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Pre-Budget Commentary
South Africa

Contents

SA can use its clean energy capabilities to overcome its economic challenges

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The risks of a global slowdown, together with ongoing local challenges such as severe power cuts, the cost of living squeeze, slow investment, sluggish reforms, extreme weather events and political uncertainty will weigh on South Africa's growth outlook in 2023. Real GDP growth is expected to slow from an estimated 2.5% in 2022, to 0.3% in 2023 according to estimates released by the South African Reserve Bank (SARB) in January 2023.[i]

While inflation already quickened towards the end of 2021, since the first quarter of 2022 South Africa's headline inflation has been driven by global price increases in food and fuel. This has affected the cost of living drastically, with household spending growth in October 2022 estimated to be less than 3% in 2022, and only 1.7% over the three years from 2022 to 2024.[ii]

Financial stress is a key concern for South Africans, given the cost-of-living squeeze: South African consumers surveyed by Deloitte at the end of December 2022 noted that they are delaying large purchases (50%), feel their financial situation has worsened over the past year (39%), and are concerned about their credit card debt (38%) and about making upcoming payments (25%).[iii]

Although headline inflation (which peaked at a 13-year high of 7.8% year on year in July 2022[iv]) is expected to moderate this year as food and fuel prices ease globally, the pressure on core inflation, which has been more subdued, could increase in 2023 as higher input costs are passed on to consumers. For example, producer price inflation for manufactured goods came in at 15% year on year in November 2022.[v]

Rising inflation saw an aggressive monetary policy tightening cycle (eight consecutive rate hikes since November 2021) by the SARB that is likely to end in the first half of 2023, as inflation is reined in. Yet higher prices, high lending rates, together with softer global commodity prices and the possibility of key advanced economies and trading partners entering a recession in 2023 will be a drag on South Africa's growth outlook.

Compounding this locally is the difficulty to keep the lights on and power the economy, with disruptions to operations and supply chains as well as limited business confidence delaying investments and net employment creation. In terms of foregone GDP from power cuts, 2022 was South Africa's worst year on record.[vi] And with severe power cuts continuing into 2023 – expected by the SARB to reduce growth by as much as two percentage points this year – the need to address this adequately is urgent. So too is the need for implementing growth-enhancing reforms to address structural bottlenecks and to spur expansion in job-creating sectors as unemployment remains unacceptably high (above 30%).

Fortunately, the country's fiscal position has improved over the past two years. Fiscal consolidation measures such as budget discipline, together with better-than-expected tax collections, primarily driven by global commodities demand, have brought down the budget deficit. Smaller deficits are forecast for the next three years, with a primary budget surplus (i.e., excluding interest payments) pencilled in for 2023–24.[vii] Rightfully, the revenue windfalls are being used to reduce elevated government debt and to support reforms at crucial state-owned enterprises. But fiscal risks (on both the expenditure and revenue side) continue to loom.

With a focus on fiscal consolidation, already low public investment has however declined further. Indeed, overall investment has been declining in recent years, with gross fixed capital formation still below pre-pandemic levels. Yet, government spending on infrastructure, including roads, rail, and water projects, is expected to almost double during the 2022–23 to 2025–26 budget period, although from a low base.[viii] And energy sector reforms under Operation Vulindlela are expected to encourage private investment.

Creating an enabling environment conducive to investment, both domestic and foreign, including political and policy certainty in the run up to the 2024 general elections, will be an important foundation for the structural changes needed in the South African economy in the medium term.

What could be a game changer for the country is leveraging the opportunities linked to its own energy transition goals (a move away from a coal-dominated energy mix while overcoming its power generation shortfalls) as well as supplying and adding value to critical commodities in a global clean energy future.

On the former, South Africa has massive renewables potential, not only in solar and wind, but also in green hydrogen. On the latter, it also has a notable comparative advantage in supplying key minerals and metals for clean energy applications. For example, this includes platinum group metals (used in catalytic agents in hydrogen electrolysis and fuel-cell applications), vanadium (input for long-duration battery energy storage applications), rare earth elements (used in permanent magnets in the electrical motors of wind turbines and in electronic vehicles [EVs]), and nickel (applications in EVs and battery storage, and hydrogen and geothermal technologies).[ix] This could help to give rise to new drivers of economic activity, that boost growth, create jobs while also ensuring a just and fair transition towards carbon neutrality.

[i] *South African Reserve Bank, "Statement of the Monetary Policy Committee,26 January 2023", accessed January 26, 2023.*

[ii] *National Treasury, "Medium-term budget policy statement – 2022", accessed November 24, 2022.*

[iii] *Deloitte, "Global State of the Consumer Tracker", accessed January 13, 2023.*

[iv] *Stats SA, "Statistical release: Consumer price index, November 2022", accessed January 13, 2023.*

[v] *StatsSA, "Statistical release: Producer price inflation, November 2022", accessed January 13, 2023.*

[vi] *Business Tech, "New data reveals ugly truth about load shedding in South Africa", October 9, 2022.*

[vii] *National Treasury, "Medium-term budget policy statement – 2022", accessed November 24, 2022.*

[viii] *Ibid.*

[ix] *Deloitte Africa, "Africa's role in a clean energy future", October 2022.*

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Protecting the South African tax base amid economic turmoil

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South Africa has experienced declining growth in recent years, worsened by the economic downturn during COVID-19. Although the South African economy has been on the road to recovery following the pandemic, it is still lagging far behind the growth levels required to bring about economic stability in the country. In addition, the high levels of unemployment, particularly youth unemployment, means that there is a missed opportunity for the revenue authority to collect additional taxes generated from employment. Owing to various challenges facing consumers in the country such as the rising cost of food, high fuel prices, energy constraints, rising interest rates and other macroeconomic challenges, government should consider effective ways to protect the tax base whilst providing relief to consumers. Government should provide tax relief to consumers in the short term amidst these challenges.

If one looks at the country's tax system and the proportionate contribution to the tax revenue collection, personal income tax (PIT) accounts for the highest tax contribution followed by value added tax (VAT). Both these taxes affect consumers directly. The recent survey by the Organisation for Economic Co-operation and Development (OECD), on the South African economy (OECD Economic Surveys: South Africa 2022), proposes measures such as a reduction in the VAT rate in order to stimulate economic growth in the country. Even if the VAT rate is not reduced, there are other factors that should be considered within the VAT system, possibly on a temporary basis, to stimulate economic growth. For example, increasing the composition of VAT exempt or zero-rated goods. An example of this would be to include the supply of bottled water as a VAT exempt or zero-rated good. This would reduce the cost of alternative water sources (a basic need) in instances where, for example, the water supply is constrained due to energy challenges. Also, government should consider adjusting the PIT brackets and suspending the fuel levy. These proposals can be implemented as temporary relief measures until some of the economic challenges have been addressed. Although these tax relief measures may seem counter-intuitive, these would lead to an increase in the households' disposable income, thereby enabling households to increase their consumption spending, particularly on basic foodstuff.

Tax revenue collection is one of the key elements to fund government expenditure on various goods and services. The main government expenditure includes the distribution of the social income grant, as well as social distress relief grants payable to individuals in dire need and not able to meet their families' most basic needs.

The social relief grant system is largely dependent on tax collections to ensure that it is sustainable. One could argue that these tax relief measures would impact the overall tax collections. However, the tax relief measures would lead to an increase in disposable income in real terms, thereby increasing consumer spending on vatable and non-vatable items and increasing the economic activity in the country. In turn, the government would be able to increase its VAT collections to the extent that there is increased household spending on vatable items. There may also be increased output in the food supply value chain due to the increased demand for food owing to an increase in disposable income.
For example, there may be an increased demand for bread, which would mean that farmers may increase their maize production. There is a fine balance that needs to be met to ensure that the basic needs are met while increasing consumer spending, protecting the South African tax base and stimulating economic growth.

As indicated, the re-introduction of the temporary suspension of the fuel levy to provide relief on the fuel price needs to be considered. With the energy constraints in the country, various businesses, including small to medium-sized enterprises (SMEs), are forced to rely on alternative power sources such as diesel generators. The reduction in the fuel price due to the suspension of the fuel levy would not only provide relief to motorists, but also to businesses.

Government has continuously communicated the need to focus on SMEs to drive economic growth and reduce unemployment in the country. However, due to the energy constraints coupled with rising fuel costs, most SMEs are closing down. The cost of doing business has increased and given the current economic situation, it is not feasible for businesses to pass down these costs to consumers.

In relation to companies, the tax relief as a result of the imminent reduction in the corporate income tax rate from 28% to 27% for tax years ending on or after 31 March 2023 is welcome. This is likely to encourage expansion of existing businesses. While we expect the reduction in the corporate income tax rate to increase spending and drive economic growth, the concurrent limitation on the utilisation of assessed loss by companies may offset this. However, the latter is expected to increase the South African Revenue Service's tax revenue collections, thereby increasing the tax base. The expected increased tax collections would be on the back of the higher-than-expected tax collections, largely from the mining industry due to the commodity boom as well as the financial and manufacturing sectors. This would potentially lead to an increase in the proportionate funding provided by the National Treasury to various imperatives, such as the social relief grant system, education, healthcare, and other priorities.

Considering a range of factors at play, regarding the rising cost of living and declining income levels, it is unlikely that the government will consider an increase in taxes and/or tax rates. Instead, we expect the government to consider ways to reduce the tax burden on consumers. We are keen to see what measures will be taken by the government to stimulate economic growth while protecting the tax base and providing relief through the tax system in the short term.

Powering up the economy to induce investment and growth

By Tumelo Marivate
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Reliable, efficient, affordable and sustainable electrical infrastructure is as key to investment and growth as oxygen is to our lungs. We cannot drive investment and grow an equitable and inclusive society without energy to fuel economic activity. The frequency and the intensity of loadshedding in recent months has increased the cost of doing business in South Africa to unsustainable levels, likely to result in reduced production and a contraction in the size of our economy. We therefore cannot hope to grow investment without addressing security of energy supply, as the main driver to the cost of doing business. Consequently, incentives to unlock renewable energy opportunities and build electricity supply resilience in the economy are a priority. Government announced in 2021 a US$8.5 billion climate finance package to support our just transition from coal and bolster energy supply. The funding is available from 2023 to 2027 and 80% of it has been prioritised for bolstering the electricity infrastructure and supporting the transition to renewable energy; 10% for the support of new technologies – specifically the development of a green hydrogen industry, and an electric vehicles industry to support our automotive manufacturers and protect jobs in the sector. To galvanise the economy, the priority for the country has to be an accelerated implementation of the Just Energy Transition climate finance plan.

Energy resilience facility

There needs to be direct funding for critical infrastructure for the utilities to stabilise electricity supply and transmission. Secondly, there needs to be an energy resilience facility for the private sector that offers subsidies to facilitate faster migration to solar energy, particularly in employment intensive businesses, and vulnerable businesses.

Small businesses are more adversely affected by the energy challenges in the country, because cashflow constraints limit their ability to invest in alternative or back-up energy solutions. It was however encouraging to see the recent announcement from the Department of Small Business Development (DSBD) that they are working on an energy relief package for small businesses to lessen the impact of loadshedding. For the support to make an impact, it should focus on reducing the reliance of small medium-sized enterprises on the national electricity grid and it should be simple to administer and easily accessible. The DSBD should not rely exclusively on government agencies to offer support but should work with private sector banks and financial intermediaries to assist small businesses with asset finance or rental solutions for solar energy or uninterrupted power supply systems.

De-risking renewable energy projects

Last year government liberalised the embedded generation market, by removing the registration requirement for private sector projects that wish to invest in utility scale renewable energy projects for their own use and potentially for distribution to other consumers. In the recent update of the country's Energy Action Plan, government reports that this has resulted in generation capacity of 9 000 MW in the pipeline. There is an opportunity to accelerate private investment in generation capacity by increasing access to finance for these projects.

A key mechanism for improving access to finance is reducing the risk of early-stage projects, through providing grant funding to private sector banks and financial intermediaries to be used for project preparation facilities, to assist in developing investment ready renewable energy projects that the banks can fund. Currently project preparation facilities are largely the domain of development finance institutions, it is estimated that up to a third of all the project preparation facilities that exist across the African continent, are housed at the Development Bank of South Africa. Opening this market to private participation, could unlock more projects, given the extensive footprint of the banking sector and the remit of the banks to provide finance.

Industrialisation of the renewable energy value chain

A number of economies around the world have announced renewable energy industrialisation strategies supported by funding and incentive packages to ensure the development of a sustainable and globally competitive renewable energy industry. For example, the European Commission has launched the REPowerEU Plan, a €210 billion programme to reduce reliance on Russian fossil-fuels and accelerate the green transition. Similarly, the USA announced at the end of last year an American Battery Materials Initiative for sourcing and processing critical minerals used in the power, electricity and electrical vehicles industries as well as a US$2.8 billion grant funding to 20 manufacturers for the manufacturing of batteries for the electric vehicle industry, and additional tax credits for consumers to make buying electric vehicles with battery components from the US more affordable.

South Africa in turn has a Renewable Energy Masterplan (SAREM) to unlock industrialisation opportunities in the renewable energy industry. SAREM outlines opportunities for supply of key input materials; production and assembly of components; as well as systems assembly for the solar, wind and battery storage industries. The majority of the interventions proposed, focus on the opportunities presented by South Africa's renewable energy public procurement process through the Renewable Independent Producer Programme. However, given the activity in the private sector market since the lifting of regulatory restrictions, there is a need to look at the lessons learnt from the development of a globally competitive automotive industry in South Africa. Policy instruments introduced in the sector have incentivised key leading automotive original equipment manufacturers (OEMs) to locate their production facilities in South Africa and a value chain of different tiers of suppliers has developed around these OEMs – leading to growth of the industry and jobs. These lessons should be applied to the renewable energy industry. Providing a suite of incentives that includes investment incentives for technology innovation and to set up manufacturing and assembly operations; import duties for strategic inputs; credits for exported components; as well as skills development support may assist in moving SAREM from a government plan to a catalyst for private sector investment in developing the renewable energy value chain.

Innovation and energy efficiency

Currently the government offers an energy efficiency tax allowance of 95c/KWh energy equivalent for energy efficiency savings. Although this incentive is not available for renewable energy projects, it is an important tool to support the decarbonisation of our economy as it promotes investment in more energy efficient technologies. Research and development (R&D), particularly in markets of the future that are presented by the alternative sources of energy imperative, is key to the growth of our economy. We look forward to seeing in this year's Budget, confirmation of the extension of the R&D tax incentive to encourage more investment in R&D by the private sector.

South Africa's carbon tax: Changes and implications for taxpayers

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As the 12th largest greenhouse gas (GHG) emitter in the world, South Africa (SA) has an obligation to help curb the effects of climate change. The carbon tax is one of the mechanisms that the SA government has put in place to help achieve its Nationally Determined Contributions as communicated under the Paris Agreement. While the pricing per tonne of carbon dioxide equivalent in SA is low, relative to other countries' policies, and to effect any meaningful change in behaviour, the introduction of the tax in SA is being done in three phases to ensure that industry is prepared for when the tax is equivalent to that of global carbon pricing ($20-$30).

The starting date of the second phase, however, was pushed from January 2023 to January 2026. Taxpayers will now continue to benefit from large tax-free allowances which reduces their carbon tax liability. While the reasoning behind the extension has not been clear from National Treasury, it is possible that it was done to grant taxpayers more time to understand the intricate carbon tax system.

Along with the extension of phase 1 of the carbon tax, the SA government has also recently introduced increases in the rate of the carbon tax, which will not only increase the carbon tax liability of all SA carbon taxpayers, but it will also have knock-on effects on the fuel and electricity prices in SA, which will influence the pockets of individuals as well.

It was initially proposed that these rate increases were linked to the US Dollar to better align SA's carbon pricing with global pricing.

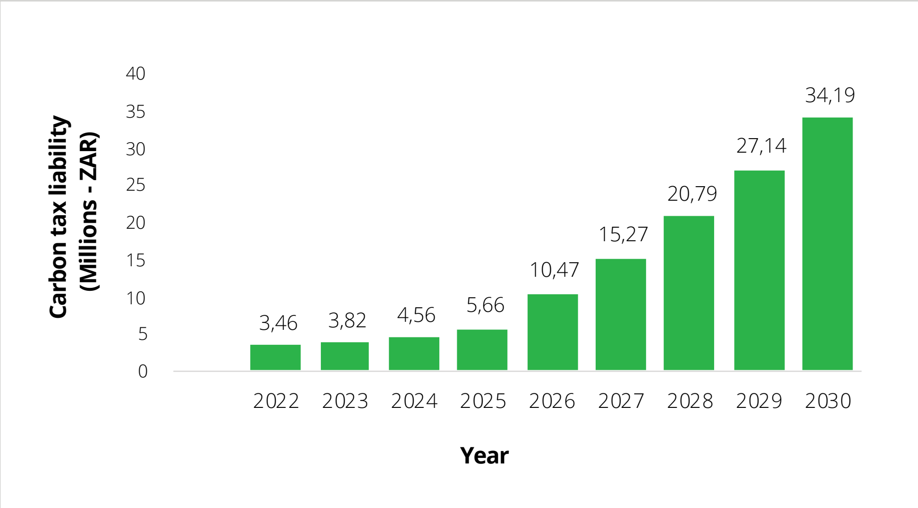
After public consultation, it was decided that the increases would be Rand-based due to the instability of the US Dollar-Rand exchange rate, which would lead to uncertainty for SA carbon taxpayers. The current rate for 2022 is R144 per tonne of carbon dioxide equivalent (tCO_2e) and the proposed increases would look as follows:

Table 1: Proposed increases to the carbon tax rate

Year	Carbon tax rate
2023	R159
2024	R190
2025	R236
2026	R308
2027	R347
2028	R385
2029	R424
2030	R462

Impact on SA companies

As evidenced in the example below (assuming company "X" emits 100 000 tonnes of carbon dioxide equivalent, which remains constant for 2023-2030), with the change in carbon tax rate and expected allowance reductions in phase 2, SA carbon taxpayers could expect drastic increases in their annual carbon tax liability, putting their existence in question, come 2030.



Impact on SA consumers

1. Fuel price

South Africans are currently paying R0.10 and R0.09 per litre at the pump for diesel and petrol respectively. The proposed increases to the carbon tax rate could increase these rates to R1.07 and R0.97 per litre for diesel and petrol respectively by the year 2030. While South Africans have grown accustomed to drastic fuel price increases in recent months, these increases will be in addition to the normal escalation of the fuel price.

2. Electricity price

Eskom is the largest contributor to SA's national GHG emissions and consequently results in high carbon dioxide emissions per unit GDP. In the first phase of the carbon tax, the Carbon Tax Act makes provision for a special tax deduction for electricity generators in the form of the renewable energy premium and the levy on electricity generation. This is known as neutrality on the electricity price. This was designed to cushion the impact of high electricity prices on energy intensive users and the entire country at large. It also allowed time to increase the share of renewable energy in electricity generation.

The neutrality on the electricity price expires at the end of 2025, which is when electricity generated by Eskom will be subject to carbon tax. This carbon tax liability will inevitably be passed on to its consumers. SA households currently pay around R2.51 per kilowatt-hour (kWh) of electricity. Deloitte's modelling of Eskom's CO_2 emissions per kWh against projected carbon tax increases shows that the proposed increase in the carbon tax rates could increase the rate consumers pay for electricity by approximately 20% by 2030 (based on the current price).

"Revenue recycling"

The carbon tax was designed so that all revenues collected would be recycled back into green initiatives. An estimated R1.6 billion in carbon tax revenue was collected in the 2022 payment period. While this amount makes up less than 0.2% of the total revenue collected in SA, it has the potential to become a significant contributor when the second phase begins in 2026, and large allowances begin falling away.

The amount of money that was recycled back into green initiatives is currently unknown, due to the revenue being pooled within the general budget. To demonstrate the success of the carbon tax in promoting a sustainable economy and increasing compliance among SA companies, greater transparency should be implemented regarding the revenue generated by the tax and how it is utilised.

Companies, and individuals alike, are encouraged to create plans to gradually lower their emissions to prevent high taxes and/or having a positive impact on the environment in which they operate.

i. *Department of Forestry, Fisheries and the Environment (DFFE). (2021) Perspective on Advancing and Inclusive and Sustainable Green Economy in South Africa.*

ii. *National Treasury and SARS (2022). Draft Response on the 2022 Draft Taxation Laws Amendment Bill & 2022 Draft Taxation Administration Laws Amendment Bill; Presentation to the Standing Committee on Finance.*

Life in the second chance economy: What government can do for distressed businesses

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At the start of 2022, green shoots were beginning to bloom across a multitude of South African sectors as consumers that had been trapped in their homes for seemingly endless lockdowns finally emerged and drove pent-up demand for a range of goods and services. Interest rates were at historic lows, providing relief to consumers and corporates alike, and inflation appeared to be a temporary blip on an otherwise sunny horizon. As we look to the finance minister, and the National Budget Speech to be delivered this year, it is striking what a difference a year can make. Central banks across the globe watched as inflation ran rampant and, as Russia's invasion of Ukraine added fuel to the fire, had no choice but to act. The age of historically low base rates was over.

As the spectre of stagflation, or a combination of high inflation and economic stagnation, looms over the global economy, it seems almost inevitable that a long-expected wave of restructuring activity will arise, as we are seeing an unravelling of the accommodative stance enjoyed by clients from lenders over the past two years. With the prospect of permanent loadshedding, an 18.65% electricity tariff hike this year, climbing interest rates, low growth and high inflation, all placing additional stress on the economy; the question is which form the looming restructuring activity will take.

For companies finding themselves in financial distress, whether a liquidation will be the only option left on the cards will be materially influenced by the speed with which management turns to address the challenges and involves the right specialists for assistance. A recurring theme in the Deloitte Restructuring Survey is the fact that if restructuring negotiations are triggered too late, the options available for recovery are limited.

Although industry practitioners are expecting a marked increase in filings for business rescue, there is evidence of a widening trust gap between practitioners and their stakeholders. This is driven in part by low success rates, experienced especially by lenders, as well as the perceived suitability of business rescue practitioners (BRPs) followed closely by a lack of post-commencement financing (PCF) as a cause of failure. This negative perception of business rescue in South Africa needs to be addressed, as it leaves only liquidation as a formal restructuring path if business rescue is not to be trusted.

However, business rescue's struggles have given rise to enhanced opportunities for distressed mergers and acquisitions (M&A), as it is rapidly gaining pace in being the preferred exit route from distress. In the last year, the rise of distressed M&A, especially when used as an exit strategy, has become evident. BRPs were the prominent stakeholders that indicated that distressed M&A played a greater part in their portfolios compared to any other stakeholder.

Commercial banks, possibly given the trust issues of business rescue, also expect greater distressed M&A activity in their stressed portfolios with 31% of commercial banks indicating that more than 25% of their stressed portfolios undertook distressed M&A in the past year, which is expected to rise to 38% over the next year. The C-Suite also clearly see the opportunity that distressed M&A will bring as there is an expectation that competition will increase for distressed assets. Not only is this highlighted through our survey results, but also in the analysis of Companies and Intellectual Property Commission (CIPC) business rescue statistics and Stats SA's insolvency and liquidation statistics.

Distressed M&A can, and often does, go hand-in-hand with business rescue. When our survey respondents were asked to make one recommendation to improve business rescue legislation, the ability to conclude a "pre-pack" business rescue was ranked in the top three options behind establishing a dedicated commercial court and almost equal with clarity regarding the ranking of PCF. A "pre-pack" business rescue facilitates an expedited transaction in the rescue process.

Ultimately, one could argue that a transaction in business rescue through a distressed M&A would achieve both objectives of business rescue. Not only would one rescue the business and provide opportunity for continued trade for creditors, but also ensure that creditors achieve a better result than in liquidation through the distribution of proceeds to the pre-commencement creditors. This can however only be achieved when all stakeholders pull together at speed to achieve the desired outcome. One regulatory milestone that needs to be addressed in order to allow for the required speed of execution in these situations is the clearance by the Competition Commission. Respondents to our survey have indicated that those deals in more accommodative jurisdictions should be more successful than others as regulatory risk remains, in their opinion, the greatest challenge. A more commercial approach, adapted to the situation at hand, by the Competition Commission will facilitate a faster rescue process and thus significantly improve trust in the turnaround regime and the likelihood of a successful outcome.

There is clearly much work to do in improving trust between BRPs and their stakeholders, with stakeholders expressing a clear desire for regular, honest communication and robust regulation.

However, it must be acknowledged that the ability to utilise business rescue as a tool to save struggling businesses is only available to companies and close corporations and is generally considered too expensive an option to consider for incorporated micro, small and medium enterprises (MSMEs). With approximately 50% of our economy made up of MSMEs this means that liquidation or sequestration are generally the only options available.

The notion of a second chance economy must provide a safe haven for all size entities; and in the absence of insolvency legislation reform (which is so desperately needed), the MSMEs will be looking to the finance minister for relief measures to assist with the prevailing economic headwinds to stay any decision to enter into liquidation. Already South Africa has the highest unemployment rate in the world, and therefore job preservation must become a key objective moving forward in the next financial year.

What is SARS' next digital transformation move?

"After the fact" supplementary declaration (IT14SD) to be potentially replaced by real-time reporting

By Tumi Malgas
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On 30 August 2022 , the South African Revenue Service (SARS) announced the discontinuation of the Supplementary Declaration for Companies or Close Corporations (IT14SD) from 16 September 2022. Many tax functions welcomed the news, however, many were also apprehensive about what will be replacing what was deemed as an onerous IT14SD.

The IT14SD was a smart requirement which forced taxpayers to self-assess and many either found savings or performed voluntary disclosures as a direct result of having completed the IT14SD. Some taxpayers decided to automate the IT14SD and use it as a management control on an ongoing basis – therefore there was some good logic behind the perceived madness of the IT14SD. We found that organisations that used the IT14SD to their advantage, are organisations that applied a data driven approach to the reconciliation. Revenue authorities are finding ways of harnessing the power of real-time access to more and more data – they want to know about a transaction and its tax effect as it happens.

In the prior year, we predicted that SARS would be moving to real-time reporting model or tax clearance model as further elaborated below. SARS has not yet made a move , however, its counterparts across the continent, including Southern Africa, have decided to embark on or implement electronic invoicing (e-invoicing).

The primary objective of tax administrators, including 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-19 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 emphasis on sharing data with revenue authorities.

The findings, of the OECD's Tax Administration 3.0 and Electronic Invoicing Report, have highlighted the following as some of the reasons why revenue authorities introduced e-invoicing:

- From a business perspective the exchange of e-invoices can enable the decrease of invoice payment times and thereby optimising cash flow processes and indicators
- A major driver behind digitally collecting invoice data by tax administrations is enhancing overall compliance risk management effectiveness. In most cases, these initiatives aim for a decrease of VAT gaps.

SARS has an opportunity to close the revenue gap in a big way by incorporating the above-mentioned concepts. The taxpayer population awaits in anticipation for the next move.

i. David Tonks, Co-Author: "SARS' next digital transformation move: Real-time access to organisations' data will reduce the administrative burden for the taxpayer and increase compliance", 2022

Interaction between Pillar One and Pillar Two and transfer pricing

By Billy Joubert
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The Organisation for Economic Co-operation and Development's (OECD) proposed Pillar One and Pillar Two initiatives continue to be very topical. The outline of this proposal has been under discussion internationally since 2019 and therefore there is a certain degree of topic fatigue – since delays in implementation and disagreement on policy details have pushed out the timelines several times. The latest targets are to try to achieve full agreement on Pillar One by mid-2023 and implementation of Pillar Two by 2024.

However, there are still significant hurdles to be cleared before there will be full global acceptance of both Pillars – most notably in the United States. So, the timing of these changes remains rather uncertain. It can be challenging to keep up with ongoing developments. For example, the OECD released an additional three-part implementation package for Pillar Two as recently as 20 December 2022.

As a brief reminder, Pillar One will mean that very large multinational enterprises (MNEs) may become subject to tax in countries where they sell their products or services (often referred to as market countries). Amount A of Pillar One would apply to MNEs with more than €20 billion in consolidated group revenues and an overall profit margin above 10%. It is envisaged that 25% of the profits above a 10% margin may be taxed in the market economies. This system is intended to supersede digital services taxes.

Pillar Two puts into place a global minimum tax system. The threshold for this system to apply is significantly lower than for Pillar One – namely consolidated group revenues of more than €750 million – aligned with the threshold for country-by-country (CbC) reporting. Broadly speaking, Pillar Two will apply to the extent that group companies are subject to tax at rates lower than 15% and would result in such under-taxed profits being subject to tax either in the country where the ultimate parent is located or, in the case of an MNE where the ultimate parent jurisdiction does not impose such tax, in the countries where other group companies are located.

Both Pillar One and Pillar Two effectively prescribe mechanical rules for determining the amounts subject to tax rather than doing so by reference to the arm's length principle, the cornerstone of transfer pricing. So the question arises to what extent the traditional way of doing transfer pricing may be replaced, or at least eroded, by Pillar One and Pillar Two.

The precise nature and extent of the interaction between Pillar One and Pillar Two ,and other tax rules (such as transfer pricing rules and controlled foreign company [CFC] rules), will probably only become clear over time. However, it seems clear that traditional transfer pricing will continue to be significant. A few points can be made in this regard.

Firstly, as regards Pillar One, the threshold for it to become effective is extremely high – particularly from a South African perspective. Consolidated group turnover of more than €20 billion means that only very large MNEs will potentially become subject to Pillar One. The further requirement is that such MNEs must also be very profitable – with overall profits above 10%.

It should be noted that it is intended to lower the threshold for Pillar One to €10 billion after an initial review period of seven years. This would significantly broaden the reach of this system. Nevertheless, as stated explicitly by the OECD, Pillar One will continue to only apply to the biggest and most profitable global MNEs.

Furthermore, certain types of business are excluded – namely extractive enterprises (mining and oil and gas companies) and regulated financial services.

Therefore, the vast majority of MNEs will fall outside the scope of Pillar One and will continue to be taxed according to traditional transfer pricing principles.

It seems clear that the impact of Pillar Two will be felt by far more MNEs since the threshold for applicability is much lower. The probable significance of Pillar Two, from a transfer pricing point of view, is to disincentivise affected MNEs from directing profits to very low tax jurisdictions via transfer pricing planning since such profits will probably end up in the corporate tax net in any event. Indeed, it seems likely that Pillar Two will be successful in deterring some of the most extreme forms of abusive transfer pricing.

However, for MNEs having a footprint which includes highly taxed countries like South Africa (SA), there will continue to be a significant incentive to transfer price profits away from such countries. As already noted, Pillar Two only applies to the extent that profits are taxed at rates below 15%. That rate is only 55.5% of the SA corporate tax rate of 27%. To the extent that MNEs with an SA presence actively do transfer pricing planning, it seems likely that they will continue to plan to shift profits away from SA as far as possible. SARS will therefore need to be remain vigilant about transfer pricing practices.

So arguably Pillar Two will, in the main, only have an effect on the most extreme forms of transfer pricing planning – such as transactions with very low tax jurisdictions including tax havens. This type of planning has probably already been quite significantly discouraged by the extent of the disclosure required to be made in terms of the CbC reporting system – which requires much greater transparency than before from taxpayers. So to what extent Pillar Two will result in MNEs restructuring their transfer pricing affairs is by no means clear.

There is considerable work to be done by SARS and all revenue authorities – and also by legislators – to prepare for the implementation of the new tax rules. Governments around the world are working on developing implementation plans. Some of the changes to be made will be embedded in intra-governmental agreements. As regards Pillar One, current double tax agreements (DTAs) do not give taxing rights of the type envisaged by Pillar One and therefore all the DTAs will need to be amended to give such rights to the market countries. Like the position with the CbC system, this is likely to be via an appropriate multilateral mechanism. One option that was considered was to amend the existing *"Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI)"* – which must be read together with existing tax treaties, and which modifies such treaties. However, the OECD has indicated that this is no longer considered the appropriate option and that this will be done via a standalone multilateral convention which co-exists with the existing global tax treaty network.

However, domestic tax laws will also need to be amended if necessary to actually put such taxing rights in place. For example, in SA, non-residents are only subject to SA tax on SA sourced income. We therefore run the risk that we are given the right, in terms of the MLI, to tax a foreign MNE in respect of its income derived from SA customers, but that there is a gap in our domestic legislation which enable the MNE to avoid being taxed here.

Our existing source rules probably do not extend to the types of income to which Pillar One will apply. It will therefore be necessary for us either to codify and extend our source rules via appropriate legislation or to pass legislation which otherwise puts in place a suitable trigger to pull foreign MNEs into the SA tax net where SA is the market country.

The successful implementation of Pillar Two will rely heavily on the introduction and successful implementation of domestic enabling legislation. Countries will also have to consider to what extent such new laws overlap with existing legislation – particularly CFC legislation. It may also be necessary to consider to what extent existing tax incentives remain fit for purpose – since the tax benefits associated with such incentives may be forfeited or eroded by the new rules.

In summary, there is much to be done and the introduction of Pillars One and Two presents a significant challenge for taxpayers, revenue authorities and legislators. However, it also seems clear that, while these rules will impact on transfer pricing planning and compliance, transfer pricing will be no less important and prevalent once the new rules are in place. This applies particularly in high tax countries like South Africa.

Diesel refunds in the wake of loadshedding

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In 2017, the National Treasury in collaboration with the South African Revenue Service (SARS) published a review of the Diesel Fuel Tax Refund System Discussion Paper for public comment. The reason for this collaboration is the fact that the diesel refund system is a National Treasury policy which is wholly administered by SARS. When the system was conceptualised and introduced , a few industries were considered to benefit. The primary objective of the system, as articulated in the discussion paper by the National Treasury, is that government was aiming at protecting the competitiveness of domestic primary producers. This means that the focus of the diesel refund administration is "qualifying primary production activities" and "use" that the government had pledged to support. Producers in the primary sector were seen to be price takers, therefore a need to cushion primary production sectors such as agriculture, forestry, fisheries, mining through a full or partial relief from diesel fuel taxes was identified. The fact that these primary production sectors were non-road users who employed many people due to the labour-intensive nature of their activities, was also a factor that was considered.

In the wake of the increasing levels of loadshedding this country has experienced, other industries are losing billions in revenue due to the inability to operate without electricity. This has led to some companies in industries not included in the diesel refund system benefit, making significant investment in procuring diesel to operate generators. The more frequent loadshedding occurs and the longer it lasts, the more diesel these companies must consume in order to continue to operate and contribute to the country's gross domestic product. It comes as no surprise that the current discourse is, whether the National Treasury can be approached on the flexibility of the state to make the diesel refund system more inclusive.

Industries such as farming, forestry, mining (both on land and offshore) commercial fishing vessels, vessels owned by the National Sea Rescue Institute, coastal patrol vessels and vessels conducting research, are some of the current beneficiaries of the system. Locomotives that are used for rail freight are also included in the system, as well as vessels that service fibre optic telecommunication cables along the coastline, the harbour vessels owned by the National Port Authority formerly known as Portnet, and vessels used by the in-port bunker barge operators. The last industry to benefit from the system is electricity generation. The qualifying plants are listed in Schedule 6 of the Customs and Excise Act. The 2017 discussion paper included proposed amendments relating to the inclusion of "wet contracts" and the permission for joint ventures to be approved as users within the criteria set out. The revision was intended to address administrative challenges that had been identified over the period of the system's existence and not aimed at increasing the number of industries that can participate in the system.

So, how is the refund determined? Although the price of fuel includes the Road Accident Fund levy and the fuel levy, the system only refunds (upon successful application) a portion of these levies according to formulas predetermined and published by SARS. The criteria and support for the refund process is strictly monitored by SARS, thus having purchased and used the fuel off road is not sufficient to entitle a claimant. One must prove their entitlement according to the guidelines that are set out in Schedule 6 to the Customs and Excise Act. What is clear from this system is that those who successfully claim the refunds, are those who have purchased fuel and not used it on the road. It is also clear that they receive a portion of their input cost with a result of improving their liquidity.

The fuel levies generate a significant amount of revenue for the state. According to the Budget Highlights document issued by the National Treasury, for the financial year 2022/23, fuel levies collected amounted to R89.1 billion. Due to other pressing matters that the government must deal with, the first question to ask is whether the government can afford to expand the pool of industries who can benefit from the diesel refund system? Secondly, will SARS be able to administer the system should more industries be included?

The system has been a fertile ground for litigation. SARS has also, over the course of the system, endeavoured to clarify the rules and regulations that govern the administration thereof. Having said that, it remains to be seen whether the revenue service has enough capacity to enforce the letter of the law. If including more industries in the system was to be considered against the loss to the fiscus argument, would such a solution be temporary until such time as the level of loadshedding is reduced? There are no perfect answers.

A difficult balance must be struck between a loss to the fiscus of funds used to assist government in delivering services and government's mandate of creating a conducive environment for businesses to thrive. When companies are profitable, they preserve and create jobs. The fiscus would receive the revenue back through higher taxes paid by taxpayers which may include higher fuel levies as a result of more road users.

What could be on the cards for electronic services?

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Since 1 April 2019, there has been major change to the value-added tax (VAT) legislation and regulations for the supply of electronic services. These changes, and how it is being applied by the South African Revenue Service (SARS), has garnered a lot of attention, as advisors, non-residents and vendors continue to navigate the proverbial waters to avoid unexpected VAT liabilities.

It is likely that electronically supplied services (ESS) will continue to receive attention, as SARS remains focused on driving improvements in VAT collection and administration.

What are the changes that could be explored?

- Measures aimed at providing clarity on the definition of electronic services to alleviate the difficulties in distinguishing between ESS and imported services.
- An exception that caters for certain ESS that may be zero rated for VAT.
- Exclusion of foreign suppliers of ESS from registration as vendors where an intermediary is liable to account for the VAT.
- Alignment of the educational services provisions, to ensure that services normally exempt in South Africa, do not fall into the ambit of ESS instead.

Distinguishing between ESS and imported services

If a service is supplied by a non-resident supplier to a local recipient, the service would need to be evaluated to determine whether it may fall within the ambit of an electronic service or that of an imported service. The Regulations Prescribing Electronic Services changed the manner in which ESS is taxed and shifted the onus of the VAT from the local recipient to the supplier of the electronic service situated outside of South Africa.

The classification of a service as an ESS or imported service is therefore critical to establish whether it is the responsibility of the non-resident supplier or the local recipient to declare the VAT respectively. However, the definition of electronic services is very broad and seeks to tax all services supplied by means of electronic agent, electronic communication or the internet. SARS has also been applying a very broad interpretation of ESS, even if human intervention is present in the service.

The broadening scope of interpretations in the definition of electronic services may have unintended consequences, where uncertainties could arise, resulting in local recipients not accounting for VAT on imported services, where appropriate. Further clarity around the intricacies in the definition of electronic services, will aid to ensure that there is a clear distinction between ESS and imported services, which will serve to improve the compliance and reporting of VAT.

Zero rating of certain electronic services

In accordance with the VAT legislation, a supply of services comprising of the arranging of international transport of passengers can be zero rated if certain conditions are met. However, the Regulations Prescribing Electronic Services disqualifies non-resident ESS vendors from applying the zero rate of VAT, when suppling international travel booking services or travel insurance. A non-resident ESS supplier could be caught in the VAT net without a similar provision in which to zero rate, creating disparity in the VAT treatment of these services. By addressing this disparity it will help to ensure that the supply of these services is treated fairly and consistently.

Registration exclusion for suppliers of ESS

The Regulations Prescribing Electronic Services provides for an "intermediary" to be the principal supplier of the electronic service when certain conditions are met. The intermediary would facilitate the supply, issue the invoice, collect the payments and would have an obligation to account for the VAT.

However, this does not absolve the foreign supplier of electronic services from a requirement to register as a VAT vendor in South Africa when the registration requirements are met, irrespective of whether the intermediary is accounting for the VAT. This means that caution must be exercised to ensure that the intermediary and foreign supplier continue to manage any VAT risks in this regard.

Further clarity is needed to address whether it is necessary for a foreign supplier of electronic services to register as a VAT vendor when the intermediary accounts for the VAT or if an exclusion may be required. This would enhance the reporting of VAT and mitigate risks of double taxation.

Educational Services attracting ESS VAT

The supply of educational services is exempt from VAT in the legislation if certain conditions are met. However, the Regulations Prescribing Electronic Services disqualifies non-resident ESS vendors from applying an exemption of VAT to an educational service if the educational institute is not regulated by an educational authority in the export country. A disparity will ultimately arise because many overseas educational institutions are not regulated and therefore will not be exempt from ESS VAT.

Consequently, a non-resident educational institute would be caught in the VAT net without a similar provision in which to exempt the VAT on the service for learners in South Africa. By addressing this disparity it will ensure that the VAT treatment is aligned for the supply of educational services.

It is important to keep abreast of the changes and recognise developments in this area.

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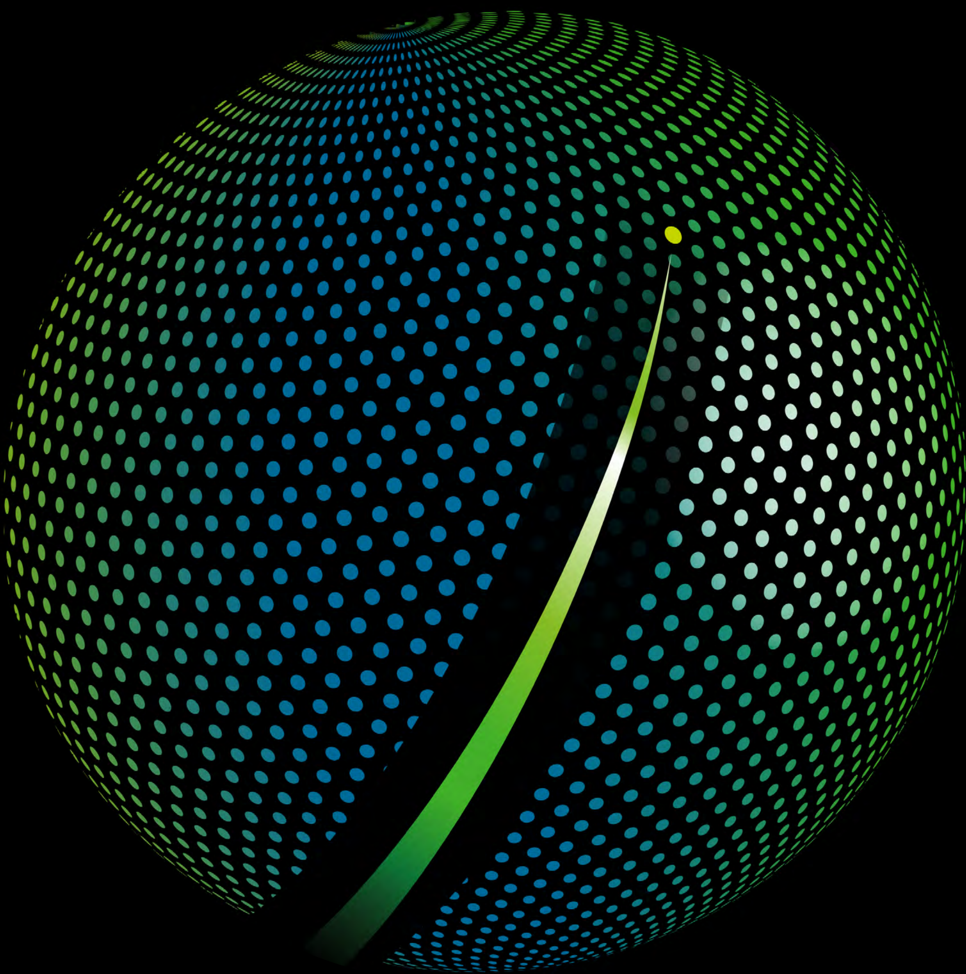

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