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University of the Witwatersrand

A comparative study on the tax compliance burden and tax incentives for SMMEs in South Africa

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Johannesburg, 2015

ABSTRACT

Small, medium and micro enterprises (SMMEs) play a key role in the development of the economy and are a significant contributor to employment. In South Africa (SA), SMMEs employ more than 68.2% of the work force in the private sector. To achieve the objective of economic growth, job creation as well as income redistribution, the government is actively promoting SMMEs. The SMMEs increase the average employment rate in SA by pulling into production unemployed low skilled labour, whose skills level is not sufficient to qualify for employment in larger firms. How do the South African tax compliance burden and tax incentives for SMMEs measure up in comparison to the tax compliance burden and tax incentives for SMMEs in the United Kingdom (UK) and the United States of America (USA)? The research reviews the tax compliance burden and tax incentives of SMMEs in SA in comparison to the tax compliance burden and tax incentives of the UK and the USA. The research was conducted through an extensive review of the literature. The literature review has indicated that tax compliance is one of the main burdens acting as a deterrent to the formalization of SMMEs for tax purposes. The review of the literature also indicated that National Treasury is trying very hard to ease the burden of tax compliance on SMMEs.

Key words: Income tax, SMMEs, tax compliance costs, tax incentives, turnover tax, value-added tax, venture capital.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Mphagahlele Ndlovu

18 September 2015

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1 INTRODUCTION

1.1 Context of the study

In many developing countries (both poor and middle-income), SMME's business owners complain that tax compliance costs (that is the cost of preparing, handling and submitting required tax forms to the country's tax authorities) add a serious burden to their operations and significantly affect their bottom line. In SA, these complaints are compounded by anecdotal evidence that tax compliance costs also prevent a lot of SMMEs from registering (with the Companies and Intellectual Property Commission, the SARS and other regulatory bodies) and joining the 'formal'[1] economy. (FIAS, 2008: p i.)

The burden of tax payments are a deterrent to the formalization of being a taxpayer. There is strong evidence that the burden of tax compliance (the time and cost associated with preparing tax returns, filing, effecting payment and interacting with the tax authorities) can often be heavier than the amount of the tax payments themselves. (Coolidge, 2012: p 250.)

Taxation ranks high as a source of regulatory costs (time taken to register and comply, bookkeeping costs) for the private sector[2]. Each tax (income tax, employees' tax, Value Added Tax (VAT) imposes administrative burdens on the taxpayer. Many of these tax returns are required to be submitted on a monthly basis which places the added burden on business to employ bookkeepers to keep its records up to date. For many SMME entrepreneurs, their role as the SARS's agent comes at a high price - high administrative costs, the burden of having to hire experts to manage the compliance burden (income tax returns, VAT returns and employees' tax returns), cash flow problems (late payments by debtors). (Hudson, 2003.)

To achieve the objectives of economic growth, employment generation and income redistribution, SA's SMME economy has been actively promoted since 1995 by the government (Berry, von Blottnitz, Cassim, Kesper, Rajaratnam, and van Seventer, 2002: p 1). The SMME sector of the economy increases the employment in the economy as a whole by 'pulling into production' unemployed low skilled labour, whose skill levels are not sufficient to qualify for employment in larger firms (Berry et al., 2002: p 10).

[1] Sector which encompasses all jobs with normal hours and regular wages, and are recognized as income sources on which income taxes must be paid. (Business dictionary)

[2] The part of the economy that is not state controlled, and is run by individuals and companies for profit. (Investopedia dictionary)

The SMME sector is in itself the main key to whether SA will succeed or fail in confronting its employment and poverty challenge (Berry et al., 2002: p 10). It is estimated that SMMEs represent more than 95 percent of formal business enterprises in various countries throughout the world (De Clercq, Tustin & Venter 2006: p 9).

SMMEs play a key role in the development of the economy and are a significant generator of employment in SA. The government simplified financing of SMMEs by the creation of the Small Enterprise Finance Agency in 2012. The government has been progressively working to simplify the tax compliance burden for SMMEs. (National Treasury, 2013: p 12.)

Clark and Thomas (2009: p 22) state that:

> SMEs are recognised as a key source of dynamism, innovation and flexibility in advanced and in emerging and developing economies.
>
> SMEs are important not only in terms of the number of firms, but also in terms of their contribution to creating employment. Indeed, they are recognised as an important source of job creation and account for a large and growing share of employment in OECD countries.

In SA, the importance of small business as a creator of jobs, particularly for those with a low skills level, is widely recognized. It is estimated that SMMEs contribute 36.1 percent of the country's gross domestic product (GDP) and employ 68.2 percent of the workforce in the private sector. In the agricultural, construction and retail sectors, it is estimated that SMMEs employ more than 80 percent of the total workforce in SA. (FIAS, 2007: p 1.)

The research report will use the UK and the USA, in the comparative study with SA. The UK and the USA are the international leaders in tax legislation (Broomberg, 2007: p 112). Another reason for choosing these two countries is mainly based on the availability of the most recent literature in English on tax compliance costs and tax incentives for SMMEs.

1.2 Problem statement

1.2.1 Main problem

How do the South African tax compliance burden and tax incentives for SMMEs measure up in comparison to the tax compliance burden and tax incentives for SMMEs in the UK and the USA?

The aim of the study is to analyse the tax compliance burden and tax incentives of SMMEs in SA in comparison to the tax compliance burden and tax incentives for SMMEs in the UK and the USA.

1.2.2 Sub problems

A number of sub-problems will assist in attempting to answer the main research problem.

The first sub-problem is: What are SMMEs?

The second sub-problem is: What are the South African tax compliance burden and tax incentives for SMMEs?

The third sub-problem is: What are the UK and the USA tax compliance burden and tax incentives for SMMEs?

The fourth sub-problem is: How does South African tax compliance costs and tax incentives for SMMEs compare to that of the UK and the USA?

1.3 Limitations of the research

SMME definitions are not consistent across SA, the UK and the USA. Different definitions are also applied within a country. The benchmark of comparison was not equal across all countries i.e. ZAR versus USD and GBP. Also, an hourly rate is used in the USA to calculate tax compliance cost for SMMEs while the number of hours is used in the UK to calculate the tax compliance cost for SMMEs. Direct comparability is not easy.

1.4 Significance of the study

SA is facing challenges of growth, job creation and poverty reduction. The tax system, being one factor, must be able to support economic growth, encourage entrepreneurship and job creation.

Tax regulations and red tape are reported as one of the constraints to the expansion of businesses both in SA and internationally (Grant Thornton, 2006: p 2). International research in the SMME field shows that tax regulatory compliance costs are a significant portion of the total regulatory cost (costs such as controls on market entries, prices, wages, development approvals, pollution effects, employment for certain people in certain industries, standards of production for certain goods) for SMMEs (Turner, Smith and Gurd 1998: p 95).

1.5 Delimitations of the study

The study will be limited to SA, the UK and the USA. Tax revenue types will be limited to income tax, employees' tax, VAT and turnover tax.

1.6 Research methodology

This research will be performed using a qualitative approach in the form of an extensive literature review.

The extensive literature review includes, but is not limited to, the following sources:

- Books;
- Legislation;
- Journals;
- Electronic resources – internet and websites; and
- Government Publications.

1.7 Chapter outline

The chapters will be arranged as follows:

Chapter 1 is the introduction chapter. It will discuss the context of the study, main problem, sub problems, delimitations of the study, research methodology as well as the chapter outline. This chapter will further look into factors that influence compliance behaviour of businesses across the globe. What tax administrators need to take into account when designing a presumptive (simplified) tax system for SMMEs? It will discuss arguments for and against tax measures favourable for SMMEs. The chapter goes into detail as to what are the key determinants of a simplified tax regime and what can governments do to ease the tax compliance burden of SMMEs.

Chapter 2 will examine the South African Income Tax Act definitions of SMMEs (s 12E (4) of the Income Tax Act 58 of 1962).This chapter will also examine the definitions of SMMEs in the UK as well as the USA (Gale and Brown, 2013b: p 873).

Chapter 3 will discuss the South African tax compliance burden and tax incentives for SMMEs. It will analyse the tax compliance burden of SMMEs in SA as surveyed by different researchers. This chapter will also discuss the initiatives taken by National Treasury to simplify the tax system for SMMEs in order to ease the tax compliance burden for SMMEs. The chapter will also discuss the cost of non-compliance with tax laws by SMMEs which among others will include inability to obtain formal licenses and permits from local and other

governmental agencies, challenges in securing credit from formal sources, while credit under informal sources may be under extortionate conditions and rates, to avoid attracting the attention of the authorities, informal business may need to maintain a low profile that will exclude the use of advertising (Engelschalk, 2007: p 20).

This chapter will discuss three main characteristics of the tax behaviour by owners of SMMEs (perceived opportunity, complexity and knowledge requirements, prospect theory and reactance theory) (Kamleitner, Korunka and Kirchler, 2012: p 334). It will discuss the tax implications of unincorporated businesses in SA. This chapter will also discuss some of the Income Tax Act provisions that are uniformly applied to firms of all sizes which may not be in favour of SMMEs such as the inability to deduct interest expense and limited loss offset rules (s 20 and s 20A of the Income Tax Act 58 of 1962).

Chapter 4 will discuss tax compliance burden and tax incentives for SMMEs in the UK and the USA. This chapter will discuss the impact of taxation regulations on SMMEs in the UK as well as the USA. It will provide a review of literature on the tax compliance costs of tax regulations borne by small businesses. This chapter will also discuss tax incentives offered to small businesses in the UK and the USA.

Chapter 5 will do a comparison of tax compliance burden and tax incentives for SMMEs between SA, the UK and the USA.

Chapter 6 will conclude by summarising the findings of the research, and propose areas requiring further research.

1.8 Key determinants of a simplified tax regime

Russel (2006: p 3) states

> Simplification has the potential of assisting the taxpayers comply voluntarily with more certainty reducing unintentional errors by those who want to comply and are unable to do so due to complexity of the various tax provisions. A complicated tax system for SMME's may discourage taxpayer's willingness to comply as they may not understand the provisions of the law. On the other hand complexity may also create a fertile soil for those intentionally seeking to evade taxation.

Whiting (2010: p 16) acknowledges that we live in a complex world and tax must to a certain extent reflect that complexity in order to be fair to all taxpayers, however the system can be made simpler administratively and technically.

According to Freedman (2003) there are several arguments for tax measures favourable to SMMEs. He suggests that there may be market failures that affect small business, such as

asymmetric information, for example on markets or products, monopoly power of large firms making entry into the market difficult, or difficulties for small firms in raising finance due to the risk associated with small firms. These may be used as a justification for general tax reliefs or for specific schemes to promote investment in small firms. (Freedman, 2003: p 14.)

It may be important to counter the disadvantages of being small by special measures, as in the case of the regressive nature of burdens on business. Compliance cost work has established the regressive nature of tax and other burdens on small businesses and this is widely accepted as being a problem that may legitimately be addressed by reliefs and exemptions and by removing certain reporting and disclosure requirements from small firms as addressed by the International Financial Reporting Standards (IFRS) for SMEs which prescribes less disclosure requirements for SMMEs. (Freedman, 2003: p 14.)

Losses bear more heavily on SMMEs than on other businesses. Tax is paid immediately on taxable profits, but relief for tax losses may have to wait until the business generates sufficient taxable profits to absorb past accumulated losses, which in some cases may take three years. This is also the case in SA. The majority of small businesses in the initial stages of their development make losses, however they have to wait to make profits before they can benefit from tax deductions. (Freedman, 2003: p 14.)

According to the International Finance Corporation (IFC) (Engelschalk, 2007: p 93), some of the key determinants of a simplified tax regime are:

- Literacy rate and education of small business owners: A high level of literacy and education among the SMMEs community facilitates the promotion of recordkeeping rules and decreases the need for overly simplified presumptive tax rules (Engelschalk, 2007: p 93). The government of SA is trying to promote literacy among SMMEs owners and employees by offering free training through agencies such as the Gauteng Enterprise Propeller, an agency of the Department of Economic Development in the Gauteng Province. It was established to provide financial and non-financial services to SMMEs in the Gauteng Province. Its objective is to make sure that it gives assistance that supports the growth and development of SMMEs. The National Youth Development Agency has shifted its core business away from Enterprise Finance towards Education and Skills Development of SMMEs owned by the youth. Other agencies that offer skills development and training for SMMEs are Tourism Enterprise Partnership which offers training at a minimal or no cost at all. Some of the training offered includes business

leadership courses, business skills, legalities and compliance training. It is also strongly recommended that tax education be taught at high schools.

- Availability of reliable data on small business transactions and profit margins: The fairness and acceptance of a simplified system for SMMEs taxation can be substantially increased if the system design can be based on sound analysis of SMMEs profitability and business risks (Engelschalk, 2007: p 93). In SA this information may be obtainable (by special request) from the SARS from the tax returns that are submitted annually, the SARS information will not be entirely correct as some of the SMMEs evade tax. Most of the SMMEs are not in the regulated industries such as financial services where they are required to submit financial statements to the regulating body thereby making it easier to get information about profitability.

- Access to tax consultancy services, either by private tax consultants or small business associations: In many countries, SMMEs do not have access to tax consultancy services, because services are too costly or a tax consultancy has not yet been developed. For the SMMEs segments that have access to tax consultancy services, the application of the standard tax regime is more feasible than for SMMEs that do not have access to tax consultancy services, it is easier to apply the tax laws with assistance of a tax consultant. (Engelschalk, 2007: p 94.) Tax consultancy has developed in SA especially in urban areas, whilst it is still a challenge for rural areas. Generally, business in rural areas remains informal due to the fact that they don't have access to tax consultancy services and in many instances they are too costly.

- Access to information technology: In case that a substantial part of the SMMEs community have access to information technology (IT), IT based solutions can be used to facilitate compliance, such as electronic filing (eFiling) of returns or electronic payment of taxes (Engelschalk, 2007: p 94). The SARS introduced the SARS's eFiling which is a free, online process for the submission of returns and declarations and other related services. This free service allows taxpayers, tax practitioners and businesses to register free of charge and submit returns and declarations; make payments and perform a number of other interactions with the SARS in a secure online environment. Taxpayers registered for eFiling can engage with the SARS online for the submission of returns, declarations and payments in respect of taxes, duties, levies and contributions. The eFiling service is on a par with international standards, being comparable with services offered in the USA, Australia, Singapore, Ireland, Chile and France. (SARS, 2014a.)

- Efficiency and honesty of the tax administration: Small business taxation puts a burden not only on SMME owners, but also on the tax administration. The design of a tax system for SMMEs needs to take into account the capacity of the tax administration to properly administer the system. (Engelschalk, 2007: p 94.)

1.9 Checklist for the design of a simplified tax system for SMMEs

Engelschalk (2007: p 99) notes that the IFC has designed a checklist for the design of a presumptive tax system together with recommendations as follows:

Kind of taxpayers subject to presumptive taxation: should the presumptive tax apply to individuals only, or should certain corporate SMMEs benefit from a presumptive tax regime? Should it apply to certain segments of the SMMEs' community only? Should certain businesses, despite being small, be excluded from the system? (Engelschalk, 2007: p 99.)

Recommendation: Presumptive tax regimes should be limited to small business operations operated by individuals. Incorporated firms could be subject to standard taxation regime if feasible. Also freelance professions should be required to keep simplified returns and to file income tax returns. The presumptive tax system may provide for different rules to calculate the tax liability of the different SMME segments, but all SMMEs apart from incorporated SMMEs and freelancers may be taxed on a presumptive system. (Engelschalk, 2007: p 99.)

In SA over and above a natural person, an incorporated company also qualifies for a presumptive tax system as long as the turnover is below R1 million; however there are exceptions that apply to professional service companies and labour brokers.

System threshold: What is the appropriate threshold for a presumptive tax system? Which criteria should be used to determine the threshold (e.g. turnover, business assets, number of staff, or a combination of several criteria)? Should there be a unique threshold for all businesses taxed under the presumptive system, or should the threshold differentiate between taxpayer groups? Should there be business segments (e.g. catering, road transport), for which no thresholds should apply? (Engelschalk, 2007: p 99.)

In SA the threshold for a presumptive tax system is based on turnover.

Recommendation: There is no ideal system threshold for the application of a presumptive regime that can be applied to all countries. The key design requirement is to avoid an overlap of the presumptive tax regime with the standard VAT. Except for countries operating particularly high VAT registration threshold, the threshold for presumptive taxation should correspond to the VAT registration threshold. Harmonizing both thresholds also requires

using business turnover as the sole criteria to determine the thresholds for the application of the presumptive system. While other criteria, such as the number of employees, sometimes are used as additional system limitations, there is little value added in broadening the set of threshold criteria, and additional criteria risk negatively affecting business decisions (e.g. they work as a disincentive for hiring additional labour). (Engelschalk, 2007: p 99.)

In SA the threshold for the application of the presumptive (simplified) tax regime is R1 million which correspond to the VAT registration threshold. In SA the simplified tax system is the turnover tax with a limit of R1 million which works out perfectly because the vat registration threshold is R1 million.

Criteria to determine tax liability: What should be the principle indicator to determine the tax liability? Many presumptive tax systems are based on business turnover, some use indicators such as the size of business premises, the value of business assets, or number of staff. (Engelschalk, 2007: p 100.)

Recommendation: Using turnover as a tax base better reflects the situation of the individual business, facilitates migration to the standard tax regime, and is a better starting point for introducing basic bookkeeping rules (Engelschalk, 2007: p 100).

The SARS is currently using turnover as a principle indicator to determine the tax liability for small business corporations and micro businesses.

1.10 Recommendations on tax compliance simplification

The decision to operate outside the formal economy can be motivated by many reasons and is not always linked primarily to taxation. The majority of empirical studies on the growth of the informal economy conclude that tax contributions are the key factors discouraging SMMEs to operate in the formal sector. The main reasons for business problems with the tax system are: (i) the large number of business taxes to pay; (ii) lengthy and complex administrative procedures, (iii) complex tax legislation; and (iv) high tax rates. (Engelschalk, 2007: p 10.)

In SA paying taxes, bureaucratic procedures attached to formalization, and government levies are among the main reasons for operating in the informal economy (Engelschalk, 2007: p 10). The informal economy in SA was estimated at 28 percent of GDP in 2002 (Engelschalk, 2007: p 4).

1.9.1 Recommendations for good practice for tax administrators in reducing regulatory and administrative barriers to formalization:

- Avoid retroactive taxation for businesses that formalize. Enterprises will be reluctant to formalize if they fear a large tax bill. (Engelschalk, 2007: p 44.) The SARS requires taxpayers to pay taxes from the date that they were due not from the registration date. Taxpayers may therefore be reluctant to register for tax if they know that they will be charged with interest and penalties for many prior years of non-compliance.

- Simplify tax administration. Tax administration is more often cited as a problem than tax rates. Consider single taxes for SMMEs as a way of reducing the number of payments. Tax administrators may offer different payment options, once off or by instalment. (Engelschalk, 2007: p 44.) All the tax monies must be paid when due, the SARS may in certain circumstances grant deferred payment terms, however the taxpayer will be liable for interest and penalties while still paying for the tax monies in instalments.

- Tax administrators need to share information on what taxes are used for, and how businesses will benefit from enhanced services. Evidence suggests that compliance rates goes up when businesses know what they are getting in return for their payments. (Engelschalk, 2007: p 44.) Through the budget speech the Treasury tell us annually how the tax monies will be used. Less corruption from government officials will assist in encouraging taxpayers to pay their taxes.

1.9.2 VAT

In order to reduce tax compliance costs of SMMEs, tax policy reforms should constantly look at ways to ease the burden of VAT compliance. For SMMEs, VAT is generally considered to be the most burdensome and time consuming tax.

1.9.2.1 Adjusting the VAT threshold

One of the ways of easing the burden of VAT compliance costs is by setting high VAT registration threshold. SA adopted this strategy of setting high VAT registration threshold in 2008, from a turnover threshold of R300 000 to R1 million. The contribution of VAT by SMMEs to total VAT revenue is generally small in many countries. By setting high registration threshold, the administrative costs of collecting the VAT revenues will be lower.

Considering the high compliance costs as well as administrative costs associated with VAT, one may argue that SMMEs should be eliminated completely from registering for VAT,

unless they voluntarily choose to do so (Engelschalk, 2007: p 46). Below are some of the advantages and disadvantages of VAT exemption for SMMEs.

1.9.2.2 Advantages of VAT exemption for SMMEs

Reduction of the VAT compliance burden and the possibility for tax administration to concentrate resources on counteracting high risk evasion of VAT (Engelschalk, 2007: p 46).

1.9.2.3 Disadvantages of VAT exemption for SMMEs

There is no possibility to get VAT refunds on VAT paid on inputs if not registered for VAT, further disadvantages of VAT exemption for SMMEs are: reduced business credibility, some businesses prefer to deal with suppliers with a VAT number, borderline businesses may be encouraged to under report turnover to take advantage of the exemption, distortion of competitive neutrality between registered and non-registered businesses. (Engelschalk, 2007: p 46.)

1.9.2.4 Choosing the optimal registration threshold for VAT

Engelschalk (2007: p 47) notes that the International Monetary Fund (IMF) proposes a formula for adjusting the VAT threshold (Z) to an optimal level (Z*).

$Z^* = {}^{\delta}A+C/({}^{\delta}-1)TV$

Where T is the rate at which VAT is levied and V is VAT per unit of output, so that the tax paid at the threshold level of turnover is TVZ. For every company that is taken out of the net as a result of setting a high registration threshold, the government will lose revenue of TUZ, but will save administration costs of A; every company taken out of the net gains after tax income of TVZ and saves compliance costs of C. Weighting the net loss to government by δ and equating the net loss to government to the gain to the private sector gives the formula for the determination of the optimal threshold. The optimal threshold will however be higher, the higher the administrative costs and the compliance costs are. (Engelschalk, 2007: p 47.)

1.9.2.5 Voluntary VAT registration

In order to avoid the negative traits associated with not registering for VAT, SMMEs below the VAT registration threshold should be permitted to register for VAT. Research has shown that the percentage of SMMEs applying for voluntary registration below the threshold generally remains at manageable levels and do not create additional burden to the tax administration. (Engelschalk, 2007: p 47.)

1.9.2.6 Move to a cash accounting system

Currently SA uses the accrual/invoice basis to account and pay VAT with the exception of natural persons with a taxable annual turnover of under R2 500 000. Many SMMEs face cash flow problems especially in SA where the government is the biggest client for SMMEs. SMMEs are forced to pay VAT before they actually receive money from clients. A number of SMMEs in SA relies on government for business and some of the government agencies can take up to a year before paying for services rendered by SMMEs, while in the meantime SMMEs incurs interest and penalties should they not pay VAT on time.

Penalties and interest are an area of tax compliance that causes significant frustrations for small business, when they are imposed, all the more so as this is an area that could be avoided if the SARS as well as taxpayers and tax practitioners were more diligent (FIAS, 2007: p viii).

2. INCOME TAX ACT DEFINITIONS OF SMALL BUSINESS CORPORATIONS AND MICRO ENTERPRISES

2.1 Small business corporations as defined in s 12E of the Income Tax Act

Different definitions of small businesses apply to the different taxes available in SA as well as other countries. This study will be focusing on income tax, VAT, turnover tax and employees' tax. The definition of small business tax will therefore be focused on these types of taxes. According to s 12E (4) of the Income Tax Act, a small business corporation is defined as:

Any close corporation or co-operative or any private company as defined in section 1 of the Companies Act, 2008 (Act 71 of 2008), all the shareholders of which are at all times during the year of assessment natural persons, where:

(i) the gross income for the year of assessment does not exceed an amount equal to R20 million: Provided that where the close corporation, co-operative or company during the relevant year of assessment carries on any trade, for purposes of which any asset contemplated in this section is used, for a period which is less than 12 months, that amount shall be reduced to an amount which bears to that amount, the same ratio as the number of months (in the determination of which a part of a month shall be reckoned as a full month), during which that company, co-operative or close corporation carried on that trade bears to 12 months;

(ii) none of the shareholders or members at any time during the year of assessment of the company, close corporation or co-operative holds any shares or has any interest in the equity of any other company as defined in section 1 of the Companies Act, 2008 (Act 71 of 2008), other than: a venture capital company as defined in section 12J of the Companies Act, 2008 (Act 71 of 2008); a company contemplated in paragraph (*a*) of the definition of "listed company"; any portfolio in a collective investment scheme contemplated in paragraph (e) of the definition of "company"; a company contemplated in section 10 (1) (*e*) (i) (aa), (*bb*) or (cc) of the Companies Act, 2008 (Act 71 of 2008); less than 5 percent of the interest in a social or consumer co-operative or a co-operative burial society as defined in section 1 of the Co-operatives Act, 2005 (Act 14 of 2005), or any other similar co-operative if all of the income derived from the trade of that co-operative during any year of assessment is solely derived from its members; any friendly society as defined in section 1 of the Friendly

Societies Act, 1956 (Act 25 of 1956); less than 5 percent of the interest in a primary savings co-operative bank or a primary savings and loans co-operative bank as defined in the Co-operative Banks Act, 2007, (Act 40 of 2007) that may provide, participate in or undertake only the following: in the case of a primary savings co-operative bank, banking services contemplated in section 14 (1) (*a*) to (*d*) of that Act; and in the case of a primary savings and loans co-operative bank, banking services contemplated in section 14 (2) (*a*) or (*b*) of that Act. Any company, close corporation or co-operative if the company, close corporation or co-operative has not during any year of assessment carried on any trade; and has not during any year of assessment owned assets, the total market value of which exceeds R5 000; or

(ii) any company, co-operative or close corporation if the company, co-operative or close corporation has taken the steps contemplated in section 41 (4) of the Companies Act, 2008 (Act 71 of 2008) to liquidate, wind-up or deregister: Provided that this item ceases to apply if the company, co-operative or close corporation has at any stage withdrawn any step so taken or does anything to invalidate any step so taken, with the result that the company, co-operative or close corporation will not be liquidated, wound up or deregistered;

(iii) not more than 20 percent of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company, close corporation or co-operative consists collectively of investment income and income from the rendering of a personal service; and

(iv) such company is not a personal service provider as defined in the Fourth Schedule.

Investment income means any income in the form of dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature; any interest as contemplated in section 24J of the Companies Act, 2008 (Act 71 of 2008) (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (*a*) (ii) (*ff*) of section 12E(4)), any amount contemplated in section 24K of the Companies Act, 2008 (Act 71 of 2008) and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and any proceeds derived from investment or trading in financial instruments, marketable securities or immovable property.

Personal service, in relation to any company, co-operative or close corporation, means any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, consulting, draftsmanship, education, engineering, financial service broking, health, information technology, journalism, law, management, real estate broking, research,

sport, surveying, translation, valuation or veterinary science, if that service is performed personally by any person who holds an interest in that company, co-operative or close corporation; and that company, co-operative or close corporation does not throughout the year of assessment employ three or more full-time employees (other than any employee who is a holder of a share in the company or a member of the co-operative or close corporation or who is a connected person in relation to a holder of a share in the company or a member), who are on a full-time basis engaged in the business of that company, co-operative or close corporation of rendering that service.

It is submitted that by excluding personal service companies from the small business corporation definition, National Treasury is trying to eliminate tax avoidance by an individual who simply creates companies with the sole purpose of reducing their personal taxes and benefiting from the reduced tax rates without making any real difference in the economy by generating more than three jobs. By ensuring that none of the shareholders or members at any time during the year of assessment of the company, close corporation or co-operative holds shares or has any interest in the equity of any other company, other than shares and interests listed in paragraph (ii) above prevents abuse, shareholders will benefit by simply creating more than one company and splitting the turnover between the few companies to ensure that they are still below the R20 million turnover mark but they are precluded from doing so.

2.2 Micro Business as defined in the Sixth Schedule and ss 48, 48A, 48B and 48C of the Income Tax Act

2.2.1 Person that qualifies as a micro business

A person qualifies as a micro business if that person is a natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency); or company, where the qualifying turnover of that person for the year of assessment does not exceed an amount of R1 million.

If a person described above, carries on a business during the relevant year of assessment for a period which is less than 12 months, the amount described above is reduced proportionately taking into account the number of full months that it did not carry on business during that year.

2.2.2 Persons that do not qualify as a micro business

A person does not qualify as a micro business for a year of assessment where:

(i) That person at any time during that year of assessment holds any shares or has any interest in the equity of a company other than a share or interest in listed South African companies, in collective investment schemes, in bodies corporate and share block companies, in venture capital companies, of less than 5 percent in consumer or social co-operatives, of less than 5 percent in co-operative burial societies or primary savings co-operative banks, in friendly societies, in any company that did not trade during the year of assessment, and which did not own assets with a total market value of assets which did not exceed R5 000 during any year of assessment and in any company that has taken steps to liquidate, wind-up or deregister;

(ii) More than 20 percent of that person's total receipts during that year of assessment consists of: where that person is a natural person (or the deceased or insolvent estate of a natural person that was registered micro business at the time of death or insolvency), income from the rendering of a professional service; and where that person is a company, income from the rendering of a professional service;

(iii) At any time during that year of assessment that person is a personal service provider or a labour broker, other than a labour broker in respect of which a certificate of exemption has been issued;

(iv) The total amounts received by that person from the disposal of immovable property used mainly for business purposes; and any other assets of a capital nature used mainly for business purposes, other than any financial instruments, that exceeds R1.5 million over a period of three years comprising the current year of assessment and the immediately preceding two years of assessment, or such shorter period during which that person was a registered micro business;

(v) In the case of a company: its year of assessment ends on a date other than the last day of February; at any time during year of assessment, any of its shareholders is a person other than a natural person (or the deceased or insolvent estate of a natural person); at any time during its year of assessment, any of its shareholders holds any shares or has any interest in the equity of any other company other than a share or interest described in paragraph (iv); provided that the provisions of this item do not apply to the holding of any shares in or interest in the equity of a company, if the company has not during any year of assessment carried on any trade; and owned assets, the total market value of which exceeds R5 000; or has taken the steps to liquidate, wind-up or deregister: provided further that this paragraph ceases to apply if the company has at any stage withdrawn any step so taken or does anything to invalidate any step so taken, with the result that the company will

not be liquidated, wound up or deregistered or it is a public benefit organisation or it is a recreational club;

(vi) In the case of a person that is a partner in a partnership during that year of assessment: any of the partners in that partnership is not a natural person; that person is a partner in more than one partnership at any time during that year of assessment, the qualifying turnover of that partnership for that year of assessment exceeds R1 million per annum.

The definition of micro business takes into account the fact that once the business makes a turnover of R1 million and above it has to register for VAT, their books needs to be in order and they will be able to correctly file other taxes separately.

2.3 Small Business Administration Definition of Small Business in the USA

The Small Business Administration (SBA) was created in 1953 as an independent agency of the federal government in the United States to aid, counsel, assist and protect the interests of small business concerns, to preserve free competitive enterprise and to maintain and strengthen the overall economy.

SBA defines small businesses on the basis of a company's annual net receipts or employment. To qualify for SBA assistance and for contracts reserved for small businesses, companies must have income or employment below the SBA's thresholds. Generally most industries other than manufacturing and mining, the size standard are $7 million in average annual net receipts for the previous three years. For many manufacturing and mining industries, the SBA uses employment for its size standard: in general, businesses can employ no more than 500 employees on average during the past twelve months to be considered small. The SBA adjusts these standard definitions in several cases, depending on industry characteristics.(Gale and Brown, 2013b: p 873.)

2.4 Small Business Administration Definition of Small Business in the UK

The UK government does not have a single definition of what a small or medium enterprise is. For the purpose of Research and Development Tax Relief, HM Revenue and Customs (HMRC) define a SME as a business with not more than 500 employees and an annual turnover not exceeding £100 million. The rest of the UK government does not however use

this definition. For the purposes of collecting statistics the Department for Business defines SMEs as companies with less than 250 employees. For accounting purposes Companies House defines a small business as employing less than 50 people and a turnover under £6.5 million and a medium business as less than 250 employees and a turnover under £25.9 million. So depending on which definition you use a SME could have maximum of anywhere between 50 and 500 employees and have a maximum turnover between £6.5 million and £50 million. (The Company Warehouse, 2012)

3 TAX COMPLIANCE COSTS OF SMMEs IN SA

Generally, compliance costs include among others, monetary, time and psychological costs as follows: Fees paid to tax advisors, lawyers and accountants, salary of staff working on preparation of tax returns and tax accounting (accounting for tax in financial records), tax literature and software, phone calls and postage, time spent by taxpayer on studying tax laws and filing tax returns, time spent to prepare and support tax audit, time spent to prepare tax appeals, stress and anxiety arising from complying with specific tax or from a tax related activity, frustration as a result of taxpayer harassment. (Engelschalk, 2007: p 11.)

3.1 Tax compliance burden of SMMEs

Small businesses worldwide have the potential to grow the economy, generate jobs and reduce poverty. Research, however, indicates that they face many challenges, including relatively high tax compliance costs as a percentage of turnover. This is mainly due to the fixed costs associated with systems necessary to comply with the requirements of the tax system, the frequency for submitting certain returns such as provisional tax, income tax and employees' tax are the same regardless of the size of the business. (SARS, 2011/12: p 5.)

Small businesses (including sole proprietors, partnerships and corporations) need enabling regulatory environment, which are developed by taking into account the needs of SMMEs and facilitating their integration into the formal sector. This will require a tax system with low compliance costs (Engelschalk, 2007: p 43).

As noted in the Grant Thornton's 2006 International Business Owners Survey, regulations and red tape are reported as one of the constraints to the expansion of businesses worldwide (Grant Thornton 2006).

According to independent research commissioned by the SARS and the National Treasury in 2007, tax practitioners charge their small business clients an average of R7 030 a year for making sure that tax returns for income tax, provisional tax, VAT and payroll tax are prepared, completed and submitted (SARS, 2011/12: p 5).

By their very nature, tax compliance costs are regressive in nature. According to the tax guide for micro businesses issued by the SARS, compliance costs ranges between 2.2 percent of turnover for businesses with a turnover of up to R300 000 per annum and 0.1 percent of turnover for businesses with a turnover of around R14 million per annum (R14 million is the old small business corporation turnover amount, from 2014 the amount is R20 million) (SARS, 2011/12: p 5).

The SARS and the National Treasury agreed to explore various options to reduce the tax compliance burden for SMMEs. It was for this reason that in 2009, an optional simplified tax system was introduced for businesses with a qualifying turnover not exceeding R1 million per annum. (SARS, 2011/12: p 5.)

According to Venter and de Clercq the tax compliance burden of SMMEs varies according to the size of the business. The size of the organisation also has an impact on whether or not the taxation function of the business is outsourced or is performed internally. Bigger organisations hire accountants and tax specialists and are able to carry out the tax functions internally. The SMMEs however, do outsource the tax function due to a lack of capacity as well as funds; it is cheaper for a SMME to outsource compared to hiring a full time accountant who comes at high price. (Venter and de Clercq, 2007: p 144.)

Clark and Thomas (2009: pp 93-94) state that:

> The costs of complying with an income tax system, VAT, and other taxes may involve a significant fixed cost component, invariant or largely invariant to firm size, as measured by turnover or assets. This means a relatively high tax compliance burden measured as a percentage of turnover or profit for SME compared with large firms. The smaller the firm measured using turnover, total assets or employment, the higher the compliance burden of a given compliance cost. In certain cases, high compliance costs may discourage SME creation and growth, depending on compliance costs encountered at different firm sizes, which in turn depends on the various taxes and corresponding thresholds in place.
>
> One could argue that a relatively high compliance cost on SME results in a misallocation of resources, with under-investment in SME relative to a case where compliance costs varied proportionately with firm size (recognising that the absence of compliance costs is not possible, given the need for taxes and the advantages of having SME pay them), and that this misallocation could be possibly addressed by retaining existing tax incentives for SME if consideration is being given to removing those incentives, or possibly introducing new tax incentives to compensate for relatively high SME tax compliance costs.

The survey of tax practitioners was carried out by the Foreign Investment Advisory Service of the World Bank Group, with contribution from the Public Sector Governance Group of the Poverty Reduction and Economic Management Network of the World Bank Group and co-financing from the Government of Switzerland. It was performed with the assistance of the University of Pretoria and local survey company BLUEtub Design and Production, and with the cooperation of the SA Institute of Chartered Accountants (SAICA), the SA Institute of Professional Accountants (SAIPA), and the SA Institute of Certified Bookkeepers (SAICB). When Smulders, Stiglingh, Franzsen and Fletcher (2012) analysed the survey of tax practitioners, the following were their findings:

- VAT is the most time consuming tax for small businesses. The number of hours required to comply with tax legislation increased as the size of the business increased; the hours

are regressive if taken as a percentage of turnover (Smulders, Stiglingh, Franzsen and Fletcher, 2012: p 193.)

- It took small businesses an average of 251.95 hours per annum to deal with VAT, income tax and employee's tax compliance related matters. For the businesses that are on the turnover tax system, it took them a total of 155.2 hours (which consists of 67.3 hours to comply with the turnover tax system and 87.9 hours to comply with employees' tax as the turnover tax system does not replace employees' tax). (Smulders et al., 2012: p 215.)
- The total time spent by a micro-business registered on the turnover tax system on complying with tax is less than two thirds of the time (61 percent) taken by a normal business (business not registered on the turnover tax system) with a turnover of less than R1million.The turnover tax regime is meeting one of its intended objectives, reducing tax compliance costs for micro businesses by reducing the number of hours required for tax compliance activities. (Smulders et al., 2012: p 193.)
- With reference to the Table 1 below (showing hours), recording information needed for VAT is the tax compliance activity that is the most time-consuming for small businesses. Employees' Tax was the tax that took the most time to calculate, submit and pay the tax due, this is because employees' tax returns are submitted to the SARS on a monthly basis. The number of hours spent dealing with the SARS and learning about tax was also the highest for Employees' Tax, which was then possibly due to the changes to this tax brought about by the SARS. Tax planning and dealing with the tax advisor for SMMEs is the highest in respect of income tax. (Smulders et al., 2012: p 194.)
- The total time spent in hours for recording information, calculating tax, filing returns and paying tax is 78.55 for VAT compared to 42.72 for income tax and 53.81 for employees' tax. The time is higher for VAT due to the fact that VAT returns for SMMEs are normally submitted every two months which is equivalent to six returns annually while income tax returns are submitted three times a year (one income tax return per year and two provisional returns per year), the information about income and expenses is initially recorded when preparing VAT returns and when the time comes to prepare income tax return some of the information has already been recorded while preparing VAT returns which then cuts the time required to record information for income tax by more than half compared to that required for VAT. The time taken to calculate, file and pay tax was the highest for employee's tax due to the fact that taxpayers are required to submit returns monthly and over and above the monthly returns they are required to submit employee's tax reconciliations twice a year. (Smulders et al., 2012: p 194.)

Table 1: Number of hours spent by SMMEs on tax compliance

Activity	VAT	Income tax	Employees' tax
Recording information	64.78	31.4	35.31
Calculating tax, filing return and paying tax	13.77	11.32	18.50
Dealing with the SARS	6.5	6.2	10.62
Tax planning	2.73	5.0	4.66
Dealing with tax advisors	5.14	8.2	5.48
Learning about tax	6.00	7.6	8.61
Other activities	0.00	0.00	0.00
Total time spent	98.92	69.85	83.18

Source: (Smulders et al., 2012: p 194)

In the survey conducted by the International Finance Corporation, the Multilateral Investment Guarantee Agency and the World Bank, tax practitioners were asked what tax they thought would be the most burdensome to comply with for taxpayers with a turnover under R14 million (R14 million was the turnover threshold for small business corporations in 2007). The results show that provisional tax is regarded by tax practitioners, who deal with small businesses, to be the most burdensome tax. (FIAS, 2007: p vii.) In SA particularly, one of the reasons that cause provisional tax to be the most burdensome is because some small businesses relies on government for business through the preferential procurement system and research has also shown that they don't always pay on time. So the taxpayer is faced with a situation where they need to pay the provisional tax before they receive the money from their clients, so they have to pay from their pockets.

In a study conducted in SA, by the Strategic Business Partnerships (SBP) for business growth in Africa report on 'Counting the Cost of Red Tape', VAT was regarded as being the single most troublesome and time-consuming regulation for all businesses except the largest (SBP 2005: p 34). Tax practitioners regarded VAT as the most time-consuming tax (FIAS, 2007: p 54).

Table 2: Summary of certain compliance costs incurred by a small business – including compliance costs expressed as a percentage of turnover (based on highest turnover in each turnover bracket)

	TURNOVER			
SERVICE RENDERED	**R1- R300 000**	**R300 001- R1 million**	**R1 000 001- R6 million**	**R6 000 001- R14 million**
Once-off burdens				
Registration	R 1 414	R 1 488	R 1 568	R 1 629
Objection- interest & penalties	R 892	R 944	R 1 031	R 1 093
Audit/inspections	R 3 084	R 3 164	R 3 297	R 3 483
Written queries	R 1 208	R 1 262	R 1 370	R 1 449
	R 6 598	**R 6 858**	**R 7 266**	**R 7 654**
Recurring burdens				
Prepare tax returns	R 6 604	R 6 959	R 7 372	R 7 118
Prepare IRP5 reconciliation	R 539	R 580	R 645	R 600
	R 7 143	**R 7 540**	**R 8 017**	**R 7 717**
TOTAL TAX COST	**R 13 740**	**R 14 397**	**R 15 283**	**R 15 372**
percent of turnover- total tax cost over max turnover	4.6%	1.4%	0.3%	0.1%

Source: (FIAS, 2007: p 40)

Table 2 above shows that tax compliance costs are regressive in nature, the higher the turnover the lower the tax compliance cost as a percentage of turnover (FIAS, 2007: p 40). For SMMEs with turnover of R300 000, their total estimated tax cost is R13 740 which is equivalent to 4.6 percent of turnover, compared to a SMMEs with a turnover of R14 million with a total tax cost of R15 372 which is equivalent to 0.1 percent, a substantial difference. Even though the total tax cost is increasing with increases in turnover, when looking at the total cost as a percentage of turnover, it is regressive. (FIAS, 2007: p 40.)

Tax compliance is not always a bad thing; it does have some benefits (Sandford, Godwin and Hardwick, 1989: p 13). Research has shown that it can results in benefits such as cash-flow benefits arising from the use of tax revenues for a period before they must be paid over to the SARS as is the case for VAT and employees' tax (Rametse, 2010: p 4).

Managerial benefits may arise in the form of better record-keeping, the use of technology (Rametse, 2010: p 1), and improved knowledge of the financial affairs of the business and

improved business or managerial decision-making due to a requirement in terms of tax legislation to maintain records (Liegnier, 2008).

3.2 Advantages and disadvantages of non-compliance with tax laws by SMMEs

In order to avoid the high tax compliance costs, some SMMEs may opt to trade informally (not register with SARS and Companies and Intellectual Commission) so that they don't have to comply with tax laws and regulations. There are however costs as well as benefits associated with informal trading, both to SMMEs, Government and the public. Some of the advantages of informal trading for SMMEs are the comparative advantage due to the possibility of offering products at lower prices, less harassment from tax officers and the avoidance of high compliance costs. For tax administrators some of the advantages of non-compliance by SMMEs are lower administration costs and the possibility of allocating scarce resources to administering high potential clients. (Engelschalk, 2007: p 20.)

Disadvantages of non-compliance for SMMEs are inability to obtain formal licenses and permits from local and other governmental agencies, challenges in securing credit from formal sources, to avoid attracting the attention of the authorities, informal business may need to maintain a low profile that will exclude the use of advertising. This will negatively affect growth for the business and suppress employment opportunities, informal trading will attract rent seeking by officials (bribes) to turn a blind eye to informality, inability to trade with the formal sector that may only buy from registered VAT vendors, inability to claim and offset withheld tax, possibly leading to over taxation in some cases and higher tax burden on compliant businesses. (Engelschalk, 2007: p 20.)

In SA the cost of non-compliance comes in many ways. To be able to get business from government you need to be registered for tax and before you can be awarded a contract your tax matters needs to be up to date. Some government agencies go as far as requesting a tax clearance certificate every time they have to make a payment above certain thresholds. For those SMMEs whose tax matters are not up to date they may have to pay bribes in order to get contracts or payments from government.

Disadvantages of non-compliance with tax laws by the SMMEs to government are incorrect revenue estimation of revenue potential for the SMMEs sector, loss of tax revenue due to tax evasion, violation of tax equity, risk of erosion of general compliance attitude, non-compliance with the tax system risks being associated with non-compliance with other laws (Engelschalk, 2007: p 20).

Disadvantages of non-compliance by the SMMEs to the public are less tax revenues available for public service (Engelschalk, 2007: p 20).

According to Engelschalk (2007:6) factors influencing compliance behaviour of businesses can be categorised into a business profile (structure- sole trader, partnership, company, trust; size and age of business; type of activity carried out; business focus- local or international;), industry (size of the industry, major participants in the industry, profit margins, cost structures, industry regulation, working patterns, infrastructure issues, level of competition), sociological (cultural norms, ethnic background, attitude to government, age and gender, education level), economic (investment, interest rates, tax system, government policies, international influence, inflation, markets) and psychological (greed, risk, fear, trust, values, fairness/equity, opportunity to evade) factors. (Engelschalk, 2007: p 6)

Engelschalk (2007: p 4) states that:

> According to Engelschalk Analysis on a regional basis indicates that the level of activities of the underground economy (black market) is substantially higher in developing countries compared to developed countries. To make an estimate of the level of tax compliance, a comparison can be made between the number of tax registered businesses with estimates of the level of business activities in a given country. Research has shown a correlation between the stability of small businesses and tax compliance attitudes. The higher the percentage of small businesses with fixed business premises and with multiple years of operation, the higher will be the compliance with tax regulations.

In a survey of South African tax practitioners carried out by the Foreign Investment Advisory Service of the World Bank Group, with contribution from the Public Sector Governance Group of the Poverty Reduction and Economic Management Network of the World Bank Group and co-financing from the Government of Switzerland which was performed with the assistance of the University of Pretoria and local survey company BLUEtub Design and Production, and with the cooperation of the SA Institute of Chartered Accountants (SAICA), the SA Institute of Professional Accountants (SAIPA),and the SA Institute of Certified Bookkeepers (SAICB). According to the estimates of tax practitioners surveyed, over 60 percent of businesses with a turnover of R300 000 and less decide to stay informal rather than formalize their business operations, when this research was done businesses were required to register for VAT when their turnover was R300 000, this may change now that businesses are required to register for VAT when their turnover is over R1million. To assist in reducing this percentage, it is recommended that the SARS make the tax compliance process, starting with registration, simple and quick. The SARS should intensify its educational campaigns by offering assistance to newly formed small businesses by means

of training. Consideration should be given to expanding the tax content included in the syllabuses currently taught at high school level. Regular training sessions (offered at a nominal fee) for small businesses or aspirant small businesses can assist in reducing the lack of knowledge/understanding of the tax compliance requirements by small business owners. (FIAS, 2007: p xi.)

SMMEs in the service sector reported a lower likelihood to register for tax (62 percent) than those in trade (66 percent) or agriculture, manufacturing and construction sectors (78 percent). (Coolidge, 2012: p 271.)

SMMEs with more employees were more likely to express a likelihood to register (75 percent for those with six or more employees) than sole proprietors with no employees (61 percent). SMMEs who kept complete financial records on paper or computer were more likely to report an intention to register for tax (75 percent) than those not keeping such records (63 percent).(Coolidge, 2012: p 271.)

Coolidge again noted that those who rented separate premises for their business reported a much higher likelihood of registering for tax (74 percent) than others, perhaps because they were aware that their tax payments would be reported by their landlords. Those who were within 30 minutes of the SARS office reported a higher likelihood to register (75 percent) than those farther away (67 percent) and much higher than those who said they did not know where the nearest SARS office was located (57 percent).(Coolidge, 2012: p 272.)

SMMEs who agreed that Government gives a good return on taxes paid in the form of government services reported a much higher likelihood of registration (80 percent) than those who disagreed (57 percent). The effect of the fear of getting caught was relatively less among the SMMEs who believed that more than 10 percent of non-registered businesses were caught by the SARS last year for tax. Those who believed that keeping books was relatively easy, or that tax compliance was relatively easy reported a higher likelihood of registering. (Coolidge, 2012: p 272.)

3.3 Tax incentives for SMMEs in SA

Economic theory prescribes that well-designed tax and spending programs, in the absence of externalities or public goods should be neutral among types of investments and forms of business organization, leaving a free market to allocate resources efficiently between small and large business. SMMEs may face special barriers to entry or to firm expansion and it is

acknowledged that the SMME sector is a principal engine of jobs, growth, and innovation which may justify a preferential treatment for the small business sector. (Gale and Brown, 2013b: p 871.)

There are several arguments for tax measures favourable to SMMEs. There may be market failures that affect small firms, such as asymmetric information, for example on markets or products, monopoly power of large firms making entry into the market difficult, or difficulties for small firms in raising finance. These may be used as a justification for general tax reliefs for SMMEs. It may be important to counter the disadvantages of being small by special measures, as in the case of the regressive nature of tax compliance burden on business. (Freedman, 2003: p 14)

Compliance cost work in various countries has established the regressive (total tax cost as a percentage of turnover declines as the business grows) nature of tax compliance cost for SMMEs and this is widely accepted as being a problem that may legitimately be addressed by tax reliefs and tax exemptions. Losses bear more heavily on SMMEs than on any other businesses. Tax is paid immediately on taxable profits, but relief for tax losses may have to wait until the business generates sufficient taxable profits to absorb past accumulated losses. (Freedman, 2003: p 14)

3.3.1 Reduced tax rates

Clark and Thomas (2009: p 106) state that:

> Where the cost of new equity finance is relatively high, the cost of funds for SMEs may be reduced by lowering the effective tax rate on business profits, as this tends to increase the amount of after-tax profits available for retention. While a small business tax rate is often singled out as achieving the objective of increasing the after tax profits available for retention, it also holds that tax relief tied to investment (e.g. through accelerated depreciation, or an investment tax credit) increases available after-tax profits, while at the same time making the tax relief conditional on undertaking investment expenditure.

The rate of normal tax on the taxable income of a small business corporation is considerably lower than the rate of normal tax of 28 percent for companies in general. A company pays normal tax at the rate of 28 percent on taxable income, while a small business corporation currently (2013/2014 year of assessment) pays 0 percent of normal tax on the first R67 111 of taxable income, 7 percent of the amount by which taxable income exceeds R67 111 but does not exceed R365 000 plus 21 percent of the amount by which taxable income exceeds R365 000 but does not exceed R550 000 and 28 percent on taxable income that exceeds R550 000. Some SMMEs may, however, try and manipulate their financial reports to ensure that they do not reach the threshold of a taxable income of R550 000. The reduced tax rates for small business corporations will encourage unincorporated small businesses to be

incorporated, a step in the right direction. An unincorporated taxpayer with a taxable income of R550 000 will be liable for tax to a value of R139 457 (R151 537 before rebates) for 2013/2014 year of assessment. An incorporated small business corporation will be liable to pay tax of R59 702, however should the after tax profits be distributed as dividends, the tax may go as high as R142 202.

3.3.2 Small business corporation assets- s 12E (1) and (1A) of the Income Tax Act

3.3.2.1 Assets used directly in a process of manufacture or process of a similar nature (s 12E (1) of the Act)

In terms of s 12E (1) of the Act a small business corporation that carries on a process of manufacture or a process which in the opinion of the Commissioner is of a similar nature, may deduct the full cost (100 percent) of an asset during the year of assessment in which such asset is brought into use for the first time. This deduction is subjected to the following requirements: The asset must be brought into use for the first time by the small business corporation on or after 1 April 2001. The asset must be used directly in the process of manufacturer or a process regarded by the Commissioner as being of similar nature. A cost should have been incurred in acquiring the asset (an asset acquired for no consideration will, as a result, not qualify). The asset must be owned by the small business corporation or the small business corporation should have acquired the asset as a purchaser under an instalment credit agreement as defined in s 1 of the Value-Added Tax Act, 1991.

The asset does not need to be a new asset. An asset which qualifies for a deduction under s 12E (1) of the Act will not qualify for any other allowance available under the Act. As the cost of an asset, used in a process of manufacture (or any other process of a similar nature), is deducted in full in the year in which the asset is brought into use for the first time, such asset will not qualify for a 'scrapping allowance' under s 11(*o*) of the Act. On disposal of the asset thereof, the asset will be subjected to recoupment provisions under s 8 (4)(*a*) of the Act.

3.3.2.2 Other assets-s 12E (1A) of the Act

A small business corporation that makes use of assets other than those used directly in a process of manufacture (or any other process of a similar nature), may elect to claim either:

The amounts allowable in respect of those assets under s 11 (*e*) (the wear and tear allowance) of the Act; or an amount over three years at the following rates: 50 percent in the year of assessment in which the asset is or was brought into use for the first time (first year); 30 percent in the second year; and 20 percent in the third year.

In this regard, the small business corporation may elect to use s 11 (*e*) of the Act if it presents a more favourable allowance than the three year spread under s 12E (1A) (*b*). The election may be done on a per asset basis.

The assets must be acquired by a small business corporation under an agreement formally and finally signed by every party to the agreement on or after 1 April 2005, for the deductions under s 12E (1A) of the Act to be effective. The deduction under s 12E (1A) of the Act is based on the cost of acquisition of the asset and the asset which was acquired for no consideration will, as a result, not qualify for any deduction under s 12E (1A).

3.3.2.3 The cost of an asset – s 12E (2) of the Act

In terms of s 12E (2) of the Act, the cost of an asset is for the purposes of both ss 12E (1) [assets used directly in a process of manufacture or process of a similar nature] and 12E (1A) [other assets] of the Act deemed to be the lesser of: The actual cost to the taxpayer to acquire that asset; the direct acquisition cost that a person would have incurred if the asset had been acquired under an arm's length cash transaction on the date on which the transaction was in fact concluded; or where the asset has been acquired to replace an asset which has been damaged or destroyed, the actual cost less the deferred recoupment which has been excluded from the taxpayers income under s 8 (4)(*e*).

The above cost excludes interest and finance charges, but includes the direct cost of installation or erection of the asset.

3.3.2.4 Cost in moving an asset- s 12E (3) of the Act

In terms of s 12E (3)(*a)* of the Act, the cost of moving an asset which has not been written off in full, must be allowed to be deducted in equal instalments in that year and each succeeding year in which that deduction is allowable on the asset. In terms of s 12E (3)(*b)* of the Act, the cost of moving an asset which has been written off in full, must be allowed in the year in which the expenditure is incurred. This will also include an asset which was written off under s 12E (1) of the Act, that is, an asset used directly in a process of manufacture (or a process of a similar nature).

3.3.2.5 Recoupment

Any amount which is recovered or recouped as a result of the disposal of an asset used by a small business corporation is subjected to recoupment provisions under s 8(4)(*a*) of the Act. The inclusion in the income of the small business corporation in respect of the amount which is recovered or recouped can, however, despite the provisions of s 8(4)(*a*) of the Act, be

deferred under s 8(4)(*e*) of the Act if the taxpayer has made an election that paragraph 65 or 66 of the Eighth Schedule to the Act should apply. The election to defer the recoupment of allowances previously granted can be made only if the proceeds for the disposal of the asset exceed the base cost of the asset and the taxpayer intends acquiring a replacement asset. The amount to be recovered or recouped as well as any capital gain (if any) is spread over the future years of assessment in proportion to the capital allowances to be claimed on the replacement asset. This method of deferring recouped allowances and capital gains is available in respect of assets which are disposed of on or after 22 December 2003.

3.3.3 Turnover tax in SA

The turnover tax system provides for a single tax that does away with the need to account for income tax, capital gains tax (CGT), withholding taxes on dividends and VAT. This turnover tax system is optional and it is therefore important for each entity to review the business when deciding whether to continue or not to continue with accounting for income tax, CGT, withholding taxes on dividends and VAT. Factors to consider when deciding whether to switch to turnover tax or not will include but not be limited to the following: profit margin of the entity, expected tax contributions as well as its tax compliance costs. (SARS, 2011/12: p i.)

An important feature of the turnover tax system is that the tax liability imposed is broadly aligned with the tax liability under the current income tax system, but on a simplified base with reduced compliance requirements, which then assists in reducing the tax compliance burden for micro businesses (SARS, 2011/12: p 6).

Tax rate for micro business under the turnover tax system at the higher end of the turnover range (R750 000 to R1 million) is increased to encourage them, as they grow, to maintain sufficient accounting records to migrate to the normal income tax system. Special consideration was given so as not to encourage micro enterprises to remain trapped in the turnover tax system, but to grow and migrate into the standard tax system. (SARS, 2011/12: p 6.)

3.3.3.1 Taxable turnover per the Sixth Schedule of the Income Tax Act

The taxable turnover of a registered micro business in relation to any year of assessment consists of all the amounts not of a capital nature received by that registered micro business during that year of assessment from carrying on business activities in the Republic.

Included in the taxable turnover of a registered micro business is 50 percent of immovable property mainly used for business purposes, other than trading stock; and 50 percent of any other asset used mainly for business purposes, other than any financial instrument; and in the case of a company, investment income other than dividends and foreign dividends. The following amounts are excluded from the taxable turnover of a registered micro business: in the case of a natural person, investment income; any amount exempt from normal tax in terms of ss 10(1)(*y*), 10(1)(*z*A), 10 (1)(zG), and 10(1)(*z*H) of the Act; any amount received by that registered micro business where that amount accrued to it prior to its registration as a micro business and that amount accrued was subject to tax in terms of this Act; and any amount received by that registered micro business from any person by way of refund in respect of goods or services supplied by that person to that registered micro business.

3.3.3.2 Registration per the Sixth Schedule of the Income Tax Act

A person that meets the requirements to qualify as a micro business may elect to be registered as a micro business-

(i) Before the beginning of a year of assessment or such a later date during that year of assessment as the Commissioner may prescribe by notice in the Gazette; or

(ii) In the case of a person that commenced business activities during a year of assessment, within two months from the date of commencement of business activities.

- A person that elected to be registered must be registered by the Commissioner with effect from the beginning of that year of assessment.

- A person that is deregistered as a micro business may not again be registered as a micro business.

3.3.3.3 Voluntary deregistration per the Sixth Schedule of the Income Tax Act

(i) A registered micro business may elect to be deregistered before the beginning of a year of assessment or such later date during that year of assessment as the Commissioner may prescribed by notice in the gazette.

(ii) A registered micro business that elects to be deregistered under subparagraph (i) of 3.3.3.3 must be deregistered by the Commissioner with effect from the beginning of that year of assessment.

(iii) A registered micro business must not be deregistered in terms of subparagraph (ii) of 3.3.3.3 unless it has been registered as a micro business for a period of at least three years.

3.3.3.4 Compulsory deregistration per the Sixth Schedule of the Income Tax Act

- A registered micro business must notify the Commissioner within 21 days from the date on which:

(i) The qualifying turnover of that registered micro business for a year of assessment exceeds R1 million, or there are reasonable grounds for believing that the qualifying turnover will exceed R1 million.

(ii) That registered micro business is disqualified in terms of paragraph 3.3.3.2 above.

- The Commissioner must deregister a registered micro business with effect from the beginning of the month following the month from which the event that led to deregistration occurred. The Commissioner may direct that a person remains a registered micro business if the commissioner is satisfied that the increase in the qualifying turnover of that person, to an amount greater than R1 million, is of a nominal and temporary nature.

3.3.3.5 Capital gains tax (CGT) and VAT per the Sixth Schedule of the Income Tax Act

A micro business that registers for turnover tax will be exempt from CGT. Micro businesses are not allowed to register for turnover tax if they are registered for VAT. This is because the VAT system requires a high standard of record keeping and thus a micro business that is registered for VAT should be in a position to comply with standard income tax requirements.

A vendor that deregisters from the VAT system is required to pay exit VAT on the lesser of the cost or open market value of the assets held before deregistering. Vendors that deregister from the VAT system in order to register for turnover tax will be allowed to pay the exit VAT over six months. (SARS, 2011/12: p 13.)

Further relief will be granted to that vendor by way of a deduction of up to R100 000 (VAT inclusive) of the value of the assets held by that vendor before turnover tax registration.

3.3.4 New tax incentives applicable to all businesses that encourage employment of youth as envisaged by Employment Tax Incentive Act 26 of 2013

President Jacob Zuma signed the Employment Tax Incentive Act 26 of 2013, making into law an initiative that will complement government's measures (as listed in the Youth Employment Accord) to create jobs for young workers and those in special economic zones. The Act took effect on 1 January 2014. The Act will encourage private employers to employ young workers by providing a tax incentive to employers, with government sharing the costs of such employment for a maximum period of two years under certain conditions. The tax encourage employers to provide jobs to the many matriculates and other school leavers who will be entering the labour market with no experience. (SARS, 2014b: p 1.)

The employment tax incentive will share the costs of employment between the government and the employers for the employed youth. The incentive will function by decreasing the amount of pay-as-you-earn (PAYE) tax (employees' tax) that is payable to the SARS for every qualifying employee that is hired by the employer. There will be no change in the wages that the employee receives but the effective cost of hiring the employee will be lower, making it more attractive for firms to increase youth employment. The tax incentive has the potential to make a real contribution towards the creation of new and additional jobs for the youth. The employment tax incentive will allow many unemployed young people to gain work experience and develop their skills, thereby improving their chances for better employment opportunities in future. (SARS, 2014b: p 1.)

The employment tax incentives are available to all private sector employers in all sectors of the economy who are registered with the SARS for employees' tax. Employers can claim the incentive on a sliding scale for any employee between the ages of 18 and 29 who has been hired on or after 1 October 2013, who possesses a South African ID and is receiving a monthly salary that is above the relevant minimum wage and less than R6 000 per month. If there is no legal minimum wage applicable in a particular sector, the monthly salary must be greater than R2 000. (SARS, 2014b: pp 7-8.)

During the first year the value of the incentive will be 50 per cent of the monthly wage up to a monthly wage of R2 000. For wages between R2 000 and R4 000 the value of the incentive will be R1 000 and for wages between R4 000 and R6 000 the incentive value will decrease linearly from R1 000 to zero. For example, an employer who hires a qualifying employee with

a monthly salary of R3 500 may decrease the amount of employees' tax they need to pay the SARS by R1 000 and for a qualifying employee who earns R5 000 the employer may decrease the amount of employees' tax they need to pay to the SARS by R500. If after taking into account the employees' tax incentive, the PAYE comes to a negative, the PAYE will be limited to zero and the remaining employee tax incentive will be carried over to the next period. The value of the incentive will decrease by half during the second year. An employer may only claim the incentive for a two year period for each qualifying employee. Employers are encouraged to use the incentive to increase employment of youth with limited work experience. (SARS, 2014b: pp 10-12.)

3.3.5 Deductions in respect of expenditure incurred in exchange for issue of venture capital company shares (s 12J of the Income Tax Act)

SMMEs are considered riskier ventures, they are often subjected to higher interest rate charges than larger enterprises. They struggle to get long term finance and do not have access to finance opportunities as large enterprises. The SMMEs high borrowing rate increases the cost of doing business and thus reduces competitiveness. High collateral and deposits requirements for loans from commercial banks prohibit SMMEs from getting finance. (Beyene, 2002: p 144.)

Freedman (2003: p 17) states that:

> Reliefs designed to meet lack of finance for small firms are commonly found in tax systems. To some extent it is arguable that the higher risk of lending to small firms should be reflected in the cost of borrowing in order to allocate resources efficiently and prevent the creation of moral hazard through uncompensated risk shifting, but there may be market imperfections such as lack of information about small firms and excessive caution by conservative lenders, as well as high transaction costs for smaller loans. Here some tax relief might be acceptable, although some deadweight cost is to be expected and some inefficient funding may be supported.

The Minister of Finance has identified one of the main challenges to the economic growth of SMMEs and junior mining exploration as access to equity finance. To assist these sectors in terms of equity finance, government has implemented a tax incentive for investors in such enterprises through a Venture Capital Company 'VCC' regime. The main purpose of the VCC regime is to act as a marketing tool that will attract retail investors. The VCC regime was effective from 1 July 2009, investors (individuals and listed companies) can claim for income tax deductions in respect of the expenditure incurred in exchange for VCC shares. The VCC regime is subject to end on 30 June 2021 after which an assessment will be made of the efficiency of the regime and a decision will be taken on whether or not it will continue. Any taxpayer qualifies to invest in an approved VCC. Investors must ensure that the VCC is

approved by the SARS and must be issued with investor certificates which will provide the SARS with the necessary proof it needs in order to allow the investor the relevant tax deduction. (SARS, 2012.)

3.3.5.1 Tax rules for VCC s 12J of the ACT

Investors who qualify can claim income tax deductions in respect of the expenditure actually incurred to acquire shares in approved VCCs. Where any loan or credit is used to finance the expenditure in acquiring a venture capital share and remains owing at the end of the year of assessment, the deduction is limited to the amount for which the taxpayer is deemed to be at risk. No deduction will be allowed where the taxpayer is a connected person to the VCC at or immediately after the acquisition of any venture capital share in that VCC. On request from the SARS, the investor must verify a claim for a deduction by providing a VCC Investor Certificate that has been issued by an approved VCC, stating the amount of the investment and the year of assessment in which the investment was made. The deduction is recouped if an individual disposes of the VCC shares to the extent of the initial VCC investment (under the general recoupment rules of s 8(4) of the Act)). Standard income tax and CGT rules will apply in respect of VCC shares. (SARS, 2012.)

3.3.5.2 Companies which qualifies to be investee companies in terms of s 12J of the ACT

- The company must be a resident; the company must not be a controlled group company in relation to a group of companies; the company's tax affairs must be in order; the company must be an unlisted company or a junior mining company; a junior mining company may be listed on the Alternative Exchange Division (AltX) of the JSE Limited; during a year of assessment, the sum of the investment income derived by the company must not exceed 20 percent of its gross income for that year of assessment;

- The company must not carry on any of the following impermissible trades: any trade carried on in respect of immoveable property, except trade as a hotel keeper (includes bed and breakfast establishments); financial service activities such as banking, insurance, money-lending and hire-purchase financing; provision of financial or advisory services, including legal, tax advisory, stock broking, management consulting, auditing, or accounting; operating casino's or other gambling related activities including any other games of chance; manufacturing, buying or selling liquor, tobacco products or arms or ammunition; or any trade carried on mainly outside the Republic.

3.3.5.3 A company must meet all of the following preliminary requirements to qualify for an approved VCC status for each year of assessment in terms of s 12J of the ACT:

- The company must be a resident; the sole object of the company must be the management of investments in qualifying companies (i.e. investees); the company's tax affairs must be in order; the company, together with any connected person, must not control any qualifying investee company (i.e. small business or junior mining company) in which it holds shares; the company must be licensed in terms of s 7 of the Financial Advisory and Intermediary Services Act, 2002.

The company must satisfy the following requirements after the expiry of 36 months from the date of the SARS approving the VCC status (SARS, 2012):

- A minimum of 80 percent of the expenditure incurred by the VCC to acquire assets must be for qualifying shares, and each investee company must, immediately after the issuing of the qualifying shares, hold assets with a book value not exceeding: R300 million in any junior mining company; or R20 million in any other qualifying company; or

- No more than 20 percent of the expenditure incurred by the company to acquire qualifying shares held by the company was incurred for qualifying shares issued to the company by any one qualifying company.

3.3.5.4 Withdrawal of VCC status S12J of the ACT

If the approved VCC does not take the acceptable corrective steps to rectify the non-compliance within the period specified in the written notice from the SARS office, the approved VCC status will be withdrawn from: the commencement of that year of assessment, or the date of approval of the VCC status where the VCC does not meet the specific requirements after the expiry of 36 months from the date of approval. Once an approved VCC status has been withdrawn by the SARS office, an amount equal to 125 percent of the aggregate amount contributed by the qualifying investor in exchange for a VCC certificate must be included in the VCC income in the year of assessment in which such approval has been withdrawn.

An approved VCC may voluntarily request for a withdrawal of their approved VCC status. The request for withdrawal must be submitted in writing and must include the following information: The VCC reference number, income tax reference number, reason(s) for the withdrawal.

3.4 Initiatives taken by the SARS to simplify the tax system for SMMEs

The following are some of the initiatives taken by the SARS to simplify the tax system for SMMEs:

- The SARS simplified the registration process by combining the Skills Development Levy (SDL), Unemployment Insurance Fund (UIF) and pay-as-you-earn (employees' tax) registration forms into one form. Employers were not required to register for SDL if the total leviable amount (the leviable amount is not only based on salaries and wages, it is based on remuneration after certain deductions) did not exceed R500 000 (previously R250 000) with effect from 1 August 2005. The VAT registration process was simplified in February 2008. The SARS increased the compulsory VAT registration threshold from R300 000 to R1 million from 1 March 2009. The SARS introduced the small retailers VAT package in April 2005. (Smulders and Naidoo, 2013: p 37.)

- A simplified turnover-based tax system for micro businesses was introduced from 1 March 2009.The SARS increased the compulsory VAT registration threshold from R300 000 to R1m from 1 March 2009. (Smulders and Naidoo, 2013: p 37.)

- The SARS introduced efiling of VAT returns in 2001 and employees' tax returns in 2008. The SARS made available the 'e@syfile' software application to assist employers to simplify the employees' tax reconciliation process. (Smulders and Naidoo, 2013: p 38.)

3.5 Taxation of unincorporated SMMEs

In the case of an unincorporated business (with or without employees) owned by one individual business income is normally subject to personal income tax. Where two or more individuals invest in a business through an unincorporated partnership, generally the same taxes apply, with business profits (and losses) allocated to the business partners to be subject to tax at the individual level. (Clark and Thomas, 2009: p 32.)

Small businesses form the core group of hard-to-tax taxpayers. In many developing countries a larger percentage of small businesses operate in the informal rather than in the formal economy (Engelschalk, 2007: p 3).

Tax compliance costs is one of the main causes for the increase of the shadow economy, some businesses do not formalise themselves as they do not want to pay taxes (Djankov, Lieberman, Mukherjee and Nenova, 2003).

3.6 SMMEs tax behaviour

Due to self-reporting and limited control over underlying money flows SMMEs have the opportunity for non-compliance; due to the need for self-reporting and facing different taxes, they require tax law knowledge in order to understand the rules and comply; and due to receiving gross sums of money some of which needs to be partly passed on to tax

authorities, they face differential opportunities for framing taxes. (Kamleitner, Korunka and Kirchler, 2012: p 334.)

3.6.1 Perceived opportunity

SMMEs have been identified in various studies as a high-risk group in terms of tax compliance because their opportunities to evade are high. Opportunity has often been identified as a major explanatory factor in non-compliance. Opportunities to evade tax exist if incomes are not subject to automated third-party reporting or if taxes are not withheld at source (e.g. in cases of receiving gross incomes or cash payments), (Kamleitner et al., 2012: p 335.)

According to Kamleitner et al. in cases where people do not deliberately capitalise on opportunities, the specific circumstances leading to evasion opportunities might still lead to non-compliance. Opportunities usually come about when tax filings are not entirely automated. Through the lack of automation, tax filing procedures are more likely to become error prone even without intent to capitalise on the entailed opportunities. As a result, opportunities may lead to an increase in intended as well as unintended tax evasion. Overall, actual opportunities can increase both intentional and unintentional evasion. (Kamleitner et al., 2012: p 335.)

3.6.2 Complexity and knowledge requirements

In order to pay appropriate taxes SMMEs must be knowledgeable about the different compliance measures and requirements. Taxation knowledge is considered to be a specific part of the general human potential of entrepreneurs, which increases the chances of business success. The extent of non-compliance arising from knowledge deficits because of the complexity of reporting and returning requirements might be substantial. The need to apply differential taxation rules depending on the amount of income or the characteristics of the taxpayer is an important explanation for non-compliance among SMMEs. (Kamleitner et al., 2012: p 336.)

Tax laws are often too complex to be understood by laymen, some business owners do not have formal qualifications and even those who have formal qualifications it may not necessarily be in tax law. Though small business owner-managers often deal with knowledge deficiencies by requesting the help of tax practitioners, they sometimes handle part of the taxpaying process themselves. (Kamleitner et al., 2012: p 336.)

Although there has been a trend towards simplification of tax laws and, more importantly, tax administration procedures, compliance costs tend to remain high. A sufficient level of

knowledge necessary to ensure procedural compliance is more difficult to reach for small than for large businesses (Gaetan, 2008). Tax practitioners do acknowledge that the complexity of taxation is making compliance especially difficult to achieve for many SMMEs. SMMEs taxpayers are sometimes not even sure about whether they are fully compliant or not. (Kamleitner et al., 2012: p 337.)

3.6.3 Focus on nascent entrepreneurs

Nascent entrepreneurship is commonly used to describe the process of business development, from business conception to the early phase of business development. During these early phases of a business, tax authorities are argued to be successful in influencing knowledge and internal framings and in establishing a climate of mutual trust. (Kamleitner et al., 2012: p 343.)

Nascent entrepreneurs have not yet established certain behavioural and perceptional patterns that will become more difficult to change the longer they persist and early interventions are likely to be received positively. A strategy of responsive regulation that involves support and advice before punishment will be effective in the case of nascent entrepreneurs. First encountering the 'big stick' might backfire and turn involuntary non-compliance into aggressive resistance. An initial experience of support will build up a climate of trust between taxpayers and tax authorities which will increase the willingness and ability to mould perceptions and comply. (Kamleitner et al., 2012: p 343.)

3.7 Basic income tax provisions uniformly applied to firms of all sizes

3.7.1 The inability to deduct interest expense (business start-ups*)*

A basic provision of an income tax is an interest deduction for the cost of debt finance (but not the cost of equity). The interest deduction is most beneficial to firms that are able to secure loans, and also able to claim a current interest deduction. To the extent that large firms are better positioned to secure loans by presenting a lower-risk to creditors, and to the extent that SMMEs tend to be in a loss position during initial years when up-front costs are high relative to revenues, it follows that tax relief from interest deductibility tends to favour primarily large profitable firms. (Clark and Thomas, 2009: p 89.)

In trying to secure a bank loan to finance a given business venture of a given risk, generally small firms would face more difficulty than large firms, to the extent that business assets that small firms can offer as collateral are of lower aggregate value due to smaller firm size, are less tangible (e.g. with the bulk of capital invested early on in product development, leaving limited funds to invest in hard assets such as land, buildings, machinery and equipment),

and are less diversified (i.e. with the bulk of capital invested in one initial product). (Clark and Thomas, 2009: p 89.)

When unable to borrow, benefits of tax deductibility cannot be realized immediately through a current tax deduction. Even where they are able to secure a loan, small firms may generally benefit less to the extent that they are more likely to be loss-making, as they are still in a start-up phase. Business losses cannot be carried forward with interest to compensate for the time value of money (that is, to compensate for a deferred rather than current tax deduction). (Clark and Thomas, 2009: pp 89, 90.)

4. TAX COMPLIANCE BURDEN AND TAX INCENTIVES FOR SMMEs IN THE UK AND THE USA

In the USA, Hopkins' estimate indicate that on average smaller firms with fewer than 20 employees face much higher costs per employee compared to larger firms. The Small Business Administration (1995) reported that smaller firms incur between 63 percent and 67 percent of the total regulatory burden. Using the telephone survey data collected from 360 firms, Hopkins found that 40 percent of small firms did not fully comply with regulations. Findings suggested that the smallest firms had substantially higher regulatory costs compared to larger firms and compliance costs on a per employee basis generally fell as firm size increased. The smallest firm's regulatory costs per employee were 1.86 times higher than those of larger firms, indicating that there were economies of scale in regulatory clerical work. Tax compliance and payroll record keeping were the most burdensome of the regulatory areas, particularly for small firms, which reported that these two areas accounted for 79 percent of their total regulatory burden, nearly twice as much for small firms. (Chittenden, Kauser and Poutziouris, 2003: p 98.)

4.1 Tax incentives for small businesses in the USA

In the United States policies to support small businesses are often justified based on the assumed effects of small businesses on the economy. Most employers are SMMEs and many employees work for small businesses. SMMEs make up more than 99 percent of US firms with employees and account for 49 percent of private sector employment. (Gale and Brown, 2013b: p 876.)

4.1.1 Accelerated depreciation

Normally, when a business purchases a piece of equipment, it must depreciate the cost of the investment over the useful life of the equipment in accordance with Internal Revenue

Code ss 167 and 168 and the Modified Accelerated Cost Recovery System. Immediate expensing is however allowed by s 179; businesses can fully deduct the cost of purchasing equipment in the year that the purchase was made, provided that the equipment (or software) will be actively used in its trade or business. The immediate expensing offered by s 179 raises the net present value of the deductions that can be taken relative to depreciating the investment over time. It effectively increases the profitability of investment, which encourages SMMEs purchases of equipment and software. (Gale and Brown, 2013b: p 879.)

4.1.2 Cash-Basis Accounting

The Internal Revenue Code requires companies to compute their taxable income using the same method by which they maintain their accounting books as long as the method is consistent in how it treats income and deductions across years (Gale et al., 2013a: p 19).
Sole proprietors, partnerships, S corporations, C corporations with gross receipts averaging $5 million or less in the three previous tax years may use the cash method of accounting. The cash-basis method is easier to administer and therefore lowers the compliance burden for SMMEs. (Gale et al., 2013a: p 19.)

4.1.3 Exemption from the corporate alternative minimum tax (AMT)

Gale et al., (2013a: p 20) states that:

> The corporate alternative minimum tax (AMT) was created in 1986 to ensure that profitable corporations pay at least some federal income tax. The AMT applies a lower marginal rate of 20 percent to a base that includes fewer tax preferences in a parallel calculation to the regular corporate tax code; corporations must use the calculation that generates the larger tax liability and most business tax credits cannot be used to reduce corporate AMT tax liability.

The Taxpayer Relief Act of 1997 granted exemption from the corporate AMT based on size. Small corporations are exempt as long as their average annual gross receipts do not exceed $5 million in their first three years. After their first three years, their rolling three-year average of annual gross receipts must not exceed $7.5 million, should the average of $7.5 million be exceeded the corporation becomes ineligible for the AMT exemption, starting in the year it exceeded the limit and continuing thereafter. Small corporations cannot regain AMT exemption once it has lost eligibility, even if its three-year average gross receipts once again drops below the $7.5 million threshold. (Gale et al., 2013a: p 20.)

4.1.4 Amortization of Business Start-Up Costs (IRC s 195)

The American Jobs Creation Act of 2004 created IRC s 195, which allows the deduction of business start-up costs. Business taxpayers that incurred start-up costs after October 22, 2004, are allowed to deduct up to $5 000 in business start-up and organizational costs for

the tax year when the business begins, including those related to the research prior to starting the business. The maximum deduction of $5 000 is reduced (down to $0) by the amount by which start-up costs exceed $50 000, which makes this especially beneficial to SMMEs. Large start-ups, however, must capitalize these costs into the asset price of the business, which can only be recouped when the business is sold. Businesses that incurred these costs on or before October 22, 2004, were allowed to deduct the costs in equal annual amounts over five years. (Gale et al., 2013a: p 21.)

4.1.5 Small business stock exemption

The USA allows taxpayers who are not C corporations to partially exclude a capital gain from selling or exchanging a qualified small business stock, provided it has been held for longer than 5 years. The exemption was 50 percent prior to 2009 and rose to 60 percent in empowerment zones. The small business stock exemption aims to facilitate the acquisition of capital stock for sale by small C corporations – those with gross assets less than $50 million. (Gale et al., 2013a: p 21.)

4.2 Tax compliance burden for small businesses in the USA

The role of compliance and evasion among SMMEs are relevant to understanding the impact of federal taxes on the SMMEs sector. The burden of complying with the tax system is significant. The IRS estimates that owners of SMMEs (with less than $10 million in assets) spent between 1.7 and 1.8 million hours and around $15 billion in out-of-pocket expenses in preparing and filing tax returns in 2002 (DeLuca, Guyton, Lee, O'Hare and Stilmar, 2007). Using estimates from Toder (2007) that value small business owners' time at $45.40 per hour, the estimates above imply a total compliance burden of about $100 billion per year. (Gale and Brown, 2013b: p 881.)

The tax compliance cost is larger relative to business size for small businesses than large ones. DeLuca et al (2007), using an estimate of small business owners' time of $25 per hour, estimate that compliance costs fall from around 150 percent of gross receipts for firms with gross receipts lower than $10 000, to around 10 percent for those between $50,000 and $100,000, and fall to 0.3 percent for firms with receipts over $1 million. (Gale and Brown, 2013b: p 881.)

Small businesses account for a large share of tax evasion in the United States. According to the 2001 data provided by the Internal Revenue Service, business income accounted for about 55 percent of all underreporting of income in the income tax. About 43 percent of all business income that should have been reported on the income tax form was not reported.

This figure is a weighted average figure of the underreporting rate for nonfarm proprietor income (57 percent), farm income (72 percent), rents and royalties (51 percent) and Partnerships, S Corporations and Trusts (18 percent). Individuals earning income from businesses have a higher chance of underreporting income since their earnings have fewer third parties reporting. (Gale and Brown, 2013b: p 881.)

4.3 Tax incentives for small businesses in the UK

In the March 2001 UK budget statement, Gordon Brown (Chancellor of the Exchequer 1997-2007) announced a package of changes to VAT to assist small businesses, especially those entering the VAT system for the first time. These measures, introduced in April 2002, are intended to reduce VAT red tape and improve small business cash flows. (Chittenden, Kauser and Poutziouris, 2003: p 102.)

The package:

- Increased the turnover limit for cash accounting to £600 000 in 2001, thus allowing approximately 40 000 additional businesses to pay VAT based on the cash they receive and pay. The result of this initiative will be to improve business cash flows especially where customers take a long time to pay their bills. (Chittenden et al., 2003: p 102.) In 2015 the turnover limit for cash accounting was increased to £1.35m. (HMRC, 2015a.)

- Reduced red tape for more than 100 000 firms by allowing businesses to calculate their VAT payments once per year (known as the annual accounting scheme) (Chittenden et al., 2003: p 103). Usually, VAT registered businesses submit their VAT returns and payments to HM Revenue and Customs (HMRC) four times a year in the UK. With the annual accounting scheme taxpayers make advance VAT payments towards their VAT bill based on their last return (or estimated if new to VAT) and submit one VAT return a year. When taxpayer submit their VAT return they either make a final payment which is the difference between their advance payments and actual VAT bill or apply for a refund if they have overpaid their VAT bill. The scheme wouldn't suit businesses that regularly reclaim VAT because the taxpayer can only be able to get one refund a year when the return is submitted (HMRC, 2015b.)

- The package introduced a new lower SME turnover limit of £100 000. Business below this limit will be able to calculate their VAT payments as a percentage of turnover without having to record VAT on every purchase and sale. The scheme could enable large numbers of small firms with turnover of less than £100 000 to grow without the owners having to incur the full cost of compliance with VAT regulations. (Chittenden et al., 2003:

p 103.) In 2015 the turnover limit is £150 000. Using standard VAT accounting, the VAT the business pay to HMRC (or claim back) is the difference between the VAT the business charge and the VAT they pay. Using the flat rate scheme the taxpayer pay VAT as a fixed percentage of their VAT inclusive turnover. The actual percentage that is used depends on the type of business. The flat rate scheme can save time and smooth cash flow. The taxpayer doesn't have to record the VAT that they charge on every sale and purchase meaning they spend less time on their accounts, and more time on their business. The taxpayer no longer has to work out what VAT on purchases can and can't be reclaimed. With less chance of mistakes, there will also be fewer worries about getting VAT right. Potential disadvantages of using a flat rate scheme are among others: The flat rate percentages are calculated in a way that takes into account zero-rated and exempt sales. They also contain an allowance for the VAT you spend on your purchases. So the VAT flat rate scheme might not be right for your business if: you buy mostly standard-rated items, as you cannot generally reclaim any VAT on your purchases, you regularly receive a VAT repayment under standard VAT accounting and you make a lot of zero-rated or exempt sales. (HMRC, 2015c.)

In the 1999 UK budget it was announced that where business collect PAYE of less than £1 000 per month (previously £600) from their employees, they will be able to make these payments to the Inland Revenue once each quarter instead of monthly. According government estimates, this will cut PAYE compliance costs of smaller business (those with employees of less than 10), by estimated 15 percent, a great initiative to assist small businesses in reducing tax compliance costs. (Chittenden et al., 2003: p 103.)

In the UK a great emphasis has been placed on direct investment of public funds in equity funds. The British interventions include tax relief to investors through the enterprise investment scheme which is designed to help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies, tax incentives for corporate venturing, establishment of Venture Capital Trusts as vehicles through which to invest in smaller trading companies, supplementing private finance with public finance in the Regional Venture Capital Funds and encouraging technology investment through the UK High Technology Fund. (Falkena, Abedian, von Blottnitz, Coovadia, Davel, Madungandaba et al., 2002: p 8.)

4.4 Tax compliance burden of small businesses in the UK

In the UK the burden of red tape falls most heavily on the smallest businesses. Taxation is the area of red tape that has caused most work for small businesses. On average small businesses with one or two employees spend 5.1 more hours per person per month dealing with government regulations compared to firms that employ more than 50 employees, a big difference. (Chittenden et al., 2003: p 104.)

In the UK, income tax imposes a lower compliance burden than VAT and PAYE. At the time these studies were conducted, income tax was, for most businesses, assessed and paid annually. In contrast, VAT and PAYE are continuously recorded and generally paid over to the Revenue authorities either monthly or quarterly. (Chittenden et al., 2003: p 101.)

The UK pointed out that the current tax regime and the VAT registration threshold in particular, act to restrain the growth and development of small business. The Small Business Research Trust (1998) found that overall, 15.3 percent of VAT registered firms have expressed the view that the registration threshold is a significant problem for them, and 18 percent of non registered business state that they intentionally forego growth opportunities for their business so that their turnover can remain below the VAT registration threshold. (Chittenden et al., 2003: p 102.)

Taxation is a major compliance cost for SMMEs; in the UK the area of red tape that has caused the greatest concern for small business is taxation (Small Business Research Trust, 2000). The Small Business Research Trust indicated that over 60 percent of business with 1 to 4 employees suggested that they spent most of their time dealing with taxation issues compared with less than 10 percent of small businesses who felt that other regulations such as employment, environmental and health and safety were more burdensome. (Chittenden et al., 2003: p 104.)

In the UK, business taxpayers were grouped in terms of their annual turnover involving three categories: small (up to £100 0000), medium (between £100 000 and £1m) and large (over £1m). On average for every £1 000 of sales for companies with a turnover below £100 000 the average tax compliance cost is £33.6 compared to £1.7 for companies with a turnover over £1m. (Chittenden et al., 2003: p 101.)

5. A comparison of tax compliance burden and tax incentives for SMMEs between that of SA, the UK and the USA

In the UK businesses that collect PAYE of less than £1 000 per month are able to make these payments once per quarter while in SA PAYE is paid monthly regardless of the PAYE amount. In the US SMMEs pay payroll taxes on a monthly or semi weekly basis (IRS, 2015a).

The USA allows SMMEs to fully deduct the cost of purchasing the asset in the year of purchase as long as the asset will be used in its trade or business. In SA, assets acquired by a small business corporation that carries on a process of manufacture may deduct the full cost of an asset during the year of assessment in which such asset is brought into use. A small business corporation that makes use of assets other than those used directly in a process of manufacture (or any other process of a similar nature), may elect to claim either: The amounts allowable in respect of those assets under s 11 (*e*) (the wear and tear allowance) of the Act; or an amount over three years at the following rates: 50 percent in the year of assessment in which the asset is or was brought into use for the first time (first year); 30 percent in the second year; and 20 percent in the third year.

In the UK businesses with a turnover of up to £1.35 million can pay VAT based on the cash they receive or pay, the UK also allows qualifying SMMEs to calculate their VAT payments once a year. In SA, the invoice basis is used to compute VAT for incorporated SMMEs, unincorporated SMMEs can make an application to the SARS to account for VAT using the payment basis provided taxable supplies in the period of 12 months ending at the end of any period does not exceed R2.5 million.

In the UK businesses with a turnover below £100 000 are able to calculate their VAT payments as a proportion of turnover without having to record VAT on every purchase and sale. In SA, businesses with a turnover of less than R1m qualify to be on the turnover tax system where tax is calculated using the turnover.

Due to the difficulty experienced by SMMEs in raising funding, the USA allows taxpayers who are not SMMEs to exclude a capital gain from selling or exchanging a qualified small business stock, provided it was held for longer than five years, this incentive encourage big corporations to invest for a long term in SMMMEs. In SA, qualifying investors are able to claim income tax deductions in respect of the expenditure actually incurred to acquire shares in approved venture capital companies.

The UK has gone much further than SA in stimulating the provision of venture capital for SMMEs. In addition to various tax incentive schemes, a great emphasis has been placed on direct investment of public funds in equity funds. The British interventions include tax relief to investors through the enterprise investment scheme, tax incentives for corporate venturing, establishment of Venture Capital Trusts as vehicles through which to invest in smaller trading companies, supplementing private finance with public finance in the Regional Venture Capital Funds and encouraging technology investment through the UK High Technology Fund. (Falkena, Abedian, von Blottnitz, Coovadia, Davel, Madungandaba et al., 2002)

6. Conclusion

The SMME sector plays an important role in both the South African and global economy as it is able to absorb low skilled labour, whose skills may not be sufficient for big corporations. Unemployment rate in SA decreased to 25.40 percent in the third quarter of 2014 from 25.50 percent in the second quarter of 2014. The unemployment rate in SA averaged 25.27 percent from 2000 until 2014, reaching an all time high of 31.20 percent in the first quarter of 2003 and a record low of 21.50 percent in the fourth quarter of 2008. (Statistics South Africa, 2014.) In order to reduce this unemployment rate and alleviate poverty; SA needs to create a conducive environment where SMMEs can grow and flourish by reducing the tax compliance burden.

For South African SMMEs, VAT was considered to be the most time consuming tax (Smulders et al., 2012: p 193) while provisional taxes were considered to be the most burdensome form of tax for SMMEs (FIAS, 2007:vii). The UK indicated that the current tax regime and the VAT registration threshold in particular, act to restrain the growth and development of small business. The Small Business Research Trust (1998) found that 15.3 percent of VAT registered businesses have expressed the view that the registration threshold is a significant problem and 18 percent of non-registered businesses state that they intentionally decline growth opportunities for their business so that their turnover can remain below the VAT registration threshold. (Chittenden et al., 2003: p 102). Over 60 percent of SA's businesses with a turnover of R300 000 (R300 000 is the old VAT registration threshold) and less decide to stay informal rather than formalise their business operations. (FIAS, 2007: p xi.)

In the USA it is estimated that compliance costs decrease from ±150 percent of gross receipts for businesses with gross receipts lower than $10,000, to ±10 percent between $50,000 and $100,000, and further decrease to ±0.3 percent for businesses with receipts over $1 million. (Gale and Brown, 2013: p 881). In the UK on average for every £1 000 of sales for companies with a turnover below £100 000 the average tax compliance cost is £33.6 compared to £1.7 for companies with a turnover over £1m. (Chittenden et al., 2003: p 101).

The study found that SMMEs are facing similar challenges as far as the tax compliance cost is concerned and each of the three countries (in this study) address the challenges faced by SMMEs in different ways.

The study also found that the SARS is working very hard to reduce the tax compliance costs of SMMEs by simplifying the tax registration process as well as introducing initiatives such as efiling, turnover tax, increasing the registration threshold for VAT as well as using one form to register for PAYE, UIF and SDL.

Recommendations:

It is recommended that the SARS consider allowing SMMEs to submit PAYE returns every quarter if their payroll taxes do not exceed a certain amount. It is also recommended that the SARS allows SMMEs to submit their VAT returns every six months if their turnover is below a certain amount. For SMMEs, the SARS may consider the cash basis of accounting for VAT and provisional tax as a result of cash flow problems experienced by SMMEs in the early stages.

The National Treasury must intensify the fight against corruption; those who agreed that government gives a good return on taxes paid in the form of services reported a much higher likelihood of registering for tax, compared to those who disagreed.

In terms of tax education, SARS is running regular sessions in order to educate taxpayers. It is recommended that tax be included as part of high school curriculum and again the SARS should try and advertise these sessions on radio and TV so that the wider community may know about these sessions instead of those who only goes to SARS branches or offices.

Further research:

Further research should be conducted into the effectiveness of the turnover tax system, the employee tax incentive scheme, accelerated depreciation and deductions in respect of expenditure incurred in exchange for the issue of venture capital company shares. Further research should be conducted into the efficiency of the SARS staff in providing guidance to SMME's regarding the adherence to the tax compliance requirements.

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