

# ITD GLOBAL CONFERENCE ON TAXATION OF SMALL AND MEDIUM ENTERPRISES – ARGENTINA 2007





# REDUCING THE COMPLIANCE BURDEN FOR SME's

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1US\$ = R6,83 as at 10 October 2007



# OVERVIEW

- Introduction
- Nature of SME's
- Balance between reducing the compliance burden and the need for regulation
- The South African context
- South African SME policy
- Tax red tape in South Africa
- South African SME tax strategy overview
- The Way Forward



# INTRODUCTION

Internationally studies have shown that small businesses have a vital role to play in the economy by:

- reducing unemployment;
- alleviating poverty; and
- increasing GDP growth.

Also found that small businesses fail due to restrictions like:

- lack of finance;
- lack of education, skills and proper planning;
- lack of infrastructure; and
- **burdensome regulation.**



# NATURE OF SME's

Typical characteristics of SME's:

- Informal and try to stay off the regulatory radar screen – fear administration burden and associated costs.
- Less sophisticated.
- Owners are usually not very well educated or skilled.
- Financially constrained.
- Have minimal access to infrastructure.
- Have minimal access to marketing, communication, and computer facilities.
- Understaffed.
- Seldom maintain proper records.



# COMPLIANCE BURDEN

Nature and effects of the compliance burden:

- Various laws and regulations imposed by various stakeholders. Government agencies form a large part of stakeholders.
- These often accumulate over long periods of time without the necessary reviews and consolidation.
- Research confirms that smaller, less sophisticated players share a disproportionately larger share of the compliance burden. It also costs them relatively more to comply in relation to their larger counterparts. Therefore: regressive.
- This overwhelming compliance burden is often the cause of failure of small businesses in start-up phase.



# COMPLIANCE BURDEN

Where does the regulatory burden rank on the list of problems experienced by small businesses?

Global Enterprise Monitor surveys placed it behind issues like crime, inadequate demand, and skills shortages.

Similar conclusions reached by World Bank Survey of the priorities of business in Greater Johannesburg.



# RED TAPE IN SA

2005 report by Small Business Project, *Counting the Cost of Red Tape for Business in South Africa*:

- Cost of regulation for a business with turnover of <R1 million (US\$1 = R6,83 at 10/10/2007) is 8,3% of turnover.
- Red tape cost SA R79 billion in 2004 = 6,5% of GDP.
- New business with >R300,000 turnover has 9 registration requirements and contact with 5 central government offices.
- Due to non-compliance, 62 per cent had stock confiscated, 19 per cent had been prosecuted and fined, and 17 per cent had been ordered to close or move on. The median estimated cost of interference was R652 per occasion. 18 per cent had to pay bribes with a median of R225 to avoid interference.
- Perceived disadvantages of registering as a formal business were **taxes** (36 per cent), costs in relation to rewards (22 per cent), “costs of official oversight” (16 per cent), and **red tape costs** (7 per cent).



# SA vs GLOBAL

World Bank's Doing Business in 2004 notes that it takes 38 days to register a new business in SA – there are 9 separate procedural requirements costing 8,7% of income per capita.

2007 Global Entrepreneurship Monitor ranks South Africa 30<sup>th</sup> out of 42 countries with regard to entrepreneurial activity.



# NEED FOR REGS

- Need regulations to maintain basic standards e.g. health, environment, child labour.
- Need regulations to avoid unfair, aggressive competition between market entrants and established, fully compliant businesses.
- Need tax laws and regulations to ensure revenue for government as tax is a “grudge purchase”.
- Need regulations to monitor and measure the informal economy to know what we are dealing with, e.g. crime and tax gap, so that appropriate measures/solutions can be put in place to address shortfalls.
- Need individuals to learn good habits of compliance to be responsible democratic citizens.



# BALANCE

Need to create a harmonious balance between reducing the compliance burden and the need for regulations to **enable** small businesses to **grow** into responsible citizens and make a meaningful contribution to the economy of the country.

**Smart regulation versus restrictive regulation.**



# SA CONTEXT

Report by Judi Hudson, *Why regulations matter: A small business perspective* :

## Legacy of Apartheid:

- During apartheid, entrepreneurial activity was either neglected or discouraged in the state of black-owned enterprises.
- Apartheid contributed to a dual economy with little interaction and division along racial lines. The vast majority of the population was kept out of the formal economy.
- Apartheid resulted in unequal access to various forms of capital and opportunity in the labour market based on race, gender, and age. It favoured large-scale and capital intensive enterprises through a wide and complex array of regulatory measures.



# SA CONTEXT

Report by Judi Hudson, *Why regulations matter: A small business perspective:*

Legacy of Apartheid:

- 1999 October Household Survey shows that Black non-survivalist entrepreneurs accounted for only 0,54% of all economically active people.
- Although South Africa lags internationally when it comes to entrepreneurial activity, current activity compares favourably with the past and is higher than 20 years ago. Also compares well with developed countries like Slovenia, Sweden, and Netherlands).
- SA now has to integrate itself into global markets whilst overcoming internal problems caused by apartheid.



# SA CONTEXT

- On the eve of the 1994 general election, South Africa's former homelands, also known as Bantustans, were reintegrated and the four existing provinces were divided into nine.
- Three tiers of government administration viz. national, provincial and local government.
- Taxation is mainly on a national basis with limited taxation at provincial and local government level e.g. gambling, motor vehicle licence and fuel levy.



# SA CONTEXT

2002 report by Stats SA, *The Contribution of Small and Micro Enterprises to the Economy of the Country: Survey of Non-VAT-Registered Businesses in South Africa*:

- Between 2 and 3 million informal small businesses in South Africa i.e. individuals with turnover of <R300,000 p.a. (about US\$ 44,000)
- Only 145,000 or 6,3% earn sufficient income to exceed the individual threshold to pay tax.
- Only about 15% employ 1 or more employees.
- These employees earned R274 million in gross salaries in the month of February 2001 with the highest monthly salary being R1,094 (US\$ 160).



# SA CONTEXT

2005 report by Small Business Project, *Counting the Cost of Red Tape for Business in South Africa*:

- 1.8 million people and about 1 million businesses operate outside the formal economy.
- Informal sector firms had a median annual turnover of R8,482 (US\$ 1,242). However, 8 per cent had annual sales of R50,000 (US\$ 7,320) or more and 3 per cent were achieving sales of R100,000 (US\$ 14,641) or more.
- Half the businesses surveyed employed between one and five people.
- 56 per cent of the businesses were growing compared to 36 per cent of “survivalists”.
- 51 per cent of businesses surveyed are one-person enterprises with a median period of existence of about 3,5 years.



# SA SME POLICY OVERVIEW

- Need to legitimise marginalised small businesses so that they can be democratic citizens and access means to grow.
- Government should not be in a position to control small businesses completely from beginning to end. Research has shown that certain countries have failed with this approach.
- Subsidising or providing cheap finance to small business must not be overdone as this could lead to non-competitiveness, stagnation, and failure.
- Need to get small businesses through start-up phase where most fail.
- Each stakeholder should have a plan of action but work with other stakeholders for holistic approach. This must be done within the country's context.
- Tax perspective: Balance between easing regulatory burden, equitable tax collection, education, taxpayer service, compliance culture, and enforcement. Sacrifice immediate revenue stream for longer term, more sustainable, larger revenue stream.



# SA MANDATE

2006 State of the Nation address:

- Recognising the vital role of SME's in growing the economy, creating employment and alleviating poverty, President Mbeki confirmed Government's mandate to develop the small business sector as a matter of priority.
- One of the interventions that he highlighted is:  
**"We will also speed up the consultative process to determine the measures we must take to improve the regulatory climate to facilitate the expansion of this sector."**

SARS can make a contribution towards easing the regulatory burden on small businesses, as part of the Government's broader mandate.



# SA REFORMS

## Macro-economic strategies:

- 1995 White Paper – regulatory environment should be more friendly to small businesses and need to address competitive disadvantages in relation to larger businesses.
- Growth Employment And Redistribution (GEAR) strategy – 1996 to 2000 – 6% GDP growth by year 2000; 400,000 jobs per annum; increase FDI; and reduce fiscal deficit.
- Small Business Act, 1996 and amendments
- State of the Nation addresses by the President
- Department of Trade and Industry (dti) initiatives
- National Budget Initiatives
- Tax initiatives



# DTI INITIATIVES

Department of Trade and Industry (dti) initiatives:

- Grow economy and create employment.
- Ntsika – agency that was set up to support SME's in non-financial ways.
- Other agencies were set up to deal with specific programmes e.g. Namac for manufacturing.
- Various funding agencies e.g. Khula Enterprise Finance Limited, Industrial Development Corporation (IDC), and SA Micro-finance Apex Fund
- Small Enterprise Development Agency (SEDA) formed in 2004 – geared towards assisting creation and nurturing small businesses – also tasked with facilitating acquisition of finance.



# SA FUNDING AGENCIES

- Industrial Development Corporation (IDC) – funds large infrastructure projects with assets of at least R500,000 (US\$ 73,200) to R3 million (US\$ 439,200) – moving into SMEs.
- Export Credit Insurance Corp of SA – Underwrites bank loans and investments outside the country to enable foreign buyers to purchase capital goods and services from SA.
- National Empowerment Fund – specialises in investing in black empowerment transactions – commits between R250,000 to R50 million (US\$ 36,600 to 7,3 million) to a project.
- Umsobomvu Youth Fund – provides Black youth between the ages of 18 and 35 with financing between R100,000 and R5 million (US\$ 14,600 to 732,000) to start businesses, except in gambling, tobacco, and property.
- Khula Enterprise Finance Limited – agency of dti established in 1996 to facilitate credit acquisition for SMEs through various institutions e.g. banks. No finance – security and credit guarantees.
- SA Micro-finance Apex Fund – will offer loans of up to R10,000 (US\$ 1,464) to micro-enterprises (turnover less than VAT registration threshold of R300,000).



# SA SME SHORTFALLS

- Insufficient harmonisation of initiatives between and within different government departments – lack of coordination is hampering small business development.
- Entrepreneurs have to approach different organisations for business advice, tender information, registration details, finance and information on potential partners.
- E.g. Umsobomvu Youth Fund provides finance for young entrepreneurs, Khula Enterprise Finance provides banks with guarantees for loans, and Ntsika Enterprises offers information and mentoring services.
- These agencies do not have offices countrywide - unfairly favours development mainly in big cities.



# DTI REFORMS

- Merge Ntsika and Namac to provide more focused approach – especially retail lending.
- Using a more segmented approach to the SME market.
- E.g. one segment needs to be served mainly by capacity building and micro-finance and another segment needs to obtain better market access through procurement and business linkages.
- Dti will now assume responsibility for SME statistics – previously done by Ntsika.



# GLOBAL TAX ISSUES

International experience with taxing small businesses:

- Hard to tax.
- Informal sector is huge, not easily visible, and mobile.
- Inadequate record-keeping and weak financial controls.
- Tax authorities do not have capacity or infrastructure to deal with them efficiently – cost versus benefit issues.
- Developing countries often resort to inefficient presumptive taxes.
- Regulatory burden serves as a huge disincentive to enter the formal sector.



# TAX BURDEN

Tax compliance burden is imposed by Government as a necessity (“grudge purchase”) to raise revenue.

As tax evasion becomes more common and more sophisticated, so too do the tax laws. Sometimes good intentions often end up being a burden e.g. complying with tax incentive legislation.

Contributions to tax compliance burden:

- Use of many, unique tax instruments.
- Complexity of legislation dealing with each instrument.
- Interpreting and complying with the legislation.
- Associated administration burden.



# TAX ADMIN BURDEN

Administrative burdens to comply with the taxes. Each tax generally requires:

- Registration
- Preparation of returns
- Filing of returns
- Payments
- Follow-up issues like refunds, objections, and appeals
- Dealing with queries and audits



# SIMPLIFIED TAX

Some countries that have introduced simplified tax systems for small businesses:

- Brazil
- Argentina
- Chile
- Sierra Leone
- Uganda
- Tanzania
- United Kingdom
- Australia
- New Zealand.



# EASE OF PAYING TAX

	South Africa	Bots wana	Argen tina	Brazil	Peru	New Zealand	United Kingdom	OECD
Payments (number)	<b>32</b>	24	35	23	53	8	22	16
Time (hours on compliance)	<b>350</b>	140	580	2600	424	70	-	192
Tax payable (% of turnover)	<b>43.8</b>	52.9	97.9	147.9	50.7	44.2	52.9	46.1
<b>Rank</b>	<b>84</b>	<b>59</b>	<b>143</b>	<b>140</b>	<b>133</b>	<b>16</b>	<b>81</b>	-

SOURCE: World Bank 2005 B



# TAX RED TAPE IN SA

A business typically has to register for following taxes:

- Income Tax – payable to SARS;
- Provisional Tax – payable to SARS;
- Employees' Tax – payable to SARS;
- Value-Added Tax (VAT) – payable to SARS;
- The Skills Development Levy – payable to SARS or the Department of Labour;
- Unemployment Insurance Fund Contributions – payable to SARS or the Department of Labour;
- Workman's Compensation – payable to the Department of Labour.

2007 Report by University of Cape Town: **Recent Findings on Tax-Related Regulatory Burden on SMMEs in South Africa:**

Average tax compliance cost is 2.9 per cent of turnover, but gradually decreases to 0.003 per cent for firms with an annual turnover of more than R1 billion i.e. disproportionate. (UCT)



# TAX RED TAPE IN SA

Complexity of each tax product (FIAS Survey:2007):

- Very complex with 80 to 95% of small businesses requiring the assistance from tax practitioners.
- Each business pays on average of R7,030 (US\$ 1,030) per annum for tax services alone.
- VAT is the most costly and time-consuming tax to comply with.
- Provisional tax is also very problematic.



# SME TAX RELIEF

## Income Tax

Favourable income tax treatment for small business corporations (close corporations and companies with turnover of up to R14 million or US\$ 2,05 million). Relief is mainly:

- Lower tax rates; and
- Accelerated depreciation for assets, especially for manufacturing sector.

## CGT

One-time exclusion of R750,000 (US\$ 109,810) on disposal of small business assets within 2 years.



# SME TAX RELIEF

## VAT

- Small retail VAT scheme
- Four-monthly submission of VAT returns
- VAT registration threshold – R300,000 (US\$ 43,924)
- VAT on cash basis for turnover of R300,000 to R2,5 million (US\$ 43,924 to 366,032).

## Skills Development Levy

Exemption if payroll does not exceed R500,000 (US\$ 73,206).

## RSC Levies

Repealed – reduces number of taxes.



# TAX AMNESTY

Small business persons had been historically marginalised – need an amnesty to bring them into formal system.

Requirements: Turnover must not exceed R10 million (US\$ 1,5 million), amnesty levy on 2006 taxable income, supporting documentation.

Intended to close on 31 May 2007 but was extended to 30 June 2007

Applicants allowed until 31 August 2007 to submit supporting documents.

More than 350,000 applications for amnesty were received.



# SURVEYS

*Tax Compliance Burden for Small Business: A Survey Amongst Tax Practitioners* completed and released by the Foreign Investment Advisory Service (FIAS) on 27 August 2007.

Further two surveys on the challenges facing informal and formal small businesses have been commissioned by National Treasury and should be available by November 2007.



# SBC SHORTFALLS

Income tax relief is only for close corporations and companies.

Fails to provide relief for huge informal sector consisting of individuals and partnerships, which are the easiest means of starting a small business.

Informal sector still has disproportionately larger tax regulatory burden.

Relief favours manufacturing over other sectors.

Turnover threshold of R14 million may unduly favour bigger businesses that should not get the relief. This is not aligned with the R10 million threshold that was used in the amnesty.



# SME TAX STRATEGY OVERVIEW

Dilemma of introducing separate, simplified tax system for SME's.  
Need to consider:

- Target market? Definition of SME's.
- End result – where do we want small businesses to be eventually?
- Need to assist businesses to get through the start-up phase.
- Need to take unique traits of the country's tax system into account.
- Introduce a simplified system that grows into/towards the formal tax system – do not create separate bureaucracy.
- Focus on simplifying existing processes e.g. registration.
- Do not want to encourage bad habits and disincentive to get into the formal tax system – avoid cliff-edge drop.
- Adjustments in growing into formal tax system must be done with ease.
- Must be cost effective.
- Simplicity and certainty should be the hallmarks.



# POINTS TO CONSIDER

- Target market - what is a small business?
- Already have tax relief for small CC's and companies - focus on informal sector – individuals and partnerships.
- Can make existing regulatory measures simpler.
- Equity.
- Aligned with current tax system for smooth transition.
- Piggy-back on other regulatory burdens e.g. accounting
- FIAS Survey - 80 to 90% use tax practitioners.
- Must have the option to enter current tax system at any stage.
- Must be cost effective – e.g. *de minimus* exemption threshold but consider need to bring onto radar screen to measure.
- New Social Security System.
- Payroll taxes – most are not liable – use tax practitioners.
- Variables – compromise.



# TARGET MARKET

What is a “small business”?

- Turnover? Small Business Amnesty – R10 million; Small Business Corporations – R14 million
- Number of employees?
- Assets?
- Size of premises?

Different forms – sole proprietor, partnership, close corporation, company.

Existing SARS' turnover parameters for compliance with different taxes.

Informal sector – individuals trading as sole proprietors and partnerships.



# TARGET MARKET

South African Small Business Act, 1996, as amended, - definitions:

- Survivalist businesses typically generate less than the minimum income standard or poverty line.
- Micro-enterprises have annual turnovers of less than R200,000 (US\$ 29,280).
- Very small enterprises operate in the formal market and have turnovers of R500,000 to R6 million (depending on sector) (US\$ 73,200 to 878,470) .
- Small enterprises operate in the formal market and have turnovers of R3 million to R32 million (depending on sector) (US\$ 439,240 to 4,7 million).
- Medium-sized enterprises have a more complex managerial structure and have turnovers of R5 million to R64 million (depending on sector) (US\$ 732,060 to 9,4 million).
- Size of premises?



# DISCUSSION PAPER

- Based on work and research already done e.g. surveys and walkabouts, draft Discussion Paper on easing the tax compliance burden on small businesses.
- Discussion Paper includes 3 options on how to reduce the tax compliance burden for SME's. These are still proposals and need to be debated and refined further.



# 3 OPTIONS - OVERVIEW

## Option 1 – cash accounting

- *de minimus* exemption threshold; income tax and VAT based on a simplified cash accounting for turnover below R2,5 million; annual assessment basis, together with simplified provisional tax payments - can link to VAT payments; retain existing VAT exemption threshold at R300,000.

## Option 2 – presumptive tax

- *de minimus* exemption threshold; only a single, progressive, presumptive tax on turnover below R1,000,000; payable to SARS on a quarterly basis as a final tax; means that VAT registration threshold must be raised from R300,000 to R1,000,000.

## Option 3 – Step/Gradual Approach – hybrid of options 1 and 2

- *de minimus* exemption threshold, progressive, single tax on turnover for second turnover band; cash accounting for income tax and VAT for third turnover band; current relief for small business corporations for fourth turnover band or current tax system for individuals; raise VAT registration threshold from R300,000 to R500,000.



# OPTION 1

## Option 1 – Cash accounting for VAT and income tax

- Retain VAT registration threshold at R300,000 (US\$ 43,920).
- Turnover up to R100,000 (US\$ 14,641) - *de minimus* exemption threshold.
- Turnover from R100,001 to R2,500,000 (US\$ 14,641 to 366,030) - cash accounting for income tax and VAT – annual payment with provisional tax – possibly linked to VAT payments.



# OPTION 2

## Option 2 – Only presumptive tax on turnover

- Raise VAT registration threshold from R300,000 (US\$ 43,920) to R1,000,000 (US\$ 146,410).
- Turnover up to R100,000 (US\$ 14,641) - *de minimus* exemption threshold.
- Turnover from R100,001 to R1,000,000 (US\$ 14,641 to 146,410) – progressive tax on turnover.
- Quarterly, final payments to avoid provisional tax and annual assessment.



# OPTION 3

## Option 3 – Step/Gradual Approach

- Turnover up to R100,000 (US\$ 14,641) - *de minimus* exemption.
- Turnover from R100,001 to R1,000,000 (US\$ 14,641 to 146,410) – progressive, single tax on turnover – quarterly, final payments to avoid provisional tax and annual assessment.
- Turnover from R1,000,001 to R2,500,000 (US\$ 146,410 to 366,030) - cash accounting for income tax and VAT – annual payment with provisional tax - possibly linked to VAT payments.
- Turnover from R2,500,001 to R14,000,000 (US\$ 366,030 to 2,05 million) – current relief for small business corporations or current tax system for individuals.
- Proposals effectively mean that VAT registration threshold must be raised from R300,000 to R500,000 (US\$ 43,920 to 73,206).

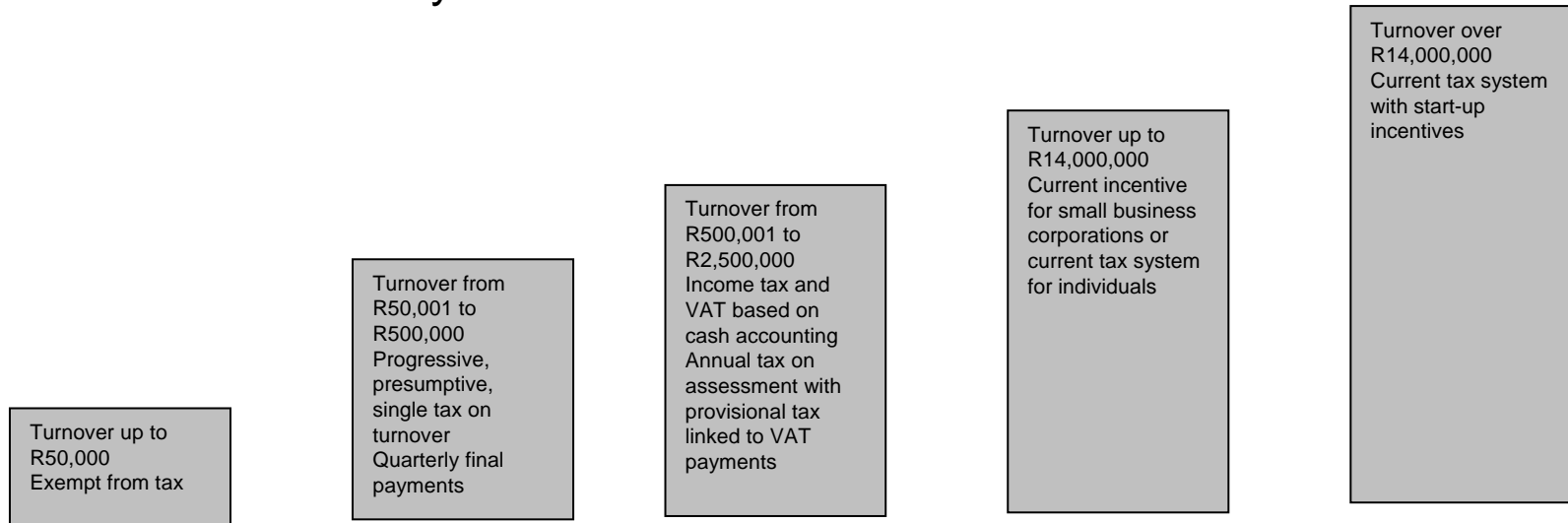


# OPTION 3

## Option 3 – Step/Gradual Approach – Illustration

Benefits of option 3:

- Creates a stepped approach/enabling environment for SME's to grow into the formal tax system.
- It is not a separate tax system with a cliff-edge drop – it is aligned with the current formal tax system.





# ADMIN FACTORS

- Dedicated Small Business Unit at Head Office,
- Dedicated small business facilities at branch offices,
- Mobile facilities to reach outlying/rural areas,
- Education programs,
- More staff,
- New computer systems,
- New forms,
- New initiatives, like accounting software and cell phone banking.



# RISKS

- Big number of taxpayers - any shortfalls will have huge impacts;
- Flat rate across the board, without closely tracking the normal tax payable, may:
  - under-tax taxpayers at the upper end of the turnover range;
  - over-tax taxpayers at the lower end, which may serve as disincentive to use simplified tax system;
- Salaried taxpayers may try to take advantage of any possible under-taxation flaw by migrating into the system as small businesses.



# THE WAY FORWARD

- Small Business Unit at SARS Head Office.
- Finalise Amnesty process.
- Formulate simplified tax system in discussion paper.
- Debate discussion paper within Government.
- Publish discussion paper for public comment.
- Surveys and more research.
- Finalise design of simplified tax system.
- Legislative amendments.
- Operational and administrative interventions.
- Build capacity at branch level.
- Taxpayer service excellence.
- Marketing and taxpayer education.



# END OF PRESENTATION



KEEP IT SIMPLE