20 and that the misalignment between the stated objectives and the provisions of the special economic zones regime will be reviewed (no time frame provided). When considering the tax rates for the different types of small businesses, the tax rates for micro businesses remained unchanged from 2018/19 (see table 1), but the tax rates for small business corporations changed ever so slightly for the 2019/20 year of assessment resulting in R59,50 (previously R168) less tax payable for businesses which earn less than R79 000 (table 2).

Although it appears funds have been generously allocated (indirectly) to SMMEs in South Africa, not much has been provided about the actual effectiveness of most of the reforms and incubator programmes for SMMEs. For instance, the 2018 budget speech indicated that work is being done to provide crucial funding to innovative small businesses when they need it most and he announced that a fund with an allocation of R2,1 billion over the medium term is being developed between the Department of Small Business Development, Department of Science and Technology and National Treasury to benefit SMEs during the early start-up phase. The money would be used to nurture and support entrepreneurs. However, how this would be done was not elaborated on. No further elaborations or progress updates were provided in the 2019 Budget either. Knowing if the proposed outcome was achieved is essential to guide further fiscal prioritisation.

**CONCLUSION**

Although SMME funding from Government is necessary, providing funding without proper planning, implementation and evaluation is a recipe for disaster. Conventional approaches appear to have been followed in the budget, which is understandable due to local and global economic conditions, but what is needed are bold actions to create an environment that stimulates good ideas, risk-taking and new ways of thinking. Unfortunately, it appears that this will not happen until the country sees accountability by those that have caused the financial crisis in the country and taxpayer morale and trust in the Government is restored.
President Cyril Ramaphosa hosted an investment conference in 2018 with the key message that ‘South Africa is open for business’. Finance Minister Tito Mboweni announced in his maiden budget speech on 20 February 2019 that R300 billion was pledged by the private sector at this conference.

This is set out as part of the Minister’s opening remarks in the budget speech in addressing the first of five tasks that the President set out for his cabinet in his State of the Nation Address on 16 February 2019. That task is to accelerate inclusive economic growth and create jobs. Among the six initiatives set out by the Minister is the increase of the income eligibility threshold for the employment tax incentive.

The employment tax incentive (ETI) was brought into existence by the Employment Tax Incentive Act, 2013, as amended. The ETI was promulgated to encourage employment of young, inexperienced workers, with the Minister proudly announcing in the budget speech that 1.1 million young people’s jobs are currently supported by the ETI. The tax expenditure associated with the ETI is R4.3 billion in the 2017/18 period.

The ETI was initially set to run until 1 January 2017, then amended in 2016 to run until 28 February 2019. The most recent amendment to the period was in 2018 with the ETI now set to run until 28 February 2029. In essence, the ETI allows an eligible employer that employs qualifying employees a reduction of his monthly employees’ tax liability. An eligible employer is an employer registered with SARS to withhold and pay employees’ tax and is neither any sphere of our government nor disqualified by the Minister from receiving the ETI. The definition of a qualifying employee is broader but the main requirement is that it must be someone between the ages of 18 and 29 years, receiving remuneration of less than R6 000 a month.

The budget speech increases the eligible remuneration bands. As of 1 March 2019, the bands are (i) income less than R2 000, (ii) income of R2 000 – R 4 500 (currently R4 000); and (iii) income of R4 500 – R6 500. The increase is said to cater for inflation.

The Government is closely monitoring the ETI, with chapter 4 of the budget speech setting out some of the findings of a review conducted by the National Economic Development and Labour Council on the ETI. The review found that the ETI resulted in more jobs being created, with no evidence of older workers being displaced as a result of younger workforce, along with halting job losses. The most significant finding of the review is that employers tended to retain workers at the end of the two-year incentive period as employees had, as a result of the ETI, gained the relevant experience. The young employees themselves indicated that the ETI initiative has the result of providing them with opportunities they would not otherwise have had.

Given the current numbers of youth employed on the back of the ETI, it goes without saying that the extension of the time period for the incentive, as well as the increase in income bands, will lead to an increase in employed youth. The ETI is a definite win in the Cabinet’s task list to ‘accelerate inclusive economic growth and create jobs’.
length transfer pricing rules. Section 31 of the Income Tax Act currently defines an ‘affected transaction’. This differs from the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, where transfer pricing rules apply to transactions between ‘associated enterprises’.

The difference between affected transactions and associated enterprises is significant. It is important to note that the concept of associated enterprises might prevent the application of the arm’s length principle. If a broad interpretation of associated enterprises is adopted it may also lead to the arm’s length principle being applied to situations for which it was not intended.

Internationally, various views exist in relation to the meaning of the term ‘associated enterprises’. The concept of what an associate enterprise means differs vastly from country to country, with several countries adopting a broader concept. Countries that apply a narrow definition of associated enterprises look at the de jure relationships (practices that are legally recognised) such as the participation in capital and management. This concept is applied by the United Kingdom and the Netherlands. It is also important to note that this is in line with the OECD’s guidance. As this is limited to de jure control, relationships are generally covered by company law.

Countries with a broader concept of associated enterprises look at not only the de jure relationships but also at de facto relationships (practices that exist in reality, even if it is not officially recognised). Often, de facto relationships can be contrary to the purpose of the arm’s length principle. Countries such as Brazil, India and China follow this line of thinking.

Finally, countries such as the United States, Germany and Norway follow an open-ended concept of associated enterprises, based on control. These countries focus on the reality of control and not on the form or mode. What is important for these countries is whether their actions influence their decisions.
Accordingly, as an example: Companies A, B and C are independent companies that have jointly created a joint venture (JV), with each company holding a 33.3% shareholding. According to the South African connected person definition these companies would be connected to the JV due to their shareholding being in excess of 20% and no other party holding the majority voting rights. However, this is different in other countries where 50%+ shareholding is required. In countries such as Norway, the domestic law in relation to associated enterprise would state that a controlling interest would be required. Therefore, should a decision be made with regard to the controlling interest of the JV, it would be hard to argue that this would not fall within the concept of associated enterprises. Further, should South Africa follow the examples of their Brics partners, we could expect situations where the arm’s length principle could be wrongly applied to open market situations without any intention of tax avoidance or evasion.

NOTES
Currently, as it stands in section 31 of the Income Tax Act, ‘affected transaction’ means ‘any transaction, operation, scheme, agreement or understanding where –
(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between

or for the benefit of either or both –
(i) (aa) a person that is a resident; and
(b) any other person that is not a resident;
(ii) (aa) a person that is not a resident; and
(b) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
(iii) (aa) a person that is a resident; and
(b) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
(iv) (aa) a person that is not a resident; and
(b) any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another; and
(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length ….’

AUTHOR | MICHEL ELS, A SAICA TRANSFER PRICING SUB-COMMITTEE MEMBER AND HEAD OF TRANSFER PRICING SOUTH AFRICA AT ERNST & YOUNG
The Minister of Finance, Mr Tito Mboweni, announced in the 2019 budget speech that there will be legislative changes to allow SARS to share information with stakeholders to curb smuggling and illicit fund flows.

This is encouraging in a time where it is no secret that fraud and corruption in our country are at an all-time high and that the fiscus needs more money in the coffers. One of the areas that is riddled with criminal activity is imports and exports. This issue has been raised by Parliament, National Treasury and SARS regularly over the last couple of years; however, very little has been achieved in curbing this fraud as the fraudsters are always one step ahead due to investigations by competent fraud units being diminished in recent years.

The former Group Executive: Tax and Customs Enforcement Investigation Unit, Johann van Loggerenberg, stated in June 2018 that the R7 billion per year tax evasion in the tobacco industry is the tip of the iceberg. He left SARS during a tobacco investigation called Project Honey Badger in which SARS investigated 15 criminal cases against tobacco manufacturers and importers that should have resulted in revenue collection of R3 billion in the 2014/15 financial year – however these cases were never completed due to the disbandment of this unit.

Mr Mboweni has been crucified by the EFF and other opposition parties after his maiden medium-term budget speech in 2018 for not addressing the issue of illicit fund flows. In a statement issued by the EFF in October 2018, the EFF registered ‘its utter disappointment that there was no mention of dealing with the phenomenon of illicit financial flows, tax base erosion and tax avoidance by in the main, multinational companies. In a situation where revenue collection is not meeting the needs of our budget, a policy statement that does not speak to the phenomenon of illicit financial flows is totally unacceptable.’

In May 2018, Mark Kingon, the acting SARS Commissioner, acknowledged to the Parliament’s Standing Committee on Finance that SARS has in the recent past not effectively dealt with illicit fund flows and other illegal flows of capital. A multi-disciplinary working group across regulators and other
stakeholders has been established to deal with these issues to curb the illegal movement of funds from South Africa to other countries. Kingon committed to change this with the re- establishment of the Large Business Unit and Illicit Economy Team. ‘The decision, made by the Acting Commissioner and the SARS Executive Committee, was based on the pivotal role that these units play in enabling SARS to provide effective and efficient service to large corporate taxpayers, and in fighting illicit trade in the country.’

The Minister announced during the budget speech that SARS’ new Illicit Economy Unit to fight the trade in illicit cigarettes and tobacco has been launched in August 2018. It is possible that the investigation against Adriano Mazzotti that resulted in a warrant of execution obtained in the North Gauteng High Court on Monday 17 February 2019 is the first successful investigation by this unit.

Another area of concern to SARS and authorised dealers is the dramatic increase in fraud through the abuse of advance payments for the purposes of importing goods. Clients will request an advance payment from an authorised dealer to pay a foreign supplier to cover the cost of permissible imports, other than capital goods, against the presentation of an invoice. This advance payment will only be facilitated upon presentation of a pro forma invoice and thereafter the funds flow to the overseas party and at a point in future, the goods will be received. Upon the goods’ arrival in RSA, the client is required to submit a document to the authorised dealer to verify against the SARB’s import verification system. If the documents are not presented in the required period from the date of payment, the client is reported to the SARB for non-compliance, which may result in the client being restricted by the SARB from performing further advance payments until they present documents.

Importers use the advance payments to get money off-shore and bring in goods at a lesser value or no goods as they forge pro forma invoices and use the customs client number of other importers to get the payment approved. By the time that the period expires to submit the relevant evidence of the receipt of the goods, the fiscus has already been detrimentally impacted as the money has already left the country.

Despite verification and risk mitigation by authorised dealers and SARB before an advance payment is approved and paid, more than R120 billion has streamed out of South Africa via this mechanism in the last year. Approximately 40–50% of transactions are being reported monthly to SARB for non-compliance. The SARB use these reports to perform further verification with SARS. This allows them to identify which goods did not arrive, or where the value of the goods that arrived does not match the payment sent.
significant implications for those affected by it. One such proposal relates to amendments to be made to the anti-dividend stripping rules.

BACKGROUND TO THE PROPOSAL

The introduction of dividends tax in 2012, and in particular the exemption of dividends paid by one resident company to another, created opportunities for taxpayers to extract value from companies in a tax-exempt manner.

In 2017 the National Treasury introduced anti-dividend stripping rules to prevent taxpayers from extracting value from shares through such dividends and thereafter disposing of the shares at a point when the value — and by implication capital gains tax on such value — is significantly lower than it would have been had it not been for the exempt dividend. Section 22B and paragraph 43A of the Eighth Schedule of the Income Tax Act apply when a company (shareholder company) disposes of shares held in another company (investee company) while it holds or has held during the 18-month period prior to disposal a qualifying interest in that investee company. The rules are targeted at exempt dividends that accrued to or were received by the shareholder company by reason of the disposal of the shares or during the 18 months prior to the disposal of such shares. The amount of any exempt dividends that constitute extraordinary dividends is treated as part of the proceeds from the disposal of the shares for tax purposes. The nature of the proceeds will depend on whether the shares were held as trading stock or as capital assets by the shareholder company. These rules became effective from the date that the first draft rules were
The rules were amended in 2018 to make provision for it to interact with the corporate roll-over rules and allow tax neutral reorganisation transactions without being hindered by the anti-dividend stripping rules.

THE PROPOSAL IN THE BUDGET REVIEW

The National Treasury announced in the Budget Review 2019 that it had identified arrangements that undermine the anti-dividend stripping rules. These arrangements apparently involve the distribution of significant dividends to existing shareholders followed by dilution of their shareholding through a subscription for shares by a third party. The existing shareholder does not immediately dispose of its diluted shareholding in the company. The proposal indicates that amendments will be made to the dividend-stripping rules to curb this abuse. Importantly, the proposal indicates that the amendments will take effect on 20 February 2019, being the date that the Budget Review 2019 was published.

ANALYSIS OF THE PROPOSAL

The concern with this proposal is not with the principle to curb abuse of an anti-avoidance rule that has been identified, but rather the uncertainty that the announcement causes. The only clue as to the arrangements targeted that is provided in the Budget Review 2019 is that the arrangements involve significant dividend distributions to existing shareholders and subsequent dilution of their shareholding when shares are issued to a third party.

While it may be relatively easy to speculate as to what an abusive arrangement that involves these two elements may entail in an extreme sense, there are many commercial arrangements not aimed at abusing the dividend-stripping rules that may also involve these two elements. One such an example is found in arrangements to introduce new shareholders to a company to improve its level of compliance with the B-BBEE codes. In order to achieve affordability for the new shareholder, a dividend is declared to existing shareholders, followed by a subscription by the new shareholder which dilutes the interest of the existing shareholders. This subscription is often at a nominal value or significant discount. The fact that the two characteristics identified as those of abusive arrangements that will be targeted by the amendments are present in this transaction means that a risk exists that a non-abusive arrangement such as the one described, undertaken on or after 20 February 2019, could inadvertently also be subject to the amendments. As the amendments that are ultimately promulgated for inclusion in the Income Tax Act are open for comment and are subject to extensive consultation, the expectation is that the amendments should be targeted in a manner that does not cause commercial transactions (especially in a B-BBEE context) to no longer being economically viable, but still catch those arrangement considered to be abusive. A taxpayer will however only have certainty as to what is considered abusive or problematic by the National Treasury once the rules have been drafted.

Taxpayers will probably only get their first glimpse of the proposed amendments, and with it some degree of certainty, when the draft taxation laws amendment bills are released for comment later this year. In the example provided earlier, in practice this will mean that a taxpayer may find itself in a position of having to choose between taking a significant leap of faith by entering into a transactions without knowing what the tax implications may be, as the law that already applies still needs to drafted, or face the impediment of having to operate a business with lower levels of compliance with the B-BBEE codes, because it may not be able to implement an arrangement to improve its compliance with the codes due to a lingering tax uncertainty.

It is submitted that this outcome does not promote an environment conducive to business, economic empowerment or tax compliance. This concern can be alleviated to an extent by more detailed information on the scope of the proposal by the National Treasury, especially considering its 20 February 2019 effective date. In the meantime, and potentially until the release of the draft legislation later this year, taxpayers would need to tread very cautiously and possibly explore other alternatives which may bring about their own risks, both from a commercial and tax perspective, when they consider entering into a non-abusive commercial arrangement that has the two characteristics alluded to in the announcement.