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Navigate uncertainty
Budget 2022/23

Pre-Budget Commentary
South Africa

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The National Budget must aim to improve momentum of economic recovery

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"This state of heightened uncertainty should not lead us to inertia and policy paralysis. We have to face the year and decade ahead with determination, decisiveness and a sense of optimism. We cannot afford to be despondent."

The 2022/23 National Budget takes place at a time when South Africa, and indeed the world, is emerging from two years of being battered by a pandemic, which has left the country reeling with low growth and high unemployment.

The International Monetary Fund (IMF) now speaks of disrupted global growth as a key feature of the year ahead. The fund has revised global growth downwards by 0,5 percentage points to 4,4% this year. At the same time, the IMF said that South Africa's economy is expected to grow by 1.9% in 2022, compared with last October's prediction of 2.2%.

The downward revision is caused by disruption to global supply chains due to Omicron, rising inflation in both advanced and developing economies leading to rising interest rates, record debt levels in parts of the world, and heightened policy uncertainty.

This state of heightened uncertainty should not lead us to inertia and policy paralysis. We have to face the year and decade ahead with determination, decisiveness and a sense of optimism. We cannot afford to be despondent.

The budget thus needs to respond to several critical issues to foster this sense of confidence.

The economic growth conundrum
Following the Global Financial Crisis in 2008/2009, South Africa's economic growth never truly recovered. Even as other middle income emerging market economies restored their growth rates to pre-recession levels, South Africa went on to record the worst decade on record for growth, according to the South African Reserve Bank Quarterly Bulletin, released in March 2021.

The government's economic management performance for the decade ahead will be judged by how quickly we can get the growth rate to pre-COVID levels and then improve to pre-recession levels. This year's National Budget needs to spell out the first steps to changing the growth trajectory.

Government's economic reform programme is characterised by lengthy lead times between an idea being formulated and it being implemented. The latest setback is the court action by telecommunications companies over the auctioning of the spectrum. Government

should not allow this to halt the overall momentum of reforms and should move on areas such as third party access to rail, announced in the Economy Reconstruction and Recovery Plan in October 2020, to help lower the cost of logistics.

Infrastructure spending

Infrastructure spending is a critical pillar of economic recovery. The government needs to decide if it is worth borrowing to fund infrastructure spending to boost economic growth. This will be a high risk move if the borrowed funds are not used as intended or the anticipated growth does not materialise.

How the tax burden will be shared

One of the most critical questions to be answered in this budget is how the tax burden will be shared between individuals and corporates. This is because, over the past year, the idea of a Universal Basic Income Grant (BIG) has gained momentum while the National Health Insurance (NHI) remains an aspiration. Both these items may require tax increases to be financed.

In last year's budget, individual taxpayers got relief of R2,2 billion through rebates and bracket adjustments. There is an even stronger case for more tax relief to help consumers cope with rising food and fuel costs, rising interest rates, and the devastating effects of the COVID-19 pandemic/outbreak on household finances. At last year's budget, it was announced that the corporate income tax rate will be reduced to 27% with effect from years of assessment commencing on or after 1 April this year. The government cannot afford to reverse this undertaking.

So, if the government needs to raise taxes in order to fund a BIG or NHI will they hurt consumers through personal income tax or value-added tax increases? Or should the burden fall to corporates or high net-worth individuals? Raising taxes may have a negative effect on the economy.

The focus should rather be on widening the tax base while lowering tax rates, a process that is already under way – with the reduction of the corporate income tax rate, accompanied by a reduction of some tax allowances such as deduction of certain expenditures and utilisation of assessed losses.

Ultimately, there is no substitute for growing the economy. A larger economy – and more people with jobs – will yield more tax revenue and assist in reducing unemployment. By contrast, imposing an even heavier burden on the existing tax base would damage the economy and therefore also tax collections in the long term.

Special focus on SMMEs

One of the most visible signs of economic devastation brought by COVID-19 has been the closure of many small, medium and micro enterprises (SMMEs). The government needs to put in place tax incentives and other measures to help stimulate the revival and growth of SMMEs as a critical engine for growth and job creation.

Government needs to focus on re-building the SMME sector as an important backbone of the economy for growth which will lead to employment where people live. Focus must be given to areas such as secondary manufacturing, agro-processing and mineral beneficiation, technology and artisanship with a feeder from Further Education and Training colleges. The growth of SMMEs should be highlighted as having a primary role in the overall growth agenda for South Africa.

SOE reform has become more critical

Last year, the IMF in its Article IV report said that the South African government should take a full inventory of state-owned enterprises (SOEs) and divest or liquidate those that are no longer relevant.

According to IMF staff, there has been little progress in the government's implementation of structural reforms at SOEs, leaving continued weaknesses. "Structural rigidities are depressing private investment and hindering inclusive growth and job creation. These rigidities need to be tackled immediately to increase the economy's productivity and competitiveness and reduce poverty and inequality", according to the IMF. There seems to be inertia in the process of reviewing the SOE portfolio and deciding which ones to keep and which ones to merge, close down or privatise. The Finance Minister must look beyond financial support for the SOEs and include managerial and governance capacity as well as competency to deliver on the mandates of these entities.

Financing the Green Transition

Last year at COP26, South Africa secured R130 billion in soft loans to move away from coal. But this is not the full amount required. In this year's Budget Speech, the Finance Minister should spell out how these funds are to be deployed and how the government will raise the balance of the required funds to finance the Just Transition without stifling growth. The use of the carbon tax and other instruments to fund and promote a clean and green energy future will be critical.

Healthcare: spending reaching inflection point between short- and long-term priorities

The COVID-19 outbreak has shown the need for a robust public health system to cope with health crises. At the same time, the COVID-19 response has taken away spending from other critical parts of healthcare spending, including HIV and TB.

Beyond 2022, health challenges are expected to begin to emerge, not only directly from the COVID-19 pandemic, but as an indirect result of all the socio-economic fallout the pandemic caused. Government will need to be aware of early indicators in the short term and to ensure that these can be addressed or risk compromising the healthcare system in the long term.

In addition, the government needs innovative ways to allocate more resources to the implementation of NHI while restoring funding to other critical programmes. That a COVID vaccine trial is currently being carried out on HIV-positive individuals is an encouraging sign that other epidemics, such as HIV/AIDS, continue to receive attention.

The establishment of the NantSA vaccine manufacturing facility recently launched in the Western Cape by President Cyril Ramaphosa is also a positive development for the continent, the budget still needs to allocate adequate resources to combat the immediate needs of South Africans beyond the COVID crisis. It is crucial that focus be expanded to other health-related burdens such as TB, non-communicable diseases such as diabetes, and socio-economic factors like teenage pregnancy.

Raising optimism

As the budget takes place against a backdrop of fragile and cautious global recovery, its main aim should be to give fresh impetus to the country's economic recovery, as well as provide growth and development plans.

Can the National Treasury reverse structural decline through enabling infrastructure?

By Dr Martyn Davies
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South Africa's economic indicators all point to an economy that is performing below its potential and in structural decline. Without robust growth, the label "emerging market" rings hollow. Whilst most leading emerging markets have been severely impacted the past two years through the COVID-19 pandemic, their growth trajectories are now becoming steeper with sustainable recoveries underway.

Many will respond with an ideologically tinged argument to my oft repeated assertion that there is no problem that a constant 5%+ GDP growth rate can't solve. But this is South Africa's problem; how to achieve higher growth rates beyond the paltry 2%-odd forecast? Urgent budget reform is needed to redirect government spending towards key enablers of economic growth.

Operation Vulindlela is an initiative of the Presidency and National Treasury to drive structural reform – or as I define it – reform that is politically difficult to do and which challenges accumulated vested interests. How the treasury allocates its budget will reflect the (shifting) economic priorities.

What then is to be done to support growth? In a publication of a few years ago, I posed the question if countries can structurally reform without a crisis, and importantly, has South Africa experienced a sufficient crisis to carry out the bold reforms that the state-owned sector of our economy so desperately requires? Ours is not a cyclical crisis, but a structural one that has been deeply worsened through the pandemic.

Structural reforms or supply-side interventions are required to address issues such as the lack of business confidence, labour market problems, poor governance, barriers to market entry, huge regulatory burdens and large infrastructure gaps. In the South African context, while many of these issues apply, the infrastructure gap is of particular concern. Successful countries are those that prioritise investment, not consumption.

The right infrastructure investment has the potential to reap large returns and benefits by stimulating the economy, enhancing overall productivity and creating the capacity for the economy to grow going forward. Enabling infrastructure can also play an important role in driving regional integration as intra-regional transport networks allow for the flow of goods and people. This enables the development of cross-border supply chains and the expansion of markets.

In 2008, South Africa was (only) investing an equivalent of 23% of GDP in infrastructure, and this was relatively high considering the lead up to the 2010 FIFA World Cup finals. Since this time, there has been a slow burn decline. The rule of thumb suggests that a country should be investing the equivalent of approximately 30% of GDP to underpin its developmental needs. As a stand-out example, China has invested over 40% of GDP annually for more than a generation. By June last year, South Africa's investment accounted for just 12.5% of nominal GDP.

Ironically South Africa has all the necessary features to enable this crucial economically enabling investment in infrastructure – a strong banking sector, development finance institutions, a growing and young population encouraging demand for infrastructure, regional connectivity, and rapid urbanisation. Of course, directing capital through the budget toward key infrastructure programmes will unlock economic growth. But it is not so much a financing challenge as it is an imperative to liberalise and allow private capital to invest in traditionally controlled state-owned infrastructure. I would argue that policy liberalisation would have an even greater impact than capital spend on driving growth. The recent opening of the power sector to private generation is an excellent example of this. As policy liberalises, capital naturally flows toward the opportunity.

Since the National Treasury already faces fiscal policy constraints due to high debt levels and servicing costs, such reform does not cost anything – it's free in fact. Competition always drives efficiency and this in turn will result in more competitive infrastructure systems emerging.

True structural reform will not just remedy the obvious financial risk that we face, but also provide the necessary confidence to domestic and foreign capital to invest for the long term in our economy.

Without deep structural reform, South Africa will underperform in growth terms going forward and will increasingly diverge from the global emerging market macro. To counter this, the budget needs to be coupled with a strong policy liberalisation agenda in order to promote a renewed growth path for the economy.

Boosting tax revenue – The imperative of increasing the tax base

By Alex Gwala
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There is no doubt that the government is under pressure as widely acknowledged by both political and economic commentators. This is attributed to the COVID-19 pandemic that has shrunk the tax base leading to low revenue collections by the South African Revenue Services (SARS).

"...the Finance Minister must walk a tightrope and make tough decisions that strike a balance..."

Based on predictions in 2021, it was anticipated that the pandemic will not slow down as shown by the rise of the Omicron variant that hit the world in December. This further worsened the high level of youth unemployment and economic uncertainty.

With all these factors in mind, the Finance Minister must walk a tightrope and make tough decisions that strike a balance between conflicting priorities of the nation and revenue collection, while bearing in mind the need to increase the size of the tax base.

1. **Value-added tax**
   Value-added tax (VAT) is currently levied at 15%, a rate that was increased by 1% in the 2017/18 financial year. This is always a focus area for adjustment.

   Since VAT is levied on consumption, a further increase will affect some basic commodities in the market as manufactures and retailers pass it to consumers who have less disposable income.

   Therefore, considering the recent statement made by the ruling party on 8 January that aims to drive investment and increase job opportunities, a VAT increase is unlikely in 2022 given the broad negative impact tax increases have on voters.

2. **Corporate taxes**
   Corporate tax is currently levied at 28%. As announced in the February 2021 National Budget Speech, the corporate income tax rate will be lowered to 27% with years of assessment commencing on or after 1 April 2022. This will give relief to taxpayers, however, it comes with limitations on interest deductions, assessed losses and write down values.

   This move was an investment drive by the government with the aim of making our tax system more attractive. It also makes sense that they wanted to do it in a tax neutral manner. A reversal of this decision is unlikely as the government needs to attract more investment.

3. **Personal income tax**
   Our country has been experiencing low levels of employment for some time now. This can be seen on the personal income tax collections in the last few years which have not been growing, even though the tax brackets have been adjusted. Similar to prior years, it is not expected that the tax rates will be changed. If anything, the brackets may be adjusted for inflation purposes only.

   High net-wealth individuals are likely to face increased scrutiny as SARS enforces its collection drive. Once again, such a drive may have a negative effect on the economy as it contributes to the migration of high net-wealth and skilled professionals to low-tax jurisdictions.

Conclusion

Government has little room to manoeuvre in the upcoming budget. There is massive political pressure to maintain the R350 social grant which was initially set to end in March 2022. This further adds pressure on the strained fiscus.

SARS also faces challenges from a collections point of view. In an effort to improve that, SARS has granted a grace period of more than 30 days for tax debt collections and payment deferrals to taxpayers to provide some extra relief. However, this also comes at the expense of collections.

Despite these challenges, SARS has implemented an aggressive collection drive to boost revenue coffers such as data mining or following up on social media platforms as the SARS Commissioner hunts down tax dodgers. We expect that SARS is already looking at the first report of the Zondo Commission with a view to identifying further taxes to be collected.

Overall, we are not expecting any new taxes to be introduced in this February budget.

Budget requires a refocus on long-term healthcare funding

By Ashleigh Theophanides
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The presentation of the 2022/23 National Budget is expected to take place with the consensus that South Africa has largely exited the fourth wave of the COVID-19 pandemic, while other geographies still grapple with high daily cases. In budget documents issued since the Supplementary Budget of June 2020, spending had been shifted forward to the immediate periods to rapidly respond to the effects of the pandemic. As the country moves into 2022, the economic and socio-economic fallout of the past two years has resulted in increases in the unemployment rate, increases in school drop-out rates, and a fall in gross domestic product and government revenue. Further, worsening disease burdens, such as the increase in non-communicable diseases as well as burden of HIV and TB, will continue to strain government finances. It remains the challenge of government to look to return to spending priorities in the medium term, while also balancing the ability to provide sufficient and immediate response to additional waves that may manifest themselves throughout 2022.

Since the 2020 Supplementary Budget, much of the focus in healthcare spending has been on bringing in additional resources to combat the worst effects of the pandemic. Budget 2021 continued this trend, allocating an additional R18 billion in funding over the medium term to the COVID-19 response. The downside to bringing forward spending is that many budget allocations were forced to reprioritise funding away from medium-term spending. Health spending was not exempt from this, as health expenditure shifted from an annual average growth rate of 5.1% over three years in Budget 2020, to a contraction of 0.3% average annual growth over the next three years in Budget 2021. Much of this spending was reallocated away from key items, such as the HIV, TB and Community Outreach Grant and the Health Facility Revitalisation Grant, to the total of R4.5 billion reprioritised in 2020/21[1].

In the years following the outbreak of the pandemic, socio-economic outcomes for the country have deteriorated. The expanded unemployment rate rose to a record high of 46.6% in the third quarter of 2021, and it is expected that around 750,000 children may have dropped out of formal schooling because of the direct and indirect economic fallout in 2021[2,3]. In addition, varying lockdowns of 2020 and 2021 limited the movement of people to access treatment, and increased the opportunity costs of accessing chronic treatment versus basic survival needs such as food. This has had knock-on effects on people living with diseases such as HIV and TB. It is also expected that the worsening socio-economic outcomes increased the number of people accessing the public healthcare system, while increasing the incidence of substance abuse and teenage pregnancy, all of which require long-term commitments to healthcare spending. This has been concerning within the context of the fall in HIV and TB-related spending, which was budgeted to contract by an average annual rate of -0.1% in Budget 2021 over three years.

> “The 2022 Budget brings about a challenging balancing act compared to previous budget processes. While Budget 2021 had a sharp focus on funding immediate responses including the vaccine rollout, the latest COVID-19 statistics have presented a different challenge.”

The 2022 Budget brings about a challenging balancing act compared to previous budget processes. While Budget 2021 had a sharp focus on funding immediate responses including the vaccine rollout, the latest COVID-19 statistics have presented a different challenge. In the latest Omicron variant-led wave, excess deaths were seen to have been a fraction of previous waves (3,087 in the week of December 19 2021, compared to the peak of 16,115 in early 2021 and just over 10,000 in the peak of the delta wave). With that, it

is expected that government's spending commitments in combating the virus have been lower than previous variants[4]. Attitudes towards COVID-19 are adjusting and in January Switzerland announced a view that the virus may transition to an endemic phase – where countries treat the virus as they would the seasonal flu[5]. It is expected that South Africa's Department of Health will soon provide guidance on this[6]. This has significant effects on the budget process, which would then result in COVID-19 funding transitioning to budgeting for consistent longer-term commitments.

If the latest variant signals the beginning of a new transition into longer-term smoothing of funding and away from short-term responses, this could signal a shift back to normality for the budget. Along with the requirement to address the effects of worsening socio-economic outcomes on rising disease burdens, government's attention should shift toward improving funding in critically underfunded areas. In January, it was reported that the Eastern Cape Department of Health was unable to place more than 90 trainee doctors as well as nurses and other medical professionals due to funding constraints[7]. It is crucial that government addresses these shortfalls urgently. Further, global trends such as the rising incidence of non-communicable diseases such as cardiovascular diseases and diabetes (expected to be the leading cause of mortality in Sub-Saharan Africa by 2030) will require significant funding, and careful planning in the short term to ensure the country is appropriately prepared[8].

The 2022/23 National Budget is expected to be delivered within the same funding challenges of rising debt as recent years. While this will constrain expansionary spending, government must move into a phase of prioritisation of long-term funding strategies to combat the direct and indirect effects of the COVID-19 pandemic. While short-term preparedness should still feature in the event of future variants, attention should now turn to improving healthcare outcomes, strengthening the healthcare system with enhanced funding, with an acute awareness of future challenges by building funding into the budget now.

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1. *National Treasury*
2. *Quarterly Labour Force Survey, Q3 2021, StatsSA*
3. *Global Citizen, 750,000 South African Children May Have Dropped Out of School Due to COVID-19 Pandemic, 9 July 2021*
4. *Business Live, Excess mortality during omicron wave 'a blip' compared to that of previous surges, 6 January 2022.*
5. *Bloomberg, Swiss Add Voice to View That Endemic Stage of Covid Is in Sight, 12 January 2022*
6. *eNCA, COVID-19 in SA – SA may transition to endemic phase, 13 January 2022*
7. *Health-e News Service, Young doctors at boiling point as EC health crisis deepens, 13 January 2022*
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Does recovery include raising more taxes?

By Musa Manyathi
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The Minister of Finance, Enoch Godongwana, is hard at work refining his 2022/23 National Budget Speech to be presented in February and alive to the numerous negative sentiments about the state of the economy – COVID-19 being one of the main culprits and weighing heavily on the minds of South Africans, and will likely continue to for a long time. In the third quarter of 2021 the official unemployment rate also accelerated by 0.5% to 34.9%, the highest it has ever been since the introduction of the Quarterly Labour Force Survey in 2008. This highlights the grave effects of COVID-19 on South Africa's economy, which was already in a poor state prior to the pandemic. The economy also has to contend with electricity supply challenges and the dire state of many state-owned enterprises, as well as the ballooning public sector wage bill.

These factors will without a doubt weigh heavily on the minister's mind, but we expect that he will draw inspiration from the better-than-expected economic outlook, boosted by high commodity prices and improved mining production. The Finance Minister should be energised that progress is being made in charting a trajectory of fiscal consolidation and debt stabilisation to avoid a debt trap, which is now expected to materialise earlier, as the overrun in revenue receipts is directed to finance additional government spending. Improved revenue collection by the South African Revenue Service (SARS) underpinned by, among others, more economic activities and the rebuilding process happening at SARS spearheaded by the SARS Commissioner is expected to add to this.

As the minister delivers the budget speech there are some key questions that he will have to consider:

What does recovery look like?

After positive news on improved economic activities together with better-than-expected revenue collection, the Finance Minister may just have some good news for parliament and taxpayers. If this recovery trajectory is sustained at the rapid pace seen recently, this could ease many uncertainties and headaches.

Can the government keep running a deficit?

It is well known that the government has been spending more than it earns, borrowing for social expenditure instead of infrastructure investment. The current total government debt is well over 80% of GDP, mostly due to the pandemic. The previous Finance Minister succinctly summed up the position when he said, "we owe a lot of money to a lot of people".

While not a consensus view, it is widely accepted that for a country such as South Africa, as an emerging market, a debt to GDP ratio above 100% is perceived to be unsustainable. Last year September this ratio was projected to peak at well over 90% in the next three to four years, uncomfortably close to unsustainable levels. Thanks to higher-than-expected tax collections from corporate income tax and value-added tax, the ratio is now projected to peak at 88,9% of GDP, which is still high but better than what was projected.

Is there a need to raise more taxes?

It was acknowledged in the 2021 Medium Term Budget Policy Statement, that tax increases over the recent past have had an adverse effect on growth rather than spending reductions, as the spending multiplier has declined. In this regard, National Treasury has also recognised that both personal income tax as a percentage of GDP as well as the country's marginal tax rate are higher than other comparable countries. Therefore, there is acceptance that further tax increases are not desirable as they will negatively impact economic recovery. Instead, the focus is to broaden the tax base whilst lowering tax rates, a journey that is already under way – with the reduction of the corporate income tax rate from 28% to 27%, accompanied by a reduction of some tax incentives such as deduction of certain expenditures and utilisation of assessed losses.

Additionally, progress is being made in rebuilding SARS with the re-introduction of the Large Business Centre, and other units with special focus on High Wealth Individuals, auditing of offshore transactions and general anti-avoidance.

"…further tax increases are not desirable as they will negatively impact economic recovery."

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What is SARS' next digital transformation move?

Real-time access to organisations' data will reduce the administrative burden for the taxpayer and increase compliance

By Tumi Malgas
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The primary objective of tax administrators, such as the South African Revenue Service (SARS), is to collect taxes from taxpayers to fund the fiscus. To be effective, this needs to be done in a manner that encourages, maintains and improves economic growth. In South Africa, the biggest challenge is to gather all applicable tax from all eligible taxpayers to offset the growing budget deficit.

Value-added tax (VAT) is one of the tax types with the biggest opportunity for SARS to increase its revenue collection. One of the reasons being that VAT is transactional in nature and therefore many transactions in a business will have a tax impact. We have experienced the worst couple of years of our times, personally and economically due to the Covid pandemic. Increasing the VAT rate will negatively impact the ordinary person in a time when they can least afford it. The alternative for revenue collection from VAT is for SARS to join the wave of tax administrators who have or are implementing regulation that enables more real-time reporting of transactions by organisations.

It is still difficult to imagine a world where there is no tax return, where tax just happens, and processes can be relied upon to produce the correct tax outcomes. However, this is what SARS should strive towards, in order to achieve a potentially radical improvement in revenue collection.

There are three VAT compliance models that revenue authorities across the world have adopted to assess taxpayers' VAT positions. Below is a brief description of each and its characteristics.

- **Post-audit model –** Review a company's books or transaction after period-end and once VAT has been claimed:
  - Low visibility of transactions
  - Delayed audit
  - Manual invoicing or voluntary e-invoicing
- **Real-time reporting model –** Obtain VAT-related transactions as they happen and calculate VAT liability or VAT due to the company soon after:
  - Extensive visibility of transactions
  - Immediate audit
  - Manual invoicing or voluntary e-invoicing
- **Tax clearance model –** Invoices are provided to the tax authority before being processed by the recipient:
  - Full and instant visibility of transactions
  - Instant audit
  - Obligatory e-invoicing

South Africa is currently using the post-audit model, which is the traditional way that all tax administrators used in the past.

Several countries (e.g. Russia, Indonesia, United Kingdom, Kenya, Nigeria) have moved, or are moving towards the real-time reporting model. The objective of the real-time data-driven tax environment has been to close the tax gaps through improved voluntary compliance. This is defined in the Organisation for Economic Co-operation and Development (OECD) guidelines for revenue bodies – Tax Administration 2.0. This model has been implemented in various ways by different countries. The least sophisticated method is the requirement to use electronic fiscal devices (EFDs). A study by the International Monetary Fund on EFDs concluded that "despite their widespread use, there is little documentary evidence to determine whether they provide a cost-effective solution to address the compliance risks that tax administrations in developing countries face". The most progressive implementation of the real-time exchange of data with revenue authorities is enabled through e-invoicing and/or through direct application programming interfaces (APIs) from organisations to the tax administrators.

Countries such as Brazil, Italy and Turkey have passed regulations that enforce the tax clearance model. While relatively few countries have implemented it, those who have are still dealing with change management and adoption challenges, but the value generated is reported to be undeniable. André Cordeiro, Planning and Management advisor at the Ministry of Finance of Bahia says:" Before, audits used to be carried out by sampling: for example, out of every 100 companies, we selected five or six to verify their tax compliance. Now, we verify all 100, and in real time, with less staff and paperwork, and more efficiency and transparency". In addition, a report by Inter-American Development Bank (IDB), states that the immediate results of digitising the invoicing process for Brazil were an increase in tax collection. This model involves the revenue authority being part of the transaction in the invoicing process of companies. For example, a company's (seller/supplier) invoices are shared with the tax authority before it is provided to the recipient company (buyer/purchaser). Owing to the immediate release of transaction data, certain tax checks may already be performed the moment the transaction takes place, thereby ensuring that most transactions processed are tax compliant.

The real-time reporting and tax clearance models provide an opportunity for SARS to:

- Reduce the administrative burden experienced by its employees in assessing compliance.
- Reduce the obligations for taxpayers in preparing VAT returns.
- Potentially eliminate the requirement for VAT reconciliation to support VAT claimed and declared.
- Remove the need to perform manual audits after the fact.
- Significantly reduce the risk of fines which could be imposed several years after the business transaction has taken place, resulting in pushback by taxpayers as well as possible litigation which costs time and money for both parties.

These models do not only make it easier to comply with regulation but may reduce the number of entities that are non-compliant; in the same way as Netflix made it simple to access a wide variety of movies legally, resulting in a reduction in pirated movies.

If we look back at an earlier Deloitte article "*SARS' shift to the digital era*", it is imperative that should SARS embark on any of these models, the revenue authority should consider more than just the technology. The overall implementation should include goals and aspirations, objectives, culture, policies, people, processes, and data before mandating a specific technology that would support the change. This holistic approach would get the tax administrator ready for concepts discussed in the OECD's Tax Administration 3.0 report (The Digital Transformation of Tax Administration). It's a paradigm shift that prescribes the integration of tax authority processes with the processes and systems used by taxpayers, other government entities and by third parties alike. This will expand and improve on some of the models discussed, prescribing specific system requirements and changes in process – with an emphasis on sharing data with revenue authorities.

International taxes: Government weighs its options

By Le Roux Roelofse
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The Minister of Finance remains under pressure to raise revenues from an already overtaxed population.

In the area of corporate taxation, government has expressed its support for international efforts to curb base erosion and profit shifting (BEPS) and changes to the international tax rules to address the tax challenges arising from the shift of a bricks and mortar economy to a digital economy. We predict that government's support for these international tax measures may lead to the ratification of the multilateral instrument (see below) in 2022, and that government will not take unilateral steps to impose new digital services taxes. We further predict that proposals to limit the deduction of cross-border interest-bearing debt by multinational groups will be stayed in 2022 pending a possible reduction in the corporate income tax rate from 28% to 27% from 2023 at the earliest. The BEPS project has various strands to it, three of which are highlighted herein:

(i) profits generated by multinational entities should be taxed in the jurisdiction where the profits emerge;

(ii) curbs should be placed on the deduction of debt to fund investments and working capital; and

(iii) the international tax rules, including bilateral tax treaties, should be updated to provide for the taxation of profits derived in the digital economy.

The first strand noted above speaks to transfer pricing and the underlying philosophy that related parties should transact with each other on an 'arm's length' basis (that is, as if they were independent of each other) to ensure that each party is compensated adequately. The temptation where related parties transact with each other is to shift profitability to the jurisdiction with the lower tax rate in order to reduce the overall tax burden to the group. South Africa has had transfer pricing rules in its income tax legislation since the 1990s to counter profit shifting through transfer pricing and has supported international efforts to strengthen the transfer pricing rules. It has also, as recently as last year, tried to strengthen its transfer pricing rules by broadening the definition of related parties (connected persons). The proposed changes were met with resistance and have been put on hold for the time being. However, we can expect further work to see how the transfer pricing rules can be strengthened in the year ahead.

The second strand referred to above has already received legislative attention in South Africa: a specific provision in the Income Tax Act seeks to limit corporate income tax deductions claimed on interest incurred by parties in a controlling relationship. Similar rules are found in several jurisdictions globally and are supported by the Organisation for Economic Co-operation and Development (OECD). South Africa, last year, proposed to extend these rules by further tightening the deductibility of interest incurred by multinationals. However, various submissions were made regarding technical difficulties with the proposed amendments and the redesign of the rules. Government has therefore delayed the implementation of the proposed changes for the time being. These rules will now take effect when the Minister of Finance announces a reduction in the corporate income tax rate in the annual Budget Speech. In last year's Budget Speech, it was proposed to reduce the corporate income tax rate from 28% to 27%; however, for various reasons, that proposal has been delayed and we do not expect an announcement to this effect in the 2022 Budget Speech. Consequently, the proposals to further restrict the deductibility of interest as discussed above will be delayed, we predict, to not earlier than 2023.

As for the third strand referred to above, the G20/OECD developed a multilateral instrument to amend bilateral tax treaties without the need for governments to amend each of their treaties. The multilateral instrument introduces minimum standards to the application of a tax treaty and proposes changes to several treaty articles to make them more fit for purpose to a modern economy. However, a country only becomes bound to the multilateral instrument once it ratifies it. Whilst South Africa has expressed support for the multilateral instrument, it has not yet ratified it. We predict that South Africa will ratify the instrument in 2022.

A further aspect of the third strand referred to above is the OECD initiative to create a new taxing right for countries in respect of profits earned in their markets by very large multinationals which do not have a taxable presence in their market; and to require a minimum corporate income tax rate of 15% per country. This initiative, known as the Pillar 1 and Pillar 2 rules, holds that in a digital economy a company could be generating significant revenues from a market where it has no presence, and that it is only fair that that market country should be entitled to some taxes from the company's profits. It further seeks to discourage a race to the bottom of corporate income tax rates by imposing a minimum level of 15% per country. South Africa already has a 28% corporate income tax rate. Consequently, it does not have to make any changes to its corporate tax laws to align itself with the Pillar 1 and Pillar 2 rules. We therefore do not expect any specific action from government in this regard, but if this project stalls (it is meant to become effective in 2023), government may decide to proceed with imposing a digital services tax.

Budget Speech – No room to manoeuvre

By Gaba Tabane
Director: Government and Public Services Industry Leader, Deloitte Africa

In the 2021 Medium-Term Budget Policy Statement, Finance Minister Enoch Godongawa, stressed the need to consolidate the small gains attained in the recovery of the economy from the devastation brought about by the pandemic, while adopting a cautious and restrained approach to public spending in the medium term. Buoyed by the resurgence of the global economy in the first half of 2021/22 on the back of growing global demand for commodities – real GDP is forecast to grow by 5.1% in 2021. Output is expected to return to pre-pandemic levels in 2022. The South African economy grew faster than anticipated in the first half of the 2021 financial year though some of these gains were eroded by the episodes of public unrest in July 2021, the onset of the third wave of the COVID-19 outbreak, and the pervasive structural constraints in the domestic economy such as inadequate energy supply.

The Finance Minister explained that government's fiscal consolidation agenda, which is to be realised through restrained spending, is driven primarily by the need to reduce the budget deficit and stabilising debt-to-GDP ratio. With little fiscal room available to government, it is expected that we will see changes to spending that will be driven by the reprioritisation and review of current government programmes. Key focus areas the Finance Minister is likely to provide significant resources to in the upcoming budget will include:

Addressing rising debt

National debt is projected to be R4 trillion. Debt service costs are expected to be the largest portion of spending for the upcoming budget. In part, government's increasing expenditure and dwindling tax revenues further exacerbate the crisis. The rising debt-service costs are expected to be in excess of R1 trillion over the Medium-Term Expenditure Framework (MTEF). As a consequence of these high debt costs individual service delivery areas are negatively impacted.

Increased fiscal allocation to service debt will crowd out spending in other service delivery functions, which in turn will impact the provision of basic services.

Narrowing the budget deficit

The minister must reflect on the plans to narrow the government's primary budget deficit in the next two years towards the end of the sixth administration's tenure in office, which ends in 2024. Looking beyond the next two years, and taking the usual three-year MTEF view, won't be helpful as government would have changed hands to the seventh administration, even if it is still a government of the current ruling party. The major question to address is whether it is possible to achieve a budget surplus or narrow the deficit to acceptable levels by the time the 6th administration completes its tenure.

Public sector wage bill

The public sector wage bill still accounts for 35% of the overall national budget. National Treasury has recently instituted a national wage bill freeze and indications are that this will continue into the new financial year. The 2021 wage agreement provides for a pensionable increase of 1.5%, as provided for in the 2021 Budget. This includes a once-off non-pensionable cash gratuity of R1,000 after-tax per person per month. This gratuity payment is expected to cost the government R20.5 billion in 2022/23. There is still uncertainty over the legal dispute pertaining to the 2018 wage bill agreement. Should government lose the dispute, there might be a requirement for the state to implement the agreement retroactively putting huge demand on the fiscus. Government might be compelled to reprioritise funding and/or borrow funds in order to do this.

State-owned company (SOC) support

The poor financial position and deficiencies in the operations of most SOCs remains a large contingent risk. It is possible that a number of these might require bailouts from the state, notwithstanding the fact that there is no additional support identified in the fiscal framework. A recent review of SOCs by the National Treasury suggests that the worst is not yet over for these companies. In all probability, the Finance Minister will announce further bailouts to support these SOCs.

The Minister of Finance must look beyond financial support for the SOCs and include managerial and governance capacity as well as competency to deliver on the mandates of these entities. The inability to manage and govern these entities is also at the heart of their non-performance.

Basic Income Grant

This has become a pertinent issue in recent times with a number of interest groups calling for the introduction of a basic income grant. National Treasury has, however, not made any pronouncements here and has called for further research on this. With the social protection grants accounting for nearly 14% of all government spend, it looks unlikely that the Finance Minister can find any space in the current fiscal framework to introduce another social grant - it would simply be unaffordable. Any such consideration would mean that certain programmes would have to be reprioritised and or discarded.

The Finance Minister is faced with many fiscal considerations in the upcoming budget. Lower growth in the economy suggests that we will likely not see a resurgence in the domestic economy to pre-COVID levels. This is not enough to offset the various economic challenges currently faced in the country though. Sluggish growth and high unemployment rates continue to constrain the economy. Fiscal policy will for the foreseeable future continue to focus on reeling in and consolidating government spending in order to reign in growing government debt.

The Finance Minister must task National Treasury and the government with re-building the small micro and medium enterprise (SMME) sector as an important backbone of the economy for growth, which will lead to employment where people live. Focus must be given to secondary manufacturing, agro-processing and mineral beneficiation, technology and artisanship with a feeder from Further Education and Training colleges. This Budget Speech is more of a National Treasury "Growth Agenda" and not only an economic development discussion in the economic cluster.

VAT principles for principals: Clarity needed to enhance compliance

By Suzanne Holme
Director: Indirect Tax (VAT), Deloitte Africa Tax & Legal

The legal construct where a South African entity is engaged by foreign suppliers to facilitate supplies into South Africa, but also into other African jurisdictions, are now very familiar. The intermediary or agent increasingly has the relationship with the end customer and is often responsible for facilitating the supply, issuing the invoices, collecting payments; and has sight of the detail behind the supply. The intermediary or agent is therefore ideally positioned to collect and pay over any value-added tax (VAT) due to the South Africa Revenue Service (SARS).

For this reason, there has historically been special dispensation rulings to VAT vendors effectively acting as intermediaries or agents, allowing them to account for VAT as principal, regardless of the registration status of the person on whose behalf the intermediary or agent acts. In addition, this allows for the intermediary or agent to claim VAT on the expenses attributable to these taxable supplies.

These rulings have been withdrawn with effect from 31 December 2021. The concessions are therefore no longer valid and have not been enacted, which means that the intermediaries or agents will no longer fulfil this function and it is up to the principal supplier(s) to account for the VAT, of which there may be several different suppliers compared to the one agent previously.

The VAT Act has provisions which allow the agent to account for the VAT in respect of supplies made by the principal e.g, auctioneers, pooling arrangements, and agents importing on behalf of a foreign principal. These provisions are, however, very specific and can only be employed in limited circumstances.

Although section 54(2B) of the VAT Act provides for "intermediaries" to be deemed the principal supplier of electronic services in specific circumstances, this section has limited application. This creates difficulties for intermediaries or agents required to be registered for VAT and to issue tax invoices on behalf of multiple principals, some of whom are registered, some not, and some required to be registered. This requires very sophisticated and expensive system capabilities in order to isolate transactions and account for the VAT accurately. This also creates significant room for error where only some transactions are accounted for, while others need to be excluded.

> "A number of uncertainties in the interpretation of the electronic services legislation, specifically with regards to intermediaries, can also be addressed should the amendment be considered."

To this end, several proposals were made requesting that the ambit of the VAT Act be widened, allowing the intermediary or agent to account for transactions on behalf of the foreign principal. Where the intermediary or agent facilitates a supply, issues the invoice and collects the payment for supplies made by its principal, that intermediary or agent should be deemed to make this supply as well as be held liable for, and entitled to, the output and input tax in relation to this supply:

- Whether or not the principal is a resident of the republic
- Whether or not the principal is a registered vendor or should be registered for VAT
- Whether the supply takes place within or outside the republic, and
- Whether this constitutes a supply of goods or services.

An amendment to this effect, will limit the risk should the foreign principal not account for the correct amount of VAT in respect of supplies effectively facilitated by the local intermediary or agent. It also addresses the risk that any imported services VAT is not accounted for accurately. Any provisions in this regard should be subject to the parties electing to utilise this concession. It should also be based on a requirement that the principal and intermediary or agent enter into a written agreement whereby the foreign principal undertakes not to account for transactions dealt with by such intermediary/agent.

A number of uncertainties in the interpretation of the electronic services legislation, specifically with regards to intermediaries, can also be addressed should the above amendment be considered. Addressing the above would provide clarity to foreign principal suppliers and their intermediaries or agents, which in turn is likely to enhance voluntary compliance.

Can government walk away from weakening SOEs?

By Jo Mitchell-Marais
Africa Turnaround and Restructuring Leader, Financial Advisory

Ken Afrah
Associate Director: Turnaround and Restructuring, Financial Advisory

Since the turn of the century, the South African government has extended R187 billion[1] in cash bailouts to state-owned enterprises (SOEs) and currently stands as guarantor behind c.R800 billion[2] of obligations. The return on investment on these eye-watering sums has been negligible, mostly due to the corruption detailed in this year's Zondo report.

These bailouts are increasingly politically toxic, not least because they now come at a time when the government can scarcely afford them. Sluggish economic growth, record high unemployment, under-performing municipalities, once-off expenditures (e.g. recapitalisation of SASRIA) and a shrinking tax base are all, rightly, priority areas for the current administration – which is why we expect Mr Godongwana to double down on his commitment not to provide further bailouts to SOEs. But what is the consequence of walking away from historically cash hungry SOEs?

Limited funding today is in the national interest

SOEs have become uncommercial and uncompetitive. Years of mismanagement makes near-term financial losses inevitable. If government does not provide additional support (or bailouts), then SOEs will need to tap capital markets to keep the lights on. But commercial financiers will not extend funding unless they see a viable business that has already begun to deliver on a coherent turnaround plan. This inevitably requires some form of support from the existing shareholder in the interim, preventing the government from fulfilling its 'no bailout' mandate.

Without short-term government funding, service delivery by strategically important SOEs will continue to deteriorate. In its latest visit, the International Monetary Fund notes that the economy is being hampered by "essential services such as electricity, telecommunications, and transportation, [that] are expensive and/or unreliable, contributing to the high cost of doing business". As the adage goes, a stitch in time saves nine, and recent experience shows that limited funding today targeted at service delivery can prevent a huge bill down the road.

Funding a bridge, not a pier

We believe that the government should perform a full inventory on its SOE portfolio:

- For SOEs of critical national importance, the government's strategy of providing careful financial support while encouraging competition in the medium term is sound. This category includes Eskom, of course, but also key infrastructure assets such as SANRAL and SASRIA.
- SOEs that are not critical but could be financially viable in the medium term should be encouraged to prepare for life in the private sector. This means drawing up a coherent turnaround plan, supported by National Treasury in the short term, and finding a strategic equity investor to take the entity off government's hands.
- SOEs that are not critical and appear unviable should be weaned off government support. This withdrawal should be partnered with exemptions from onerous red tape to give these entities the best chance of realising value, e.g. the requirement for ministerial consent for non-core asset disposals. Any business units that carry out government functions should be integrated into the relevant organs of state.

Ultimately government does not have the luxury of just walking away from its weakening SOEs. Those that require bailouts should, as a condition of funding, be required to put together (with professional assistance) robust turnaround plans to which they are held to account. The funding gap – i.e. maximum bailout – should be clearly articulated and monitored with enhanced scrutiny to minimise slippage or at the very least, bring about more proactive, early engagement.

To the extent that the SOEs are required to go 'cold-turkey' without government bailout assistance, we are likely to see the continued poor management of cash resources which inevitably results in greater funding requirements in the future to prepare these SOEs for support from capital markets.

Therefore, while an uptick in government support for SOEs may be unpopular in the immediate term, it will protect our economy and pave the way for possible reform.

1. *Mr Tito Mboweni response to parliamentary question from the DA, dated 26 August 2020*
2. *Medium Term Budget Policy Statement 2021*

Consolidating tax incentive reforms

Paving the way for a future reduced corporate tax rate

By Tumelo Marivate
Senior Associate Director: Global Investment and Innovation Incentives Leader, Deloitte Africa Tax & Legal

The challenge for government each fiscal year, is consolidating economic policies and introducing reforms that will contribute to long-term growth, through removing barriers to investment and employment; and reducing the cost of doing business, whilst broadening the tax base and not negatively impacting government revenues.

Over the past two years, government has placed emphasis on the review of tax incentives to improve efficiency and equity. Government sees tax incentive reform as a potential lever for broadening the tax base, with the view that reducing tax incentives and placing limitations on benefits such as assessed loss carry forward, will provide the fiscal room to reduce the corporate tax rate. Ten years ago, our effective corporate tax rate was 34.5%, and in 2013 it was reduced by 6.5% to 28% and has remained constant. However, our international tax competitiveness has declined over the years relative to our key investment and trade partners, with the worldwide average corporate income tax rate sitting at 23.5% and at 21.3% for European Union countries, and 23% for Organisation for Economic Co-operation and Development (OECD) countries[1]. The relatively high corporate income tax rate affects the attractiveness of the country for new investment projects and thwarts the investment appetite for expanding production capacity locally. Thus, a lower corporate tax rate should be more conducive to growth and employment. Looking at the global average income tax rates, it is questionable whether a 1% reduction in the corporate tax rate mooted by National Treasury would significantly impact international competitiveness.

Given this context of incentive tax reform, we expect to continue to see a reduction in the range of tax incentives available particularly to corporates in sectors such as manufacturing, film, port assets and rolling stock – with the focus on broadening the progressiveness of the tax system. Ironically, this seems to be in juxtaposition to the country's industrial policy that is focused on promoting growth through supporting certain sectors in the economy. Notwithstanding this conflict, we are likely to see the continued trend of incentives that have reached their sunset clauses not being extended, particularly those that are sector specific, with a move to promote more neutrality and equity. There is also likely to be an increasing number of incentives that are up for review, with the R&D tax incentive and the energy efficiency incentive both having sunset clauses that fall in the new budget year.

However, absolute neutrality in tax is a pipe dream. In the ideal world, businesses make decisions purely on market considerations and not tax primarily; although, tax is often used as a tool to change behaviour. For example, the carbon tax was introduced in South Africa as an environmental levy to assist in shifting our country towards a low carbon economy. To address the market failures to energy efficiency, the Section 12L energy efficiency incentive, which gives an incentive of 95c/KWh energy saved, has proved to be an important inducement to encourage firms to invest in energy efficiency projects, with the South African National Energy Development Institute (SANEDI) reporting that 273 projects have saved 27 070 GWh of energy since the inception of the incentive in November 2013[2].

Similarly, the research and development tax incentive has been found to have a positive impact on the expenditure and volume of research and development (R&D) conducted in South Africa, with companies receiving the incentive conducting R4 million more R&D than those not accessing the incentive, and that every Rand of tax benefits received results in R1.83 of additional R&D expenditure[3]. This is similar to data in the OECD paper, where it was found that a unit of R&D support resulted in 1.4 additional units of R&D[4].

Given the existence of some evidence of the additional benefits for Section 11D and 12L relative to the tax forgone, and their emphasis on equity in the sense that they are available across the sectors to entities engaging in the required R&D or energy efficiency initiatives, we expect to see an indication of the extension of these sunset clauses, even if it is to allow room for a detailed review of their impact and recommendations for design modifications.

1. *Sean Bray: "Corporate Tax Rates Around the World, 2021"; Tax Foundation Fiscal Fact Sheet November 2021*
2. *SANEDI: https://sanedi12ltax.org.za/#!/content/home*
3. *South African National Treasury and Department of Science and Innovation: "Discussion Document: Reviewing the design, implementation and impact of South Africa's Research and Development Tax Incentive", December 2021*
4. *OECD Science, Technology and Industry Policy Paper: "The Effects of R&D Tax Incentives and Their Role in the Innovation Policy Mix: Findings from the OECS microBeRD Project 2016-2019", September 2020 No. 92*

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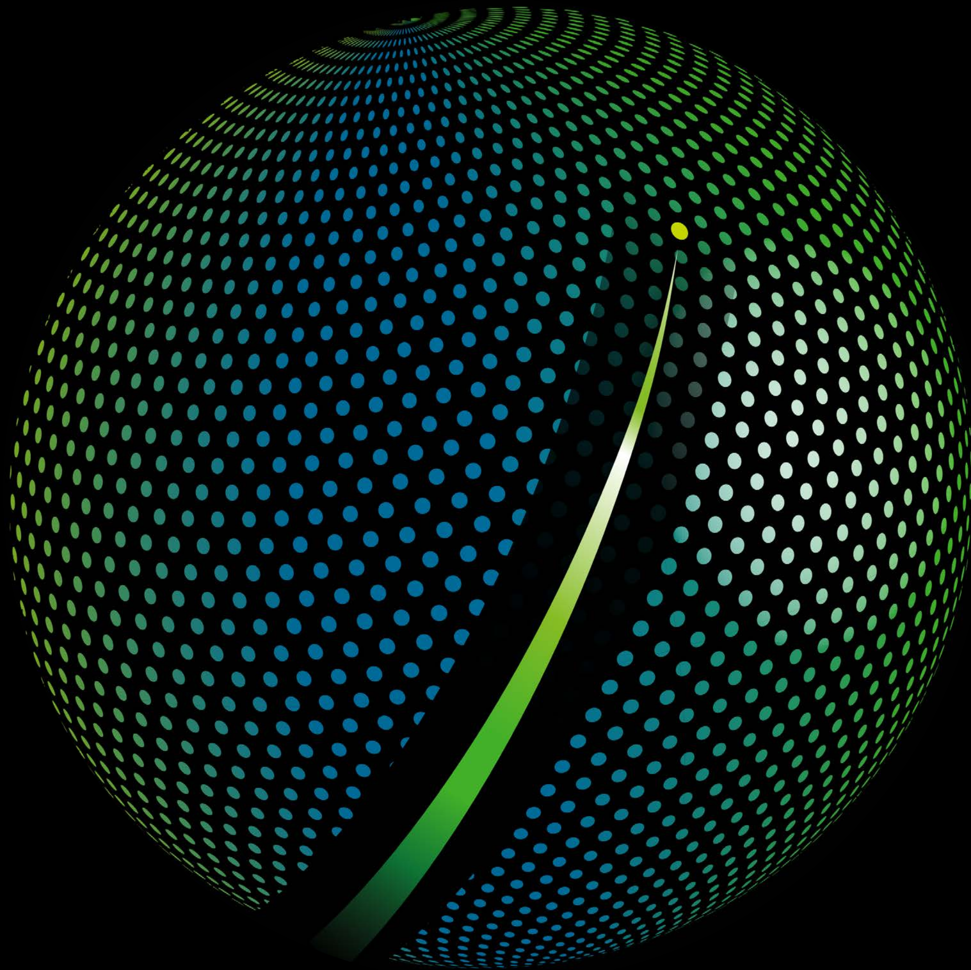

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Transfer pricing: SARS' response to the shifting tectonic plates

By Billy Joubert
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Transfer pricing (TP) rules have existed for several decades internationally. In South Africa we have had TP legislation since 1995 and a detailed TP Practice Note – based on the Organisation for Economic Co-operation and Development (OECD) TP Guidelines – since 1999. TP rules have continued to evolve – with updated OECD Guidelines having been released in 2010 and 2017 and expected in January 2022.

Yet the South African Revenue Service (SARS) Practice Note 7 (the TP practice Note) is still in force, except for the rules relating to mandatory record keeping which were passed in 2016. The balance of the Practice Note continues to apply, despite having been superseded to a significant extent by fundamental changes in the OECD Guidelines. SARS Practice Note 2 (the thin capitalisation practice note) was also issued in 1999. However, that was effectively made redundant by changes in our TP legislation and it was subsequently withdrawn and has never been replaced. Although SARS issued a Draft Interpretation Note on thin capitalisation several years ago, it has not been finalised.

Changes to TP rules, over the past few years, impose a much greater compliance burden on taxpayers. In line with OECD guidance, the preparation and annual submission of TP documentation is now compulsory for South African taxpayers with significant (or relatively significant) cross-border transactions with related parties. In many cases this includes both an entity specific local file and a group-wide standard master file. Significant multinational enterprises (MNEs) are also required to prepare a country-by-country (CbC) report, which may be required to be submitted to SARS by South African based MNEs and are then shared by SARS with other revenue authorities where the group has a presence. For significant foreign based MNEs with a South Africa (SA) presence, the reverse scenario generally applies.

SA has generally been an early adopter of these rules which impose a greater reporting and compliance burden on taxpayers. The implementation of these rules has been effected by ensuring that the necessary domestic enabling regulations and international treaties are put in place timeously.

However, where SARS has been less responsive is in providing guidance to taxpayers which could assist them in navigating the pitfalls and areas of uncertainty associated with such a complex area as TP. More specifically:

- The TP Practice Note is now very out of date, as already noted
- The thin capitalisation Practice Note was superseded and the interpretation note which was intended to replace it has not been finalised.

SARS is working on an updated TP Interpretation Note and had an engagement with the South African Institute of Chartered Accountants TP Sub-committee during 2021 to discuss this. Following which, the members of the sub-committee submitted written recommendations to SARS. However, it is not clear when a draft of the Interpretation Note can be expected.

A significant challenge with issuing a new Interpretation Note now is that, for impacted larger MNEs, the way in which TP works globally is about to be turned on its head. Therefore, there is a real risk (perhaps a likelihood) that a new Interpretation Note will very quickly become obsolete or, at the very least, incomplete.

Whereas TP rules have evolved gradually for many years, there are certain very fundamental changes which are being worked on by the OECD and which are associated with tax challenges associated with the digitalisation of the global economy. These are primarily embodied in the so called *"Two-Pillar Solution"*. The threshold for Pillar One to apply (global group turnover above 20 billion Euros – reducing in future to 10 billion Euros) is much higher than for Pillar Two (group turnover of 750 million Euros). Therefore, practically speaking, far more MNEs will be affected by Pillar Two than by Pillar One.

Pillar One will enable revenue authorities to tax certain revenues realised in market jurisdictions – being those countries around the world into which a multinational enterprise makes its sales without creating a taxable permanent establishment in-country currently. This measure is intended, amongst other things, to replace digital services taxes. Therefore, it is envisaged that a multilateral convention (MLC) will be signed by all participating countries which undertakes, amongst other things, to remove all existing digital services taxes. It is also envisaged that the MLC will be signed by participating countries during 2022.

Pillar Two will, amongst other things, enable the revenue authority in the country where the parent of an MNE is located to impose top-up tax on profits which have been undertaxed elsewhere in the group (i.e. taxed at a rate of less than 15%).

It is envisaged by the OECD that both Pillar One and Pillar Two will become effective in 2023 – so time is short. The implementation of both pillars involves a combination of international agreements and, more than likely, significant changes to domestic laws. For example, in South Africa the interaction between Pillar Two and our controlled foreign company (CFC) rules will need to be examined and the CFC rules amended as necessary.

There will be other areas which require consideration. For example, the trigger in our domestic laws which gives the South African fiscus the right to tax income of foreign tax residents in our source rules; foreigners are taxed here on South African sourced income. Yet the principles of our source rules exist in our common law and evolved long before Pillar One was even dreamed of. We will therefore need to suitably amend our tax rules and treaties through enabling legislation and the MLC to make sure that we cast our net widely enough to capture the income of foreign residents which will potentially become taxable under Pillar One.

These are just two examples of how our domestic tax laws and treaties will need to be amended to keep up with the changes.

An area where SARS has been successful in maintaining momentum is with the proposed establishment of an Advance Pricing Agreement (APA) programme. APAs are agreements that revenue authorities concluded with taxpayers in respect of future transactions regarding the pricing of such transactions. Such an agreement can be exceptionally valuable for taxpayers since it can eliminate the TP risk associated with the pricing of significant transactions for an agreed period. SARS issued a discussion paper on the possible implementation of an APA programme in late 2020. Having received comments on that paper and after further consideration, in late 2021 it issued a document entitled *"Proposed Model for Establishing an Advance Pricing Agreement".* SARS has invited comment to be submitted on that paper by end January 2022.

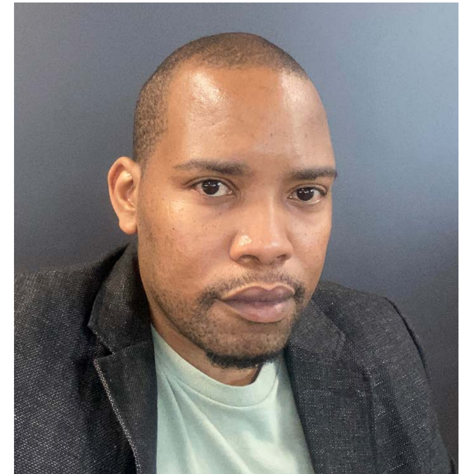
That paper includes certain draft legislation as an annexure. It also outlines a proposed high-level process flow which tracks an end-to-end process from APA pre-application through negotiation to termination or renewal of the APA. The wording of that process flow seems to envisage only bilateral APAs (i.e. between revenue authorities of more than one country and the respective taxpayers) and not unilateral ones (between SARS and the SA taxpayer only), presumably as bilateral APAs are covered in the OECD's peer review reports on the dispute resolution mechanisms available per country. It also makes it clear that certain key aspects of the APA system – such as which persons are eligible to apply to SARS for an APA and the minimum value of the affected transactions – will be managed by public notice in the Government Gazette. These aspects are therefore not clear at this stage.

SARS is to be commended on maintaining the momentum of putting an APA process in place. This would certainly be a value-adding step for taxpayers (and prospective investors into our economy). If it is intended only to have a bilateral APA programme, then SARS should consider extending the scope of the advance tax ruling (ATR) process to include TP matters. TP is currently expressly excluded from the ATR process. This should assist taxpayers (and SARS) in avoiding costly TP disputes. Presumably, the reason for excluding TP from the ATR process so far is that TP is considered to be a very complex area requiring significant technical resources and SARS was not confident that it had the capacity to handle ATR applications relating to TP. However, the implementation of the APA process involves resourcing a team with sufficient technical skill to manage the APA process. Therefore, perhaps these additional resources may enable SARS to consider extending the ATR programme to TP matters.

In summary, it is clear that SARS faces considerable challenges in keeping pace with the changes in the global tax environment. The pace of change has increased dramatically and the effectiveness with which SARS responds is an important factor in South Africa's effectiveness both in optimising tax collections and offering a globally up-to-date tax system to investors.

"SARS faces considerable challenges in keeping pace with the changes in the global tax environment."

What you need to know: Tax deductions for home office expenses



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The way we work has changed significantly since the onset of the COVID-19 pandemic, with many employers opting to adopt a hybrid working model. As such, as an employee, you may have had to work from home, or will work from home, more regularly and may have incurred (or will incur) additional expenses to run your home office.

For purposes of filing your annual income tax returns to the South African Revenue Service (SARS) you may want to assess whether you are, or will be, permitted to claim certain of these expenses as a tax deduction in your income tax return. It is important to note that the fact that you worked from home for at least six months during a given tax year does not necessarily mean that you will be entitled to claim a tax deduction for the home office expenses that you have incurred. The Income Tax Act, 58 of 1962 (Income Tax Act), sets out rigid requirements that must be met before employees can claim a tax deduction for home office expenses, and there will be no relaxation of these tax rules because of COVID-19. The provisions in the Income Tax Act that allow employees to claim a tax deduction for home office expenses are not new in our law, nor are they COVID-19 tax relief measures. Many employees have simply not previously made use of these provisions as they mainly worked from their employers' premises.

In this article, we provide a brief overview of the requirements that need to be met by salaried employees (i.e. employees other than commission earners and independent contractors) to qualify for a tax deduction for home office expenses, the types of expenses that can be deducted, the manner in which to disclose the tax deduction on your income tax return and the types of supporting documents that SARS may request to substantiate the deduction.

What requirements must salaried employees satisfy to qualify for a tax deduction?

If you are a salaried employee and your employer has permitted you to work from home and you have set aside a room or part of your home to be occupied for purposes of carrying out your employment (i.e. for purposes of carrying out your "trade"), you may be allowed to deduct certain home office expenses for tax purposes.

A room or part of your home or dwelling will be considered occupied for the purposes of your employment if:

- such room or part is specifically equipped (i.e. fitted with all the necessary equipment/tools) for purposes of your employment; and
- such room or part is regularly (as opposed to occasionally) and exclusively used for purposes of your employment.

The recent draft interpretation note issued by SARS, which deals with the tax deduction of home office expenses incurred by persons in employment or persons holding an office (Draft Interpretation Note 28 [Issue 3]) (Interpretation Note 28), provides that you will not be permitted to claim the deduction if you use your home office for any purpose other than your employment. For example:

- if your home office is used as an office by day and a television room by night, you will not be permitted to claim the tax deduction, as your home office is not exclusively used for purposes of your employment.

SARS does however note that there may be certain exceptional circumstances where the exclusivity test may be satisfied where two taxpayers have a separate, but not shared, space which has been specifically equipped for purposes of employment. Whether the exclusivity test is satisfied will depend on the facts and circumstances of each case.

Interpretation Note 28 also provides that SARS is of the view that you will have difficulty in discharging the burden of proving that a part of your home was used exclusively for purposes of your employment if that part does not constitute a separate room on the premises.

In addition, if you are a salaried employee, you will only be eligible for a tax deduction in respect of your home office expenses if:

- the income from your employment or office is derived mainly (i.e. more than 50%) from commission or other variable payments and you do not perform your duties mainly (i.e. more than 50%) in an office provided by your employer; or
- you mainly (i.e. more than 50%) perform your duties in your home office. Under this requirement, as a non-commission earner, you will need to assess how often you work from your home office as opposed to your employer's office or from a client's premises. If you work mainly on the road or from a client's premises it cannot be said that you worked mainly from home.

What expenses can you claim as a tax deduction?

Importantly, not all the home office expenses that you have incurred can be claimed as a tax deduction. If you meet the above qualifying criteria, then you may only claim the following expenses as a tax deduction:

- rent of the premises
- cost of repairs to premises
- any other expenses in connection with the premises. These costs include expenses such as:
  - interest on a bond
  - rates and taxes
  - levies
  - electricity
  - cleaning costs (e.g. domestic worker's salary)
  - security costs (excluding capital expenditure)
  - household insurance that it insures against damage to the premises.

These expenses cannot be claimed in full as a tax deduction and you will need to apportion the expenses, based on the floor area of your premises, so that only the portion of the expenses that relate to the home office can be claimed as a tax deduction (unless the expense is specifically incurred only for your home office).

The following expenses are typically not allowed as a tax deduction as they do not comprise expenses incurred *"in connection with the premises"*:

- phone costs (including monthly subscription) and internet expenses
- stationery and printing expenses
- cost of bond insurance or insurance relating to household contents
- tea, coffee and other refreshments
- computer or communication equipment
- bond repayments.

However, if you conduct a trade other than employment or you are mainly a commission earner, then certain of the home office expenses which are not ordinarily allowed as a tax deduction to salaried employees (e.g. phone costs, stationery, printing, etc.) may be claimed as a tax deduction, provided that these expenses have been incurred in the production of your commission (or other) income and for the purposes of your trade.

Other amounts that may be claimed as a tax deduction, by both salaried employees and persons who are mainly commission earners, include wear and tear on furniture, fittings and equipment used in your home office for business purposes (i.e. you are allowed to claim a wear and tear allowance on assets used for purposes of your employment irrespective of whether or not you qualify for the home office tax deduction). The cost of these assets may be written off over their anticipated useful life for tax purposes.

How to disclose the tax deduction on your income tax return

If you have not yet filed your 2021 income tax return, and you are satisfied that you meet the above requirements, disclose qualifying expenses in the correct fields on your 2021 income tax return (ITR12) as follows:

Completion of wizard

Under the "Standard Questions" heading on the wizard, tick "Y" to the question "Did you receive any other income (excluding amounts received/accrued as a beneficiary of a trust(s), or deemed to have accrued in terms of s7) and/or incur any other allowable expenses not addressed above?"

Also tick "Y" to the question "Did you incur any expenditure that you wish to claim as a deduction that was not addressed by the previous questions?" (this is located under the "Comprehensive Questions" heading). This will add the section for "Other Deductions" to your ITR12.

Completion of ITR12

Your qualifying home office expenses should be disclosed under source code 4028, "Home Office Expenses" in the "Other Deduction" section on your ITR12.

The wear and tear allowance (if any) should be disclosed under source code 4027, "Depreciation" in the "Other Deduction" section on your ITR12.

Please note that the abovementioned disclosure relates to the 2021 income tax return. This may change in a subsequent tax years.

Examples of supporting documents which SARS may request from you

The onus of proving that the expenses you have incurred qualify for a tax deduction rests with you as the taxpayer, and not with SARS.

Should you claim a tax deduction for home office expenses on your ITR12, it is likely that SARS will verify this and will request supporting documents from you. Such supporting documents can include, for example:

- a letter from your employer stating that you were permitted to work from home;
- proof that more than 50% of your duties/work was performed in your home office. In this regard, you will need to provide records of the dates you worked from home and from your employer's office during the tax year;
- a copy of your home's floor plan showing that the space is a dedicated home office;
- photographs showing the space that is specifically equipped for work;
- the underlying apportionment calculation showing how you calculated the amount reflected on the tax return; and
- documentation to prove the actual expenses incurred (e.g. lease agreement, bond statements, bills from the municipality, etc.).

The above-mentioned list is by no means exhaustive and SARS could request further information. SARS may also conduct a home visit should further proof be required that your home office meets the above requirements.

Tax tips

- Generally, relatively few employees who earn a salary income only, or no/limited commission income, would qualify for a tax deduction for home office expenses. You should therefore only claim such a tax deduction if you are able to demonstrate to SARS that you have met the above requirements.
- Retain all your supporting documents for a period of at least five tax years, unless the tax years have not yet prescribed (in which case you will need to maintain these for longer until the relevant tax years have prescribed).
- Since you have likely been carrying on your employment from home, adverse capital gains tax implications may arise when you sell your home (whether or not you claimed a tax deduction for home office expenses). Any capital gain derived upon the sale of your property will be apportioned with reference to the extent to which your property was used for business (i.e., employment) versus domestic purposes. The "primary residence" exclusion for natural persons (currently R2 million) will apply to the portion of your home that relates to domestic use.
- As many employers start to adopt hybrid working arrangements, many employees are likely to continue to work from home, at least partially, in future years. It is therefore important that employees collate and retain all supporting documents for home office expenses incurred in each tax year should they wish to claim a tax deduction for these expenses.

The uncertainty regarding the definition of electronic services

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From 1 April 2019, the law dealing with electronic services supplied by foreign entities into South Africa was amended. The change in legislation effectively resulted in scrapping a very narrow definition of 'electronic services', which was introduced in 2014 and outlined a new definition to broaden the scope of 'electronic services' supplied by foreign entities.

The National Treasury set out the new definition of 'electronic services', and this definition refers to any services supplied by means of an electronic agent, electronic communication or the internet for any consideration; excluding certain educational, telecommunication and intra-group transactions.

The reason for the change, which is explained in the Explanatory Memorandum (EM)[1] issued by National Treasury in March 2019, is to increase visibility of e-services to the South African tax authorities. This levels the playing field and ensures fairness in the tax treatment for all taxpayers regardless of whether they are domestic or foreign suppliers. As a result, where a foreign entity supplies 'electronic services' from a place in an export country to a recipient based in South Africa, such a foreign entity would be required to register for value-added tax (VAT) in South Africa subject to meeting certain requirements.

It is however unclear how far reaching the new definition was supposed to be. The concern is that any service provided electronically could easily find its way into this new definition; however, was this the intention of the legislator? Most suppliers of electronic services were of the view that the intention was to only include the services which are electronic in its nature and not all services delivered electronically.

The EM addresses only those services which are provided using minimal human intervention, and for only those to be subject to VAT. In other words, any service supplied by a foreign entity which involves a fair amount of human intervention will not be regarded as an electronic service. The EM provides the following example of when a service will not be an electronic service: Legal advice was prepared outside of South Africa but emailed to the recipient in South Africa. The South African Revenue Service (SARS) also provided a frequently asked questions guide[2] that was released shortly after the changes to the Act clarifying which services fell 'in' or 'out' of the new 'electronic services' definition.

Whilst this guide contains various scenarios along with the SARS guidance and interpretation, there is a risk that it could also be contrary to the intention of the policy. The uncertainty therefore creates confusion as to who should account for the VAT; i.e., is it the South African recipient (imported services) or the non-resident; and also whether all services supplied to South African residents would result in the non-resident applying for VAT registration if the threshold is exceeded.

We would like to see National Treasury firm up the legislation and that the regulation provides a clear definition of electronic services that supports the policy intention as captured by National Treasury in the EM.

1. *Regulations prescribing electronic services for the purpose of the definition of "electronic services" in section 1(1) of the Value-Added Tax Act, 1991*
2. *SARS Frequently Asked Questions: Supplies of Electronic Services Issue 3 date 5 July 2019*

Measures by the revenue authority to curb illicit cigarette trade

Anti-forestalling rules and draft rules on installation of CCTV cameras at tobacco warehouses

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Commonly known as 'sin taxes', the South African Revenue Service (SARS) has been religiously collecting the excise duty that is derived from the manufacture, importation and distribution of tobacco, and tobacco products such as cigarettes for a long time. The current Customs and Excise Act (which imposes these duties) came into effect in 1964. This contribution is so important to the fiscus that the revenue service has formulated specific rules to deal with the financial leakages that occur in the industry caused by illicit trade and in general, tax avoidance. In this article we touch on the two measures that SARS has put in place to try and limit duty losses in the tobacco and cigarettes industry.

Anti-forestalling rules to secure higher margins in excise collection

It was April Fools Day when on 1 April 2021, SARS gazetted rules imposing restrictions on clearing a large volume of cigarettes in the run up to the National Budget Speech, before the excise duty rate increase. It is hoped that the restrictions imposed will be successful in controlling the amount of forestalling that has become a practice in South Africa. South Africa is not a pioneer of anti-forestalling regulations. The imposition of restrictions on the clearance of cigarettes was imposed by Her Majesty's Revenue and Customs, United Kingdom back in 2014. The South African anti-forestalling rules have been inserted in Section 58A of the Customs and Excise Act, 91 of 1964. The rules do not define what forestalling is, however. An ordinary meaning of forestalling is the act of "pre-empting" or "anticipating" something and acting before that anticipated event occurs.

The anti-forestalling rule is one of the few mechanisms that SARS is trying to implement to reduce tax avoidance and collect as much duty as possible from cigarettes. Why is this anti-forestalling rule only applicable to cigarettes? Cigarettes are viewed as one of the most high-risk commodities that SARS must deal with due to several factors including illicit trade. Over the years, it has been a practice that manufacturers and importers of cigarettes clear a significant volume of product before the National Budget Speech is delivered in order to pay the lower rate of duty.

The rules require importers and manufacturers of cigarettes to clear a specific number of cigarettes for home consumption during what is called "a controlled period". This period commences on 1 December each year, and ends on the date of the National Budget Speech delivered by the Minister of Finance during the second half of February yearly.

The number of cigarettes that can be cleared for home consumption is calculated using a specific formula. According to this formula, an average per year preceding the controlled period must be calculated which is the number that must be entered for home consumption. There are instances where the importer or manufacturer might need to clear more products than the calculated total. In such instances, the manufacturer or importer must apply to the SARS Commissioner for permission. The conditions for such an application are stated in the anti-forestalling rules.

The rules further make provision for new entrants in the market. New entrants are manufacturers or importers of cigarettes who start entering such goods for home consumption 30 days or less before the start of a controlled period, and therefore will have no average for a previous year. This is a welcome change as it might assist in curbing illicit trade which impacts negatively on the viability of legitimate business.

This action by SARS is likely to be considered for other commodities, such as alcoholic beverages. When that will happen remains to be seen.

SARS at the forefront of fighting illicit trade

According to the study titled "Illicit cigarette trade in South Africa: 2002–2017", the illegal cigarette market in South Africa is a multi-billion Rand industry which cost the South African taxpayer more than R8 billion in lost taxes in a year, and more than R40 billion since 2010.

The revenue service is in the forefront of fighting the illicit trade within the tobacco industry. The latest intervention is the introduction of Rule 19.09 to the Customs and Excise Act. According to this rule, SARS will install (at its own cost) Closed-circuit Television (CCTV) cameras in all the manufacturing and storage warehouses of tobacco. This rule is still at its draft stage but will take effect from 1 June 2022.

The move to install these CCTV cameras was introduced by the need to regulate and account for every single product manufactured and imported upon which duty must still be paid. The revenue service is empowered to install the CCTV cameras by virtue of these warehouses being licensed as customs-controlled areas in terms of the customs and excise legislation. This means that as a condition for a license, the applicant must grant SARS officials uninhibited access to the warehouse in order to install CCTV cameras.

On premises that have already been licensed, the licensee must allow the officials into the premises to install CCTV cameras. Failure to do so will lead to SARS suspending or cancelling the license where such has been granted and where there is still an application pending, such a license will not be granted. CCTV cameras will be installed in such a way that the manufacturing, storing and loading of tobacco (and tobacco products) will be captured by the CCTV camera. According to the draft rule on CCTV cameras rule; no one can obstruct, temper or manipulate the CCTV camera. Doing so will invite a fine not exceeding R50 000 and/or up to two years' imprisonment.

In conclusion, it is suggested that clients that trade in the tobacco and cigarette industry take time to understand the rules and ensure that all records pertaining to the manufacture, importation and distribution of their product are kept in the correct condition.

"The revenue service is in the forefront of fighting the illicit trade within the tobacco industry. The latest intervention is the introduction of Rule 19.09 to the Customs and Excise Act."

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