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Redefining Resilience: Navigating an economic path to prosperity in South Africa

Pre-Budget 2024/2025 Commentary

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Foreword

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"Redefining resilience: Navigating an economic path to a prosperous South Africa"

As South Africa strives to redefine resilience and navigate an economic path towards prosperity, we are faced with various challenges as a country, and many opportunities too.

It is with this background that I am pleased to present our pre-Budget booklet which looks into some of the critical issues affecting the South African economy and tax landscape today. The insights provided herein offer an overview of the current economic climate and the potential strategies for addressing the prevailing headwinds.

The predicted declining tax base that's coming at a time when government expenditure demands are increasing is one such example, creating a significant strain on public finances. There is also a pressing need to increase tax revenue collections however indications of a shortfall for the 2024/25 tax year is a matter of concern. The measures being considered, like broadening the tax base and refraining from inflationary adjustments, reflect the complexity of balancing revenue generation with economic growth.

The Presidential Climate Commission is expected to play a pivotal role in facilitating the automotive sector's green transition, considering the budgetary constraints on the fiscus. Additionally, the rise of new energy vehicles (NEVs) and the transitional strategies in the automotive sector highlight the need for incentivising the green transition and supporting the development of NEV industries. The global shift towards sustainable transportation solutions necessitates proactive measures and incentives to facilitate a smooth transition from Internal Combustion Engine vehicles to NEVs, aligning with the global commitments toward decarbonisation.

Amid this sobering economic outlook, the palpable effects of slow reforms are evident; particularly in sectors such as electricity and logistics. The impact on real GDP growth and the challenges faced by industries like agriculture, manufacturing, and mining underscore the urgency of addressing supply-side constraints and implementing structural reforms to foster sustainable growth.

Small businesses play a critical role in our economy and the need for incentives and regulatory changes to facilitate their transition from the informal to the formal sector is vital. By understanding the challenges they face, and exploring potential remedies, we can unlock their full potential and concomitantly contribute towards sustainable economic development.

The impact of automatic income tax assessments on individual taxpayers also comes into the spotlight in the pages that follow.

The implementation of automated assessments by the South African Revenue Service reflects the ongoing opportunities presented by their digital evolution and the efforts to streamline tax processes. Managing the impact of automatic assessments and ensuring they accurately reflect individual tax affairs is crucial for taxpayers.

As we navigate these unprecedented times, it's essential for policymakers, businesses, and individuals to collaborate and leverage the insights provided here to drive sustainable economic growth, financial resilience, and fiscal prudence.

I trust our pre-Budget Booklet will serve as a valuable resource that provides a deeper understanding of the economic landscape, taxation dynamics, and the potential pathways towards a more sustainable and inclusive economic future.

South African economic outlook

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Palpable cost of slow reforms amid gloomy economic picture

The South African economy remains under pressure going into 2024, mainly due to supply-side constraints in the electricity and logistics sectors. Real GDP growth for 2023 is expected to fall below the National Treasury's forecast of 0.8%. The economy only posted 0.3% year-on-year growth over the first three quarters, including a decrease of 0.2% year-on-year in the third quarter of 2023. Outlooks for 2024 and beyond have also moderated and are dependent on the (historically slow) speed of structural reforms, largely to address record levels of load shedding experienced during 2023.

Real GDP growth is forecast at 1% in 2024 and, on average, only 1.4% between 2024 and 2026. This does not compare well with the International Monetary Fund's 4% projection for emerging and developing economies, and even falls below the outlook for advanced economies of 1.7%.

After being a strong performer earlier in the year, the agriculture sector decreased by 9.6% year-on-year in the third quarter of 2023. Furthermore, manufacturing, construction, mining, and trade industries also contracted — of those, manufacturing and mining have faced more challenging circumstances due to ongoing electricity shortages, weaker freight and logistics capacity, and — in the case of mining — lower commodity prices. Manufacturing and mining are among the six industries (besides electricity, construction, trade, and transport) that by the end of the second quarter of 2023 were still trending below their 2019 levels of gross value added (based on average quarterly gross value added).

The statistics on the expenditure side are no better. Household final consumption expenditure decreased by 0.3% year-on year in the third quarter. Households continue to struggle financially given high-interest rates, elevated inflation — particularly food- and fuel-related — the impacts of load shedding on the cost of living, lower real disposable incomes, and higher debt.

While South Africa's headline inflation moderated to 5% year-on-year in the third quarter of 2023 — from a peak of 7.6% year-on-year in the third quarter of the previous year — this trend reversed going into the fourth quarter, averaging 5.5% y-o-y. Still, the final reading of 2023 came in at 5.1% y-o-y in December, marking the second lowest reading of the year. The South African Reserve Bank (SARB) noted in its Monetary Policy Committee (MPC) meeting in January 2024 that although headline inflationary pressures at a global scale appear to be moderating, core inflation remains sticky. The MPC would like to see South African inflation trend further towards the midpoint of its targeting band of 3%-6% and subsequently made the unanimous decision to keep the policy rate unchanged at 8.25%, noting that risks to the upside remain for the inflation outlook.

From a fiscal perspective, South Africa's public finances (both current and outlook) weakened in 2023. An increase in the budget deficit to 4.9% of GDP was projected in November 2023 — up from the 4% estimate in the February 2023 budget. This means gross debt is expected to rise to 77.7% of GDP in the 2025/26 fiscal year. Maintaining a fiscal policy stance that stabilises debt is one of the key action items tabled by the National Treasury to unlock much-needed growth and, in turn, address many social and developmental woes the country faces. Another key required action includes a focus on improving the efficiency of public spending.

One of the most significant focus areas in the medium term will need to be investment in infrastructure to stimulate economic growth. This will require the government to enhance infrastructure delivery by upping both quantity and quality. It needs to crowd in more private sector financing for larger projects, review the public-private partnership framework, and establish an agency to support finance and implementation of infrastructure.

The need for continued progress on structural economic reforms, specifically in the electricity and logistics sectors, is now more urgent than ever.

The economic costs of failure and inefficiency in these sectors have mounted over the past year, partly due to lack of investment but also due to mismanagement, corruption, and even theft. Reforms in the electricity sector – including lower restrictions on self-generation and reforms to encourage private investment – are expected to add over 11GW of renewable sources to help curb the power crisis in the medium term. With the electricity supply crisis continually weighing on economic growth, it is critical that these reforms continue to be implemented to curb power cuts, unlock investment and get the economy back on course.

The already gloomy picture could get worse if the pace of reforms remains sluggish. Real GDP growth averaged about 1.4% per year between 2010 and 2022 – a rate well below the target set in the 2030 National Development Plan that was released in 2011. To make a dent in unemployment, create jobs, and to reduce poverty and inequality, South Africa needs a faster pace of growth; but slow reforms will mean sluggish to no growth in the foreseeable future. With limited space for accommodative policy on both the monetary and fiscal fronts, it is imperative that reforms are implemented timeously and effectively if the South African economy is to have a chance at recovery.

Increasing tax revenue collections to stimulate growth

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The South African economy is struggling to return to the desired levels of growth, this in addition to the unemployment rate in the country being at an all-time high. When delivering the Medium-Term Budget Policy Statement (MTBPS), the Minister of Finance indicated that government is, in fact projecting a shortfall in tax revenue collection for the 2024/25 tax year.

The increase in commodity prices that have, in the past contributed to higher-than-expected tax revenue collections are unlikely to be achieved in the current tax year. This is due to lower commodity prices as a result of, among other factors, an increase in the interest rates.

The Minister of Finance also indicated during the MTBPS that they would consider tax measures that will be implemented to raise additional tax revenue of R15 billion during the 2024/25 tax year. With economic growth being strained and the taxpayers' purse stretched, the South African Revenue Service (SARS) together with National Treasury have to balance increasing tax revenue collection without crippling the economy or taxpayers.

Increasing tax revenue collections is one way to stimulate economic growth. This can be done by increasing taxes or increasing consumption. Where consumers increase their spending, there is likely to be additional value-added tax (VAT) collection.

SARS has cited broadening the tax base as one of its key objectives. We agree that SARS ought to consider ways in which to broaden its tax base; however, it must be careful that these efforts do not negatively impact the economic growth. Research shows that an increase in taxes where the taxpayers are financially constrained may be detrimental to domestic economic growth. Rising prices and interest rates have led to the reduction of taxpayers' disposable income in real terms thus an increase in Personal Income Tax is not viable in the current economic climate.

In line with global trends, SARS has recently reduced the corporate income tax rate to 27%, an indicator of government's efforts to have a favourable tax landscape that will attract foreign direct investment into the country. Due to the recent reduction in the corporate income tax rate, it is unlikely that this would be increased in the current tax year.

The government may, not apply an inflationary increase to the Pay-As-You-Earn (PAYE) tax brackets. This leads to an increase in the PAYE collections where the inflationary increase in taxpayers' salaries is not offset by an inflationary increase in the PAYE tax brackets. Thus, taxpayers may pay more taxes where their salary increases push them to higher PAYE tax brackets. It is worth noting that the inflationary adjustment of the PAYE tax brackets in the 2023/24 tax year resulted in government having to forego R15.7 billion in tax revenue.

The South African personal income tax rates are some of the highest in the world. Based on the PAYE collections statistics, a small proportion of the South African population are subject to the marginal PAYE rate of 45% (the so-called high-income earners). This means that a high proportion of the PAYE tax burden falls on a few, a situation which is not sustainable. Where only a handful of the population pays the maximum taxes, with so many remaining untaxed – through non-compliance for instance - this may discourage those who are tax compliant from remaining in the country. Owing to the financial constraints on the taxpayers, specifically the rising cost of living and declining income levels in real terms, we do not expect the government to introduce a wealth tax in the short term. It is also unlikely that the government will consider an introduction of new taxes and/or increase in the tax rates in the short term.

It has been encouraging to note the increased tax audits that have been carried out by SARS across various tax types, in certain instances leading to the issuance of tax assessment on non-compliant taxpayers. We are keen to see whether SARS will succeed in collecting the outstanding tax revenues to reduce the anticipated shortfall and stimulate economic growth through the increased tax revenue collections.

Tinkering amid a public finance double whammy

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South Africa faces a double whammy of a declining tax base while government expenditure demands are increasing.

This is the uncomfortable situation facing the Finance Minister and his colleagues as they prepare to table the 2024 Budget Speech.

Rising costs are a function of several things:

- Irregular and wasteful expenditure.
- An increasing public wage bill.
- A growing need to provide a more extensive social welfare net.

Revenue declines when the government is urged to extend social grants.

We are dealing with a recipe for disaster or the perfect ingredients for a fiscal storm. The government has to go on a substantial cost-saving exercise to avert the storm or a deterioration in the fiscal situation. But that may not be feasible in an election year, and it is a route the government has historically avoided. A genuine cost-saving effort may not be palatable for all as it may mean job cuts in the public sector.

In the past, the idea of reducing the size of the national executive has been mooted. That might mean a much smaller layer of ministers or doing away with the deputy ministers.

Running the national executive, including ministers and their deputies, is a big ticket. Serious money could be saved from that alone.

The idea of rightsizing the cabinet has a lot of proponents, but obviously, it may not be feasible in an election year.

In general terms, it is easy to believe there will be no appetite for tightening the belts in areas that matter. The Finance Minister can end up tinkering here and there.

In the absence of deep cuts, government borrowing will continue.

The problem with such an environment of the double whammy of increasing costs and expenditure, plus the debt spiral, is that the affordability of just about anything will be problematic.

It is more than just the national government that is in a tight space with no fiscal wiggle room. That picture cascades through all the layers, with most public entities facing the same issue.

The broad problem is epitomised by the struggle faced by several state-owned companies (SOEs) which will look to the Minister for much more than just a helping hand as they do not have the kind of balance sheet that will allow them to invest in the required growth driving capital projects. Saving a struggling SOE creates a perpetual problem in that it invites other state companies to make similar pleas. Given the tight financial position that national government finds itself in, the role of public-private partnership becomes very important in stabilising the ailing state-owned companies.

The private sector has a definite appetite because it is also in their interest as they are losing money in the current environment and cannot operate efficiently. That also affects the tax the South African Revenue Service can collect.

There will likely be movement from the government's side to prepare the ground to enable the growth of the PPPs by laying out the enabling policies and regulations.

Equity injections alone will not help. What is required in addition to financial support is the introduction of strategic equity partners, as the government calls them. Private sector players can help state companies shore up their balance sheet, giving the entity wiggle room regarding operational expenses. Private players can also bring in expertise, both managerial and technical. One of the benefits of a partnership is the spreading of risks, which currently are concentrated on the government side.

SOE failure affects industries and throttles big swathes of the economy. When risk is concentrated in one area, it quickly becomes a systemic risk. That is certainly the case with our SOEs when borrowing introduces a concentration risk among South African-based lenders. The nature of this risk, therefore, cuts across the entire economy.

Suppose the distinctly negative fiscal trajectory does not stop. In that case, South Africa may have to go to institutions like the International Monetary Fund for more loans, which may, on the downside, come with strict conditions. Such loans are akin to a country losing its sovereignty as that nation's affairs fall firmly into the lenders' hands.

Are things looking up for the South African consumer?

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Deloitte Consumer Signals research conducted on a monthly basis throughout 2023 revealed ongoing consumer concerns around rising prices and inflation.

Many challenges, such as a rise in the cost of living and economic constraints, marked the year 2023. Deloitte Consumer Signals research conducted on a monthly basis throughout 2023 revealed ongoing consumer concerns around rising prices and inflation. Muted saving intentions were displayed by lower-income and middle-income groups consumers who diverted the greater share of their wallets to groceries, housing, clothing and other essential items. Consumer confidence continued to decrease and remained low throughout the period.

As 2024 takes off, the South African consumer industry is not out of the woods yet, although consumers can expect some respite this year in the form of slowing inflation and expected decreased debt servicing costs. However, consumer confidence is expected to remain muted, spurred on by a sluggish economy and continued high levels of unemployment. Uncertainty around the general elections -- expected between May and August 2024 – are also weighing in on confidence levels. Electricity shortages continue to form part of the daily lives of South Africans, further impacting confidence and contributing to weak output growth and higher costs.

The growing reality of state owned logistics infrastructure failing to cope with current levels of imports and exports, has resulted in producers and manufacturers slowing down operations and adjusting their output. In January, the South African Reserve Bank's Monetary Policy Committee (MPC) alluded to ports and rail issues having become a serious constraint. "These constraints are expected to persist, severely limiting the potential growth of the economy," said SARB Governor Lesetja Kganyago on January 25, as he announced the MPC decision to hold interest rates at 8.25% per year. Kganyago also noted that household consumption and investment have eased significantly while government spending has been sustained.

Interest rates are expected to decrease as inflation slows down to within the threshold targets set by SARB. This could incentivise greater household spending, particularly on previously postponed larger-ticket items. Essential spending – food and non-alcoholic drinks, clothing and footwear, housing and utilities, communications and transport – will however still account for the majority of total household spending in 2024. Stimuli to boost the economy, create jobs, address current infrastructure challenges and the easing of rates are needed to stimulate growth.

State of SA businesses navigating the 'Zombie Zone'

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Although GDP growth in South Africa is forecast to double in 2024, it is coming off a very low base from the 0.5% anticipated for 2023 year-on-year growth. We may even find ourselves in a technical recession when the Q4 2023 GDP growth is released. However, the doubling of our growth rate does not necessarily translate into improved trading conditions for South African businesses, as 1% growth is still woefully inadequate to address our socioeconomic challenges.

As we prepare for our annual Deloitte Restructuring Survey, the overwhelming sentiment of respondents is that our home-grown issues are likely to continue to constrain us during 2024 – the crisis at our ports, ailing and failing infrastructure, and continued load-shedding to mention a few.

In addition, the effects that a challenging global macro environment may throw at us are unforeseeable – geopolitical tensions, supply chain issues and a year fraught with political uncertainty. Furthermore, in what is being dubbed as a 'super election year', more than 60 nations have their elections this year– marking the biggest election year in history. As a result, 2024 looks set to be another year where grit and resilience are core attributes required of business owners who will need to navigate through both local and global headwinds that will blow our way.

Despite these challenges, we are anticipating the commencement of a falling interest rate cycle as inflation continues to decline – falling to 5.5% in November 2023 from 5.9% in October 2023. However, Governor of the South African Reserve Bank, Lesetja Kganyago earlier this year said that an interest rate cut from the current 14-year high is not expected until inflation is keenly controlled and closer to the 4.5% sustainable inflation requirement. Therefore, a fall in the interest rates is more likely towards the second half of 2024.

With this little bit of good news as a backdrop, how do we expect South African businesses to fare during 2024?

Our expectation is that tough trading conditions will persist as the past few years continue to take their toll. The average consumer in South Africa is worse off entering into 2024 due to the fall in the average real monthly salary, which is experiencing a declining trend, having been R16,124 in February 2021 and averaging R13,942 in October 2023[1]. This decline translates into lower discretionary income and likely lower GDP growth. Lower disposable income impacts businesses with discretionary products and so **retail** businesses are expected to face further challenges into 2024.

Real estate took a beating during the COVID-19 pandemic with a perfect storm of factors affecting vacancy rates, rental receipts, and interest charges. Although trends are positive as we enter 2024, there is still a way to go before this sector hails a full recovery.

Tourism and hospitality is arguably faring better than pre-pandemic levels, with the latest data from NightsBridge[2] revealing an upwards trend with total bookings from January to October 2023 exceeding the same period in 2019 by 7.4%. In Cape Town, more than 317,000 overseas travelers arrived in December 2023[3], representing an increase on pre-pandemic levels of 290,000 in January 2020 as well.

Major logistical challenges at our country's ports, together with load-shedding as well as the cost-of-living continue to impact discretionary income and will likely put a damper on any new vehicle market sales growth in 2024. This is supported by a year-on-year decline of 3.3% in December 2023, the fifth consecutive month of year-on-year decline[4]. As a result, the Automotive sector is expecting a tough 2024.

South Africa, when assessed on the expanded unemployment rate, has the highest level of unemployment in the world at 41.2% in Q3:2023[5,6]. Further job losses have been announced into 2024, specifically in the mining sector. Job creation is surely required (and growth rates of 1% do not provide much hope), but equally the importance of job preservation cannot be over-emphasised.

[1] Latest in the SA Economy | Investec Focus
[2] https://tourismnewsafrica.com/south-africas-tourism-outlook-for-2024/
[3] https://www.businesslive.co.za/bd/national/2024-01-16-partnership-helps-cape-town-set-record-for-foreign-tourists/
[4] https://businesstech.co.za/news/motoring/741309/big-hopes-for-south-africas-car-industry/
[5] South Africa's unemployment rate remains highest in world (iol.co.za)
[6] Statistics South Africa on Quarterly Labour Force Survey quarter three 2023 | South African Government (www.gov.za)

What are the options available to businesses struggling to make ends meet and entering the realm of financial distress?

Business rescue, in South Africa, has had some reputational challenges; with media reports focusing on the cost and length of the process. Many 'successful' business rescues are those where the business and assets are sold to a third party – hardly compelling for a business owner seeking to rehabilitate their business and continue as a going concern.

This negative perception of business rescue leaves many businesses in the 'zombie zone' – i.e., limping along, with no growth and worsening working capital cycles. These businesses are called 'zombies' because they are merely treading water and not making any progress towards growth due to a lack of capital to invest. They generate enough money to cover operating expenses and service their debt but cannot repay it. Generally, they are one event away from insolvency and in the South African context; an 'event' may be worsening load shedding, inaccessibility at our ports, or a quarter of poor financial performance. In these circumstances, the business owners cannot afford the cost of expert intervention – either an advisor-led turnaround, business rescue or liquidation. Creditors also choose not to spend money making a court application for the termination of the business when they know there is little chance of recovering of any monies outstanding to them.

There is anecdotal evidence of a rise in companies in the Zombie Zone. The liquidation statistics provided by StatsSA highlight a fall in liquidations year-on-year, with 1,520 companies having filed for liquidation in the year to 30 November 2023 - a decline of 13% for the same period in 2022[7]. We have not seen a commensurate increase in business rescues in 2023 (although data from CIPC is not as reliable and consistent as StatsSA) and trading conditions during 2023 were some of the toughest experienced since the global financial crisis in 2008. Perhaps this lack of filing for insolvency is indicative of businesses taking no decisive action and merely treading water, as is expected of a Zombie company.

The early recognition of financial distress provides more options for business owners to save their businesses and avoid the zombie zone. This has been confirmed in our Deloitte Restructuring Survey 2021 where 94% of our respondents agreed that seeking restructuring advice early is seen to have a higher probability of achieving a turnaround. In fact, 91% of respondents in the same survey said that early identification of financial distress was a very important factor to improve within our local market.

Oftentimes, it is the 'ego-effect' that prevents a business owner putting up their hand to ask for help. Executive teams do not want to admit to their boards that they may have erred or that the problem is too complex for them to solve. While we may have a pool of highly experienced executives who run profitable companies, a different set of skills is required when needing to steer a struggling company through choppy waters.

Knowing when to call in turnaround and restructuring experts, having tough conversations with key creditors (including lenders) while outlining a recovery plan as well as a tight and decisive management style, are all very necessary components for businesses that will survive into 2025.

[7] https://www.statssa.gov.za/publications/P00431/P00431November2023.pdf

Tax and grant incentives to pave the way for the automotive sector's green transition – Developing a NEV industry

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Considering the anticipated announcement of support measures aimed at assisting the automotive industry transition from producing Internal Combustion Engine (ICE) vehicles to a dual platform of New Energy Vehicles (NEVs) and ICE vehicles, the automotive sector is expected to come out with a 'win' from the 2024 National Budget Speech.

The pressure is now on South Africa to create a conducive environment for the manufacturing, export and adoption of NEVs - by the transport sector as well as by motorists – to stave off the decline of the automotive sector.

The UK is already imposing penalties for car manufacturers whose ICE sales exceed 78% of total sales, starting from this year – 2024. This is after having imposed a 22% minimum electric car sale requirement as a percentage of all car sales. The UK expect that by 2035[1], all their motor vehicles sales will be electric cars.

Similarly, the European Union (EU) also aims to eliminate vehicle CO2 by 2035, with registration of ICE vehicles permitted only if those vehicles use carbon-neutral fuels. The EU represents a significant market of South Africa's exports, with 63% of total automotive production (2.9% of GDP) being exported.[2] Thus if South Africa does not respond adequately to the global decarbonisation of transport, this will contribute to the de-industrialisation of South Africa's economy, given the current dominance of the South African automotive production in markets that are leading the drive to restrict or /ban the sale of ICE vehicles.

A common feature among countries that have embarked on an automotive industry green transition is the provision of incentives and public sector investment. The US's Inflation Reduction Act, seen as the most significant climate legislation in US history;[3] was introduced in 2022 - a US$386 billion[4] package of incentives and public investment for climate and energy. This package gives comprehensive support in the form of tax credits, grants, loans, and state investment for production of NEVs. The package also covers the production of components as well as the processing of critical minerals used in batteries and fuel cells for NEVs. Infrastructure for charging stations, consumer incentives to generate demand, upgrading of ports to promote use of zero emission technology and a broad programme to reduce greenhouse gas emissions in the transport sector.

The EU has also introduced financial support for NEVs in the form of public investment in charging infrastructure, public procurement of NEVs for government fleets and public transport as well as indirect consumer incentives that include exemption from tolls as well as regulatory incentives such as sales targets for NEVs.[5]

South Africa's BRICS partners are also following a similar trend of public investment to spur the market for NEVs, with China having introduced subsidies from as far back as 2019, and now leading the global market. The rapid growth of China's NEV sector has exceeded many people's original expectations, with the country producing 51% of the NEVs and 90% of global medium and heavy truck NEVs in 2021.[6] South Africa's EV whitepaper also highlights the need for incentives to support adoption of NEVs, and notes some of the benefits that have been introduced by other countries in the continent. These include Rwanda, Kenya, and Uganda as well as other vehicle producing countries such as Morocco and Egypt. Thus, South Africa's fiscal response to this global industry trend is long overdue.

Currently South Africa spends a significant part of the incentive budget in support of the automotive sector. In 2020/21 alone, government relinquised R26.2 billion in automotive tax incentives. Our expectation is that in the short - to - medium term the National Treasury will focus on recapitalising existing programmes in the automotive sector, ensuring that the South African automotive industry can still compete for future global Original Equipment Manufacturer (OEM) supply contracts.

It is expected that the National Treasury will provide additional funding for the Automotive Investment Scheme so as to facilitate private sector investment in production capacity of NEVs. This is a grant incentive that currently gives automotive assemblers a benefit of up to 25% of their investment costs in getting plant and machinery for new and replacement vehicle models. National Treasury has already indicated in the Medium-Term Budget Policy Statement, that R728.8 million of the AIS budget will be for NEVs.

[1] Forbes, 22 October 2023
[2] NAAMSA Export Manual data
[3] United States Environment Protection Agency
[4] Committee for Responsible Federal Budget
[5] European Environment Agency – European Environment State and Outlook Report
[6] Deloitte (EV)olution – Electric Vehicle Trends

The Department of Trade, Industry and Competition has made a commitment to revise this scheme to accommodate new energy vehicle assembly and component manufacturing. There is also an opportunity to revise this scheme to facilitate commercialisation of sustainable fuels like green hydrogen. From a tax incentive perspective, it is expected that the Automotive Production Development Programme, supporting local automotive production, value addition and exports, will also be revised to include NEVs. This includes a possible reduction of import duties on batteries, until South Africa can develop a regional value chain with other countries in the continent, for production of batteries.

With the budgetary constraints on the fiscus, it is expected that the Presidential Climate Commission will play a pivotal role in facilitating the automotive sector's green transition. Through the Just Energy Investment Plan, there are already indications that part of the funding required for creating an NEV industry will come from the US$ 8.5 billion committed by the Just Energy Transition Partnership, South Africa's collaboration with France, Germany, UK, US and the EU to facilitate transition to a low carbon economy.

Our expectation is that this funding will be made available to South Africa and will largely be used for developing the NEV market, including such interventions such as establishing charging infrastructure, supporting increased grid capacity to support NEV uptake in the local market as well as developing a green hydrogen value chain.

One of the other factors that is thought to have driven growth in the three largest global NEV markets (China, the EU and the US) is strict emissions standards.[7] The carbon tax legislation has provided a framework for disincentivising greenhouse gas emissions through a fuel levy, an environmental levy for new vehicles and a tax on process emissions. Although our carbon tax is low relative to many countries that have imposed carbon pricing, it is expected that it will continue to increase as it aligns with global pricing (US$20-30 per tonne carbon dioxide equivalent).

Policymakers have been slow in outlining policy for NEVs however, there is now some policy certainty following the publication of the EV White Paper in November last year. We do hope that despite the balancing act that the National Treasury has to strike each budget year, it is able to introduce support measures of sufficient scale and quantum to allow South Africa to play catch-up with the rest of the global automotive market.

Our expectation is that this funding will be made available to South Africa and will largely be used for developing the NEV market, including such interventions such as establishing charging infrastructure, supporting increased grid capacity to support NEV uptake in the local market as well as developing a green hydrogen value chain.

[7] *Deloitte (EV)olution – Electric Vehicle Trends*

SA's golden tax goose

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As South African taxpayers eagerly await the delivery of the 2024/2025 National Budget Speech, scheduled to take place on Wednesday 21 February 2024; the question on many taxpayers' minds is whether South Africa's already over-burdened taxpayers will see further tax hikes proposed in the National Budget so as to boost the state's revenue collections.

In the 2023 Medium-Term Budget Policy Statement (MTBPS), it was noted that revenue collections were expected to be approximately R56 billion below the budget estimate. This anticipated shortfall comes at a time when South Africa is in desperate need of a buoyant revenue base to meet its many challenges.

Based on the 2023 Tax Statistics report, issued by National Treasury and the South African Revenue Service (SARS) on 29 December 2023 (the Report), Personal Income Tax continues to be the highest contributor of revenue to the state's coffers, at 35.7% of total revenue collections. This is followed by value-added tax (VAT) at 25%, and corporate income tax at 20.6%. These three revenue sources collectively contribute 81.3% of the total tax revenue collected.

The report again highlights the continued fragility of the South African revenue collection ecosystem as we remain reliant on a relatively small base of taxpayers to generate the majority of the country's revenue collections.

Encouragingly, the report notes that tax compliance revenue, which was generated by focused efforts made by SARS, yielded R231.8 billion for the 2022/2023 fiscal year, that is R16 billion (or 7.5%) higher than in the preceding year. These efforts also include SARS making it easier for taxpayers to comply through various platforms, an increase in the use of data to drive insight, improve risk assessment and audit outcomes as well as various engagements with stakeholders in the tax ecosystem.

The number of registered individual taxpayers also increased overall by 14.5% from 22.2 million in 2018/19 to 25.9 million in 2022/23. This growth in the number of registered taxpayers is driven mainly by various, intentional initiatives which SARS has implemented over the last few years, including the revised employer filing and employee registration processes; enabling bulk registration at places of employment; an online SARS facility to register employees when submitting monthly Pay-As-you-Earn (PAYE) returns; and increasing the number of employers registered for PAYE.

Notably, while around 7.1 million of the 25.9 million registered individual taxpayers were expected to submit income tax returns for the 2022 tax year, only approximately 5.9 million taxpayers (84.7%) had been assessed (based on available data as at October 2023) - with reported aggregated taxable income of R2.1 trillion and a total tax liability of R447.6 billion. Of these 5.9 million individuals who were assessed, 19.4% earned taxable income above the R500 000 threshold and collectively contributed 74.7% of the tax assessed.

The average tax rate payable by taxpayers was 21.8% compared to 21.3% in the previous tax year. Income from salaries, wages, pension, overtime, and annuities accounted for the highest portion (75.5%) of total taxable income.

These statistics again confirm that while there has been significant growth in tax collections[1] over the years, a relatively small percentage of the South African population is financing the country's tax bill. the 'man-on-the-street' also continues to pay a significant amount of tax (both direct taxes, such as personal income tax as well as indirect taxes, such as VAT).

These statistics should be viewed within the context of South Africa's progressive income tax system where high-income earners contribute a greater proportion towards revenue (i.e., the more you earn, the higher tax you should pay). What the numbers also suggest is that these taxpayers seem to be bearing a high share of the country's tax burden and will continue to feel the lingering fiscal pinch on their disposable incomes.

A budget that supports South Africa's future, should go further than just tax increases. Although the main component of our revenue base will always be tax revenues, tax is not the sole solution and other revenue-generation measures such as among others, efficient tax administration, broadening the tax base and enforcing compliance with existing tax laws should continue to be implemented. As well as measures to stabilise public finances, and economic reforms to generate higher growth also need to be implemented.

[1] During the 2022/23 fiscal year, R2.07 trillion was collected by SARS in gross tax revenue, (R183 billion or 9.7% more than in the preceding year) R381 billion in tax refunds, (R60 billion or 18.7% more than in the preceding year) and a net tax revenue of R1.69 trillion, (R123 billlion or 7.8% more than in the preceding year).

Real-time VAT reporting is coming - Are you ready?

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For many organisations and their leaders, the introduction of real-time VAT reporting requires a new approach to data management, compliance, and business strategy.

There is a major change coming that will fundamentally change the way value-added tax (VAT) is reported and collected in South Africa.

In October 2023, the South African Revenue Service (SARS) published a discussion paper on "Value-Added Tax Modernisation", which outlines the proposed framework to modernise the VAT system primarily through digitalisation. This will involve the adoption and implementation of real-time or close to real-time transmission of transaction data from registered vendors to SARS, and the reporting of VAT data using the modern VAT return.

This investment in digitisation by SARS will ramp up its ability to access more business information in real time. More importantly, it has the potential to unlock the value of data for SARS; gaining more insight on the behavioural pattens of taxpayers and working towards making them more compliant.

The shift to real-time reporting will also drive fundamental changes within organisations. Whereas in the past tax teams could analyse and correct tax data before filing the tax return, now SARS will be receiving that data directly and in real time. This means that SARS will have eyes on an organisation's tax data at the same time as the tax function, as a result tax data quality and governance will become more important. The changes will compel many organisations to adapt to the new ways of interacting with the tax authority or face significant penalties and increased operational risk.

This article outlines some of the key considerations – for SARS and organisations operating in South Africa - as SARS begins the VAT modernisation journey aimed at moving them closer to being the digital tax authority they aspire to be. We share key learnings from tax authorities that have taken the leap ahead and embraced technology.

We also delve into how these revenue authorities are using technology to shift compliance into the digital realm, as well as discuss what organisations operating in South Africa can start doing as they prepare for the new regime.

Key considerations for SARS

Modernising the tax administration is a key component of improving capacity, introducing efficiencies and closing the tax gap, however, focusing only on technology as part of digital transformation will not achieve the desired result.

As more tax authorities adopt digital administration, we see that the digital transformation approaches applied are ever evolving. The experiences of tax authorities along the journey so far reveals that there isn't a single endpoint but rather a continuous process evolving many individual steps.

The Organisation for Economic Co-operation and Development (OECD) Forum on Tax Administration (FTA) conceptualised a tax administration's digital transformation journey by sketching the starting point, in-between stages, and aspirational endpoint as follows:

- "Tax Administration 1.0" a paper-based tax administration, traditional functions;
- "Tax Administration 2.0" an e-administration, where most of the functions are digitised, although the fundamental processes are the same (but faster and more efficient); and
- "Tax Administration 3.0" represents a paradigm shift, where the taxpayer and tax administration systems are interconnected, where compliance is automatic and seamless, and where traditional decision functions are done by technology.[1]

Ronnie Nielson, Deloitte Tax Thought Leader (Denmark) explains that even though this provides a conceptual framework that tax authorities can adopt, in reality digital transformation rollouts have adopted a phased approach. Chile is a good example of a country that has managed to systematically whittle away the VAT gap by cleverly using information from electronic invoicing. This was first implemented for the largest businesses - a small number of conglomerates controlling a large part of the economy - and cascaded through their supply chains. They have since built a range of taxpayer-facing services as well as internal use cases (e.g., analytics applications to identify high risk cases).

The experience of Deloitte member firms in regions where tax authorities have adopted digital transformation shows that the best starting point for SARS would be to define the end game. This means not just focusing on real-time reporting but also how the transformation aligns with the digital tax administration of the future and government's broader digital ambitions. The value of data for compliance purposes is but one aspect, albeit a very important one; of the business case.

The "end game" should clearly profile its vision and desired future state.

In addition, it should also outline the overall principles for technology and architecture as well as the business choices arising thereof. There is enough insights and experience from early adopters (such as Latin America) to inform such a vision. Their implementation roadmap should be informed by their vision and should allow them to gradually progress towards the desired end state. This involves both design of the real-time reporting initiative, rollout of the initiative through a phased approach that's likely to start with government and large businesses, as well as initiatives to take advantage of - and extract value from - the data.

The data quality challenge

The tax functions will face many challenges in preparing and complying with the requirements of real-time reporting. However, data quality will be the most critical factor that they will have to contend with and address. Many tax functions spend the bulk of their time accessing tax data, making corrections, performing reconciliations, and formatting the data for tax compliance. But a process like this will be under increasing pressure as SARS introduces near to real-time reporting and demands more tax data in greater detail.

Many organisations that have yet to invest in digitising their tax data processes will struggle to obtain and transmit the right data to SARS. As the data demands are likely to increase, the data challenges will intensify for many reasons, e.g.,

- **Access to tax data:** In many organisations, the tax function often has access only to a limited number of reports; and finds difficulty in accessing the relevant systems or databases that house required tax data. This creates a dependency on the IT and finance departments when additional data is required for tax compliance and analysis.

  A trend revealed in the Tax Transformation Trends study shows that having visibility into enterprise-wide tax data has proven difficult for many companies. Integrating tax-related data across the company (36%) is the second most cited challenge for tax departments as they pursue increased efficiency and access to better data[2].
- **Tax data housed in multiple locations**: Real-time reporting requires that data is right the first time, in a tax-ready format and provides the right level of granularity. However, often the data is received from multiple sources in less than useful formats, with inadequate levels of detail for use by the tax function. Data must often be manually enriched and reconciled to be useful for tax purposes.
- **Inaccurate tax data:** Tax functions are often required to make corrections to the data extracted from systems before using it for the tax return. This often points to the incorrect tax set-up in the underlying systems leading to incorrect data being provided to the tax function.
- **Inadequate data management tools:** Many tax functions do not have access to data analytics tools that can efficiently analyse tax data and pro-actively identify areas of risk. They tend to use spreadsheets that lack the more sophisticated capabilities that new technologies can bring. When tax functions fall short of obtaining and analysing their tax data at the required speed, the risk of fines and penalties due to non-compliance exposure will increase.

Organisations will need to have the relevant data capture processes and controls that ensure high quality data is in place. This data will not only be relied upon for real-time submissions but, also for downstream VAT compliance return preparation processes as well as tax authority verifications. Lack of data quality is where many organisations are likely to fall short and face increasing risk of non-compliance .

What could be next?

- **A modern VAT return:** Data transmissions will be aimed at simulating a vendor's VAT return in the future. SARS will likely seek to modernise the current VAT return to prepare vendors to disclose detailed VAT data that will be scalable for real-time reporting.

  Taking cognisance of the fact that the changes are aimed at garnering meaningful disclosure to SARS, it may – for example – distinguish the types of zero-rated and deemed supplies, VAT rates, apportionment adjustments to input tax. The same applies to tax data from other systems, such as customs and income tax. All of this to identify variances that used to be dealt with via the discontinued IT14SD reconciliations.
- **Electronic invoices:** Electronic invoicing (e-invoicing) will allow for electronic submission of VAT data to SARS in the future. SARS will likely seek to prioritise the compliance requirements for vendors implementing e-invoicing, using a graded approach to digitisation, such as clarifying the level of detail required on e-invoices.
- **Tax thresholds:** National Treasury is looking at adjusting the current tax thresholds for vendors, this because the provisions may be outdated insofar as addressing inflation and revenue trends.
- **Penalties:** Legislation to introduce or amend penalties to deter non-compliance as the modernisation initiative progresses.

[1] *Forum on Tax Administration (OECD, 2020). Tax Administration 3.0: The Digital Transformation of Tax Administration.*
[2] *Deloitte 2023 Tax Transformation Trends*

What organisations should be doing now...

While the implementation of real-time VAT reporting presents several challenges as outlined above, it also creates many opportunities. It can act as a strong lever that the tax function can use to improve processes and data quality issues.

What measures can thus be taken by organisations in South Africa?
To better prepare the tax function for the future, tax and finance leaders should consider implementing these measures:

- **Start enhancing your tax data now:** Given that the tax function relies upon every transaction housed in the data generated by the business, organisations should be looking at their full VAT compliance process. This includes where the data is sourced, which systems are used, and how this information is adjusted as well as consolidated. This will provide a clearer picture. Organisations should also consider leveraging emerging technologies such as artificial intelligence to detect anomalies, monitor and anticipate tax data related issues, opportunities and risks.
- **Monitor regulatory and tax trends:** By releasing the discussion paper on VAT modernisation, SARS is offering a strong signal of how the VAT system will evolve over the coming years. The tax function must start to invest in understanding the proposed changes and contribute to the dialogue with SARS as they evolve.
- **Envisioning a target operating model:** Tax functions must start thinking about their future operating model, as this will be key to helping define as well as execute initiatives and technology roadmaps. The tax functions should also look outside the traditional tax infrastructure to assess existing capabilities and technologies across the organisation that can be leveraged and then develop a digital road map. The said roadmap should align with the department's long-term goal and how that can be achieved through practical and achievable steps.
- **Generate internal support:** Responding to the change will require broad-based support from across the organisation. The tax function must start building the business case for change, not only for generating internal buy-in but to also secure the investment and leadership support that will be required. You could start by looking for other transformation initiatives that are starting or underway (e.g., transition to enterprise resource planning [ERP] cloud or finance transformations) and leverage these to prepare for the proposed VAT real- reporting requirements.

Conclusion

There is no doubt that digital transformation through the VAT modernisation initiative will contribute to SARS meeting its objectives of enhancing efficiency, speed and transparency, lower compliance costs and collecting more revenue through enhanced compliance.

However, for the revenue authority to achieve these objectives; the digital tax transformation strategy, planning, and implementation thereof should be linked to the larger digital administration agenda as well as a clearly defined vision. Although the path and endpoints in transitioning to the future digital VAT administration may differ between countries, there are common steps and issues in planning, designing and executing the journey that SARS can adopt. These include setting a vision, making decisions on design and phasing and the construction of a digital roadmap that contains all components required to achieve the desired future state.

For taxpayers, the move to real-time reporting should act as a lever to build a business case for investments in improving the quality of data or as a reason to improve upstream finance processes and improve legacy system issues. A holistic approach that considers how the processes, people, data and technology will interact should be adopted. It is time for tax leaders to get the rest of the organisation to stand up and realise that they need to make fundamental changes and build tax requirements into every stage of the process. The pressure from digital tax requirements is only going to increase in the years ahead. Organisations will need to get comfortable providing a level of transparency to SARS which they have not historically had to. Those who take a strategic and proactive approach in response to the expected heightened data demands, will be rewarded with increased efficiency and more accurate VAT reporting.

Pillar Two – Global minimum tax legislation expected

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The OECD/G20 Inclusive Framework (Inclusive Framework), formed by the Organisation for Economic Co-operation and Development (OECD) together with the G20 countries has two pillars. These two pillars are aimed at ensuring that multinational enterprises (MNEs) pay a fair share of tax wherever they operate and generate profits. Work under Pillar One focuses mainly on the digital economy whereas Pillar Two focuses on other base erosion and profit shifting (BEPS) matters, including the introduction of a global minimum tax (GMT).

In December 2021, the OECD published model rules that form the basis for a GMT. MNEs with annual consolidated revenue in excess of 750 million euros will be required to pay a minimum tax of 15% in each jurisdiction in which the MNE operates. If the minimum 15% tax has not been paid in a particular jurisdiction, additional top-up taxes are payable, although not necessarily in that jurisdiction.

Jurisdictions that have already introduced final GMT legislation include the United Kingdom, Denmark, Hungary and Japan while countries such as Canada, Germany and New Zealand have introduced draft legislation[1].

To date, neither South Africa nor any other African country has introduced any Pillar Two legislation. In the tax proposals forming part of the South African 2023 Budget Review the following was stated in relation to Pillar Two: "During the 2023 legislative cycle, government will publish a draft position on the implementation of Pillar Two for public comment and draft legislation will be prepared for inclusion in the 2024 Taxation Laws Amendment Bill"[2]. As it transpired, no such draft position was published in 2023.

In October 2023 the African Tax Administration Forum (ATAF) issued its revised Suggested Approaches to Drafting Domestic Minimum Top-Up Tax Legislation. ATAF notes that many African countries have granted tax incentives to MNEs which could result in such MNEs having an effective tax rate of less than 15%. Where that is the case and the relevant country has not introduced Pillar Two legislation (and more specifically, a domestic minimum top-up tax); another tax jurisdiction, usually where the MNE is headquartered, will collect the top-up taxes due. Therefore, ATAF strongly recommended that African countries immediately enact domestic minimum top-up tax legislation "to protect themselves from giving away taxing rights to developed countries on top-up tax arising from their own tax incentives"[3].

Until such time that GMT legislation (including a domestic minimum top-up tax) is introduced in South Africa, it is possible that South Africa could lose out on top-up taxes to other jurisdictions that have implemented such legislation. We expect that the 2024 Budget Review may still include draft GMT legislation, including a domestic minimum top-up tax.

It is worth noting that even if the introduction of GMT legislation in South Africa does not result in significant additional tax revenues, MNEs that meet the scoping requirements will nonetheless be required to comply with onerous reporting requirements. In this regard, more than 190 data points will be needed for every entity (including permanent establishments) within an MNE group and most of the data will have to be calculated specifically to comply with the GMT legislation. In other words, it's not just about accessing new data; it's also about obtaining, analysing, and reporting on information that was not previously captured for tax purposes, in new and different calculations.

In any event, regardless of whether South Africa introduces GMT legislation, South African-based subsidiaries or permanent establishments of MNEs that are based in jurisdictions that have implemented legislation will have to perform the minimum tax calculations and comply with reporting requirements that feed into the parent entity's reporting.

In these circumstances, South African taxpayers that are likely to be caught by GMT legislation (either because South Africa introduces GMT legislation or because they are part of an MNE group that has presence in another jurisdiction that has introduced legislation) are well advised to prepare for the inevitable arrival of the legislation. This includes understanding the technical data and technological requirements, as well as assessing whether full compliance with the detailed rules is required or whether there are any "safe harbours" that could apply to significantly reduce compliance obligations during the transition period.

[1] Refer to Deloitte's Global Pillar Two Legislative Tracker for up-to-date information on the status of GMT legislation across the globe.
[2] 2023 Budget Review Revenue Trends and Tax Proposals – Chapter 4, page 51.
[3] Refer ATAF media statement dated 4 October 2023 (https://www.ataftax.org/ataf-unveils-revised-suggested-approaches-to-drafting-domestic-minimum-top-up-tax-legislation)

Transfer pricing: Current trends and changes in the landscape

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Transfer pricing (TP) is an area which has been changing rapidly in recent years. This as a result of the ongoing focus of the Organisation for Economic Co-operation and Development (OECD) on base erosion and profit shifting (BEPS). Indeed, the burden associated with TP compliance is significant and is set to become more so with the imminent introduction of Pillar Two rules. Compliance for South African taxpayers, which form part of a multinational enterprise (MNE), has become increasingly arduous with compulsory preparation and submissions of transfer pricing local files and master files (for MNEs with cross-border related party transactions above certain thresholds) and also of the country-by-country (CbC) report for significant SA based MNEs.

As a consequence of these changes MNEs have to accept that they are subject to a much greater degree of transparency when it comes to their worldwide group. The CbC report enables tax administrations to establish exactly where the group is making its profits – and the extent of such profits. The introduction of the Pillar Two minimum global tax regime, and of the broader BEPS initiatives, may further contribute to this trend.

Access to the CbC report equips tax authorities to mine the group's financial information and identify potential areas of vulnerability. Indeed, the OECD has issued a comprehensive handbook to enable tax administrations to use the CbC report to effectively determine areas of risk. This includes identifying 19 specific "Potential tax risk indicators".

So far, we have not seen any queries from the South African Revenue Service (SARS) arising explicitly from information obtained from the CbC report of a group. However, this is the expectation. There is also technology available which allows information to be mined automatically and generates reports highlighting areas which could justify further investigation. This would be low hanging fruit for SARS and other tax administrations.

An exciting recent development is the promulgation, in December 2023, of the South African advance pricing agreement (APA) legislation. Further details of how the APA programme will work will be contained in regulations still to be issued and the effective date of the APA programme will be determined by the SARS Commissioner via public notice. The APA programme is designed to mitigate TP risk by providing taxpayers with the opportunity to obtain certainty via an agreement with the relevant tax authorities in advance of embarking on significant large-scale international transactions. There is considerable excitement about this programme and it is expected to be a significant area of focus going forward.

Another trend is that TP continues to be a focus area for SARS and other tax authorities across Africa. Thus far, TP disputes have generally been settled via the alternative dispute resolution (ADR) process.

However, we have seen a persistent and significant trend of taxpayers and SARS battling to reach a settled solution via the ADR process. Expectation gaps of possible settlement options that the parties feel they can live with are sometimes just too wide. Therefore, taxpayers are increasingly pursuing other options – including litigation or proceedings via the mutual agreement procedure (MAP) process in terms of tax treaties. Until recently, TP court cases have been unheard of in South Africa. How will these unfold in court? That remains to be seen. Yet we are aware of several matters that are likely to proceed to court, – some imminent. We are also aware of several recent and imminent MAP proceedings, some of them being multilateral MAPs.

All of this means that TP specialists, both in-house specialists and practitioners, need to focus simultaneously on the past, the present and the future. The past often remains with us because TP disputes always relate to previous years, sometimes up to seven or eight years in arrears. We have recently seen new disputes arising which relate to financial years as far back as 2016. This often indicates significant exposure in subsequent years if the transactions, and associated TP policies, have remain unchanged.

Where such cases proceed to court there can be significant challenges with gathering evidence, and obtaining witnesses who can reliably testify to events dating that far back.

We are also forced to live in the present as the everyday issues remain, and there is also the increasing compliance burden outlined above. We have often seen MNEs implementing significant operational or structural changes that greatly affect their TP situation but only thinking about TP once the new transactions need to be included in the local files. Since TP documentation is prepared significantly in arrears, under this scenario any exposures resulting from such changes are crystalised by the time a TP lens is used. This risk can only be mitigated by ensuring that in-house tax specialists are aware of such developments within the group and are responding in real time – including obtaining specialist advice where required.

The upcoming implementation of an APA regime will require us to cast our minds into the future. SARS has chosen to go the route of allowing bi-lateral APAs first and then implement unilateral APAs. The negotiation of bi-lateral, or multilateral, APAs requires the involvement of multiple tax authorities. They therefore typically take extended periods to negotiate and reach an agreement. This means that MNEs will need to do significant advance planning to take advantage of the APA regime.

In summary, the trends which we foresee affecting the TP environment include the following:

- MNEs will, to varying degrees, continue to tax optimise. TP will continue to be part of this picture.
- However, when it comes to TP, it should be assumed that any tax advantages resulting from such planning will be clearly visible to tax authorities. Therefore, any such tax planning strategy will be aligned with substance and will be meticulously planned, implemented and documented.
- There will continue to be increased use of technology (including AI) both for enabling the ever- increasing compliance burden to be met, as well as for risk profiling.
- There is a persistent trend of TP being focused on by revenue authorities in Africa (including SARS) as a source of filling revenue gaps. This is nothing new but this trend is expected to continue.
- There has also been a hardening of attitudes of many African tax administrations, which has made settlement of TP disputes significantly more difficult to achieve in practice.
- While negotiated settlements will continue to be significant, we see an increased move towards TP court cases and MAPs. These will both absorb significant amounts of time for TP specialists.
- In view of the extent and significance of TP risks, we foresee that there will be a significant uptake in applying for APAs once the new APA regime becomes effective.

The tax compliance burden for small and medium enterprises

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Small and medium enterprises (SMEs) have long been, and continue to be recognised, as a priority sector for growth and development in South Africa as it plays a critical role in our country's economic growth and employment creation engine.

Over the years, South Africa has achieved steady successes in broadening its tax base amongst small businesses and various legislative measures were enacted to provide preferential tax treatment to these small businesses.

In the South African 2023 Tax Statistics Report, an annual report issued jointly by National Treasury and the South African Revenue Service (SARS) which was published in December 2023, it is noted that as at 30 September 2023, of the approximately 1.06 million companies assessed for the 2021 tax year, 159 307 were small business corporations (SBCs) who paid tax at the preferential graduated income tax rate (instead of the fixed corporate tax rate of 27%).

SARS also continues to share relevant information with SMEs pertaining to their tax compliance matters via dedicated SARS newsletters.

Despite the significant progress made, the regulatory burden and the cost of tax compliance remain a significant challenge for SMEs as they often do not have the necessary staff resources and skills to navigate the complex tax rules to comply with all their tax obligations timeously and fully. The cost of tax compliance can thus add significantly to the cost of doing business for SMEs (e.g., additional resources that have to be employed to comply with tax rules, significant penalties imposed for non-compliance with tax rules, administrative non-compliance penalties imposed for outstanding tax returns, among other costs).

Given the importance of this sector to the South African economy, it remains imperative that government continues to reduce the tax compliance burden for SMEs, provide tax incentives that benefit the SME sector (such as the turnover tax regime), simplify the tax laws affecting SMEs and provide support for these business to avail themselves of the Voluntary Disclosure Programme to regulate their tax affairs with SARS, where relevant.

As many of these small businesses operate within the informal sector, incentives and regulatory changes are critical to ensure the transition from the informal sector to the formal sector.

Over the years, South Africa has achieved steady successes in broadening its tax base amongst small businesses and various legislative measures were enacted to provide preferential tax treatment to these small businesses.

Value-added tax default remedies: Voluntary disclosure, request for remission and the question of interest

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We expect the upcoming Budget Speech to focus on increased revenue collection to close the revenue gap announced in the Medium-Term Budget Policy Statement at the end of 2023. The focus on revenue collection will, of course; lead to assessments levied in respect of defaults and errors. Value-added tax (VAT) defaults can either arise from classic capturing errors when completing a VAT return to an incorrect VAT treatment assigned to a supply in the enterprise resource planning system. In instances where a vendor identifies a default prior to a South African Revenue Service's (SARS) audit or investigation, submitting a revised VAT return may seem a possible method of regularising past errors. However, it is also important to consider other possible remedies so as to determine the most appropriate and efficient resolution to the matter.

Let's take a scenario where input tax was overstated in a VAT return and compare the processes of submitting a revised return (coupled with a request for remission of the various penalties) as a first option and then the application for Voluntary Disclosure Program (VDP) relief as an alternative.

Compliance with the technical requirements of both processes

Once a revised return has been submitted, the late payment penalty will automatically be levied, together with interest and in addition - an understatement penalty may be levied. The next step is to consider how these penalties can potentially be mitigated.

Late payment penalties

The late payment penalties may only be remitted by SARS under specific conditions. A vendor will have to request remission on the grounds that exceptional circumstances gave rise to the late payment penalties as contemplated in section 218 of the Tax Administration Act, 28 of 2011 (TAA) or because it was the taxpayer's first incidence of non-compliance as contemplated in section 217(3) of the TAA.

Understatement penalties

A taxpayer will need to either prove that the default was as result of a "bona fide inadvertent error" or object to the levying of the understatement penalties. There is no avenue to request remission as a first step, like the late payment penalties.

Based on the Guide to Understatement Penalties (Issue 2), SARS only considers typographical errors as qualifying under the "bona fide inadvertent error" exclusion.

A successful application submitted through the VDP, as provided for in Chapter 16 of the TAA, allows for the regularisation of a default without the liability for late payment penalties or understatement penalties.

If the VDP option is followed, it is important to ensure that a VDP application is valid and complies with the requirements of section 227 of the TAA, namely:

- The applications must be voluntary.
- Involve a default which has not occurred within five years of the disclosure of a similar "default" by the applicant or a person referred to in section 226(3).
- Be full and complete in all material respects.
- Involve a behaviour referred to in column 2 of the understatement penalty percentage table in section 223.
- Not result in a refund due by SARS; and
- Be made in the prescribed form and manner.

It is important in this regard to take note of the **Purveyors case**, which highlighted that in order for a VDP to be considered "voluntary" SARS should not have any prior knowledge of the default.

Ease of application

A revised return can simply be submitted via eFiling. However, in some instances this is not possible; for example, where SARS has previously performed a verification.

Where the eFiling portal does not accept a revised return, a manual request for a revised return will have to be submitted.

In addition to a revised return, a remission request must be submitted for the 10% late payment penalty; however, this application can only be made once the revised return has been successfully submitted. Should the remission request not be successful, an objection and subsequent appeal may be filed and this could extend the timeline. Should understatement penalties be levied, an objection will have to be filed.

The period may be lengthy due to the various submissions that need to be made and the expected turnaround time of each application, factors that do not necessarily run concurrently.

The VDP process also requires the submission of revised returns, however where a vendor is unable to submit the revised return/s via eFiling, the VDP unit may make the necessary adjustments to the VAT account to reflect the liability due in the correct tax period. The VDP unit may request additional supporting information; however, no additional application has to be made to SARS to adjust the VAT account to reflect the default.

The revised return option may involve the submission of multiple applications to different divisions within SARS while a VDP application is a once-off submission to the unit.

What about interest?

The TAA makes provision for interest to be remitted or reduced in certain exceptional circumstances and SARS' discretion in this regard is limited to whether the payment of tax was made late as a result of circumstances beyond the vendor's control. SARS notes, in the VAT404 Guide for Vendors, that circumstances beyond a vendor's control is limited to the following circumstances:

- A natural or human made disaster.
- A civil disturbance or disruption in services; and
- A serious illness or accident.

As part of a penalty remission request, a vendor can include an application for SARS to consider the remission of interest if arguments to support the assertion that the default was caused by circumstances beyond the vendor's control can be advanced.

A request for interest remission, as part of the VDP application, is more complex and has in the past been the subject of litigation between SARS and a VAT vendor. The VDP process involves the determination of a tax debt payable in consequence of a default, which includes interest. In addition, the VDP agreement is an agreement to pay mutually agreed tax debt, which again includes the capital and interest payable in relation to the default. In concluding the VDP agreement, the VDP unit includes the applicable interest, and this agreement would need to be acknowledged and signed by the vendor.

Can a vendor request remission of interest when applying for VDP relief?

The High Court in Medtronic International Trading SARL v CSARS (33400 – 2019((2020) ordered SARS "to consider, adjudicate and decide on the applicant's request for remission of interest in terms of section 39(7)(a) of the VAT Act, dated 12 October 2018, and inform the applicant of its decision within 15 days of the order being granted." The remedy to request interest remission would therefore still be available despite any VDP application.

As can be seen from the above, various factors can impact a VAT vendor's final decision on which remedy to follow when disclosing and correcting a default. The best path to follow may not be as simple as just submitting a revised return. As a result, each case must be considered on its own merits. The correct process will enhance the taxpayer's experience and encourage vendors to come forward voluntarily, thus increasing tax compliance.

Individual taxpayers: Automatic SARS income tax assessments

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Over the years, the South African Revenue Service (SARS) has made steady progress on gathering data from third parties. Medical aids, retirement annuities, public benefit organisations and financial institutions all provide SARS with their income tax data.

In the past, South African data has been pre-populated on income tax returns as well as automatic (auto) income tax assessments issued. We expect that it will not be long before SARS is able to pre-populate foreign sourced information onto the taxpayer's income tax return and/or auto assessment as well – an example of this would be foreign interest, dividends, and capital gains.

Given that SARS already has a vast amount of data from third parties, the revenue authority is able to generate an automatic income tax assessment that is based on the taxpayer's history with SARS as well as the current data that is available to them.

The automation of income tax assessment has reduced the number of personal income tax returns that need to be submitted to, and assessed by, SARS on an annual basis. This has had the effect of streamlining SARS' processes as well as reduced the burden on taxpayers to submit basic income tax returns.

It's important for taxpayers to act when they receive a notification from SARS noting that they have been auto assessed.

Although the taxpayer does not have to "accept" the automated assessment so as to make it final, SARS does expect the taxpayer to review the assessment and make any changes necessary. For example, let's say an individual earns rental income and interest from a local source and SARS has only included the local interest on the auto assessment, it's the taxpayer's responsibility to file their annual income tax return to include the rental income as well.

We expect that for the 2024 income tax year of assessment (1 March 2023 – 29 February 2024) SARS will again be automatically assessing as many taxpayers as possible. It's important for taxpayers to act when they receive a notification from SARS noting that they have been auto assessed. Taxpayers are likely to have until the 2024 tax filing date (still to be determined) to make any corrections to the auto assessment.

Should an auto assessment be issued to a taxpayer after the tax filing date, we expect that they will have 40 days to file a corrected income tax return if the individual disagrees with the auto assessment.

In conclusion, auto assessments will increasingly become a reality that taxpayers will have to contend with, especially taking into consideration the tax revenue authority's push towards digitisation. As such, taxpayers should not only take note of the benefits of SARS' digital evolution, but also check that their assessments accurately reflect their tax affairs.

Foreign employers and their SA employment tax obligations

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Many non-South African tax resident multinational companies, including their South African (SA) branches (i.e., foreign employers), have expatriate employees (assignees) who are seconded to South Africa to render services in the country on international global mobility assignments. In certain cases, foreign employers may also have SA tax resident assignees rendering services to them in foreign countries. Prior to the promulgation of the 2023 Tax Bill, the foreign employer didn't have an obligation to withhold employees' tax Pay-As-You-Earn (PAYE) in South Africa in respect of any SA taxable remuneration it pays or is liable to pay to these assignees in respect of their services rendered in South Africa or the foreign country. However, effective 22 December 2023;

- all non-SA tax resident employers (foreign employer) that conduct business through a permanent establishment (PE) in South Africa; and/or
- all foreign employers who have a representative employer (as defined) in South Africa, now fall into the SA PAYE net.

Accordingly, these foreign employers must deduct PAYE from any SA taxable remuneration paid to any persons, unless the South African Revenue Service (SARS) directs otherwise. These foreign employers are also required to register as an "employer" with SARS for PAYE purposes where it has any employees who have a tax liability in South Africa.

Interestingly, the requirement that the foreign employer must have a PE or representative employer in South Africa, for it to have a PAYE obligation in South Africa, was not extended to the relevant Skills Development Levies (SDL) and Unemployment Insurance Fund (UIF) Acts as expected. This means that the anomaly and non-alignment between the PAYE provisions and the relevant SDL and UIF Acts remain, in that where a foreign employer does not have a PE or representative employer in South Africa, and thus would not have a PAYE withholding obligation in South Africa, it will continue to have an SDL and UIF obligations in South Africa.

The amendment does therefore not achieve alignment between the Income Tax Act and the relevant SDL and UIF Acts.

In addition, despite it not having a PAYE withholding obligation in South Africa, the foreign employer would also still have a PAYE registration obligation in South Africa, as the PAYE registration requirements were also not aligned.

Accordingly, where a foreign employer does not have PAYE withholding obligation in South Africa, the law as it currently stands, continues to place SDL and UIF withholding obligations (and in PAYE registration obligation) on the foreign employer.

It would be a positive development for foreign employers should the National Budget propose the alignment of the provisions of the SDL and UIF Acts that will bring them into the SA employment tax net and their PAYE registration requirements, to the relevant PAYE provisions, so that where a foreign employer does not have a PAYE withholding obligation in South Africa, it should also not have SDL and UIF obligations in South Africa and it should also not have an obligation to register for PAYE.

In the absence of such proposal, foreign employers who pay SA taxable remuneration to any persons should carefully assess their SA employment tax obligations. In addition, the fact that the foreign employer may operate a shadow payroll in South Africa does not automatically eliminate its employment tax obligations in South Africa and/or its employees' provisional tax obligations. Specialist advice should therefore be obtained when setting up a shadow payroll arrangement in SA to ensure that all employment tax risks are adequately addressed or mitigated against.

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