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Trade-offs required to achieve shared prosperity

Deloitte commentary on South Africa Budget 2020/21

Making an impact that matters

Budget 2020/21

*" Winning requires hard work,
focus, time, patience and resilience.
Achieving economic growth and higher
employment levels requires a plan."*

Minister of Finance
Mr Tito Mboweni, 26 February 2020

Foreword

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Finance Minister Tito Mboweni's 2020 Budget Speech was delivered against the backdrop of President Cyril Ramaphosa's State of the Nation Address in which the President made the following sobering comments:

"Our country is facing a stark reality. Our economy has not grown at any meaningful rate for over a decade. Even as jobs are being created, the rate of unemployment is deepening. The recovery of our economy has stalled as persistent energy shortages have disrupted businesses and people's lives. Several state-owned enterprises (SOEs) are in distress, and our public finances are under severe pressure."

Against the backdrop of this deteriorating economic outlook, the Minister of Finance has reiterated in this budget that South Africa must strive for fiscal sustainability, measured as stabilisation of the debt-to-GDP ratio, by moderating spending as a share of GDP and reducing the wage bill as a share of overall spending. The budget indicates that there is a realisation that there are some difficult, painful choices and trade-offs which will be needed. This will not be easy, it will be a tricky road to navigate with affected stakeholders.

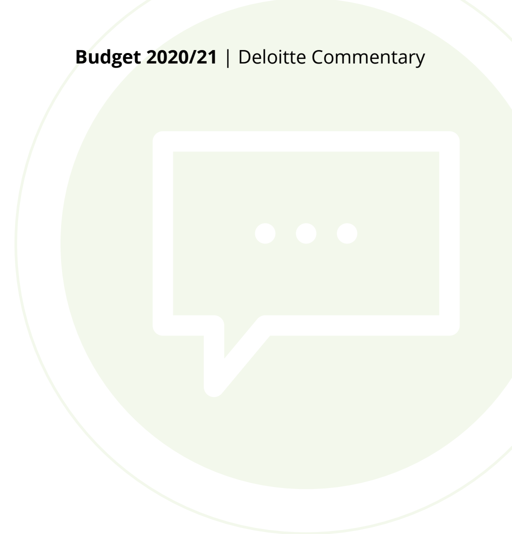
The Minister indicated a bleak economic growth context of the budget by indicating that South Africa's economy is expected to expand by only 0.9% in 2020. Consequently, tax revenue is expected to be significantly lower than the 2019 mid-term budget policy statement (MTBPS) estimates. Budgeted gross tax revenue for 2019/20 was R1.42 trillion (the revised estimate is R1.36 trillion). This means that the revised gross tax revenue for 2019/20 is R63 billion less than budget. This has worsened since the MTBPS, however, the gross tax revenue for 2019/20 is still 5.5% up on last year.

Budgeted expenditure for 2020/21 is R1.95 trillion (2019/20 revised estimate: R1.84 trillion). The largest portion of the budget has been allocated to learning and culture (R396.4 billion – increased by 3%) followed by social development (R309.5 billion – increased by 9%) and health (R229.7 billion – increased by 3%). Debt-service costs of R229.3 billion (increased by 12%) remain relatively high and curtail the ability to further invest in areas such as economic development which sees an allocation of R211.5 billion (increased by 6%).

The budget deficit is expected to grow to R370.5 billion (2019/20 originally at R243 billion) or 6.8% of GDP. Gross national debt will reach R3.56 trillion, amounting to 65.6% as a share of GDP by the end of 2020/21.

It is perhaps as a result of this current state of play, that many commentators anticipated wide-ranging tax increases. However, as pointed out in National Treasury's Budget Review 2020, despite large tax increases over the past five years, the difference between projected and collected revenue has continued to widen. This is attributed to slow economic growth and a weakened South African Revenue Service (SARS). As a result, it is believed that further substantial tax increases are unlikely to be effective as it is conceded that South Africa already has a relatively high tax-to-GDP ratio compared to similarly developed countries.

Accordingly, government will not raise additional revenue from tax proposals for 2020/21. Therefore, it seems clear that the strategy for addressing South Africa's burgeoning debt levels is focused on containing public expenditure rather than raising taxes. To achieve fiscal sustainability, the Minister announced a spending drop of R156 billion over the next three years relative to last year's Budget projections. The makeup of this spending drop includes a baseline spending reduction of R261 billion (made up of a first part of approximately R100 billion adjustments on programme spending and a second part of approximately R160 billion from slashing the public sector wage bill in the medium term). This is partially offset by R111 billion of various additions and reallocations, some of which is for SAA and Eskom.



Gross tax revenue for 2020/2021 is expected to reach R1.43 trillion, which is 26.3% of GDP. Around 80% of the gross tax revenue for 2020/21 (of R1.4 trillion) is expected to comprise of the following:

- personal income tax - R546.8 billion (2019/20 revised budget: R527.6 billion)
- value-added tax - R360.6 billion (2019/20 revised budget: R344.2 billion)
- corporate income tax - R230.2 billion (2019/20 revised budget: R216.7 billion)

While no significant tax increases have been proposed, government will seek to broaden the corporate tax base. This is to be achieved by minimising tax incentives and introducing new interest deduction and assessed loss limitations. The possibility of future reductions to the corporate tax rate was also mentioned in order to, amongst others, improve South Africa's competitiveness as an investment destination. Additional revenue raised from indirect taxes is to be offset by personal income tax relief. Relief in personal income taxes is to be achieved by above inflation increases in the personal income tax brackets and the primary, secondary and tertiary rebates. Detailed commentary on some of these tax proposals is provided in this publication.

The budget also focussed on strengthening SARS, both from a governance perspective as well as a capability perspective. In keeping with global trends, emphasis will likely also be placed on the digitisation of SARS as a means of improving the tax authority's efficiency and effectiveness. Additional tax revenue will hopefully flow from a more effective SARS.

In addition to the measures announced by the Minister for broadening the tax base, emphasis should be placed on multinational firms operating in a growing digital economy. While this is acknowledged in National Treasury's Budget Review 2020, there are no tax proposals that specifically address the issue and the approach that appears to have been adopted is to wait and see where negotiations amongst members of the Organisation for Economic Co-operation and Development (OECD) lead.

Further significant themes emerging from the budget include funding of the proposed sovereign wealth fund, lowering the cost of doing business, renewed focus on illicit criminal activity and a new law to stop excessive salaries at public entities. Emphasis was also placed on measures to address youth unemployment – with further details to follow in the MTBPS.

Today's Budget Speech fully acknowledges the tough economic situation that we face as a country. Evidently, the strategy for addressing this relies on achieving fiscal sustainability by taking steps to stabilise the debt-to-GDP ratio and relook at and optimise government expenditure – especially by tackling the public sector wage bill and wasteful expenditure – rather than by further burdening taxpayers.

Economic outlook: *moving forward, slowly…*

South Africa's economy continues to struggle. Load shedding, rising debt, policy uncertainty, wasteful expenditure, misfiring state-owned enterprises (SOEs) and the inability to make difficult structural reforms have been weighing down the country's economic growth and competitiveness over the past decade.

"Winning requires hard work, focus, […] and resilience", said Finance Minister Tito Mboweni, reading his 2020 Budget Speech.

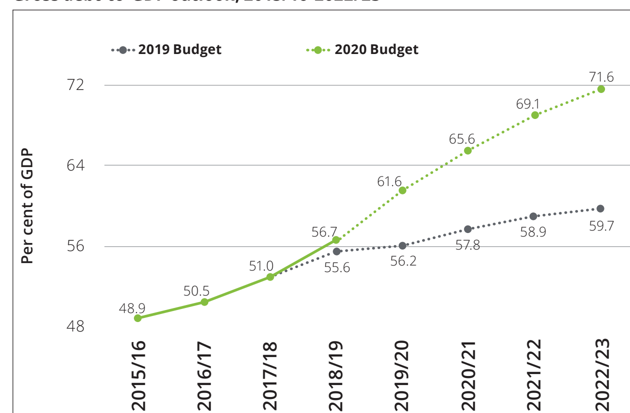
With growth for 2019 revised down to 0.3%, and growth projections for this year only at 0.9% , reaching 1.6% by 2022, indeed, hard work needs to persist to unlock the country's growth potential.

Despite the continued low growth environment, Minister Mboweni emphasised that "we are moving forward". South Africa boasts the most diversified economy in Africa, a sound macroeconomic framework, strong institutions, and a young population – key foundations for economic growth. Furthermore, low inflation, interest rate reductions, and the ongoing reform agenda may indeed "jump start the economy". Yet many downside risks to an economic recovery remain.

The disappointing economic environment has not improved the public finances outlook. The consolidated budget deficit is forecast to expand further from 6.3% of GDP in 2019/20 to 6.8% of GDP in 2020/21, owing to inter alia slower than expected economic growth and more financial support to SOEs. The budget deficit is expected to narrow to 5.7% in 2022/23.

Unsustainable debt-to-GDP ratios were already flagged in Minister Mboweni's 2019 Medium-Term Budget Policy Statement (MTBPS). The gross debt-to-GDP ratio is now expected to have increased to 61.6 percent in 2019/20 (previously estimated at 56.2% in the 2019 Budget). It is expected to mount to 65.6% in 2020/21 and 71.6% in 2022/23 – up from previous forecasts. Debt is not expected to stabilise over the medium term.

Gross debt-to-GDP outlook, 2015/16-2022/23



Source: National Treasury

Halting this fiscal deterioration requires implementing various measures. As the 2020 Budget outlines, these measures include a shift in the composition of spending, slower non-interest expenditure growth such as moderating growth in the public service wage bill, as well as the ongoing restructuring of SOEs. Other measures include a greater focus on efficiencies in spending, with key reforms already underway. Spending cuts of R261 billion over the next three years are proposed.

Still, total expenditure increases to R1 954.4 billion in 2020/21 from a revised R1 843.5 billion for 2019/20. Average nominal growth in spending remains dominated by debt-service costs at 12.3% over the 2020/21 to 2022/23 period. Although learning and culture, and social development spending are the top key spending categories, debt-service costs also make up the third largest spending category over the next three years.

Consolidated revenue is revised down to R1 583.9 billion in 2020/21, partly due to the government's decision not to implement additional tax revenue measures, with some tax relief granted, as well as the slower than previously expected growth environment.

Fundamental pillars to the government's economic reform agenda, such as lowering the cost of doing business through modernising network industries and preferential measures for small businesses; restructuring SOEs; and implementing the reimagined industrial strategy among others, will need to gain more momentum and yield visible results going forward.

While some of reforms are already underway although at varying speeds, the most urgent of these is to ensure the restructuring of the electricity sector, with R230 billion allocated over the coming decade towards this end. Inadequate and interrupted power supply will continue to be among the largest downside risks to the economic and fiscal outlook of South Africa.

Tax policy proposals

Tax Policy Proposals

The Minister announced that no major tax increases were proposed for 2020/21. The following are the major proposals:

- personal income tax brackets and rebates are to be adjusted to give above inflation relief for individuals. In the prior year no relief was effectively granted for inflation
- corporate interest deductions are going to be limited to combat base erosion and profit shifting
- the ability of companies to fully offset assessed losses from previous years against taxable income will be restricted
- the fuel levy is to be increased by 25c per litre which consists of 16c per litre increase in the general fuel levy and 9c per litre increase in the Road Accident Fund levy from 1 April 2020.
- the annual contribution limit to tax-free savings accounts is to increase by R3 000 per annum to R36 000 per annum from 1 March 2020
- excise duties on alcohol and tobacco are to increase by between 4.4% and 7.5%
- a new excise duty on heated tobacco products is introduced with immediate effect at a rate of 75% of the cigarette excise rate
- the exemption of foreign remuneration earned by South African residents is to be adjusted to R1.25 million from the current proposed exemption of R1 million from 1 March 2020. The tax on foreign remuneration is due to be implemented for the first time on this date.

These and other tax proposals are considered in further detail below.

Curtailing Excessive Corporate Interest Deductions

It is proposed to restrict net interest expense deductions for companies to 30% of earnings (EBITDA) for years of assessment commencing on or after 1 January 2021. Consultation on the design of this proposed interest limitation begins immediately and a discussion paper has been published on the National Treasury website with a closing date for comments of 17 April 2020.

Based on the analysis conducted, government proposes to implement the OECD recommendations. Illustrative examples show that replacing the existing interest limitation rules (specifically those in section 23M of the Income Tax Act) with the OECD approach will provide a more uniform approach to all interest payments flowing out of the country (regardless of which country the loan emanates from), as well as enhance the level of base protection. Government proposes to restrict net interest expense deductions to 30% of earnings. This is a decrease from the current 40 per cent (adjusted according to prevailing interest rates) of earnings interest limitation. The rules should only apply where the recipient is not subject to tax in South Africa.

It is proposed that the new rules replace section 23M. Transitional measures for existing loans will be considered for third-party loans.

The OECD has recommended countries retain targeted rules that are in place to curtail base erosion. Section 23N is an existing targeted rule, which will remain in place.

Limiting the Use of Assessed Losses to Reduce Taxable Income

Government proposes broadening the corporate tax base by restricting the set-off of carried forward assessed losses against current year's income to 80% of such taxable income. The change is proposed with the effect from years of assessment commencing on or after 1 January 2021. The Budget Review states that the proposal is viewed as a reasonable approach that affects all businesses equally, rather than restricting the number of years of carrying forward assessed losses, which would disproportionately hurt businesses with large initial investments or long lead times to profitability.

International tax

The transfer pricing rules do not apply where no tax benefit is derived in a non-arm's length transaction between two foreign connected parties (one being a CFC). Government believes that circumstances may arise where the SA resident shareholder of the CFC may derive a tax benefit as a result of a lower inclusion of the CFC income. To address the aforementioned situation it is therefore proposed that the legislation be amended to refer to a tax benefit that may be derived by a person, in relation to a CFC.

Corporate rules

Amendments will be proposed to the anti-avoidance provisions contained in intra-group corporate rule to address an anomaly. It is understood that the interaction between the anti-avoidance rules for de-grouping, and rules for the transfer of assets and the assumption of related debt may result in double taxation.

An amendment will be proposed to the unbundling corporate rule to close a loophole that has come to the attention of government. At present the rollover relief does not apply if, after the transaction, 20 percent or more of the shares in an unbundled company are held by non-residents either alone or together with individuals connected to those non-residents. Government believes that the current rule creates a loophole. To close this loophole it will be proposed for the 20% rule to apply irrespective of whether non-resident shareholders are connected to each other.

Acquisition of assets in exchange for debt issued

Government will propose amendments to address anomalies arising on the acquisition of assets in exchange for debt issued. At issue is whether the specific base cost rule for debt issued on the acquisition of assets overrides the Income Tax Act's anti-avoidance provision for transactions between connection persons.

Mining capital expenditure

Taxpayers deriving income from mining operations are permitted to claim an accelerated capital expenditure deduction. Historically, it was understood that only the mining rights holder qualified for the deduction. Although the Supreme Court of Appeal held in March 2019 that a contract miner also qualified for the accelerated deduction, the Court expressed the view that the dispensation was not intended to benefit contract miners. It is proposed that the provisions dealing with allowable mining capital expenditure be reviewed in order to address concerns as to whether both the mining rights holder and the contract miner should qualify for the accelerated capital expenditure deduction.

It is also proposed that the discretion which the Minister of Finance, in consultation with the Minister of Mineral Resources and Energy, has to permit the deduction of capital expenditure incurred on one mine from taxable income derived on another mine be reviewed with the aim of its removal or restructuring.

Tax treatment of doubtful debts

The tax rules for determining the tax claim for doubtful debts by bank and non-bank taxpayers were recently amended. These rules take cognizance of whether the taxpayer applies IFRS 9 or not. Further refinements to these rules will be proposed.

Incentives

National Treasury proposes introducing a 28 February 2022 sunset date for certain tax incentives. Government will review the incentives in question before the sunset date to determine whether they should be extended.

The section 12I tax incentive related to industrial policy projects will not be renewed beyond 31 March 2020. The urban development zone incentive will be extended for one year while a review of the incentive is completed. Where incentives do not currently have sunset dates, government intends inserting such dates to avoid benefits continuing indefinitely without adequate oversight.

In addition, the following has been noted in respect of incentives:

- small businesses will receive a much needed boost as Government gears incentives away from large business. Government has reinforced the commitment to reducing red tape for small businesses to encourage growth and consequently job creation
- R6.5 billion has been allocated for small business incentive programmes of which R2.2 billion will be transferred to the Small Enterprise Development Agency expected to be largely for loan funding and non-financial support. To encourage technology development and innovation, The Innovation Fund will be capitalised with R1.2 billion over the next three years. A One-Stop platform for small medium and micro enterprises will be established in order to improve access to financial and non-financial support.

  There has also been an allocation focused on township economies, with R2.8 billion set aside for the Township Entrepreneurship Fund to facilitate improved access to finance in the lower LSM
- allocations for special economic zones in the Infrastructure Investment Support sub-programme are expected to increase at an average annual rate of 13%, from R1.1 billion in 2019/20 to R1.6 billion in 2022/23, yet government does not intend to extend tax incentives beyond the six special economic zones that have been approved by the Minister of finance.
- government will continue to offer Industrial business incentives worth R18.5 billion, and much of this budget will be largely targeted at the automotive sectors, black industrialists and infrastructure grant support. Financial support to industrial parks is estimated to increase to support the refurbishment of 27 industrial parks across South Africa
- in line with Government's mandate, the Department of Tourism's (DoT) focus will be on the transformation and job creation. In the medium term, the DoT plans to restructure the Tourism Transformation Fund to make funding more accessible. The DoT has also set aside R856 million for the implementation of 31-capacity building programmes and 15 incentives to transform the sector and to provide developmental support to rural tourism enterprises. The Working for Tourism programme, through the Destination Development programme is expected to increase its spending by R66 million, in the medium term, in the hope of creating approximately 16 000 new jobs

- the agricultural sector is one of the priority sectors in SA's industrial policy. A R4.8 billion allocation to the comprehensive agricultural support programme will be made in the medium term in the Food Security, Land Reform and Restitution programme. These funds will be used to provide subsistence, smaller-holder and commercial farmers with much needed infrastructure in areas of grain, livestock and horticultural production to facilitate growth.

Individuals

Relief granted to individuals by the adjustment to the personal income tax brackets and increases in rebates amounts to R14 billion (R12 billion is to adjust for inflation with the balance of R2 billion being relief granted in excess of inflation). The tax-free threshold increases from R79 000 to R83 100. In addition, an increase is proposed in the value of medical tax credits from R310 to R319 per month for the first two beneficiaries, and from R209 to R215 per month for the remaining beneficiaries. The increase of 2.8% is in line with the announcement in the 2018 Budget Review that the credit would be adjusted by less than inflation to help fund the rollout of the National Health Insurance (NHI).

Employer-provided bursaries

Employer bursary schemes are currently being promoted which seek to reclassify ordinary remuneration as tax-exempt bursaries granted to the dependents of an employee. Government proposes amendments taking effect on 1 March 2020 to close this loophole.

Anti-avoidance rules for trusts

Anti-avoidance measures were introduced in 2016 to curb the transfer of growth assets to trusts using low interest or interest-free loans, thereby avoiding estate duty. These rules were subsequently amended in 2017. It has come to the attention of government that certain taxpayers are undermining the adjusted rules by subscribing for preference shares in companies owned by trusts that are connected to individuals. Further amendments will be proposed to the rules to prevent this new form of abuse.

VAT

The following VAT related amendments were proposed:

- electronic services - it is proposed that intermediaries be permitted to account for VAT on the payments basis
- telecommunication services – it is proposed that the definition of telecommunication services be clarified due to unintended consequences of the current definition
- corporate reorganisation rules - where the rollover relief provisions are used in part for corporate income tax, it is proposed that this election should not lead to unintended VAT consequences. Therefore, section 8(25) (or 11(1)(e)) will be amended to ensure these transactions qualify for relief
- clarifying the VAT treatment of irrecoverable debts - where a vendor hasn't paid a supplier within 12 months it must reverse any input tax it previously deducted. There is uncertainty regarding the value of supply rule that applies in certain circumstances. It is proposed that clarity be provided in the legislation to address the uncertainty. In other words, clarity on the value of the adjustment will be legislated where partial payments are made
- introducing measures to address undue VAT refunds on gold - schemes and malpractice to claim undue VAT refunds have been detected in the value chain relating to gold exports. It is proposed that appropriate regulations be considered or legislation be amended to address this.

Export Taxes

Government proposes the introduction of export taxes on scrap metal which could replace the current price preference system. The Budget Review states that the reform is intended to improve the availability of better quality scrap metal at affordable prices for domestic foundries and mills. Consultation with the affected industries will begin immediately and will be concluded by the end of May 2020 for consideration in the annual tax bills.

Transfer duties

The brackets to calculate transfer duties will be adjusted for inflation from 1 March 2020. From 1 March 2020 no transfer duty will be payable on the purchase of property with a value below R1 million.

Taxation of heated tobacco products

Government will introduce a new category or tariff subheading for heated tobacco products in the schedule of excise duties, to be taxed with immediate effect at a rate of 75% of the cigarette excise rate.

Electronic cigarettes

Government plans to tax electronic cigarettes in 2021 due to concerns about health effects.

Excise duties on alcohol and tobacco

Government will increase most excise duties by an amount that matches expected inflation of 4.4% for 2020/21, and by 6% in the case of sparkling wine and 7.5% for pipe tobacco and cigars.

Carbon tax

The carbon tax rate will increase by 5.6% for the 2020 calendar year. The carbon tax rate will thus increase from R120 per tonne of carbon dioxide equivalent to R127 per tonne of carbon dioxide equivalent.

Purchase tax on motor vehicle emissions and incandescent global tax

Vehicle emission tax will increase with effect from 1 April 2020 in line with global standards and shift to fuel-efficient cars.

Similarly, government proposes to increase the incandescent light bulb levy with effect from 1 April 2020 to encourage the uptake of more energy-efficient light bulbs

Levies on plastic

Government proposes to the raise plastic bag levy from 12 to 25 cents with effect from 1 April 2020. A review of the current levy, including a clarification of the tax treatment of compostable bags, will be undertaken.

Tax administration

The legal framework and administration of PAYE will be reviewed with a view to implementing a more modern, automated process for employers that is easy to understand, access and maintain. The reforms are expected to reduce the administrative burden for employers, payroll administrators and SARS.

In addition, the following tax administrative initiatives were noted:

- Government will strengthen the Office of the Tax Ombud and separate it financially and operationally from SARS
- recognising the need for an independent office to oversee governance and conduct within SARS, government will propose a SARS Inspector General
- government proposes the correction of an anomaly that currently exists within the PBO legislation which has the effect of not applying the sanction for non-compliance with the PBO legislation to all non-compliant PBOs
- provisions will be proposed providing for the refund of withholding tax on royalties in cases where the underlying royalty becomes irrecoverable
- in view of the abuse of duty-free purchases by certain diplomats it is proposed that SARS be permitted to disclose information regarding duty-free purchases by diplomats to the Director-General of the Department of International Relations and Cooperation
- it is proposed that the Customs and Excise Act be amended to provide for the publication of tariff determinations and rules prescribing the circumstances in which such publication may take place, the kind of information that may be published and the manner of publication
- SARS recently published draft diesel refund rules and notes to the Customs and Excise Act for public comment. The reform proposals and legislative framework will be refined further based on the outcome of stakeholder engagement during 2020
- the interest provisions of the Mineral and Petroleum Resources Royalty (Administration) Act and that contained in the Tax Administration Acts will be aligned
- SARS may currently issue an estimated assessment to a taxpayer who does not file a return. It is proposed that SARS be permitted to also issue an estimated assessment in cases where specific relevant material was requested from a taxpayer on more than one occasion, without an adequate response.

Tax policy reviews and research

The draft Upstream Petroleum Resources Development Bill was recently published for comment.

National Treasury will undertake or complete the following projects during 2020/21:

- examining regulation treatment of unlisted REITs
- reviewing the tax treatment of amounts received by portfolios of collective investment schemes

Exchange Control

The Minister announced a proposed modernisation of the current foreign exchange system which will be phased in over the next twelve months. Going forward, all transactions will be permissible except for a risk-based list of capital flow measures. While these measures are mainly applicable to legal corporate entities there will also be exchange control reforms applicable to individuals.

The risk-based list of capital flow measures referred to above will include:

- South African corporates will not be allowed to shift their primary domicile, except under exceptional circumstances and as approved by the Minister
- approval conditions for corporates with a primary listing offshore will be aligned to current foreign direct investment criteria
- cross-border transactions will still need to be conducted via Authorised Dealers
- prudential limits on institutional investors and banks remain
- the unhedged foreign currency exposure for banks will remain limited to 10% of liabilities
- the domestic treasury management company policy will remain in place as well as the international headquarter company regime
- export of intellectual property for fair value to non-related parties will not be subject to approval
- the current policy pertaining to loop structures will remain until tax amendments are implemented to address the risks.

As regards individuals, whilst no mention is made of changes to current investment limits applicable to individuals/natural persons, reference was made to transfers in excess of R 10 million and this will come with a more stringent verification process by SARS. It thus appears that there will be no limits on individuals externalising funds provided the necessary tax clearance has been obtained. Natural person residents and natural person emigrants will be treated identically and the current exchange control emigration concept will be phased out and be replaced by a SARS verification process. This will also effect withdrawal of retirement funds on emigration and transferring dual listed shares abroad.

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