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A small business perspective on tax compliance

All South African stakeholders and political parties surely agree on the importance of promoting the establishment of small businesses and facilitating their growth. That importance cannot be over-emphasised, particularly in the context of high unemployment. Stakeholders would also agree that small and medium enterprises (SMEs) are broadly labour-intensive, unlike large capital-intensive mining or industrial projects. So no aspect which hampers the growth of micro-businesses into small businesses and their eventual ability to make a substantial contribution to the formal economy, should be left unexamined.

Taxation ranks high as a source of regulatory cost and disincentive for small-scale entrepreneurs. Micro-enterprises can be assumed to be generally reluctant to enter the formal economy – despite the many advantages such as access to bank finance – because this step implies falling into the tax net. This is a loss not only to the economy, but also to state revenue, because micro-enterprises operate on a cash basis without a ‘paper trail’, making the enforcement of compliance by the South African Revenue Service (SARS) that much more difficult.

To the layman, tax laws are generally incomprehensible. If the tax system is too complicated – as South Africa’s undoubtedly is – hiring the expertise to advise on compliance raises the cost of doing business and drains resources that could have alternative productive uses. Not only are these heavy compliance costs undesirable, they disadvantage small firms.

The current complexity of the tax system in South Africa combined with the increased likelihood – in the present climate of aggressive enforcement – of getting caught for cheating on tax, tilts the cost-benefit calculation in favour of the taxman and against the income earner already in the net through registration as a taxpayer. The result? Those in the system pay when SARS says so. Those outside the tax loop undoubtedly often choose to stay out. To them the benefits of formalising their businesses might not outweigh the costs of compliance and the risk of harsh penalties for non-compliance. SARS is now tougher on those already in the tax net, while its strenuously proclaimed efforts to cast the net wider will remain hampered by the above-mentioned considerations.

It is important to distinguish between the burden of tax rates, the compliance costs of the tax system, and the different implications for firms in the formal and informal sectors. This edition of *SME Alert* deals mainly with the issue of compliance and the disincentive effect of tax complexities on the willingness of informal businesses to enter the tax loop. South Africa’s small businesses are unlikely to comply with their tax obligations with gusto. So the intention must be to make tax compliance easier and thereby encourage informal operators to enter the tax system and reap the rewards of formalisation.

The Small Business Project (SBP) is well aware of the factors hindering the simplification of South Africa’s tax system for the benefit of small businesses. This is not an agenda to be embarked on lightly. The introduction of special concessions for small



'It is common knowledge that the burden of tax and regulatory compliance impacts adversely on small businesses...'

Trevor Manuel

businesses might complicate the tax system still further, so increasing compliance costs. So providing stability in the tax system is in itself a good way to avoid increasing compliance costs. Also there could well be a positive spin-off for the small business in deciding to comply with the tax rules, as this requires the introduction of accurate record-keeping – a discipline which will be of great general value to the business far beyond tax compliance.

To summarise the case for making the tax system more 'user-friendly': business in general, but especially small business, should be enabled to concentrate on its basic task of creating wealth and jobs rather than filling out forms.

Big successes in revenue collection, but does South Africa's taxman really 'think small first'?

South Africa has managed to become one of the world's successful income tax collectors. However, one report has estimated the 'tax gap' – the difference between tax due and tax collected – is still at a substantial R30bn annually. Most of this is probably in the formal sector. It is extremely difficult to establish what this might be in the informal sector.

The additional revenue collected can be used to fund development challenges and increase social spending while holding down the budget deficit. We also welcome the fact that the government has attempted to improve the tax system for SMEs in SA. For example:

- the VAT registration threshold has been increased to R300 000. Firms below the registration threshold are relieved of the necessity of administering the tax – though at the cost of not being able to recover input taxes;
- a concessionary income tax rate of 15% is now available on the first R150 000 of taxable income. Taxable income above that ceiling is taxed at the normal company rate of 30%;
- in 2002 businesses fitting the description of 'small business corporations' were granted tax

relief in the form of accelerated wear and tear allowances applicable to manufacturing enterprises;

- the raising of the revenue threshold for enterprises to qualify for lower company taxes from R3 million to R5 million in the 2003 budget; and
 - the double deduction businesses can now claim for the first R20 000 spent in establishment costs.
- Government does acknowledge that many small business owners are ill-equipped to face the complexity and multiplicity of tax returns. During his Budget speech on 20 February 2002, Finance Minister Trevor Manuel said, 'It is common knowledge that the burden of tax and regulatory compliance impacts adversely on small businesses. Administrative procedures and the existing penalty provisions will be reviewed with the aim of simplifying tax compliance for small business. In addition, a simplified approach to calculating VAT obligations will be investigated.'

Notwithstanding, no costing exercise for taxpayer compliance has been carried out. Not much has been done in terms of reducing compliance costs, bar the issue of explanatory leaflets running to some 34 pages – in itself an admission that the system is too complex.

Possible to count the costs of tax compliance? Yes, and necessary too

Essentially, the compliance costs consist of:

- efficiency costs - involving tax induced market-distortions;
- operating costs of tax - costs to the government of administering and collecting tax, and costs expended by taxpayers in complying with their tax obligations.

The latter include:

- the all-inclusive costs of labour-time expended in the totality of tax-related activities. These should include the time taken by a businessman to acquire appropriate knowledge to deal with complex tax obligations such as PAYE or VAT, not to mention the time taken in appropriate record-taking;
- the costs of expertise hired to ensure full tax compliance; and
- incidental expenses incurred in tax compliance, including the acquisition of computer software, postage and deliveries.¹

Studies have shown that tax compliance absorbs a large share of the total administrative costs of businesses. In the UK, for example, tax compliance costs – on the basis of studies available – appear to account for 40 to 50% of all regulatory costs. An American survey showed that taxation matters absorbed approximately 75% of government’s own paperwork and compliance activities.

A major corporation may well be able to absorb costs but small businesses cannot. Large companies can afford in-house or outside tax consultants and are able to comply relatively easily with the tax system and its frequent changes. Economies of scale must also benefit large corporations in their tax compliance procedures. The situation is different and more difficult for smaller businesses, given their limited administrative resources, uncertain cash flows, restricted clout in government, limited understanding of their rights in relation to tax matters. One size does not fit all. Regulations impose disproportionate costs on SMEs because they do not have the administrative capacity to absorb them easily.

‘Gotcha’ - live dangerously, be an employer

The Peruvian economist Hernando de Soto has extensively studied the problem of excessive form-filling in his own country. But South Africa does not do too badly in competing for the booby prize. The Katz Commission Report noted that the minimum number of returns to be submitted by any small enterprise totalled 46 – 3 for income tax; 13 for PAYE; 6 for VAT; 12 for RSC levies; and 12 for UIF. In addition, there are the Skills Development Levies, provisional tax returns, and ancillary company tax returns such as those for Secondary Tax on Companies (STC) and those applicable to non-resident shareholders, not to mention property tax and customs and excise. Many of these returns have to be submitted monthly, which places the added burden on businesses to keep their records up to date. To complicate things further, payments have to be made on different days. All in all, present arrangements require all businesses, the small entrepreneur most onerously, to act as unpaid tax

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collection agents for government.

Each additional tax imposes further administrative burdens on the taxpayer. When government introduced the National Skills Development Levy, for example, it could easily have increased PAYE instead and then apportioned an amount from the State Revenue Account to the bodies responsible for the system. Instead a separate tax was introduced. Many small

businesses see the new South African Skills Development programme - revolving around levies on the payrolls of businesses and learnerships - as ‘just another tax’. Being unable to reclaim their levy for financial or administrative reasons, many SMEs have not yet produced a training plan that could be recognised by their Sector Education Training Authority, and end up paying their levy without recovering it. The identical argument applies to the Regional Services Council (RSC) levies. The payroll tax element in both levies is the last thing South Africa should have while unemployment is rampant, while the turnover tax in RSC levies simply echoes the VAT system. The RSC levies in particular are overripe for repeal, the lost revenue similarly to be made up out of general revenue.

Guilty first

The tax laws broadly apply the principle that the taxpayer is guilty until proven innocent when it comes to irregularities in tax assessment – through the ‘pay now, argue later’ provisions. Thus section 36 of the Income Tax Act empowers SARS to enforce payment of an amount before the individual or business has had the opportunity to appeal against the claim in court. In addition, if you owe taxes the Receiver can take them out of your bank account, without giving notice. The tax laws also contain garnishee provisions to recover outstanding taxes. The provisions are similar to those of a garnishee order issued by a civil court to satisfy a judgment debt, where the judgment creditor is entitled to attach a money debt due to the judgment debtor from a third person.

SARS’ method is robust, some would say aggressive, as the two case studies quoted in this study demonstrate. Dave King, the subject of the biggest

disputed personal tax claim in SA's history, strikes a chord when he says 'I might have the resources to fight it out in court, but what about the man in the street who can't? People are paying taxes they genuinely do not believe they owe, simply because the consequences of standing up to the receiver are too onerous.' These provisions create an unbalanced tax system tilted towards the authorities. If we want to have willing compliance instead of sullen obedience to the tax laws, these provisions should go or at least be modified substantially in favour of the taxpayer. We also make a plea for the right to exact payment and argue later to be used with the greatest restraint by SARS – essentially in cases in which

there is really strong suspicion that the taxpayer is planning to remove or conceal funds.

We need to strike a better balance between enforcement of tax laws and the rights of taxpayers. It must be acknowledged that SARS has addressed this concern in important respects through setting up a complaints office in Pretoria to respond to concerns about administrative difficulties in the assessment process. This office is intended to administer a dispute resolution process that will permit taxpayers to negotiate with the revenue service, rather than going to court.

What is the problem with VAT? Admin for a start, not to mention the impact on cash flow

VAT is successful in generating revenue. It is cheap to collect and is self-policing in the sense that registered traders have an incentive to ensure that their suppliers invoice them correctly so that they can reclaim input tax. Intermediate parties pay VAT on a net basis only – that is on value added. Only the final consumer (who cannot reclaim any input taxes) actually bears the full weight of the tax. VAT is largely unavoidable since it is payable on business inputs from formal enterprises. Even an unregistered minibus operator, for example, pays VAT on fuel, tyres and spare parts.

VAT requires reasonably high standards of bookkeeping skills as well as time to fill in the VAT forms, deal with queries from customers and suppliers, bad debts and so on. Interestingly, a UK study of VAT collection costs in 1992 showed that two thirds of the total costs were borne by smaller businesses with a turnover of less than £500 000. A more recent report found that 15.3% of VAT-registered firms in the UK felt that the registration threshold is a problem, 18% of non-registered businesses stated that they intentionally forego growth so that their turnover remains below the VAT-registration limit. Furthermore, competition from non-VAT registered firms was a significant problem for many business. So VAT provides an additional incentive for producers to avoid taxation altogether and join the informal economy.

Crucially, some years ago SARS became stricter in imposing the rule that VAT should be paid on invoice and not on receipt of payment. This hit small businesses hard because of shortage of capital and the need to finance start-up for an extended period

Case study: Pay now, argue later

- Metcash Trading Ltd v Commissioner, SARS 2000 SA 232 W & 2001 1109 CC

In 1999 Metcash offices were raided by SARS officials. VAT assessments were issued against Metcash subsidiary Metcash Trading relating to trading division Metro International. The deals to which the assessments related were orchestrated by third parties who had the intention of defrauding SARS and Metcash. It is difficult to see why Metcash should be liable to refund SARS the R77 million it had received as an input-VAT. The fraud had been committed against Metcash and SARS, not by Metcash itself.

SARS claimed the R77million, imposed double taxes (i.e. a further R154m, penalties and interest), resulting in a claim totalling R265 million, which exceeded the company profits. Metcash lost a third of its market capitalisation value as its shares tumbled. It had problems with a rights issue it was planning and market contagion took place as other retailers feared similar treatment at the hands of SARS and investors sold off their shares.

Metcash objected to the SARS assessment. Under normal circumstances the matter would proceed to a Special Tax Court which would adjudicate on the validity of the SARS claim. However, SARS decided that Metcash should 'pay now and argue later' and demanded immediate payment. Metcash brought an urgent application to block SARS and an order declaring SARS action to be unconstitutional which the High Court duly granted. This was however, overturned by the Constitutional Court. The Constitutional Court's decision confirmed the legitimacy of the 'pay now, argue later' principle. Neither court considered the merits of the SARS claim. On 6 November 2000 Metcash decided to reach a settlement with SARS in the amount of R128 million.

Why did Metcash settle? The VAT claim had pushed Metcash into the red which as a consequence lost 36% of its market capitalisation. Instead of running a business, the directors had to concentrate on VAT collections for the state. Shareholders indicated that they should settle so that they could concentrate on running the business.

before they produce positive cash flows. So this regulation has led to serious cash flow problems for small businesses, in particular those that sub-contract to larger entities which often take their time to pay. There is an overwhelming case for placing small businesses on a cash (i.e. receipt) basis for VAT, even though SARS will no doubt grumble that this will make enforcement more difficult and will retard its cash flow. We suggest that this is a situation where assisting small businesses should be given priority.

And income tax? Ditto

The Ntsika Regulatory Review of 1999 noted that 'the current provisions of the Income Tax Act which tax income either in the year of receipt or in the year of accrual, whichever occurs first, have an adverse impact on the cash flow of SMEs'.

Capital Gains Tax could on relatively rare occasions also be problematic when dealing with the

'I'm beginning to wonder what I did all the time until I registered for VAT!'

Philip Larkin, 1977

cost of an asset. If, in the year that a taxpayer disposes of an asset the purchase price is not payable on or before that tax year, no deduction will be granted for the cost of the asset. The proceeds will be equal to the capital gain. The year in which the taxpayer pays the cost of the asset would form a capital loss. Says a Deloitte and

Touche tax partner, 'From a cash point of view the taxpayer could be out of pocket'. This might be unusual, but it could happen.

Against the backdrop of problems faced by small business in accessing capital, particularly working capital, paying on invoice rather than receipt of payment causes significant hardship, particularly to those small businesses in their start-up and growth years. As in the case of VAT, we urge strongly that the incentive to small business should take priority over SARS' cash flow and ease of enforcement.

The cost of non-compliance

Quoting surveys of informal entrepreneurs in Mmotla (Eastern District Council) and the Cape Peninsula, Professor Carel van Aardt of the Bureau for Market Research points to a number of 'disincentives' to formalising businesses that have been identified. These include paying taxes, the bureaucratic procedures attached to formalisation and government levies. Van Aardt says it is easier to operate in the informal sector than in the formal sector under these conditions.

It is often assumed that informal businesses stay that way because their owners do not wish to pay taxes. But informality can be uncomfortable too. Those that choose to stay informal face at least two disadvantages:

- they cannot source formal financial services, such as bank loans, and corporates will not take them on as suppliers. Development requires formalisation because it is only when SMEs operate in the formal sector that they can access capital and utilise infrastructure to grow; and
- SMEs need a tax certificate to tender for government contracts and to enter the supply chains of many large corporates - important access to markets.

Inappropriately complex tax systems offer incen-

Case study: Banks lend SARS a helping hand....

Hindry v Nedcor Bank Ltd and another 1999 2 SA 757 W

SARS erroneously refunded a taxpayer approximately R70 000, relating to the 1988 and 1990 tax years. Some years later, SARS discovered its error and took steps to recover this money. This was despite the Income Tax Act which does not allow actual assessments to be re-opened after a period of three years have elapsed. The taxpayer, via his attorneys, objected to SARS attempting to do so.

In March 1997, SARS, without advising the taxpayer, wrote to Nedcor, the taxpayer's banker appointing them as the taxpayer's agent (in terms of Section 99 of the Act), instructing them to pay over to SARS the amount in dispute to be taken from the taxpayer's account.

No notice was given to the taxpayer, nor was the bank required to notify the taxpayer. The taxpayer took the matter to court seeking *inter alia* an order declaring SARS' action to be unconstitutional.

The judge decided that SARS' action was in the interests of speedy recovery and to prevent the taxpayer from putting amounts beyond the reach of SARS. Adding a bitter twist, the taxpayer was also liable for interest on SARS's error.

This was the first time in South Africa's history that the state's power to raid private bank accounts was recognised.

How does SA compare internationally?

While there is much talk of SA's non-compliance culture - Minister Manuel himself has said that 'the compliance levels in SA are still unacceptably low. There are still too many individuals and businesses who should be registered for tax that are not' - South Africa's level of compliance with national tax is apparently much higher than that of Brazil, a far larger economy. However, and less flatteringly, a survey of 58 countries' corporate tax rates by KPMG found that South Africa's rate of 37,8% - including the effects of secondary tax on companies (as a tax on dividends) - is higher than the global average of 33,75%. Ordinary corporate tax in South Africa on its own is 30%.

tives to remain small and informal. Loosening them has a far better pay-off. This can be done by altering the cost-benefit ratio towards ensuring that the costs of operating legally are below those of surviving in the extralegal sector.

The government has an opportunity and challenge to broaden the tax base by encouraging those in the informal sector to pay taxes and thereby reap the benefits of government services and other advantages of formality. According to one small business expert, 'The challenge is to get entrepreneurs out of paying bribes and into paying taxes'.

The rise of the tax consultant

Rather than engage with the tax system directly, many choose to buy-in the expertise through the

use of tax consultants. Indeed, the current complexity of the system favours those who can afford professional advice to exploit the loopholes that exist as a result of the law's complexity, not to mention the tax practitioners themselves.

Tax advisors in South Africa are to be regulated by January 2004. In terms of the proposed legislation, anyone offering tax advice or services will be compelled to belong to the Association of Tax Practitioners. Failure to comply will result in a fine or up to two years imprisonment.

SARS might usefully consider efforts to simplify the system and thus render the tax practitioner less necessary. Tax experts themselves are reportedly battling to keep up with new tax legislation and changes to the tax system.

What is to be done?

Taxation is only one of several issues that influence the overall regulatory environment for SMEs. The issue has to be addressed in the broader context of an appropriate enabling environment for private sector growth incorporating labour, health and safety, and related business regulatory and compliance issues. The forces adding complexity include pressures for fairness and the need to control avoidance and evasion of tax obligations. Given political will, however, there is scope to take some of the drudgery out of the tax calculations.

VAT lags

Number of taxpayers registered with SARS 1998-2002

	Total				% increase
	1998-1999	1999-2000	2000-2001	2001-2002	
Persons registered for income tax	2 485 703	2 798 126	3 187 072	3 556 023	43
Companies registered for income tax	774 864	839 591	976 720	1 081 788	40
PAYE-registered entities	202 806	213 202	211 425	219 732	8
Vendors (registered for VAT)	478 002	424 020	450 630	479 666	0

Source: SARS national office

As the table shows, one area that has lagged is VAT registrations and collections. As a proportion of GDP VAT collection increased by 0,46% over the period 1998-2002, equivalent to about R5 billion. According to the Centre for Policy Studies, this increase is due to better compliance and enforcement rather than an increase in the number of registered VAT vendors and further that the gains are 'not a consequence of an increased SARS penetration of the informal economy'.²

Most importantly, SBP's analysis suggests that a critical amendment to VAT and Income Tax procedures would be to simplify business' cash flow issues through implementing cash-based accounting, so that small business will only pay on amounts actually received as opposed to amounts accrued. The Katz Commission has recommended the cash basis of taxation for small and micro-enterprises.

Other amendments for consideration, include:

- Conduct a costing exercise for taxpayer compliance;
- Implement single registration and single return for all taxes for a small business. A single payroll tax should be introduced for SMEs to replace

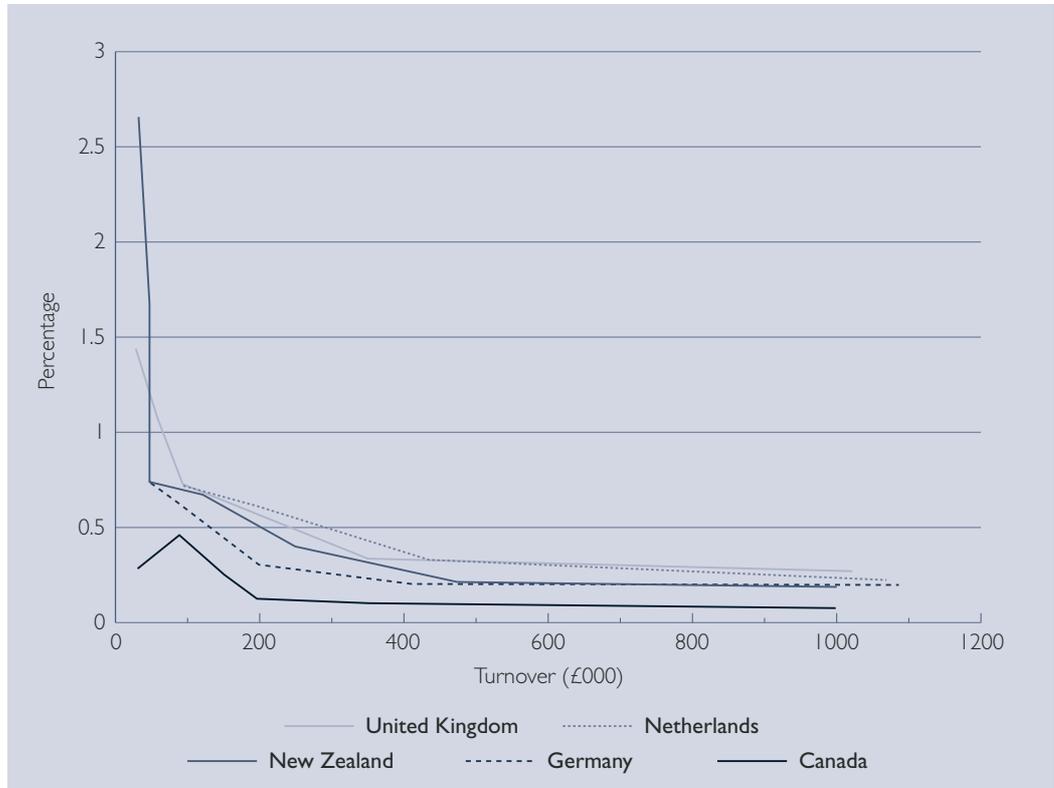
the existing payroll taxes, in this way simplifying the administration of small businesses. Better still, exempt them altogether from these taxes, or - as suggested above - even repeal taxes such as RSC levies in their entirety and make up the lost revenue out of general funds;

- Simplify definitions by streamlining notions of 'Small Business Undertaking', 'Small Business Corporations' and 'Small, Medium and Micro-Enterprises' so that small businesses can work out more easily whether they qualify for the various obligations and easements;
- Implement business support and education related to tax issues;

Compliance costs vary with firm size

International statistical comparisons come with hazards - cultures, tax systems and administrative arrangements differ. The graph below illustrates the general point that compliance costs vary and fall significantly with firm size.

Comparison of gross compliance costs as a proportion of taxable income³



Source: NAO 1994

Note: This graph illustrates the similarity of the compliance cost: turnover curve. Comparisons between individual countries' figures are not valid because the tax regimes are different and the research has been carried out on different bases.

OECD on tax: Broad principles

In its *Fostering entrepreneurship* Policy Brief, the following recommendations on tax are made:

- Examine the overall effects of the tax system on entrepreneurship, and identify features that discourage entrepreneurs or the financing of entrepreneurial activity.
- Ensure that the tax system is transparent and that compliance is straightforward. Ongoing costs of complying with government administrative, regulatory and reporting requirements can also be quite high, and may thus discourage entrepreneurial activity.
- Ideally, taxes should have a minimal effect on the decisions that entrepreneurs make, but in practice there are many distortions within tax systems that do exert influence.

Source: OECD *Fostering entrepreneurship* Policy Brief No. 9, 1998

- SARS must bear the risk associated with tax collection and as a result loosen the harsh penalty system;
- Raise the VAT threshold further, especially to keep up with inflation – this reduces the compliance burden on the small business taxpayer and relieves the administrative burden on SARS;
- Small firms should be compensated for some of the compliance costs they currently bear. An

allowance against taxable income can be made on estimates of actual collection costs and in the case of SMEs the state should advance the cash needed for this collection;

- Scrap the STC (at present 12,5% on dividends and on distributions from ccs). While STC encourages reinvestment of profits, eliminating it would heighten the international competitiveness of SA's tax regime. The problem here is the loss of substantial revenue. South Africa would also deprive itself of the recent imposition of STC on the assets of companies becoming non-resident – evidently done to block the flood of major groups expatriating themselves to the UK. The ideal would be to go from STC to an integrated system of taxing companies and their shareholders, giving the latter credits for tax paid on company profits. This would, however, involve additional demands on computing capacity and complicate the assessment process. It seems a distant demand for now.

More broadly, the focus of policy makers in South Africa should shift from punishing wrongdoers to making the system easier to comply with, in this way 'encouraging' those outside of the system to join, or at least not discouraging them still further. The overall long-term aim should be how to reduce the compliance burden as a whole.

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Endnotes

- 1 Evans, C 'The `operating costs of taxation: A review of the research' in *Journal of the Institute of Economic Affairs*, Vol 21, no.2, p.5.
- 2 Smith, L *The power of politics: The performance of the South African revenue service and some of its implications*, Johannesburg, Centre for Policy Studies, Policy: Issues and Actors, Vol 16, No 2, 2003.
- 3 Quoted in Bannock, G 'Reforming value added tax' in *Journal of the Institute of Economic Affairs*, Volume 21 no.2.

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