

# The effectiveness of tax incentives for small and medium sized entities in South Africa: An analysis of section 12E and Interpretation Note 9

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## Key Words

*small and medium sized entities (SMEs); South Africa; income tax; section 12E; tax incentive; compliance rebate*

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## Abstract

*Small and medium sized entities (SMEs) supposedly provide job creation, economic growth and poverty reduction, and tax incentives aimed at this sector should lead to inclusive economic growth. Section 12E of the South African Income Tax Act No. 58 of 1962 (the Act) offers accelerated depreciation allowances to SMEs. However, this allowance is not meeting its intended purpose. Through a doctrinal research approach, this study interrogated the aim of section 12E, its limited coverage, the definition of small and medium businesses in the Act, and the effectiveness of policies targeting SMEs. The allowance is not adequately targeting the correct small businesses and informal enterprises. Additionally, taxation compliance is a challenge for these businesses, and thus taxation allowances that are intended to support SMEs may be misused or incorrectly applied. This study also found that a refundable compliance rebate may be more equitable and offers a solution to existing compliance issues faced by SMEs.*

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## Introduction

Small and medium sized entities (SMEs) are an increasing feature of the global economy, and various developing nations have identified them as a cornerstone to growth in their macroeconomic policies (Johri et al., 2024). The South African government subscribes to this view as evidenced by the National Development Plan: Vision for 2030 (NDP) (NPC, 2011).

In terms of the South African socio-economy, unemployment, poverty and inequality are issues of national concern (Burns, Tomita & Lund, 2017). South Africa's unemployment rate of 30.8% is persistently high (Burns, Tomita & Lund, 2017; Statistics South Africa, 2020b). The NDP, which informs the national budget, is government's long-term strategy to eradicate the socio-economic challenges where the vision is of "an economy that is more inclusive, more dynamic and in which the fruits of growth are shared more equitably" (NPC, 2011:10). The proposed actions to meet this objective are a simplified regulatory environment for SMEs and increased small business support (NPC, 2011). The rhetoric of the NDP is echoed in the African National Congress's (ANC's) National Policy Conference Discussion Document. The ANC underscored the importance of small, black-owned businesses in achieving economic transformation and redressing the historical systematic injustices of apartheid. The document reiterates that "black entrepreneurs would be more successful if they had some form of targeted financial support, including tax breaks, and improved market access" (ANC, 2017:4).

Using correct incentives, entrepreneurship can drive the South African economy from low growth and encourage the unemployed into business ownership and development (Parsons, 2018). This cycle is self-fulfilling as economic growth positively impacts entrepreneurship, which improves income growth, thereby enriching all in South Africa (Moloi et al., 2022).

With the dismantlement of apartheid in 1994, policy-makers introduced programmes to support SMEs in an effort to correct poverty and inequality (Rogerson, 1999). More recently, SMEs have garnered political attention as they employ the vast majority of the South African population and account for more than 50% of South Africa's Gross Domestic Product (GDP) (Petersen, Bruwer & Mason, 2020). Thus SMEs are linked to poverty alleviation as they typically employ the poorest members of society (Bhorat et al., 2018;

Maksimov, Wang & Luo, 2017). Most SMEs fail in their first year of business and a simplified and supportive regulatory environment is purported to decrease such failures (Kauffmann, 2005).

Governments determine resource allocation among citizens and businesses (Maksimov, Wang & Luo, 2017) through fiscal policy, which comprises taxation and government spending (Mountford & Uhlig, 2009). Income tax has been found to be a perceived barrier to both start a business and business growth in South Africa (Khoase *et al.*, 2020). Thus, analysing taxation legislation provides valuable macroeconomic insight. As small businesses are touted as a solution for driving economic growth and promoting an inclusive economy, it is important to assess whether policies, including tax incentives, aimed at helping small businesses are fulfilling their intended purpose (Maksimov, Wang & Luo, 2017).

Section 12E of the South African Income Tax Act No. 58 of 1962 (hereafter s 12E) provides a small business corporation (SBC), as defined, an increased tax incentive in the form of an accelerated depreciation allowance. This study thus aims to identify whether s 12E creates the intended tax relief for small businesses, so fostering economic growth and employment. Section 12E is important, as the Davis Tax Committee (DTC) has questioned the section's effectiveness (DTC, 2014). Assessing the DTC's findings and insights is valuable, and will enhance understanding of how current tax policies are supporting the objectives of inclusive growth and employment.

The seventh issue of Interpretation Note 9 (hereafter IN 9) was released on 25 June 2018. The South African Revenue Service (SARS) releases such notes to provide guidance on the application of sections within the Act (SARS, 2018). Thus, assessment of IN 9 provides insight into how legislative provisions are enacted and applied to taxpayers.

## Methodology

This qualitative study used a doctrinal research approach and document analysis to evaluate and interpret results. Document analysis is the evaluation of all forms of documents (Bowen, 2009). Textual analysis was used, which emphasises the meaning one can extract from documents (De Vos, Strydom, Fouche & Delport, 2011).

To answer the research question of whether s 12E has developed the intended tax relief for small businesses (i) the purpose of the allowance was established with reference to the NDP, (ii) the definition of a SBC was investigated, (iii) tax statistics were used to analyse the impact of tax policy on SMEs (Carpenter, 2016; DTC, 2014; Gale & Brown, 2013; Knittel *et al.*, 2011), and lastly (iv) prior literature was reviewed with respect to the SME sector's role in employment creation and economic growth, poverty reduction and transformation.

## Discussion and findings

### *Overview of section 12E and Interpretation Note 9*

The Act offers accelerated allowances on assets owned by SBCs. For plant and machinery used directly in manufacture, an immediate write-off from taxable income is granted if the asset is brought into use by a SBC for the first time. For businesses that are not SBCs, such assets would normally qualify for a deduction under a different section of the Act over a write-off period of four or five years.

Section 12E(1A) offers an incentive for assets not used directly in manufacturing, but for trade as stated in section 11(e). Section 12E(1A) offers an election between the prescribed section 11(e) write-off (in Interpretation Note 47) or a write-off of 50% on the cost of the asset in the first year of use and 30% and 20% write-offs in the two subsequent years. The Act prescribes the 'cost' of the asset on which allowances are granted as the lesser of the actual cost incurred by the taxpayer and the arm's length cash cost (market value) of the asset at the transaction date. Thereafter, s 12E contains the SBC definition that outlines qualifying criteria for classification as a SBC, and entities that meet the criteria in the SBC definition are granted the accelerated allowance.

SARS released IN 9 to offer guidance over the provisions of s 12E. However, as per the South African Revenue Service Act No. 34 of 1997, SARS's mandate is limited to collections of tax revenue and ensuring compliance with tax legislation, and thus Interpretation Notes are not legally binding, and are an explanatory guide to support statutory provisions.

### ***Intended purpose of section 12E and Interpretation Note 9***

The first issue of IN 9 on 13 December 2002 cited the role of SMEs in economic development and employment creation as the rationale behind special taxation dispensations for SMEs. In the South African context and with regard to government's vision to increase black participation in the economy, the purpose includes helping the growth of black businesses (ANC, 2017; NPC, 2011; Rogerson, 1999).

As s 12E offers accelerated allowances on capital assets, it encourages the procurement and development of fixed assets in the SME sector (Kitchen & Knittel, 2016). For prospective investments that are evaluated using net present value or discounted cash flow measures, speedier allowances (as offered in s 12E) increase profitability due to reductions in taxable income at the outset of a project (Bond & Xing, 2015; Gale & Brown, 2013) which therefore stimulate the accumulation of fixed assets and growth within SMEs. The first issue of IN 9 (2002) also stated that s 12E was introduced to regulate the tax relief granted to SMEs through the definition of a SBC, which detailed the criteria for an entity to qualify for SBC allowances. The definition attempted to limit the recipients of accelerated allowances to businesses that will potentially promote growth and employment.

SMEs in South Africa encompass informal micro-enterprises and formal medium sized entities that employ numerous individuals (Achieng & Malatji, 2022; Bureau for Economic Research, 2016; DTC, 2014). The NDP categorises small businesses into three categories (NPC, 2011): (i) *survivalist businesses*, which are informal and do not usually use capital assets; (ii) *lifestyle businesses*, which operate in middle-upper income areas and include professional persons such as doctors; and (iii) *entrepreneurial businesses* that innovate, employ individuals and offer opportunities for economic growth and expansion.

The NDP views entrepreneurial business as the primary source of employment creation (NPC, 2011), and thus they are the intended recipients of tax incentives for SBC (DTC, 2014). Hence, s 12E aims to stimulate entrepreneurial business activity and investment to achieve radical transformation of the South African economy.

This study pertains *solely* to the provisions in s 12E, which contains the SBC definition and accelerated allowances available to SBC.

### ***Analysis of the Small Business Corporation definition***

The effectiveness of s 12E depends on whether the incentive targets intended recipients (specifically entrepreneurial businesses). Each aspect of the SBC definition is now analysed with reference to relevant commentary and literature:

#### ***The legal entity requirement***

To qualify as a SBC, the potential recipient must be a close corporation, co-operative, private company or personal liability company, as contemplated in the relevant sections of the Companies Act No. 71 of 2008.

#### ***The holder of shares requirement***

To qualify as a SBC, all shareholders of the company must be natural persons and may not hold an interest in any other company, with various special exemptions. IN 9 (2018) explains that such provisions prohibit an individual from splitting income between various SBC in an effort to abuse the incentive.

The natural person requirement dictates that SMEs funded by companies such as venture capitalists may not qualify as SBC. This dissuades institutional investment that could help SBC growth (DTC, 2014). To evaluate the DTC's argument, the role of the venture capital industry in SME development is analysed.

Limited access to funding is a pervasive obstacle faced by SMEs (Ayyagari, Demircuc-Kunt & Maksimovic, 2014; Bureau for Economic Research, 2016; de Kok, Deijl & Velhuid-Van Essen, 2013). Therefore, legislative measures can add value by encouraging institutional investment. Fatoki and Odeyemi (2010) questioned the prevalence of venture capital in SME funding by stating that only 3.8% of venture capital funds have a SME focus. Despite this, Mbhele (2012) argued that venture capital does support entrepreneurial activity and SME growth in South Africa.

Recent revisions of the Broad-Based Black Economic Empowerment Codes and the introduction of the SA SME fund aim to stimulate investment in black-owned businesses. Thus, these initiatives have created demand for specialised venture capital funds that finance small, black-owned businesses (South African

Venture Capital and Private Equity Association, 2017). Small, black-owned businesses financed by venture capital are the entrepreneurial businesses envisaged by the NDP. Their ability to obtain funding speaks to their promise and ability to grow, their access to venture capital funding correlates with higher success (Mbhele, 2012), and they are black-owned, increasing diversity in business ownership. Thus the encouragement of venture capital investment would grow the SME sector and transform the economy. The legislature recognises the importance of venture capital, and thus introduced section 12J in the Act that provides incentives to venture capitalists to grow equity investment in SMEs.

However, the natural shareholding limit in the SBC definition unwittingly conflicts with the legislature's intention to encourage investment in SMEs. Therefore, SBCs that receive institutional support should benefit from accelerated allowances in s 12E.

To prevent abuse of the incentive and to allow equity investment into SMEs, the DTC's SME report proposes that corporate shareholdings of SBC should be limited to 33.3% (DTC, 2014). This relaxation may increase the coverage of the allowance to businesses with institutional funding, while preventing abuse. Furthermore, the limitations and exemptions on shareholdings in other companies in the SBC definition are complex and verbose (DTC, 2014). The DTC's SME report suggests that the provision be simplified to exclude companies where any shareholder holds an interest in any other SBC.

#### *Gross income requirement*

To restrict the size of qualifying companies, the SBC definition limits gross income of an entity to R20 million. The DTC's SME report however believes that the limit is too restrictive and should be increased to R50 million (DTC, 2014).

To evaluate the reasonability of this limit, the DTI classification of enterprise size is used. The DTI classifies entities into small, medium and large enterprises on the basis of annual turnover. Although turnover (as described in the SBC definition) and gross income (as used by the DTI's categories) are different metrics, these numbers are largely similar for entities. This is because turnover constitutes receipts in cash or credit by the taxpayer for their financial year. Therefore, it forms part of gross income as defined in section 1 of the Act.

The DTI classifies small enterprises to have a turnover range from R13.5 million to R81 million and medium enterprises from R81 million to R432 million (Statistics South Africa, 2020a). Therefore the suggestion to increase the gross income limitation seems reasonable. Furthermore, the United States of America (US) tailors SME size requirements across economic sectors, which is useful as sector-specific factors impact size in each industry (Gale & Brown, 2013). Therefore, if adopted in South Africa, different limits for each sector may capture size per sector with more precision, and this would achieve consistency with the DTI's classification.

Ultimately, any increase in the gross income limitation would increase the coverage of the incentive – possibly promoting growth and profitability in more businesses. Furthermore, tailoring the gross income requirements caters to differing cost structures and business models across sectors.

#### *Business activity requirement*

A company cannot qualify as a SBC if more than 20% of its gross income is derived from investment income or income from personal services. Furthermore, personal service providers, as defined, may not qualify as SBC. The income from personal service limitation is meant to exclude the owners of lifestyle businesses, as outlined in the NDP. This is apparent from the first issue of IN 9 (2002), which stated that SBC dispensations are not intended to benefit any professional person. The exclusion of professional persons is achieved through the personal service definition that appears in section 12E(4)(d).

Interpretation of the definition of personal service has been the subject of debate, as illustrated in XYZ CC vs Commissioner of the South African Revenue Service (2012), wherein the Commissioner disputed a close corporation's status as a SBC on the grounds that more than 20% of the corporation's receipts and accruals constituted income from consulting services. During the case, the fifth iteration of IN 9 (2009) was in issue, which stated that the ordinary and grammatical definition of each of the fields listed in the personal service definition applies. Thereafter, it stated that each term is "to be construed in their widest possible sense" (IN 9, 2009). The presiding judge however disagreed with the Commissioner's stance that the widest

interpretation applied to 'consulting services'. Consequently, the prevailing ruling is that the ordinary or dictionary definition of words be applied in the personal service definition. Note, however, that this was a Tax Court case, and therefore not binding legal authority.

The seventh issue of IN 9 (2018) does not adjust its guidance on the definition of a 'personal service' despite this ruling. The 20% limitation of personal services as a business activity is also questioned in the DTC's SME report (DTC, 2014). It is established that s 12E is not intended to benefit professional persons (IN 9, 2002). Despite this, however, the DTC's SME report highlights that 34% of businesses that receive s 12E allowance are within the fields of insurance, finance, real estate, medicine and veterinary sciences, meaning that professional persons (not the intended recipients of the incentive) disproportionately receive SBC incentives.

Thankfully, these personal service businesses only account for 3.5% of the SBC (Department of National Treasury & SARS, 2024). However, the legislature targeted professional persons with sound intent. The seventh and current version of IN 9 (2018) explains that these businesses are in the ambit of the SBC definition, in order to encourage employment.

The professions listed in the definition are only considered personal services to the extent that the person performing the service has an interest in the company and the company employs less than 3 full-time employees. Until issue 6 of IN 9 (2016), there was silence on the calculative nuances of this requirement. Since issue 6, it has been clarified a Rand-value apportionment of the income attributable to a shareholder's involvement in the performance of a service is required in the calculation of the 20% limit. This amendment helps entities determine the percentage of services performed that are "personal services".

### *Compliance considerations among small business corporations*

To assess the impact and effectiveness of SBC allowances, compliance with taxation legislation is important (Gale & Brown, 2013). According to Kamleitner, Korunka and Kirchler (2010), SME owners lack meaningful tax knowledge, perceive more non-compliance opportunities than salaried employees, and are more likely to frame taxation as a painful loss. This concurs with OECD research that flags small business owners as a high-risk group of taxpayers in terms of non-compliance (Kamleitner, Korunka & Kirchler, 2010).

The cost of tax compliance is a perceived challenge to small business owners. A significant portion of total compliance expenditure in SMEs is attributed to tax compliance (Ilhomola, Rankhumise & van Niekerk, 2010), and these costs are regressive in nature, meaning that the cost of compliance is a greater burden to smaller businesses (Smulders & Stiglingh, 2008). Moreover, the complexity of tax systems is a challenge in respect of compliance for small businesses (Abrie & Doussy, 2006).

Smulders and Stiglingh (2008) aimed to quantify the cost of compliance for SMEs in South Africa. They found that, on average, tax practitioners charge SMEs an annual fee of R7 030, which in today's terms would be a conservative estimate.

The apparent risk of non-compliance and the burdensome cost of compliance with tax legislation among SMEs suggests that various entities may, intentionally or erroneously, understate and misreport their tax liabilities (Abdul-Jabbar, 2009). This may be due to a lack of resources (Rabie, Cant & Wiid, 2016). If non-compliance is rife among SMEs, any incentive aimed at supporting SBC will be ineffective due to the possibility of misuse of the tax system. Moreover, s 12E can only be considered effective if SBC are aware of and use the allowance. While older research, Abrie and Doussy (2006) highlight that 42% of SMEs are aware of s 12E but only 18.7% use the allowance. However, they classify SMEs based on their number of employees and therefore the entities surveyed may not be representative of the SBC population – which justifies the lack of use and awareness of s 12E. Despite the shortcomings in Abrie and Doussy (2006), however, it is doubtful whether SMEs are aware of and utilise the accelerated allowance available in s 12E. Furthermore, non-compliance risks suggest that SMEs may not conform to the provisions of s 12E. Hence, the impact of accelerated allowances is potentially diminished due to non-compliance and lack of awareness.

### *Asymmetry of profits and losses*

For s 12E to be an effective allowance, a taxpayer must have taxable income from which accelerated allowances can be claimed. The asymmetry of profits and losses with regard to taxable income dictates that entities with taxable income may claim allowances, while businesses in assessed taxable loss-making positions cannot (Freedman & Crawford, 2011). Furthermore, it is argued that this asymmetry limits the ability of intended recipients to benefit from the allowance (DTC, 2014) when these businesses in loss-making positions are possibly more worthy recipients thereof.

The asymmetry of profits and losses means that profitable entities derive a greater benefit from the allowance than those without any taxable income. This prevents s 12E from targeting all intended recipients of the incentive. As of December 2023, 40% of qualifying SBC have assessed losses or zero taxable income (Department of National Treasury & SARS, 2024). Thus, almost half of qualifying SBC cannot utilise the accelerated allowances in s 12E, and only 88 457 entities can receive accelerated allowances.

### *The role of SMEs in growth, employment and transformation*

The s 12E allowance is a taxation policy intended to aid small businesses. The rationale for policy intervention (such as s 12E) that supports the SME sector is rooted in the premise that SMEs have a great capacity for job creation, growth and poverty reduction. Therefore, in determining whether such policy meets its intended purpose, this notion must be interrogated.

#### *SMEs as a driver of growth and employment creation*

Tax incentives were introduced to support SMEs, based on the belief that smaller firms offer higher growth and employment creation prospects. However, in developing nations, there is uncertainty about the link between firm size and job creation. Ayyagari, Demirguc-Kant and Maksimovic (2014) found that small firms contribute the largest share of job creation in developing countries – even after controlling for firm age. However, de Kok, Deijl and Veldhuis-Van Essen (2013) show that SMEs are not role-players in both job creation and economic growth in developing countries. They state that SMEs play a more significant role in job creation than larger enterprises, but there is uncertainty about the contribution of other employment sources to job growth.

The relative size of the SME sector in terms of contribution to employment and GDP is often cited as justification for policy interventions relating to SMEs. SMEs employ the vast majority of the South African population and account for more than 50% of South Africa's Gross Domestic Product (GDP) (Petersen, Bruwer & Mason, 2020). However, this is not an indicator of employment creation and growth, as there is no causal relationship between the SME sector's share in an economy and economic growth (Ayyagari, Demirguc-Kant & Maksimovic, 2014). Furthermore, with an average lifespan of 3.5 years and a failure rate of 70%, many South African SMEs do not survive to create employment and growth (Bureau for Economic Research, 2016). Moreover, most South African SMEs are survivalist businesses that are less likely to grow and transition into the formal economy (Bureau for Economic Research, 2016). As a result, the propensity for South African SMEs to create jobs is dubious.

Given the literature and statistics, the assertion that small businesses are a source of employment creation and economic growth in South Africa should be explored. At present, the link between firm size and growth is questionable, and it is plausible to state that allowances targeting SMEs will be ineffective.

#### *SMEs as a driver of transformation and poverty reduction in South Africa*

The promotion of transformation to correct the historical injustices of apartheid is an important policy consideration in South Africa. Accordingly, the role of SMEs in transformation and poverty reduction must be evaluated. SMEs are seen as a mechanism to lift South Africans out of poverty and to promote inclusion in the economy, as they employ most of the labour force in South Africa (Bhorat et al., 2018). The SME sector has the capacity to promote transformation, as 71% of SME owners are black (Bureau for Economic Research, 2016).

Agupusi (2007) and Maksimov, Wang and Luo (2017) recognise that informal SMEs in low-income areas offer the greatest capacity to alleviate poverty, as they support and employ the poorest members of society. The Bureau for Economic Research (2016) corroborates this proposition. As of 2015, 51% of SMEs in

the formal sector are white owned and operated, while black ownership of informal SMEs is measured at 89%. Agupusi (2007) contends that informal businesses face various challenges that limit their ability to diminish poverty, and de Kok, Deijl and Veldhius-Van Essen (2013) state that wages paid to employees of SMEs are insufficient to alleviate poverty in developing nations. Furthermore, government policies largely benefit formal businesses, with lack of support for informal entities (Agupusi, 2007).

SMEs do offer potential to alleviate poverty and enhance transformation. However, it seems that governmental policies such as s 12E cater for formal entities and neglect informal businesses that offer the most potential for transformation and poverty reduction. Thus it seems that s 12E cannot successfully promote inclusive growth.

### *The effectiveness of tax incentives as a policy intervention tool*

Taxation incentives can be used to assist SMEs. Therefore, to evaluate the effectiveness of s 12E the relative impact of tax allowances on SMEs, as compared to other tools, is worth assessing. International research suggests that the use of tax incentives to stimulate SME growth is limited. However, when used with direct subsidies, tax incentives do stimulate output in SMEs (Radas *et al.*, 2015). Thus, a tax incentive appears to be an effective policy tool when coupled with direct subsidies – although local research is needed to corroborate this.

### *The refundable compliance rebate*

In their SME report, the DTC interrogated the collective effectiveness of various SME tax incentives – especially s 12E and concessionary tax rates for SBC. As part of their recommendations, the DTC's SME report suggests the removal of accelerated allowances (as afforded in s 12E) and concessionary tax rates, to make way for a refundable compliance rebate. The possible impact of the proposed rebate is now discussed.

#### *Loss of accelerated allowances*

Section 12E is meant to encourage investment in capital assets in SMEs, as it offers an increase in future cash flows of potential investment projects (Kitchen & Knittel, 2016). The proposed compliance rebate will not directly stimulate capital accumulation in the same way as an accelerated allowance, as it will not be considered in future cash-flow projections of investment projects. However, the impact of accelerated allowances is thought to be minimal (DTC, 2014). Businesses that do not qualify as SBC receive allowances on capital assets in sections 12C and 11(e). The allowances under s 12E are accelerated versions of 12C and 11(e). Consequently, s 12E merely offers a timing difference in allowances to SBCs.

The DTC's SME (2014) report reveals the minimal impact of accelerated allowances by highlighting that claims under s 12E amount to about R220 million a year. This amounts to about R4 462 per qualifying SBC, and thus the relinquishment of an accelerated allowance will not be detrimental to SBC owners, as its current benefit is negligible. Furthermore, the Bureau for Economic Research (2016) quantifies the total SME population at 2 251 821 businesses, meaning that accelerated allowances are afforded to only 2.2% of SMEs.

#### *Enhanced equity under a rebate*

The s 12E allowance is calculated on the cost of assets owned. Hence, larger or more capital-intensive businesses receive the greatest benefit from the allowance. A uniform rebate is however more equitable in that its benefit will carry more weight for smaller SMEs (Batchelder, Goldberg & Orszag, 2006). Moreover, compliance costs are more burdensome for smaller businesses (Smulders & Stiglingh, 2008). Therefore, a refundable compliance rebate offers a solution to an existing constraint faced by smaller SBC. As tax compliance is an established and significant burden for SMEs, targeted support that directs this problem would be welcomed by small business owners.

#### *Assisting with and incentivising compliance*

The compliance rebate is intended to incentivise compliance with taxation legislation by SBC (DTC, 2014). As small businesses are a high-risk group in terms on non-compliance, increasing voluntary compliance is worthwhile (Kamleitner, Korunka & Kirchler, 2010). Assistance with compliance may also lead to higher tax revenues from the SME sector.

*Dissenting views on the rebate*

In the 2014 Draft Explanatory Memorandum to the Taxation Laws Amendment Bill, there was a proposal for a refundable compliance rebate of R15 000, but tax practitioners considered this inadequate. The loss of concessionary tax rates to SBC coupled with the introduction of a refundable compliance rebate would result in an increased tax bill in certain circumstances (Explanatory Memorandum to the Taxation Laws Amendment Bill [Draft], 2014). More specifically, larger SME tax bills may increase due to the loss of concessionary tax rates. However, the replacement of the concessionary rates and accelerated allowances with a rebate benefits smaller businesses with lower taxable income – thus achieving a more equitable outcome. However, the importance of SMEs in economic growth, employment creation and transformation appears to be overstated, and thus tax allowances that reduce the tax bill of SBC are unsubstantiated and do not achieve their intended purpose. Moreover, the purpose of the refundable compliance rebate is not meant to reduce the tax liability of all SBC, but rather aims to assist SBC with tax compliance. Smulders and Stiglingh (2008) found the average cost of compliance was R7 030. Thus, R15 000 will adequately reimburse SBC for tax compliance costs, even if inflation since 2008 is accounted for.

*Functioning of a rebate for businesses without taxable income*

Due to the asymmetry of profits and losses, entities can only claim a rebate to the extent that they have available taxable profits. Therefore, a rebate as opposed to an allowance cannot increase the coverage of s 12E. However, the impact problem can be improved by carrying forward any unused portion. Section 6quat of the Act affords South African taxpayers a rebate for taxes paid to a foreign government that can be carried forward to the next year of assessment if the taxpayer does not have sufficient tax payable against which to offset the rebate. Thus the proposed refundable compliance rebate should contain a similar ‘carrying-forward’ provision to include businesses that have incurred taxable losses.

**Recommendations**

Based on the evidence, recommendations to enhance the effectiveness of s 12E include:

- i. Firstly, that the ‘natural shareholding’ requirement should be replaced with some form of corporate shareholding limit in SBC to allow investment from institutions such as venture capitalists. The DTC (2014) suggested an appropriate limit of 33.3%.
- ii. Secondly, in order to simplify the SBC definition, provisions dealing with corporate shareholdings should be replaced with a provision stating that “all SBC shareholders may not hold an interest in any other SBC”. This will prevent taxpayers splitting their income amongst various SBC to avoid taxation.
- iii. Thirdly, to increase the coverage of s 12E and to achieve consistency with the DTI’s classification system, the gross income limitations should follow the DTI’s lower limits in classifying small and medium entities. This will increase the coverage of s 12E as the DTI’s limits are mostly higher than R20 million, and will help tailor size requirements in each economic sector.
- iv. Fourthly, the sentence explaining the “wide interpretation” of the professional services listed should be removed from IN 9. This is in line with the prevailing court ruling, and would still encourage employment in the SME sector. A more informative alternative, albeit restrictive regarding the use of s 12E, would be to include explicit guidance on the breadth of the personal services listed, or to expand the list.
- v. Lastly, the accelerated allowance should be replaced with a refundable compliance rebate, and the rebate should allow disallowed portions to be carried forward to future years.

**Conclusion**

Employment creation, economic growth and poverty reduction are critical in South Africa. A thriving SME sector is a perceived solution to these problems. In light of this, the plight of SMEs has garnered political support that has led to public policy initiatives to promote this vital cause.

The NDP (2011) envisions a diverse and inclusive economy wherein small entrepreneurial businesses are supported through policy interventions, and they in turn will create jobs and employment. However,

the role of small businesses in job creation is unclear, as there is no clear link between firm size and employment creation. This suggests that policies such as s 12E aimed at incentivising small businesses may not be reaching their target. Furthermore, entrepreneurial enterprises in low-income areas are neglected by government policies and legislation, as they are informal. As these businesses are potential proponents for inequality reduction, s 12E is not achieving its purpose of transformation and poverty reduction.

Section 12E and IN 9 are intended to aid entrepreneurial businesses. However, the SBC definition does not directly target such businesses in South Africa. Consequently, institutional investors should be allowed to hold shares in a SBC (up to a certain limit), and complex provisions of corporate shareholding should be simplified. In addition, the impact of s 12E is limited, as many small businesses are at a high risk of non-compliance with tax laws, are possibly unaware of the allowance, and have assessed losses. The effect of these inhibiting factors is clear – as only a small percentage of SMEs utilise accelerated allowances.

Although s 12E is not meeting its intended purpose, taxation compliance is a significant challenge for small business owners. Furthermore, as SMEs are a significant contributor to employment, GDP and possibly transformation, a targeted rebate to assist with tax compliance is justified. The proposed refundable compliance rebate of R15 000 is equitable, as it benefits smaller firms that require assistance with compliance in greater proportions. Furthermore, the amount of the rebate will cover the average estimated costs of compliance for SMEs in South Africa.

Considering the extent of poverty, unemployment and inequality in South Africa, effective state intervention is vital – and as SMEs contribute significantly to production and employment, tax incentives directed to this sector must be effective. That said, this study demonstrates that s 12E is not stimulating investment, growth and job creation as intended. Greater targeted support in the form of a refundable compliance rebate is thus presented as a solution for SMEs in South Africa.

### Limitations of the study and areas for future research

Section 12E and IN 9 are considered in isolation relative to other allowances and policy tools. The performance of small businesses and their capacity to create jobs is linked to the macro economy and the regulatory framework in South Africa, and the study is limited in its discussion of how these variables impact SME growth.

The cost of the recommendations is not considered in this study. In the DTC's SME report, the replacement of concessionary rates and accelerated allowances with a refundable compliance rebate was found to be affordable (DTC, 2014). However, due to the proposed changes to the SBC definition in this study, the number of businesses receiving the proposed rebate should increase.

Further research in South Africa could include, firstly, providing further insight into the link between SMEs, employment creation and economic growth. Secondly, probing the role of SMEs in transformation and poverty reduction. Thirdly, a broader investigation of the impact of all tax incentives on the SME sector. Fourthly, and lastly, a more detailed probe into the cost of compliance and risks of non-compliance for SMEs.

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