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TITLE: Is South African tax Policy creating an enabling environment for small business?	
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ABSTRACT

Small business is widely recognised as the true engine room of the South African economy, despite this an alarming 440 000 small businesses have failed in the past five years. The existence of a difficult or complex regulatory environment in which small business operates, which South Africa undoubtedly has, can discourage entrepreneurship and the creation of new business. Amongst the regulatory environment for small business, the tax system is regarded as a key obstacle to doing business. In line with this, SARS and the National Treasury has as part of its broader mandate from Government to encourage entrepreneurship and create an enabling environment for small businesses to survive and grow, introduced a number of initiatives for small business. These initiatives were evaluated by this research report, by way of a literature review, and it was found that the design of South African tax policy for small business is generally in line with international best practice. The research also recommended that there are new tax policies that may be introduced for small business in South Africa. In addition, options have been identified for the streamlining of existing policies in order to be more effective in creating an enabling environment for small business.

KEY WORDS

Small business, enabling tax environment, international best practice, special tax treatment, SARS, South African tax policy

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Small business is widely recognised as the true engine room of the South African economy, despite this an alarming 440 000 small businesses have failed in the past five years. The existence of a difficult or complex regulatory environment in which small business operates, which South Africa undoubtedly has, can discourage entrepreneurship and the creation of new business. Amongst the regulatory environment for small business, the tax system is regarded as a key obstacle to doing business. In line with this, SARS and the National Treasury has as part of its broader mandate from Government to encourage entrepreneurship and create an enabling environment for small businesses to survive and grow, introduced a number of initiatives for small business. These initiatives were evaluated by this research report, by way of a literature review, and it was found that the design of South African tax policy for small business is generally in line with international best practice. The research also recommended that there are new tax policies that may be introduced for small business in South Africa. In addition, options have been identified for the streamlining of existing policies in order to be more effective in creating an enabling environment for small business.

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1 INTRODUCTION

1.1 Background

March 1995, the first democratically elected Government of South Africa released a *White Paper on National Strategy for the Development and Promotion of Small business in South Africa (1995).* The Finance Minister at the time, Trevor Manuel, wrote in the foreword of this document:

> *"With millions of South Africans unemployed and underemployed, the Government has no option but to give its full attention to the fundamental task of job creation, and to generating sustainable and equitable growth. Small, medium and micro-enterprises (SMMEs) represent an important vehicle to address the challenges of job creation, economic growth and equity in our country. Throughout the world, one finds that SMMEs are playing a critical role in absorbing labour, penetrating new markets and generally expanding economies in creative and innovative ways. We [the Government] are of the view that – with the appropriate enabling environment – SMMEs in this country can follow these examples and make an indelible mark on this economy onto a higher road – one in which our economy is diversified, productivity is enhanced, investment is stimulated and entrepreneurship flourishes".*

Seventeen years down the road and his sentiments are as relevant as they were in 1995. Small business still offers the only real prospect of large-scale job creation in South Africa (Moneyweb, 2012). Despite this, the Adcorp Employment Index (2012) reports that, an alarming 440 000 small businesses have failed in the past five years. In addition, the number of people trying to start their own business has fallen from 250 000 in 2002 to 58 000 in 2011, which is a worrying decline of 76 percent. The gravity of these numbers is emphasised by the fact that 68 percent of all South African workers are employed by small business (employing fewer than fifty people) and the decline of small business activity has resulted in a reduction of the economy's job creation potential by about 2.3 million jobs (Adcorp, 2012).

Although the recession is much to blame for the dismal performance of the small business sector, the existence of a difficult or complex regulatory environment in which small business operates, which South Africa undoubtedly has, can discourage entrepreneurship and the creation of new business (International Finance Corporation (IFC), 2007; Adcorp, 2012).

1.2 Research Question

Is South African tax policy creating an enabling environment for small business?

In order to unpack the research question the following sub questions will need to be considered:

- What is an enabling environment for small business and what are the recommendations of international experts in this regard?
- What tax instruments has South African tax policy introduced in order to create an enabling environment for small business?
- Are the South African tax instruments in line with international best practice?
- If the South African tax instruments are not in line with international best practice, what recommendations can be put forward in order to improve the tax environment for small business?

1.3 Objectives

The objective of this research is to evaluate the appropriateness of the small business tax reforms introduced by the National Treasury and SARS, against the benchmark of international best practice. Guidelines for international best practice will be obtained from a literature review of the policy guidelines prepared by international organisations specialising in the field of small business taxation. The research will then continue to evaluate the progress of South African tax policy for small businesses in creating an enabling environment for small business. The research will then attempt to comment and recommend on possible changes that the SARS may consider in order to improve the South African tax policy for small businesses.

1.4 Importance

The economic importance of the small business sector is encapsulated in its demand-generating ability, its income-generating potential and ability to act as a driver of employment creation and human capital consolidation (Chamberline & Smith, 2006:3). Given the potential that small business has in the economy, an increased focus has been placed on the taxation of small business in recent years (IMF, 2007). This is evidenced by the ample literature dealing with the tax compliance costs faced by small business (Foreign Investment Advisory Service (FIAS), 2007).

SARS and the National Treasury have also understood the importance of small business and have introduced a number of tax reforms for small business, *inter alia* the Turnover Tax regime contained in the Sixth Schedule to the Income Tax Act No. 58 of 1963 (the Income Tax Act) and the provisions of s 12E of the Income Tax Act which deal with ‘small business corporations’. There, however, is a lack of literature evaluating these reforms. This research report aims to fill the above-mentioned gap, to benchmark the appropriateness of the small business tax reforms introduced into the Income Tax Act, against international best practice. This may be relevant in designing new tax policies for small business in South Africa or for the streamlining of existing policies in order to be more effective in creating an enabling environment for small business.

1.5 Research Methodology

The research will follow a normative literature review. A review will be done on various international policy documents relating to the taxation of small business in order to understand what an enabling environment for small business is, and the various instruments that may be implemented to create one. This will provide a benchmark against which South African tax policy can be evaluated. The Income Tax Act as well as well as other Government publications will be reviewed in order to identify the relevant provisions of the Income Tax Act that have been introduced by National Treasury and SARS as part of its mandate to encourage entrepreneurship and create an enabling environment for small business (SARS, 2011a). These provisions will then form the subject of the evaluation of the research.

1.6 Scope

Internationally, a key inhibitor in creating an enabling environment for small business is the cost of compliance with regulations (Chamberline & Smith, 2006:1). Regulatory costs impose a higher burden on small business as they do not have the administrative capacity to absorb them easily (SBP, 2003). For the purpose of this research, the broader regulatory environment of small business will not be considered as the focus is on tax policy. The focus on taxation is mainly due to it being ranked as one of highest sources of regulatory burden for small business (SBP, 2003).

The provisions of the Value-Added Tax Act No. 89 of 1991 (the VAT Act) will only be considered by this research to the extent that it relates to the design of Income Tax policy for small business.

2 ENABLING TAX ENVIRONMENT FOR SMALL BUSINESS

2.1 Introduction

Primarily, for a small business to flourish there needs to be an overall conducive business environment (OECD, 2004). Amongst the overall business environment, the single most important element in an economic growth strategy for any country is an appropriate regulatory environment (SBP, 2002). Furthermore, it is the

Government's role to create and implement this enabling regulatory environment for small business (RSA, 1995). An important question that needs to be asked is what an enabling environment for small business is and how can it be designed.

Research suggests there is no definitive definition of an enabling environment for small business but rather there are certain characteristics that it should have. One of the key characteristics of an enabling environment for small business is that it has enabling legislation that keeps the small business environment as market-orientated as practically possible. This can be done by Government ensuring that inappropriate and burdensome legislation, regulations and administrative requirements do not prevent markets from operating effectively (SBP, 2002; RSA, 1995).

A key point to note is that although the focus of this research is taxation (see scope 1.6) it is only one of several issues that influence the overall regulatory environment for small business. The issue of taxation needs to be addressed by Government holistically, and in the broader context of an appropriate enabling environment for small business (SBP, 2003).

Concerning this, Part 2 will firstly outline the general characteristics of an enabling tax environment for small business. It will then identify the different categories of small business requiring special tax treatment as well as the international best practice tax policy for each category.

2.2 Characteristics of an Enabling Tax Environment for Small Business

A distinct feature of the small business sector is its heterogeneity, as a result, there is no single 'best' approach to the taxation of small business applicable in all circumstances and across all countries (IMF, 2007).

However, what research suggests is that there are certain key characteristics and parameters that need to be taken into account when designing an enabling tax framework for small business. Broadly speaking the tax framework for small business needs to be as simple, administerable, and equitable as practically possible (CIC, 2009).

The characteristics of an enabling tax environment for small business are discussed in more detail below:

- A small business tax framework should facilitate the creation and succession of small enterprises (IFC, 2007).
- Tax systems should be simplified for small business to ensure that compliance costs incurred in complying with tax legislation are kept as low as practically possible (OECD, 2004; IFC, 2007).
- Small business taxation should be designed in such a way as to encourage small business to formalise. Formalise the structure in which it will conduct business, register for tax and keep accounting records (IFC, 2007).
- Any special tax regime designed for small business should facilitate their integration into the formal sector and from a micro size upwards to a larger size (OECD, 2004).
- A small business tax framework should promote growth and support the re-investment of profits in the small business. Incentives should be provided to encourage investment in business assets and research and development by small business (IFC, 2007).
- The design of small business taxation should take into account the taxpayer's capacity and skills in accounting and record keeping (CIC, 2009).
- The administrative costs of dealing with small taxpayers must be kept to a minimum for the tax authorities. (CIC, 2009).
- A small business tax system should entail transparent and equitable application of tax legislation (OECD, 2004).

- The stability of tax legislation is also a core element of an enabling tax framework for small business because it creates certainty of what, where and how tax will be payable (Engelschalk, 2004).

For Government to combine and reconcile these objectives into a practical tax strategy for small business is difficult. Trade-offs will constantly need to be made between simplicity, fairness, efficiency, and administrative feasibility (CIC, 2009; Corthay, 2011).

2.3 What Instruments and Design Options can be used to create an Enabling Environment for Small Business?

2.3.1 Introduction

Several tax instruments can be used to create an enabling environment for small business; however, there is no single best practise that can solve all the issues that arise in trying to implement a tax system that is simple, administerable and equitable (CIC, 2009). A range of tax instruments can, however, be chosen to ensure that the most appropriate tax design is chosen taking into account the needs of small business.

2.3.2 Partitioning of Small Business

A constant sentiment that is echoed throughout this research is that the small business sector is not one homogenous block, and as a result, different sized businesses may require different tax treatment (CIC, 2009). Accordingly, the first step in designing enabling tax legislation for small business is the partitioning of taxpayers into different groups for distinct special tax treatment (IMF, 2007). This is necessary to ensure that tax incentives and simplified tax regimes are correctly targeted to businesses requiring special tax treatment (see Part 2.4) (IFC, 2007) .

International experts suggest that taxpayers should be classified into the following three categories: (CIC, 2009; IFC, 2007)

- Micro enterprises;

- Small enterprises and
- Medium enterprises.

It is important to note that these above-mentioned terms do not necessarily have the same meaning from a tax perspective as it would have for common law purposes. This is as tax laws do not directly define these taxpayer groups, but rather they define specific criteria to determine the eligibility for special tax treatment, which is usually done using thresholds (IFC, 2007; IMF, 2007).

Thresholds to distinguish between small business categories.

In order to distinguish between micro, small and medium enterprises a wide range of measures can be used. An important design principle in creating enabling tax legislation for small business is that the eligibility criteria to qualify for any special tax treatment must not be so complex that it increases the compliance burden for small business; neither should it be so extremely narrow that it limits eligibility (Arendse, 2007).

An important principle in designing an enabling tax framework for small business is that the VAT threshold should be used as an anchor for the partitioning of taxpayers into different categories for special tax treatment (IMF, 2007). This is an important principle since enterprises above the VAT threshold will be complying with the normal VAT system, therefore it would be keeping reasonably sophisticated records. Hence, it should have the skills and capacity to comply with the standard income tax system, meaning accrual accounting and deprecation (IMF, 2007). In order to harmonise the VAT threshold with the small business threshold the most appropriate measure is turnover. Turnover is the simplest way to segment taxpayers into different categories as all business operators are likely to have some idea of what their total receipts are and turnover would generally be verifiable by the tax authorities (CIC, 2009; IMF, 2007).

2.3.3 What Form of Special Tax Treatment?

Once the taxpayers have been separated into different categories, the next step is to determine what form of special tax treatment, if any, should be applied to each taxpayer category (IMF, 2007).

2.3.3.1 Micro Enterprises

Firstly, micro enterprises at the subsistence level should be tax exempt for poverty reduction reasons (IFC, 2007). Secondly, micro enterprises above the subsistence level can be assumed to have incomes below the personal tax threshold. Hence, it would make no sense to tax these micro enterprises when their counterparts, who are marginal workers, are earning the same amount as the entrepreneurs but as wages, and is therefore not subject to tax as the wage is below the tax threshold (IMF, 2007). One could argue that these enterprises should simply be excluded from taxation (IMF, 2007). The strongest argument for including them in the tax system is that this is important to achieve a long-term objective of creating a taxpaying culture. However, the compliance burden for the taxpayer as well as the administrative burden for the tax authorities should be kept as low as possible (IFC, 2007).

The most appropriate system to tax micro enterprises would be a simple uniform patent, which levies a uniform lump sum amount on micro enterprises regardless of their profit; this is similar to a license fee. The patent system would replace the regular income tax and it should be the only tax the micro enterprise is subject to (IMF, 2007; IFC, 2007). The main advantage of a patent system is its simplicity, thereby ensuring that the tax compliance and administration costs are kept as low as possible, which is a key element in creating an enabling environment for small business (IMF, 2007).

2.3.3.2 Small Enterprises

These are enterprises which are above the micro level, for them complying with the standard income tax system not only requires costly record keeping requirements but it is also often beyond the capacity and skills of an entrepreneur. Therefore, small enterprises require the standard income tax system to be adjusted in order to take into account the limited abilities of the small business (IFC, 2007). A key instrument in reducing the small business compliance burden and bringing informal small businesses into the tax net is a presumptive tax system (IFC, 2007). Presumptive taxes are a replacement tax for an income tax; they rely on a base that acts as a proxy for income tax (OECD , 2007).

Presumptive taxes are important for businesses at a small enterprise level as it ensures that they participate in the tax system while at the same time reducing their compliance burden. It also eases a small enterprise's migration into the standard income tax system, thereby ensuring the continuing participation of small business in the formal economy (OECD , 2007). There are a number of presumptive tax systems that may be chosen for small business, each with its own advantages and disadvantages for example the indicator based tax system (system taxes a small business based on an indicator other than turnover for example the total number of employees, floor space, inventory values, electricity consumption and other variables that may be correlated with income (OECD , 2007)), cash flow based system (this method will allow the immediate deduction of all investment spending but no deductibility of finance costs (IMF, 2007)) and the turnover tax system (the turnover tax system only tax cash receipts (IMF, 2007)).

Turnover tax requires the taxpayer to perform at least some basic record keeping procedures (as they will need to account for their business turnover on a regular basis) without imposing the burdensome accounting requirements required of the mainstream tax system (IFC, 2007). Turnover is generally the best proxy for profit estimation, as it better reflects the position of the business (IFC, 2007). Due to the advantages of a turnover tax system, research suggests that an appropriate tax system for small enterprises is a turnover tax (IFC, 2007).

i. General Design Principles of a Presumptive Tax System

a. Should the presumptive tax substitute all other taxes?

Research suggests that there is little disagreement that smaller enterprises should pay a simplified form of income tax. However, it is less clear whether it should also replace the VAT (IMF, 2007). Most importantly, the objective of a presumptive tax is to reduce the overall small business compliance burden. Therefore a reasonable assumption is that it should not only replace income tax but other turnover based taxes such as VAT (IFC, 2007). Research suggests that the case for a presumptive tax to replace the VAT is weaker than that for a replacement of the standard income tax (IMF, 2007).

b. Treatment of Social Taxes

According to international experts, social taxes should not be replaced by the presumptive tax. Social taxes are generally the social contributions and personal income taxes on employees, which are normally collected by employers (IFC, 2007).

c. Effective tax rate levied by presumptive tax system

A key design principle of a presumptive tax system is that the effective tax rates levied under it are relative to those in the standard income tax system (IMF, 2007). This will ensure that the tax burden faced by businesses close to the upper threshold of the presumptive tax system face a burden that is not substantially lower than businesses at the lower end of the standard tax system (IFC, 2007). The effective tax rate needs to be high enough to avoid discouraging businesses from growing and migrating from the presumptive tax system into the standard tax system. It should also be high enough not to encourage small enterprises to hide their growth by undering income or splitting into multiple entities (IMF, 2007; IFC, 2007). This can be achieved ensuring that the presumptive tax has a progressive feature (IFC, 2007).

d. Should tax rates be differentiated based on industry type?

Research suggests that it is not recommended to adopt a large number of different rates based on industry sector or business type. This creates problems for enterprises with multiple activities as well as disputes arising between the taxpayer and the revenue authorities concerning their classification (IFC, 2007).

However, it should be remembered that the trade and service sectors generally face different profit margins as a percentage of turnover; therefore, it may be useful in terms of fairness for a presumptive regime to distinguish between these two industries (IFC, 2007). Two or three distinct rates are likely to be enough, with a reduced rate allowed for businesses in sectors with generally lower profit margins as a percentage of turnover (IMF, 2007).

However, instead of applying different tax rates, it may be more appropriate to establish an adjusted turnover tax (OECD , 2007). Under an adjusted turnover tax the turnover tax base is adjusted for business costs. A possible way of doing this is instead of small enterprises capitalising the costs of assets, an immediate deduction may be allowed for the purchase. Similarly, instead of the small enterprise, keeping records of inventory purchases and inventory on hand, a simple lump sum deduction may be allowed based on a percentage of turnover (OECD , 2007). Such a tax system may have the effect of achieving fair treatment of enterprises with lower profit margins as a percentage of turnover while at the same time keeping the tax compliance burden low for small business (OECD , 2007).

e. Should small enterprises be allowed to opt out of the presumptive tax?

Research suggests that small businesses that are able and willing to comply with the standard tax regime should be allowed to be a part of it. This option is also particularly important for small businesses that are in a loss making situation as well small businesses with low profit margins (IFC, 2007).

f. Should there be a Time Limit on the Application of a Presumptive Tax System?

Small businesses that grow will automatically move to the standard tax system once its turnover exceeds the threshold. Other small enterprises should be allowed to remain in the presumptive tax system without any time limit. If a time limit is placed on the application of a presumptive tax, small enterprises will simply close down and open under a new name, which may negatively affect their business (IFC, 2007).

g. Treatment of Professionals

According to international best practice, professionals should not be included in the presumptive tax as they are well educated and should not have problems with keeping records and filing standard tax returns. Additionally many professionals have a comparatively high income and should therefore be taxed in accordance with the standard income tax system in order to increase tax equity and revenue collection (IFC, 2007).

2.3.3.2 Medium Enterprises

These enterprises are generally above the VAT threshold. Such enterprises should be taxed under the standard tax system, as these enterprises should be able to keep reasonably sophisticated books (meaning accrual accounting, depreciation investments, and so on) (IMF, 2007). In order to create an enabling environment for these medium enterprises, incentives should be provided to encourage investment and growth (IFC, 2007).

i. Incentives to increase business assets:

Due to the financial constraints that a medium enterprise faces as well as the higher finance costs that they incur on the borrowing of funds to invest in business assets, the tax system can be used to assist the taxpayer in alleviating this burden. This can be done by creating more simplified and more favourable depreciation schemes for medium enterprises, thereby subsidising the cost of the investment, promote growth and encourage investment. Simplified depreciation schemes will also reduce the accounting burden for small business, as complex depreciation calculations will be avoided (IFC, 2007).

ii. Investments in Research and Development

Investment in research and development is a key element in ensuring the survival of medium enterprises. Although promoting research and development is generally an element of the standard tax system, additional incentives should be provided to medium enterprises. The main element of a research and development incentive is to allow a larger amount to be deducted than the actual expenditure incurred in the research and development activity (IFC, 2007).

2.3.4 Incentives for Start-up Small Businesses

An enabling tax environment must facilitate the creation of small business. Tax holidays may be offered to small businesses in the start-up phase (IFC, 2007). However, this is likely to be of little benefit for start-up small enterprises as they are likely to be in a loss-making situation in their early years of operation, therefore an assessed loss may be the only benefit to them; a tax holiday may result in this benefit being lost (IMF, 2007). However, a tax holiday is prone to abuse by taxpayers; small enterprise owners may cease the operation of a business just before the expiration of the tax holiday period and then re-establish the business under a new name to continue to enjoy tax-free business operations (IFC, 2007). A more appropriate way to assist businesses in the start-up phase is through the use of accelerated depreciation and research and development tax deductions or tax credits as mentioned in 2.3.4 rather than a tax holiday (IFC, 2007).

2.4 Conclusion

This part has outlined the international best practice design of an enabling tax environment for small business. We have identified the international best practice design of an enabling tax environment for small business. This will serve as a benchmark against which South African tax policy for small business can be evaluated. **Part 3** will identify and discuss South African tax policy for small business.

3 SOUTH AFRICAN TAX POLICY FOR SMALL BUSINESS

3.1 Introduction

As part of the Government's broader mandate to encourage entrepreneurship and create an enabling environment for small businesses to survive and grow, the National Treasury and SARS have introduced various initiatives for small business (SARS, 2011b).

The initiatives that will be discussed in this part are the turnover tax system for a qualifying "micro business" and the favourable tax treatment of business that qualifies as a "small business corporations"

3.2 Turnover tax

The turnover tax is a simplified tax system for "micro businesses" and it is determined in accordance with s 48 and the Sixth Schedule of the Income Tax Act. Turnover tax is a stand-alone tax and does not form part of the normal income tax payable by a taxpayer on his taxable income. Therefore, the receipts of a business forming part of the turnover tax system will be exempt for the purposes of calculating a taxpayer's income tax liability in terms of the Income Tax Act. (SARS, 2011a). The turnover tax system replaces the Income Tax, Capital Gains Tax (CGT) and VAT (from years commencing 1 March 2012, a registered VAT vendor can also qualify as a micro business, a situation that was previously not allowed (Gordhan, 2011)).

The turnover tax system that may only be elected by businesses with a "qualifying turnover" of less than R1 million. " Qualifying turnover" is defined in para 1 of the Sixth Schedule as the total amounts received from the carrying on of business activities, but excludes receipts or accruals of a capital nature and Government grants that are exempt from income tax. (SARS, 2011a; Gordhan, 2012). Furthermore, the Sixth Schedule allows only for businesses that have a financial year that ends on the last day of February to elect the turnover tax system. If the turnover tax system is elected by a qualifying micro business, the turnover tax will apply for as long as the conditions for registration apply.

In terms of para 3 of Sixth Schedule there are a number of taxpayers that are disqualified from the turnover tax system. Micro businesses will pay tax in terms of ss 48A and 48B of the Income Tax Act based on tax rates annually fixed in Parliament. A qualifying micro business will also be allowed to pay turnover tax, VAT and employees' tax twice a year. This means that the number of returns and payments a year for a micro business will be reduced from about 18 to just two (Gordhan, 2012).

3.3 Small Business Corporations

SARS has introduced tax relief measures for small businesses at the medium enterprise level. In order to qualify for these tax relief measures an enterprise will need to meet the requirements of a "small business corporation" (SBC) in terms of s 12E(4)(a) of the Income Tax Act. Interpretation Note 9 provides guidance on the application of s 12E of the Income Tax Act.

Two major concessions apply to a SBC; the first concession is the special tax rates that apply to SBC's. Their taxable income of up to R350 000 is taxed at reduced rates, with the first R63 556 taxed at nil percent (Gordhan, 2012). The second concession is that the SBC is allowed favourable write-off periods for both assets used in a process of manufacturing as well as in the production of income. Section 12E(1) of the Income Tax Act allows an SBC an immediate deduction of all plant or machinery used in a process of manufacture or similar process ("manufacturing assets") in the year of assessment that it is brought into use for the first time. Additionally an SBC is allowed to elect the accelerated allowance of s 12E(1A) of the Income Tax Act for depreciable assets (other than manufacturing assets) at a rate of 50% in the year of assessment during which it was first brought into use, thirty percent in the second year of assessment, and twenty percent in the third year of assessment.

3.4 Conclusion

The key tax policies applicable to small business in South Africa is the turnover tax system and the tax relief measures for an SBC. **Part 4** will evaluate these tax policies for small business in South Africa against the international best practice tax design of an enabling tax environment for small business, which was discussed in Part 2.

4 EVALUATION OF SOUTH AFRICAN TAX POLICY FOR SMALL BUSINESS

4.1 Introduction

This part will look at each of the taxpayer segments identified in Part 2 and evaluate whether the South African tax policies for small business, as discussed in Part 3, is designed in accordance with international best practice, as discussed in Part 2 of this research .

An important point to note while evaluating South African tax policy for small business is that there is no single 'best' approach to the taxation of small business applicable in all circumstances (IMF, 2007), therefore certain South African tax policies for small business may not be in line with international best practice, nevertheless it may be appropriate considering the unique challenges facing South Africa.

4.2 Micro Enterprise Level

A patent tax system is the recommended design for businesses at the micro enterprise level; however, in South Africa micro enterprises generally do not pay tax under the turnover tax system, this is as turnover up to R150 000 is taxed at 0%, which is likely to be the turnover of micro enterprises (Gordhan, 2012). Although this is not in accordance with international best practice, this provision may nevertheless be appropriate considering the high levels of unemployment and informality in South Africa.

4.3 Small Enterprise Level

As mentioned in Part 2 a key instrument in reducing the compliance burden and encouraging small businesses to formalise is a presumptive tax system. The presumptive tax system should preferably be a tax based on turnover. Accordingly, the Government has introduced the turnover tax system for small businesses with the goal of creating an enabling tax environment for small business (SARS, 2011a). After accessing the turnover tax system it is clear that the eligibility criteria are quite extensive and complex for a small enterprise. International best practice suggests that the eligibility criteria for a presumptive tax should not be so complex that it increases the compliance burden for small business; neither should it be so extremely narrow that it limits its eligibility (Arendse *et al.*, 2007).

International best practice suggests that professionals should be taxed in accordance with the standard income tax system; the turnover tax system in South Africa accordingly excludes small enterprises that provide professional services from the turnover tax. A personal service provider or a labour broker that has not been issued with a tax exemption certificate by SARS is also excluded from the turnover tax system; this is a necessary anti avoidance measure to avoid employees from abusing the turnover tax system (SARS, 2011a).

We can see that the eligibility criteria to qualify as a “micro business”, although extensive, it is appropriate to prevent abuse of the tax system and revenue leakage. Genuine start-up small enterprises should not run into complicated problems with tax legislation when applying the turnover tax system (SARS, 2011a).

The turnover tax system in South Africa has in accordance with international best practice, not replaced the various social taxes by the presumptive tax. International best practice also suggests that that the effective tax rates levied by the presumptive tax system is relative to those in the standard income tax system and the effective tax rate needs to be high enough to avoid discouraging businesses from growing and migrating from the presumptive to the standard tax system. Accordingly, the turnover tax system in South Africa imposes a tax liability that is broadly aligned with the standard income tax system (SARS, 2011a). The turnover tax in South Africa only applies on election by the taxpayer and a time limit has not been placed on the turnover tax system; this is in line with international best practice. South African tax policy for small business also makes no provision for tax holidays, which has been discouraged by experts. The VAT threshold of R1 million is linked to the turnover tax threshold, this is also in accordance with international best practice.

As was mentioned in Part 2 there is a lack of consensus concerning whether a presumptive tax should also substitute for VAT. The Government has adopted a policy of allowing micro businesses to choose whether they want to operate as a VAT vendor or not (micro businesses have a turnover of less than R1 million, and enterprises with a turnover of less than R1 million can voluntarily register as a VAT vendor (Stiglingh, 2011). Ultimately, the taxpayer who operates a micro business is in a position to elect whether operating as a VAT vendor will be to his advantage or not.

There is only one set of rates for the turnover tax system in South Africa, whereas international best practice suggests that it may be appropriate to distinguish between the trade and service sectors as they generally face different profit margins as a percentage of turnover. The South African turnover tax system also makes no provision for any reductions to be made from turnover, which is a key design principle in ensuring that low profit margin industries can benefit from the turnover tax system.

The above mentioned shortfalls of South African tax policy for small enterprises may be a possible reason as to why only 7 700 businesses have registered for the turnover tax system since 2009, of which 88 percent were previously registered for income tax (SARS, 2011c).

4.4 Medium Enterprise Level

International best practice suggests that taxpayers at the medium enterprise level should be subject to the standard income tax system. Specific incentives should however be provided to medium enterprises to encourage investment and growth.

Accordingly, in terms South African tax legislation SBC's are subject to the standard income tax system. However, they are allowed reduced tax rates for taxable income up to R350 000. This is an important incentive in creating an enabling environment for small business, as this incentive will encourage small businesses to incorporate, and thereby reap the benefits of a more formal approach of doing business (such as access to finance etc.) (Du Toit, 2012).

The 100% write-off of manufacturing assets and the accelerated allowance of non-manufacturing assets are in line with international best practice, which suggests that simplified and more favourable depreciation schemes should be created for medium enterprises.

Similar to the eligibility criteria of the turnover tax system; the eligibility criteria for an SBC are extremely narrow and complex which may limit its eligibility. Arendse *et al.* (2007) suggests that these anti avoidance measures may not only apply to aggressive tax planners but also to unwary taxpayers. However, from the Governments' perspective these requirements are necessary safety features (as was discussed in 4.3) to ensure that the tax relief concessions are only taken up by the intended recipients and to ensure that the tax base is protected from revenue leakage. Genuine medium enterprises should not run into complications in applying s 12E of the Income Tax Act (SARS, 2011a). A shortfall of the provisions for an SBC is that the eligibility criteria is very strictly applied, in the sense that even if the medium enterprise has one rand of taxable income that is over the R14 million threshold, it will be disqualified from all of the SBC concessions for that year (Arendse, 2007). For example, assume a company has met all the other requirements of an SBC and had a taxable income of R13.5 million in year one, R14.4 million in year two, and R13.7 million in year three. The company would be an SBC in years one and three but would be disqualified in year two, as it does not meet all the requirements of an SBC as defined in s 12E of the Income Tax Act for that year (Arendse *et al*., 2007).

This may place a taxpayer in a difficult situation, as in year two it will not be allowed the SBC concessions, even though the gross income exceeding R14 million is temporary, accordingly Government should introduce phase out provisions for SBC's (Arendse *et al*., 2007).

Research and Development is a key element in ensuring the survival of medium enterprises. International best practice suggests that a research and development incentive should allow a larger amount to be deducted than the actual expenditure incurred in the research and development activity. Concerning this SARS has introduced s 11D of the Income Tax Act as a general element of the standard income tax system to encourage research and development. It is interesting to note that taxpayers incurring expenditure in terms of s 11D of the Income Tax Act on or after 1 April 2012 will only be able to claim a 100% deduction for research and development activities undertaken. An additional 50% will only be allowed if the taxpayer applies to and receives approval from the Minister of Science and Technology before the research and development activity is undertaken (Deloitte, 2012).

For a medium enterprise, this significantly increases their compliance burden and this incentive will therefore not be sufficient to encourage research and development activity amongst medium enterprises. International best practice suggests that specific incentives should be designed for medium enterprises in order to stimulate their investment in research and development.

4.5 Conclusion

The evaluation performed in this shows that the overall tax design of South African tax policy for small business is generally in line with the international best practice in creating an enabling environment for small business.

The introduction of the turnover tax system in South Africa is a positive move in creating an enabling environment for small business. The overall design of the turnover tax system is in accordance with international best practice, deviations from international best practice have an appropriate rationale behind them. However, there seems to be little incentive for small enterprises with lower profit margins as a percentage of turnover to elect the turnover tax, accordingly Government needs to address this. The tax relief measures provided to an SBC is a key tool in encouraging investment by medium enterprises and facilitating their growth. Various options that may be considered by Government in order to streamline existing policies and create new policies for small business in order to be more effective in creating an enabling environment for small business will be discussed in **Part 5.**

5 RECOMMENDATIONS AND CONCLUSION

5.1 Introduction

Part 4 concluded that the design of South African tax policy in creating an enabling environment for small business is generally in line with international best practice. Some shortfalls of South African tax policy for small business were, however, identified and recommendations will be put forward in this to address them.

7.2 Small Enterprise Level

As mentioned in Part 4, there is little incentive for small enterprises with lower profit margins as a percentage of turnover to elect the turnover tax system. As a result, they will continue to face the high burden of complying with the standard income tax legislation. A possible solution to this is that Government can adjust the turnover tax system to be more appealing to small enterprises with lower profit margins as a percentage of turnover, by allowing simplified deductions to be made against taxable turnover. These deductions need to be easily measured and should not significantly increase the compliance burden, as this would be counterproductive. A possible way of achieving this is to allow an immediate deduction against taxable turnover for the purchase of business assets and allow for a lump sum deduction for inventory purchases based on a percentage of turnover (OECD , 2007). Austria provides an example of this, whereby the tax base for small enterprises is calculated as turnover less wages, less the cost of goods and VAT on inputs, less deductible expenses (which is simply measured as 12 percent of turnover limited to a maximum of $34,317) (OECD , 2007). Such an adjustment will have the effect of the turnover tax being more appealing to small enterprises with smaller profit margins, without significantly increasing their tax compliance burden.

Cash flow based income tax

Another option that can be used to create an enabling environment for small enterprises is for income tax to be levied on a cash flow basis, rather than on an accrual basis. This method will allow for the immediate deduction of all investment spending (but no deductibility of finance costs). This will appeal to taxpayers as the cash flow based method is more closely linked to profitability when compared to the turnover tax; however, the cash flow based income tax requires a more sophisticated method of record keeping (IMF, 2007)
.

5.3 Medium Enterprise Level

A possible solution to the lack of phasing out provisions for SBC's, is that Government can introduce a provision whereby, even if the gross income of the medium enterprise exceeds the R14 million cap, it can continue to be designated as an SBC if the business can prove that this was a small and temporary event. This is similar to para 10(3) of the Sixth Schedule, which relates to a micro enterprise whose turnover has temporarily exceeded the R1 million turnover limit (Stiglingh, 2011).

5.5 Final Conclusion

This research concludes that the South African tax policy for small business is generally in line with international best practice, and it is appropriate in creating an enabling environment for small business. This research has also identified certain shortfalls of South African tax policy for small business and accordingly recommendations for the streamlining of existing policies in order to be more effective in creating an enabling environment for small business in South Africa has been provided.

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