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**Research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (Taxation)**

# THE IMPACT OF TAX AVOIDANCE PRACTICES ON TAX REVENUE COLLECTION IN SOUTH AFRICA

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# DECLARATION

I, Hendrick Legamane Nkadimeng declare that, the research reported in the report, except where otherwise indicated, is my original research work, that the research work has not been submitted for any degree or examination at any other university, that it does not contain other persons' data, pictures, graphs or other information, unless specifically acknowledged as being sourced from other persons, that it does not contain other persons' writing, unless specifically acknowledged as being sourced from other researchers. Where other written sources have been quoted, their words have been re-written but the general information attributed to them has been referenced, where their exact words have been used, their writing has been placed inside quotation marks, and referenced. The research work do not contain text, graphics or tables copied and pasted from the Internet, unless specifically acknowledged, and the source being detailed in the References sections.

ABSTRACT

The study examines the impact of the tax avoidance practices on the collection of tax revenues by the South African Revenue Service. It examines the extent to which collection of tax revenues is compromised by the application of some of the tax avoidance practices by the taxpayers.

Various tax avoidance practices were studied and analyzed for the purposes of the study. The analysis includes, amongst others, the court cases, online academic articles, books, media releases and theses for the purposes of putting together reliable source of data. Each source of information was studied and analyzed separately for the purposes of the study.

South Africa, as a developing country, has been impacted negatively by some of the tax avoidances practices applicable within the South African tax law. The country has lost quite significantly, over the years, some of the tax revenue amounts which could have been collected had the tax avoidance practices not been applicable within the tax legislation in South Africa.

The research study concludes by analyzing few possibilities and recommendations on how the South African Revenue Service could possibly ensure that collection on tax revenues is maximized while the tax legislation remains fair and transparent to the taxpayer.

**KEY WORDS**

Tax avoidance, General Anti-Avoidance Rule, Revenue Collection, Transfer Pricing, Tax Payer, South African Revenue Service, Impermissible Tax Avoidance.

# INTRODUCTION

## 1.1 BACKROUND

Tax avoidance In South Africa is such an interesting topic because it restricts the South African government's ability to collect sufficient tax revenues and to put the relevant legislation into practice as taxpayers make use of the various legalized ways of reducing their tax liabilities (Kumarasingam, 2010). This is the reason why investigating the impact of the avoidance practices on the collection of tax revenues has been a subject for discussion over the years.

The context of the study is relevant to different terms:

> If tax avoidance represents a continuum of tax planning strategies, at the lower end we have perfectly legal tax reducing strategies, while terms such as 'noncompliance,' ''evasion,' and 'sheltering' would be closer to the other end of the continuum. Tax avoidance is the legally avoiding of stating and paying taxes to the South African Revenue Service". (Hanlon and Heitzman (2010).

For the purposes of this research study, tax evasion is defined as tax practices that are illegal within the South African tax law, while tax avoidance practices within the provisions of the South African tax law. More precisely, tax evasion is 'the wilful attempt to defeat or circumvent the tax law in order to illegally reduce one's tax liability' (Mocanu, Constantin & Răileanu, 2021)). In other words, "tax evasion is pecuniary and criminally sanctioned" (Mocanu, Constantin & Răileanu, 2021)). On the other hand, by definition (Kagan, 2021), "tax avoidance is the lawful underreporting of tax obligations", (Mocanu, Constantin & Răileanu, 2021)

## 1.2 THE PURPOSE OF THE STUDY

The purpose of the research is to investigate the effects of tax avoidance practices on the collection of tax revenues by the South African government. The sources include various articles on tax avoidance practices in South Africa with special focus on the effects of such practices on the country's tax revenues.

## 1.3 DEFINITIONS

**Tax Avoidance -** the use of legal methods to minimize the amount of income tax owed by an individual or a business.

**Tax Evasion** - the illegal non-payment or underpayment of tax.

**GAAR** - General Anti-Avoidance Rule.

**SARS** - South African Revenue Service.

## 1.4 THE RESEARCH QUESTION & SUB-QUESTIONS

### *1.4.1 The research question.*

What is the impact of the tax avoidance practices on the tax revenue collection by the South African government?

### *1.4.2 Sub-questions*

What are the tax avoidance practices?

What is the tax revenue?

How is the tax revenue collected?

What is the impact of the tax avoidance practices on tax revenue?

## 1.5 RESEARCH METHOLOGY

### *1.5.1 The purpose of the research study*

A qualitative research method adopted for the purposes of the research study. The qualitative research focuses mainly on the collection and analysis of words and textual data.

The following sources are used to for the purposes of this research study:

1. Thesis.
2. Books.
3. Online Articles.
4. Webpages.
5. Media Releases.
6. Conference articles.
7. Court cases.

# CHAPTER 2: WHAT ARE THE TAX AVOIDANCE PRACTICES?

## 2.1 Tax avoidance by definition.

The term tax avoidance refers to the use of legal methods to minimize the amount of income tax owed by an individual or a business (Kagan, 2021). Many allowable deductions and credits are claimed in most cases of tax avoidance. Some investments that have tax advantages are also a perfect example of tax avoidance, such as buying municipal bonds that are tax free as per the South African tax law. It is quite clear that evading tax is illegal while avoiding tax is legal in South Africa.

> Tax avoidance is generally the legal exploitation of the tax regime to one's own advantage, to attempt to reduce the amount of tax that is payable by means that are within the law whilst making a full disclosure of the material information to the tax authorities. (SA Tax Guide, 2021).

> Tax avoidance occurs when a person or company legally exploits the tax system to reduce tax liabilities, such as establishing an offshore company in a tax haven. Simply put, it means paying as little tax as possible while still staying on the right side of the law. (Cardens Accountants, 2022).

### Differences between Tax Avoidance and Tax Evasion

There is a fine line between avoidance and evasion. Tax evasion occurs when a person or company escapes paying taxes illegally while the tax avoidance practically involves the methods that are legal in minimizing the tax liability for an individual or a company. Tax evasion occurs by concealing the true state of their financial affairs to tax authorities.

"By contrast tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade the payment of taxes by illegal means" (Kumarasingam, 2010).

> Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting, such as under declaring income, profits or gains; or overstating deductions. (SA Tax Guide, 2021).

> Tax avoidance may be considered as either the amoral dodging of one's duties to society or just the right of every citizen to find all the legal ways to avoid paying too much tax. Tax evasion, on the other hand, is a crime within the context of the South African tax law and subjects the guilty party to fines or even imprisonment. (SA Tax Guide, 2021).

The following table summarizes the differences between tax avoidance and tax evasion.

***Table 1: The differences between tax avoidance and tax evasion***

| TAX EVASION | TAX AVOIDANCE |
|---|---|
| (i). A tax payment is avoided through means that are illegal or fraudulent. | (i) A tax payment is avoided and there is compliance to the South African tax law. |
| (ii) Unlawful means of avoiding tax payments are implemented. | (ii) Advantage is taken over the weaknesses in the current tax law. |
| (iii) It is unlawful and often punishable. | (iii) There is absolutely no intention to commit any unlawful act in avoiding or reducing any tax payment. |
| (iv) The tax liability is often evaded after it arises. | (iv) Tax avoidance involves tax planning processes that are normally implemented before the tax liability arises. |

## Understanding Tax Avoidance.

"Tax avoidance is a legal strategy that many taxpayers can use to avoid paying taxes or at least lower their tax bills" (Kagan, 2021). Individuals and businesses in South Africa may use some form of the tax avoidance practices to reduce their tax liabilities to the South African Revenue Service.

Tax payers will normally identify weaknesses within the current tax law and plan to reduce their tax liability before any tax assessment by the South African Revenue Service.

Stiglitz 1985, pp. 325 – 337 distinguishes three basic principles of tax avoidance within an income tax:

> The postponement of taxes, tax arbitrage across individuals facing different tax brackets (or the same individuals facing different marginal tax rates at different times), and tax arbitrage across

income streams facing different tax treatment. Many tax avoidance devices involve a combination of these three principles. In an example used by Stiglitz, the basic feature of an Individual Retirement Account (IRA) is the postponement of tax liability until retirement; if the individual faces a lower tax rate at retirement than at the time the income is earned, then the IRA also features tax arbitrage between different rates. Finally, if the individual can borrow to deposit funds in an IRA and the interest incurred to finance the deposit is tax deductible, then the IRA is a tax arbitrage between two forms of capital, one of which is taxed, and the other of which is not taxed. Stiglitz argues that, with perfect capital markets, these three principles can be exploited to eliminate all taxes while leaving the individual's consumption and bequests unchanged relative to the zero tax case, and facing no more risk than in the original situation. But capital markets are not perfect, and therefore all tax liability is not eliminated by tax avoidance, and to reduce tax liabilities distorting actions (such as investment in sectors where it is easier to convert ordinary income into capital gains) are utilized. There is considerable empirical evidence testifying to the extent and tax sensitivity of these kinds of avoidance behaviors. (Stiglitz, 1985)

Below is an assessment of the three examples in a South African context and how the South African Revenue Service has dealt decisively with such instances,

### *2.1.1 Retiming*

VAT as one form of taxation in South Africa is one good example. The South African Revenue Service has previously challenged some vendors on their timing of the deductions on the VAT that is payable on the importation of goods depending on your VAT cycle.

It is a requirement that the vendors that are on monthly cycles will file the returns on the 25$^{th}$ of each month after the end of the cycle or they could alternatively file by the last day of the month through the e-filling services, with the use of clearing agents shipments are cleared and invoices issued after the entry bill and the notification on customs released have been received from SARS.

There are also some specific arrangements between SARS and the clearing agents to have the payments to SARS deferred to a day between the 7$^{th}$ and 14$^{th}$ of the following month.

The input tax on the importation of goods into South Africa could also be deducted from the output tax at the earlier of the invoice date or payment date as allowed by the VAT Act.

### *2.1.2 Tax arbitrage*

In South Africa the normal income tax rules do apply to crypto assets and the affected taxpayers need to declare crypto assets' gains or losses as part of their taxable income.

A crypto asset defined by SARS as "a digital representation of value that is not issued by a central bank, but is traded, transferred and stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility, and applies cryptography techniques in the underlying technology".(SA Tax Guide, 2021)

Any income received or accrued on crypto asset could be taxed as gross income though the tax payers are entitled to claim the expenses that are related to the crypto asset accruals or receipts provided such expenditure is incurred in the production of the taxpayer's income and for purposes of trade.

### *2.1.3 The classification of income*

Taxpayers are classified into major categories as either individuals or corporations in a South African context.

## Tax Avoidance in a South African context

In South Africa, it has always been a serious struggle to maintain a very strong balance between the needs of the government and those of the tax payers in as far as the fundamental principles of the tax avoidance in a South African context are concerned. The tax payers will always try and find some of the creative ways of trying to reduce on their tax liability while ensuring that they do not find themselves on the wrong side of the law, while the South African government will continuously try to improve the tax legislation of the country in an attempt to ensure that tax payers do not succeed in reducing their tax liabilities through the tax avoidance practices. The concept of the general anti-avoidance rules was introduced legislatively to discourage tax payers from engaging in so many tax avoidance practices that are usually reducing the collection of tax revenue by the South African Revenue Service. The rules were designed primarily to curb the use of the tax avoidance practices. Though the GAAR was implemented, there was no perfection by the rules when it comes to the main intention why these rules created and implemented.

The South African Revenue Service was expected to benefit more on the implementation of the GAAR as it was meant to increase the revenue collection by giving more authority to the commissioner on how the South African taxpayers are to conduct their tax affairs. The rights of the taxpayers are practically limited or eliminated by the implementation of the GAAR. The risk of giving so much allowance to the tax payers for engaging in various tax avoidance practices is always being managed through the design and implementation of the rules and laws by the South African Revenue Service with the aim of discouraging such practices.

The general anti-avoidance rule is practically characterized by the controlling measures aimed at ensuring that the taxpayers do not abuse certain provisions of the tax law that allows the tax avoidance practices, hence the concept of "abnormality" was introduced in line with section 80B. Section 103(30 of the Income Tax Act also provides the special conditions upon which the onus of proof is introduced.

The general anti-avoidance rule has been in existence for over 65 years in South Africa. It has got a very detailed history of various case laws where the tax avoidance concept and the provisions of the anti-avoidance were formulated and implemented successfully. One strong characteristic of a well-operates within the entire legal system in South Africa. The South African Revenue Service has discovered and reported some inconsistencies in the application of section 103 of the SA Income Tax and at times the tax authority will conclude that the application of the section is literally ineffective in dealing with the anti-avoidance schemes and other practices that are considered to be impermissible.

The following are few cases which were selected to give a practical example of the ineffective section 103 of the SA Income tax on how to deal with the tax avoidance schemes.

- *In CIR v Louw 1983 (3) SA 551; 45 SATC 113* a partnership of professional engineers "incorporated" their practice so that they could henceforth practice as a company as opposed to a partnership. The "scheme" entailed the incorporation of a new company with the partners as the directors and only shareholders of the company. The partners then sold their practice to the company on credit, without requiring the payment of interest and with the payment terms depending on the financial circumstances of the new company. The Appellate Division (now the Supreme Court of Appeal) unanimously held these arrangements to be "perfectly sound and businesslike" and rejected the Revenue contention that they were abnormal. Importantly the court accepted "the realities of the situation" which were that the company to which the practice was sold by the partners had as its shareholders and directors the self-same partners and was controlled by them. (SARS 2005).( *Cir v Louw 45 SATC 113).*

- In *CIR v Conhage (Proprietary) Limited 1994 (4) SA 1149; 61 SATC 391* the taxpayer entered into a transaction which, in the world of finance, is internationally described as a "sale and leaseback transaction". The facts may be summarized briefly. The taxpayer was the owner of a manufacturing plant. It required finance for expansion and, instead of simply borrowing the money, it accepted a proposal from its bankers to conclude a sale and leaseback transaction because such a transaction improves the after-tax cost of funds to the taxpayer. The taxpayer sold its manufacturing plant to a bank and immediately hired it back so as not to lose the use thereof. Predictably, the highest court in this country rejected the Revenue allegation that transactions of this nature are "abnormal. (*CIR v Conhage 61 SATC 391)*

Section 103(1) contained the general anti-avoidance rules in the Income Tax Act for quite some time, Section 103(1) however contains certain inherent weaknesses that resulted in the incorporation of the new provisions into the Ac and as a result there was a need to revise the Income Tax Act to ensure that it remains effective. The provisions are found in the SA Income Tax at Part IIA of Chapter III in sections 80A to 80L and applies to any arrangement entered into on or after 2 November 2006. The new provisions have taken into account most of the requirements which were previously applied by section 103(1).

Certain of the new provisions, however find their origin in other parts of the world. Although the new sections contain many of the same concepts as section 103(1), it does not mean that these concepts apply in the same context or in the same manner or have the same meaning. In this part will strive to provide an overview and analyze each of the elements of the new General Anti-Avoidance Rules as it is contained in section 80 A-L. There are four requirements that have to be established for the commissioner to rely of the new general anti-avoidance rules.

1. The existence of an avoidance arrangement;
2. The arrangement must have been entered into on or after the effective date, 2nd November 2006
3. The sole or main purpose was to obtain a tax benefit
4. The arrangement must include an abnormality element.

A closer look into each of the four requests is analyzed as follows: (Lexis Nexis Editorial Staff, 2018/19)

### *2.1.4 Arrangement on avoidance*

The provisions of the new General Anti-Avoidance Rules will apply where there is an impermissible avoidance arrangement as defined in the Act in section 80A. The focus of the following parts is to determine what constitutes an arrangement in the event that there was avoidance by the taxpayer. It also looks at what constitutes steps or parts of an arrangement.

The meaning of 'arrangement': the Act defines an arrangement in section 80L as "*any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property*". (South African Revenue Service, 2005)

> An 'arrangement' is often described and interpreted according to the case of FCT v Newton where the court held that: 'an arrangement has been interpreted as requiring a conscious involvement of two or more participants who arrive at an understanding. It cannot exist in a vacuum and presupposes a meeting of minds, which embodies an expectation as to future conduct between the parties, that is, an expectation by each that the other will act in a particular way''.( *FCT v Newton 2 All ER 759*)

> This interpretation of the court leads one to believe that consensus between all parties must exist with regards to the terms and conditions of the arrangement, before a valid arrangement exists. The determination of an 'arrangement' is but the first step to determine whether the outcome of the analysis constitutes impermissible tax avoidance. The definition of "arrangement" has however gone a step further in the clarification, by including the words "enforceable or not." This effectively means that it is not required for a transaction, operation or scheme to be legally enforceable for the new GAAR to apply. SARS in its *Draft Comprehensive Guide to the General Anti-Avoidance Rule (GAAR)* pp.38 have included some examples of agreements that are not legally enforceable, but which will as per section 80A, be included in the definition of an 'arrangement.

Transaction, operation or scheme, this part of the definition was also contained in the now repealed section 103(1). The rules laid down by the courts in the cases of *Meyerowitz, Louw and Ovestone*, where the definition of "transaction", "operation" and "scheme" has been interpreted, shall continue to apply under the new GAAR. (South African Revenue Service, 2005).

In *Meyerowitz v CIR49*, the court held that, 'The word "scheme" is a wide term and I think that there can be little doubt that it is sufficiently wide to cover a series of transactions…' *In CIR v Louw*, the court approved the interpretation above and held that, '… the term scheme is wide enough to cover situations in which later steps in a course of action were left unresolved at the outset'. In *Ovenstone v CIR* the court looked at the term 'entered into' and stated that, 'It was held that 'entered into' does not mean formulated because of its context it has, I think, a connotation of implementation that is similar to 'carried out'. Probably both expressions were used because it was considered that 'carried out' is more appropriate to connote the implementation of a scheme, while 'entered' into is more apposite to connote the implementation (i.e. the taxpayer's actually engaging in) of a transaction or operation.

Having regard to the above cases, it is clear in the way that the definition of an "arrangement" was drafted, that the words "transaction, operation or scheme" should be interpreted wide to assist the Commissioner, so that the definition or "arrangement" can be applied to any possible transaction or scheme that has the intention to avoid tax.

### *2.1.5 The sole or main purpose was to obtain a tax benefit*

The meaning of 'sole or main purpose, In terms of section 80A:

> An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit'. In SBI v Lourens Erasmus (Edms) Bpk, the court looked at the meanings of the words 'solely' and 'mainly'. The court held that, '… in the context under consideration, the word 'mainly' establishes a purely quantitative measure of more than 50% and the associated use of the word 'solely' or mainly is inserted, ex abundante cautela, to circumvent the possibility that what may be described as being 'solely' of a particular character would not qualify as being 'mainly' of that character. (*SBI v Lourens SA 344*

The court held that 'solely' refers to the only purpose of the taxpayer, whereas 'mainly' will refer to a quantitative measure of more than 50%. From a quantitative perspective solely would mean 100%. In *CIR V Bobat 58* the court held that, '… "*a main purpose is obviously one which must be dominant over any other, because in ordinary language 'mainly' means for the most part, principally or chiefly". (CIR v Bobat and Others 67 SATC 47)*

Testing the objective vs. subjective; under section 103(1) the purpose of a transaction, operation or scheme, was determined by applying a subjective test. Section 103(1) (c) referred to the purpose for which a transaction, operation or scheme was carried out, as opposed to the purpose of an arrangement. This subjective approach was confirmed in *SIR v Gallagher, 59* where Corbett JA held that, *'… the criterion to be applied was, not objective, but subjective; that where a taxpayer wishes to negate tax avoidance as one of the purposes of a scheme, it is generally incumbent upon him to establish positively what the purpose, or scheme in fact were'*. The implication of the above meant that one had to take into account the purpose of the taxpayer when determining whether a transaction, operation or scheme was entered into for the purpose of obtaining a tax benefit. It was required to look into the mind of the taxpayer who entered into the transaction, under the subjective test. This may result in problems as it is very difficult to determine the intention of the taxpayer with regards to certain transactions. In the case of *Newton v FCT60* it was decided that an objective test should be used to determine the purpose for which a transaction was entered into. The court stipulated that, '… *the word purpose used in the context of an arrangement, regard must be had to the objective effect of the arrangement. Purpose in this sense means not intention, but the effect with which it sought to achieve the end accomplished or achieved*'. An objective test would thus require the court to look at whether the terms of the arrangement have the effect of creating a tax benefit. In section 80A it is stated that an avoidance arrangement is impermissible if 'its sole or main purpose' was to obtain a tax benefit. This can then be viewed as the move towards an objective test for purpose, as one cannot determine the state of mind of an arrangement. In section 80G however lies a rebuttable presumption, in that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of a tax benefit, unless and until the party obtaining the tax benefit proves that, reasonably considered in the light of the relevant facts and circumstances, that obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. Once the Commissioner has thus proved that an avoidance arrangement exists, it will automatically be presumed that the sole or main purpose of the arrangement was to obtain a tax benefit. The onus will then be shifted to the taxpayer to prove otherwise. The inclusion by the Legislature of the words, 'reasonably considered in light of the relevant facts and circumstances' means that the taxpayer's intention must be considered, taking into account the facts and circumstances of the case at hand. It can thus be seen that more explicit direction from the Legislature is needed, in terms of what test should be used, as it is still unclear if one should use the subjective or objective test to determine 'purpose'.

### *2.1.6 Tax Benefit*

In order for an arrangement to be an "avoidance arrangement" under the new GAAR, there must be a tax benefit, and the sole or main purpose for entering into such arrangement must have been to acquire a tax benefit.

Section 1 of the Act describes a tax benefit as follows: "*it includes any avoidance, postponement or reduction of any liability for tax". (*South African Revenue Service, 2005*)*

Tax is defined in section 80L to include, *'any tax, levy or duty imposed by the Income Tax Act or any other Act administered by the Commissioner'" (*South African Revenue Service, 2005*).*

It can thus be noted that the definition of 'tax benefit' can be interpreted very widely and can potentially include any transaction by the taxpayer that has the effect of reducing his tax liability. It can also indicate that a tax benefit in respect of the avoidance of tax could relate to a current, accrued or a past liability.

This notion is confirmed in *CIR v King* where the court stated:

> There are many ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or of freeing himself from taxation on some part of his future income. For example, a man can sell investments which produce income subject to tax and in their place make no investments at all, or he can spend the proceeds in buying a house to live in, or in buying shares which produce no income but may increase in value … He might even have conceived such a dislike for the taxation under the Act that he sells all his investments and lives on his capital or gives it away to the poor in order not to have to pay such taxation. If he is a professional man he may reduce his fees or work for nothing … He can carry out such operations for the avowed purpose of reducing the amount of tax he has to pay, yet it cannot be imagined that Parliament intended by the provisions of section 90 to do such an absurd thing as to levy a tax upon persons who carry out such operations as if they had not carried them out. (*CIR v King 2 SA 196*).

In the case of *Smith v CIR*, the judge held that:

> To avoid liability in this sense is to get out of the way of, escape or prevent an anticipated liability, GAAR will find application when a taxpayer enters into an arrangement which has the effect of avoiding liability which will result in a tax benefit. (*Smith v Commisioner 40 B.T.A 1038*).

The test to determine a tax benefit, is that it should be submitted that there is no formal test to determine the existence of a tax benefit, nor is there any section in the Income Tax

Act that expressly provides for a test to be applied in determining a tax benefit. "In ITC 1625, the court held that a possible test to determine the existence of a tax benefit was whether the taxpayer would have suffered tax but for the transaction. The Commissioner would then need to determine or predict another transaction or scheme that the taxpayer would have entered into. The court also made reference to *CIR v Louw*, 65 where it was held that,

> Another way the question has been posed by the courts as follows; had it not been for the transactions…..detailed above, the dividend by the IMC to the SA company and the letter to the Rhodesian company, would have come into the appellants hands and he would have been liable for tax thereon'. In this case there was no income that accrued. The directors of the company caused the entity to make loans to them instead of issuing them with dividends that would have been subject to tax. The court held that taxable salaries would have been paid if the loans had not been paid. The Commissioner then raised tax payable in respect of those salaries that would have been paid. The approach in both of the abovementioned cases is problematic, as it would require the court to make a subjective inquiry into predicting what the taxpayer could have done. The situation could also very well exist where the taxpayer would not have entered into any transaction that gets predicted by the Commissioner. It is thus clear that although there is no clear test for the determination of a tax benefit to be found in the legislation, the courts have adopted their own test and enunciated that a "but for" test is used. (South African Revenue Service, 2005).

### *2.1.7 Abnormality*

Section 80A (a) states that:

> Impermissible tax avoidance arrangements.—An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and— (a) in the context of business— (i) it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C; (b) in a context other than business, it was entered into or carried out by means or

> in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit; or (c) in any context— (i) It has created rights or obligations that would not normally be created between persons dealing at arm's length; or (ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part)." (Lexis Nexis Editorial Staff, 2018/19)

It is thus clear that there are three ways to determine the abnormality of a transaction in terms of the Act, namely: In the context of business, in a non-business context and in any other context.

# CHAPTER 3: WHAT IS TAX REVENUE?

## 3.1 Tax revenue by definition.

Tax revenue is the funds collected by the South African Revenue Service on behalf of the South African Government through taxes on income and profits. The South African Revenue Service is legislatively mandated to collect all taxes payable to the government by the taxpayers, SARS is also responsible for ensuring that taxpayers do not abuse the provisions of the tax law in the country. SARS is also responsible to ensure that taxpayers to know and understand their obligation to pay taxes to the South African Government.

Income earned by the government through the taxation on either profits or individuals is referred to as the tax revenue. The South African government do consider the taxation revenue as the primary source of income in comparison to other sources of income for the government.

Various tax rates are set and authorized for implementation by the South African Revenue Service. It is upon the application of the tax rates that the tax revenues are billed and collected. The review of the tax rates is done annually by the South African Revenue Service. SARS will annually publish the total amounts of tax revenue collected from various forms of taxation. The minister of finance will annually table before parliament the projected collections on the tax revenues for each financial year, such projections are compared to the actual tax collections. “Total tax revenue as a percentage of GDP, indicates the share of the country's output collected by the government through taxes. Tax revenue can be regarded as one measure of the degree to which the government controls the economy's resources”. (Economic Co-operation and Development, 2021).

Taxes collected from both direct tax and indirect tax are the government’s tax revenue. It includes collections from income tax, corporation tax, customs and other taxes.

Direct tax is the tax that is paid directly to the government by individuals and companies. Income tax, corporation tax and property tax are some examples of direct tax. Indirect taxes are those that are collected by intermediaries from individuals and corporations who bear the burden of the tax and pass on to the government.

## 3.2 Taxation in South Africa

In South Africa the tax system normally involves the payments to either the South African Tax Revenue or the local government. The South African tax system was previously on a "source-based" and recently the system has changed to "residence-based". On a source-based system the income is taxed in the country in which it originates, for the residence-based system the taxpayers residing in South Africa are taxed on their worldwide income irrespective of where the income is earned.

## 3.3 The following are the types of taxation in South Africa.

South Africa as a country broadly levies taxation in a form of Personal income tax (38.3%), VAT (25.2%), Company income tax (16.6%), Fuel levy (5.9%), Dividends (2.3%), Customs duties (4.3%), Specific excise duties (3.2%), other direct and indirect taxes (4.2%). (SARS, 2022)

**Personal Income Tax**, "Income tax is the normal tax which is paid on your taxable income" (South African Revenue Service, 2005).

Examples of amounts an individual may receive, and from which the taxable income is determined, include:

- Remuneration (income from employment), such as, salaries, wages, bonuses, overtime pay, taxable (fringe) benefits, allowances and certain lump sum benefits
- Profits or losses from a business or trade
- Income or profits arising from an individual being a beneficiary of a trust
- Director's fees
- Investment income, such as interest and foreign dividends
- Rental profit or losses
- Income from royalties
- Annuities
- Pension income
- Certain capital gains

You are liable to pay income tax if you earn more than:

For the 2023 year of assessment (1 March 2022 – 28 February 2023)

- R 91 250 if you are younger than 65 years.
- If you are 65 years of age to below 75 years, the tax threshold (i.e. the amount above which income tax becomes payable) is R141 250.
- For taxpayers aged 75 years and older, this threshold is R157 900.

For the 2022 year of assessment (1 March 2021 – 28 February 2022)

- R 87 300 if you are younger than 65 years.
- If you are 65 years of age to below 75 years, the tax threshold (i.e. the amount above which income tax becomes payable) is R 135 150.
- For taxpayers aged 75 years and older, this threshold is R151 100.
  (South African Revenue Service, 2021)

- **Corporate Income Tax**

Corporate Income Tax (CIT) is a tax imposed on companies resident in the Republic of South Africa i.e. incorporated under the laws of, or which are effectively managed in, the Republic, and which derive income from within or outside the Republic. Non-resident companies which operate through a branch or which have a permanent establishment within the Republic are subject to tax on all income from a source within the Republic.

CIT is applicable (but not limited) to the following companies which are liable under the Income Tax Act, 1962 for the payment of tax on all income received by or accrued to them within a financial year.

- Listed public companies
- Unlisted public companies
- Private Companies
- Close Corporations
- Co-operatives
- Small Business Corporation (s12E)
- Body Corporates.

When is the CIT payable to the South African Revenue Service?

Provisional Tax, First payment – within six months from the beginning of the year of assessment

Second payment – on or before the last day of the year of assessment

Third payment – seven months after the year of assessment for taxpayers with February year-end and six months after year of assessment for all other cases.

Tax on Assessment payment of tax upon an assessment notice issued by SARS must be done within the period specified in such notice.

For the years of assessment ending on any date between or on or after 31 March 2023 the rate of Corporate Income Tax payable is 27% (previously 28%).

- **Value Added Tax**, Value-Added Tax is commonly known as VAT. VAT is an indirect tax on the consumption of goods and services in the economy. Revenue is raised for government by requiring a business, that carries on an enterprise (as defined in section 1(1) of the VAT Act), to register for VAT. In doing so, the business will charge VAT on supplies of goods and services made by it, on the importation of goods and on imported services (subject to certain conditions). The business will also be entitled to deduct any VAT charged to it, or under limited circumstances from a business that is not registered for VAT, in respect of a supply made to it. VAT is therefore non-cumulative, meaning that a credit/deduction is allowed for VAT paid in previous stages, within the production and distribution chain. The business is required to pay the difference between the VAT charged by it and the VAT charged to it, or claim a VAT refund where the VAT charged to it exceeds the VAT charged by it.

  VAT is therefore, charged at each stage of the production and distribution process and it is proportional to the price charged for the goods and services.

  “The standard rate of VAT increased from 14% to 15% from 1 April 2018. There is a limited range of goods and services which are subject to VAT at the zero rate or are exempt from VAT”(South African Revenue Service, 2005).

  Compulsory registration is required for any enterprise with taxable supplies with a rand value above R 1 million.

The VACT Act also makes provision for a person to register voluntarily if the taxable supplies are below R 1 million.

There are five categories of voluntary registrations (South African Revenue Service, 2005):

The first category applies to a specific type of person where there is no threshold for the value of taxable supplies.

The second category applies to a person that has made R50 000 in the past period of twelve months.

The third category applies to a person where the value of taxable supplies has not exceeded R50 000 and the conditions for registration are listed in a Regulation.

The fourth category applies to a person that has acquired a business as a going concern.

The fifth category applies to a person that carries on a specific nature of activity as listed in a Regulation. In addition, there are other general requirements that must also be met for a voluntarily registration for VAT

In terms of section 1(1) of the VAT Act, persons operating any enterprise may possibly qualify to register for VAT purposes. For the purposes of the VAT registration, the definition of a person includes not only individuals but enterprises such as partnerships, companies, trust funds and municipalities to name few.

Any person registered for VAT purposes either under compulsory or voluntary registration is referred to as a vendor.

**Capital Gains Tax**, Capital gains tax exists from the moment when an asset is disposed. The capital gains tax came into effect on the 1st of October 2001 for the proceeds that are in excess of the base cost of an asset.

The tax rate on capital gains is relatively lower than that is ordinarily taxed on persons. The disposal of an asset will not automatically require accumulate a tax payable, some of the asset disposal will not raise any gains and as a result no capital gains tax will arise.

“A withholding tax applies to non-resident sellers of immovable property (section 35A). The amount withheld by the buyer serves as an advance payment towards the seller’s final income tax liability” (SARS 2022).

CGT applies to individuals, trusts and companies.
A resident, as defined in the Income Tax Act 58 of 1962, is liable for CGT on assets located both in and outside South Africa (SARS 2022).

> A non-resident is liable to CGT only on immovable property in South Africa or assets of a “permanent establishment” (branch) in South Africa. Certain indirect interests in immovable property such as shares in a property company are deemed to be immovable property. (SARS 2022).

Some persons such as retirement funds are fully exempt from CGT. Public benefit organizations may be fully or partially exempt.

**Donations Tax**, for the month of February 2018 and prior months, it is a flat rate of 20%.

From 1 March 2018, donations tax is levied at a rate of 20% on the aggregated value of property donated not exceeding R30 million, and at a rate of 25% on the value exceeding R30 million (section 64(1)). Take note of the following:

- In determining the R30 million threshold, the aggregate value of property donated commences from 1 March 2018 to date of current donation. Any donations made prior to 1 March 2018 must not be taken into account;
- the aggregate value of property to determine the R30 million threshold is calculated after deducting any exemptions (s56);
- where the donor has exceeded the R30 million threshold, all subsequent donations will be taxed at the rate of 25%.

Donations tax applies to any person (for example: individual, company or trust) that is a resident. Hence, non-residents are not liable for donations tax.

The person making the donation (donor) is liable to pay the donations tax, however if the donor fails to pay the tax within the payment period the donor and donee are jointly and severally liable (section 59).

The Commissioner may at any time raise an assessment on the donor or donee (or both) for the donations tax including where the Commissioner is satisfied that the full amount of donations tax was not paid, he can raise an assessment for the difference. The payment by either the donor or donee will discharge this joint liability (section 60(5)).

There are four (4) categories of exemptions (SARS 2022) –

(1) Certain donations are completely exempt from donations tax. For example, a donation made to a spouse; an approved public benefit organization; any sphere of government; that is cancelled within six (6) months from the date that it took effect; etc. (section 56(1).
(2) In the case of a donor who is not a natural person (for example, companies and trusts), the exemption is limited to casual gifts not exceeding R10 000 per year of assessment (section 56(2)(a))
(3) The first R100 000 of property donated in each year of assessment by a natural person is exempt from donations tax (section 56(2) (b)).
(4) So much of any bona fide contribution made by the donor towards the maintenance of any person. This exemption is limited to what the Commissioner considers reasonable (section 56(2) (c)).

**Dividend Tax**, Dividends Tax is a tax on shareholders (beneficial owners) when dividends are paid to them, and, under normal circumstances, is withheld from their dividend payment by a withholding agent (either the company paying the dividend or, where a regulated intermediary is involved, by the latter). A dividend is in essence any payment by a company to a shareholder in respect of a share held in that company, excluding the return of contributed tax capital (i.e. consideration received by a company for the issue of shares). It is triggered by the payment of a dividend by any:

- South African tax resident company; or
- Foreign Company whose shares are listed on a South African Exchange.

Dividend payments by headquarter companies are not subject to Dividends Tax.

Dividends Tax replaced STC in an effort to:

A lign South Africa with the international norm where the recipient of the dividend, not the company paying it, is liable for the tax (South Africa was one of only a few countries with a corporate level tax on dividends, such as STC)

Make South Africa a more attractive destination for international investment by eliminating the perception of a higher corporate tax rate (STC is an extra corporate tax) coupled with lower accounting profits (STC had to be accounted for in the Statement of Comprehensive Income (Income Statement)). (South African Revenue Service, 2005)

Some beneficial owners of dividends are entitled to an exemption (local and/or foreign persons) or a reduced rate (foreign persons) under the Dividends Tax system, whereas dividends received by them under the STC system were taxed in full in the company declaring the dividend.

> Dividends Tax is payable by the beneficial owner of the dividend, but is withheld from the dividend payment and paid to SARS by a withholding agent. "The person liable for the tax, however, remains ultimately responsible to pay the tax should the withholding agent fail to withhold the correct amount of tax. An exception to this general principle is where a dividend consists of a distribution of an asset *in specie*, resulting in the liability for the tax falling on the company itself (such as with STC), which means that it may not withhold the tax from the dividend payment. (South African Revenue Service, 2005)

The rate of Dividends Tax increased from 15% to 20% for any dividend paid on or after 22 February 2017 (irrespective of declaration date), unless an exemption or reduced rate is applicable.

**Pay as You Earn**, Employees' Tax refers to the tax required to be deducted by an employer from an employee's remuneration paid or payable. The process of deducting or withholding tax from remuneration as it is earned by an employee is commonly referred to as PAYE.

An employer who is registered or required to register with SARS for PAYE and/or Skills Development Levy (SDL) purposes, is also required to register with SARS for the payment of Unemployment Insurance Fund (UIF) contributions to SARS.

The amounts deducted or withheld must be paid by the employer to SARS on a monthly basis, by completing the Monthly Employer return (EMP201). The EMP201 is a payment return in which the employer declares the total payment together with the allocations for PAYE, SDL, UIF and/or Employment Tax Incentive (ETI), if applicable. A unique Payment Reference Number (PRN) will be pre-populated on the EMP201, and will be used to link the actual payment with the relevant EMP201 payment declaration.
It must be paid within seven days after the end of the month during which the amount was deducted. If the last day for payment falls on a public holiday or weekend, the payment must be made on the last business day before the public holiday or weekend.

# CHAPTER 4: HOW IS TAX REVENUE COLLECTED?

## 4.1 How does the South African government collect its tax revenue?

The South African Revenue Service is responsible for the collection of taxes within the Republic of South Africa. The mandate and vision of the South African Revenue Service, quoted from their website, is to (SARS 2022):

- Collect all revenues due.
- Ensure optimal compliance with Tax, Customs and Excise legislation.
- Provide a customs and excise service that will facilitate legitimate trade as well as protect our economy and society.
- SARS is driven by the aspiration to contribute directly to the economic and social development of the country by collecting the revenue due to enable government to deliver on its constitutional obligations, policy and delivery priorities in pursuance of better life for all in South Africa. By encouraging tax and customs compliance, we also aspire to contribute to the building of fiscal citizenship reflected by a law abiding society.
- The anchor for SARS to deliver on this mandate is the higher purpose and values which drives and informs all SARS employees' behavior."
- The South African Revenue Service (SARS) was formally established on 01 October 1997.

For the year ending 31 March 2022, SARS collected a gross amount of R1 884.9 billion (R1 540.5 billion in the prior year). Offset by refunds of R321.1 billion (R290.7 billion in the prior year), this results in net collections of R1 563.8 billion, which represented a surplus of R314.0 billion (25.1%) against the prior year 2020/21.Measured against the Budget Estimate of R1 547.1 billion, this results in a surplus of R16.7 billion (1.1%). The main sources of revenue that contributed to the R1 563.8 billion collected were Personal Income Tax (PIT), which contributed R555.8 billion (35.5%), Value-Added Tax (VAT) contributing R390.7 billion (25.0%), Company Income Tax (CIT), which contributed R323.6 billion (20.7%) and Customs duties contributed R58 billion (3.7%).

SARS had collected R16.3 trillion since October 1997 when it was established up to 31 March 2021, for the 2021/22 financial year this amount now stands at R17.8 trillion.

Revenue collections have been buoyant because of strong economic recovery boosted by elevated commodity prices for much of the reporting period. Better than anticipated corporate earnings supported CIT and PAYE collections, while stable interest rates and pent-up demand shored up VAT collections. In line with the strategic intention of inculcating Voluntary Compliance, SARS continues in its endeavors to make it easy and simple and less costly for taxpayers to comply with their tax obligations. But SARS also makes it hard and costly for taxpayers that deliberately do not want to comply. It has made a distinction between tax revenue received (for example monthly PAYE payments) and tax revenue that it collects through targeted compliance interventions.

> In the 2021/22 tax year these compliance interventions resulted in the collection of R209.7 billion, representing 13.4% of total revenue collections. The substantial improvement in total tax revenue collections resulted in a 25.0% tax-to-GDP ratio, exceeding the high percentage attained in 2007/08 of 23.8%, given the context of the rebasing of the GDP, signposting a quicker return to pre-Covid pandemic levels. Faster progress in implementing structural reforms will contribute to a more durable economic recovery and improved revenue collection. (South African Revenue Service, 2011).

There are other internal factors that have contributed to the improved revenue collection. The information and technology infrastructure has been modernized, additional skilled staff were employed, the multi-year customs modernization program is under way, and work has been intensified to counter criminal and illicit activity. The majority of the Nugent Commission recommendations to address management and governance failures at SARS have been implemented.

***Table 2: 2021/22 Revenue Collections vs. Revised Budgeted Estimates***

[redacted]

| R'million | Actuals 2021/22 | Budget 2022 | Var | Var % | MTBPS 2021 | Var | Var % | Budget 2021 | Var | Var % |
|---|---|---|---|---|---|---|---|---|---|---|
| Personal Income Tax[1] | 555 780 | 555 543 | 237 | 0.0% | 543 948 | 11 832 | 2.2% | 518 721 | 37 059 | 7.1% |
| Corporate Income Tax[1] | 323 577 | 321 902 | 1 675 | 0.5% | 292 399 | 31 178 | 10.7% | 216 542 | 107 035 | 49.4% |
| Dividends Tax / STC | 33 397 | 32 182 | 1 215 | 3.8% | 29 945 | 3 452 | 11.5% | 26 172 | 7 225 | 27.6% |
| Value-added Tax | 390 697 | 383 724 | 6 974 | 1.8% | 373 630 | 17 067 | 4.6% | 370 177 | 20 520 | 5.5% |
| Domestic VAT | 448 782 | 446 738 | 2 044 | 0.5% | 439 970 | 8 812 | 2.0% | 430 062 | 18 720 | 4.4% |
| Import VAT | 204 332 | 196 928 | 7 405 | 3.8% | 193 274 | 11 058 | 5.7% | 181 333 | 23 000 | 12.7% |
| VAT Refunds | -262 417 | -259 942 | -2 475 | 1.0% | -259 613 | -2 804 | 1.1% | -241 217 | -21 200 | 8.8% |
| Specific Excise Duties[2] | 49 552 | 48 212 | 1 340 | 2.8% | 42 295 | 7 258 | 17.2% | 43 734 | 5 818 | 13.3% |
| Fuel Levy | 88 877 | 89 884 | -1 006 | -1.1% | 89 647 | -770 | -0.9% | 83 148 | 5 730 | 6.9% |
| Customs Duties[3] | 57 970 | 55 821 | 2 149 | 3.8% | 54 715 | 3 254 | 5.9% | 53 142 | 4 827 | 9.1% |
| Other taxes | 63 914 | 59 803 | 4 111 | 6.9% | 58 836 | 5 079 | 8.6% | 53 488 | 10 427 | 19.5% |
| Total Tax Revenue (Cash) | 1 563 765 | 1 547 071 | 16 695 | 1.1% | 1 485 415 | 78 351 | 5.3% | 1 365 124 | 198 641 | 14.6% |

[redacted]

The South African Revenue Service has successfully collected tax revenues above the budgeted amounts for the 2021/22 tax year. The collections were 1.1% above the estimated budget amounts.

***Table 3: 2019/20 to 2021/22 Revenue Collection variance in rand value (millions) and percentage.***

[redacted]

| R'million | 2019/20[4] | 2020/21[5] | 2021/22[6] | Var 2019/20 → 2021/22 | Var % 2019/20 → 2021/22 | Var 2020/21 → 2021/22 | Var % 2020/21 → 2021/22 |
|---|---|---|---|---|---|---|---|
| Personal Income Tax[1] | 529 172 | 488 446 | 555 780 | 26 608 | 5.0% | 67 334 | 13.8% |
| Corporate Income Tax[1] | 214 986 | 204 399 | 323 577 | 108 591 | 50.5% | 119 178 | 58.3% |
| Dividends Tax / STC | 27 930 | 24 845 | 33 397 | 5 467 | 19.6% | 8 552 | 34.4% |
| Value-added Tax | 346 761 | 331 197 | 390 697 | 43 937 | 12.7% | 59 501 | 18.0% |
| Domestic VAT | 399 288 | 392 936 | 448 782 | 49 494 | 12.4% | 55 846 | 14.2% |
| Import VAT | 179 987 | 166 454 | 204 332 | 24 345 | 13.5% | 37 878 | 22.8% |
| VAT Refunds | -232 515 | -228 193 | -262 417 | -29 902 | 12.9% | -34 224 | 15.0% |
| Specific Excise Duties[2] | 46 827 | 32 273 | 49 552 | 2 726 | 5.8% | 17 279 | 53.5% |
| Fuel Levy | 80 175 | 75 503 | 88 877 | 8 702 | 10.9% | 13 375 | 17.7% |
| Customs Duties[3] | 55 428 | 47 290 | 57 970 | 2 541 | 4.6% | 10 679 | 22.6% |
| Other taxes | 54 502 | 45 800 | 63 914 | 9 413 | 17.3% | 18 115 | 39.6% |
| Total Tax Revenue | 1 355 781 | 1 249 753 | 1 563 765 | 207 985 | 15.3% | 314 013 | 25.1% |

[redacted]

The above table demonstrate an improvement in collection of tax revenue from the 2019/20 tax year to the 2020/21 tax year, the table shows a collection improvement from 15.3% to 25.1% in the 2020/21.

## 4.2 An analysis of the Tax Revenue Growth as reported by the South African Revenue Service in relation to the Tax Avoidance practices in South Africa

The South African Revenue Service has collected over R 1.5 trillion in tax revenue in the 2021/22, a 25.1% increase over the previous year.

Net collections for the period totaled R1, 563.8-billion. This was R16.7-billion or 1.1% more than was forecast in the budget, which means a slightly smaller budget deficit than anticipated at a time when the Treasury is trying to contain a swelling and potentially crippling debt load. Compared to the R 1, 239.753-billion collected in the previous financial year, when the economy locked down and was on its knees, it was an increase of 25.1%.

"Revenue collections have been buoyant because of strong economic recovery boosted by elevated commodity prices for much of the reporting period. Better than anticipated corporate earnings supported CIT and PAYE collections, while stable interest rates and pent-up demand shored up VAT collections," SARS reported.

The table demonstrates a graphical breakdown on the main revenue sources:

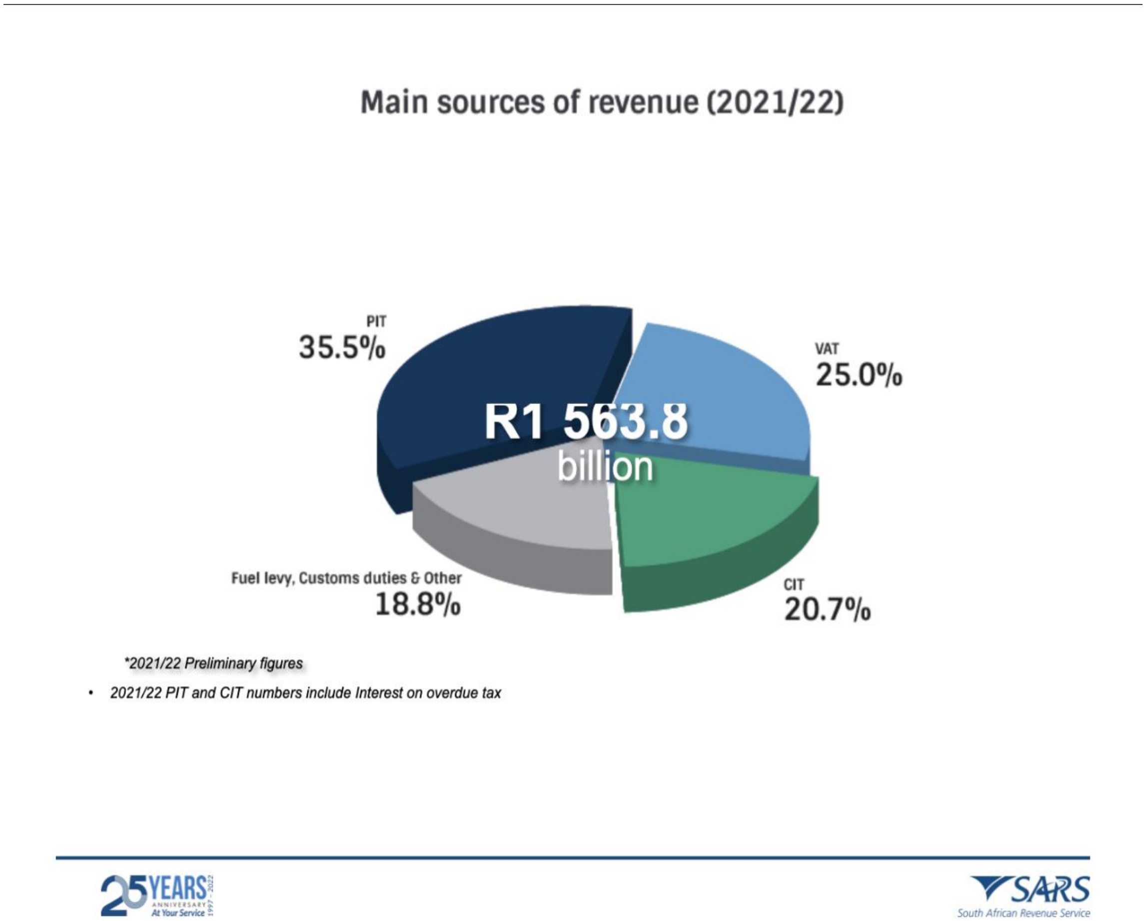



***Figure 1: Main sources of revenue (2021/22)***

Record prices for a range of commodities have led to record earnings from South African mining companies, which translated into the sector paying record taxes and royalties. South Africa's fragile fiscal condition would have been much worse without this timely injection.

### *4.2.1 Corporate vs. personal*

Corporate income tax accounted for 20.7% of all revenue collected, compared to 16.4% in the previous year. Personal income taxes remain the biggest contributor, but as a percentage of revenue collected, fell to 35.5% from 39.1%.

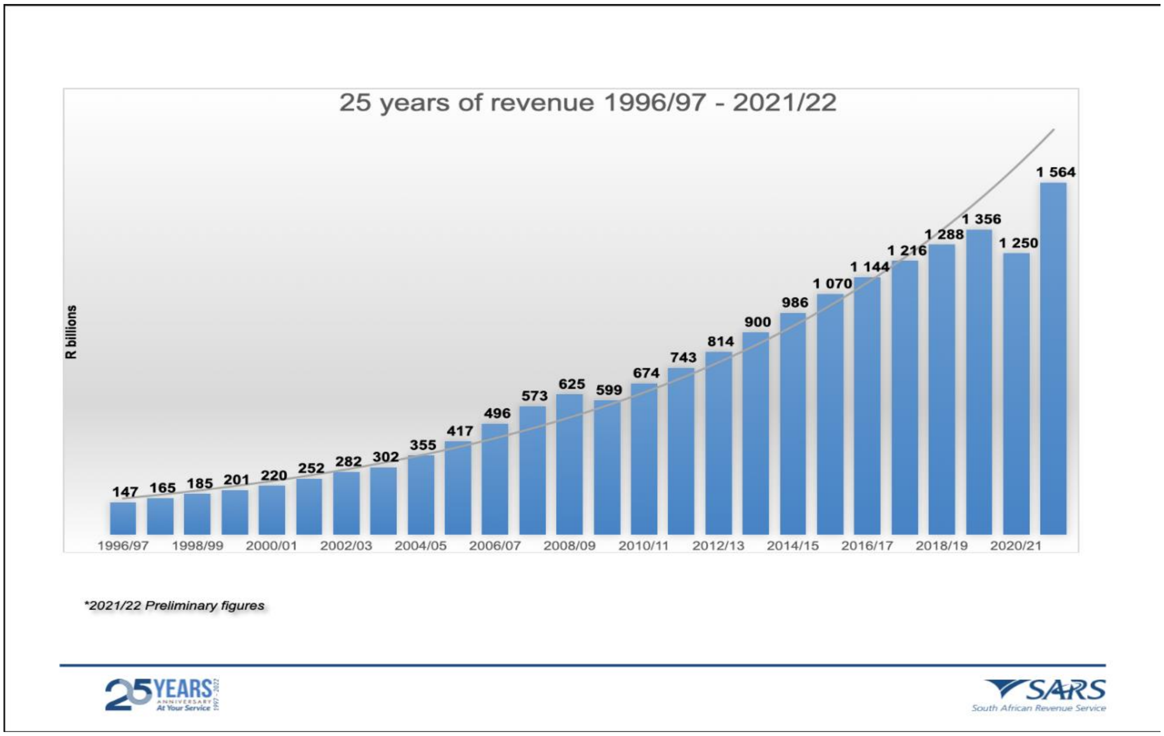



***Figure 2: 25 years of revenue 1996/7 - 2021/22***

The National Treasury and the South African Revenue Service  Tax Statistics 2021 edition shows that during the 2020/21 financial year, total tax revenue collections declined by 7.8% to R1.25-trillion from the R1.36-trillion collected in the preceding year.

Revenue collections in the 2020/21 fiscal year were severely impacted by the Covid-19 pandemic lockdown restrictions, and an already struggling economy that contracted by 7% in 2020.

The fourteenth yearly edition of tax statistics provided an overview of tax revenue collections and tax return information for the 2017 to 2021 tax years, as well as the 2016/17 to 2020/21 fiscal years, and showed that total tax revenue collected by SARS increased from R1.14-trillion in 2016/17 to R1.25-trillion in 2020/21, growing at a compound annual growth rate (CAGR) of 2.2% over this period.

Additionally, the tax-to-gross domestic product (GDP) ratio moderated from 23.8% in 2019/20 to 22.5% in 2020/21. This was mainly owing to yearly reductions in the revenue collected from personal income tax, value-added tax (VAT) and domestic specific excise duties.

Personal income tax at 39.1%, corporate income tax at 16.4% and VAT at 26.5% together remained the largest sources of tax revenue and comprise 81.9% of total tax revenue collections.

Further, corporate income tax revealed that, out of the 812 306 companies assessed as at September 2021 for the 2019 tax year, 24% had positive taxable income, while 48.3% had taxable income equal to zero and the remaining 27.7% reported an assessed loss.

Additionally, personal income tax, geographic, demographic and other analysis of taxpayers assessed at the end of September 2021 for the 2020 tax year showed that 2.091-million, or 40.1%, of assessed taxpayers were registered in Gauteng.

Further, 687 261 of assessed taxpayers lived in the Johannesburg Metropolitan area and were taxed on an average taxable income of R481 209.

Meanwhile, 1.365-million, or 26.2%, of assessed taxpayers were aged between 35 and 44 years, and 2.79-million, or 53.6%, of assessed taxpayers were male and 2.42-million, or 46.4%, were female.

Assessed taxpayers had aggregate taxable income of R1.8-trillion and a tax liability of R407.2-billion. Their average tax rate was 22.4% compared with 22.3% in the previous tax year. Income from salaries, wages and other remuneration as well as pension, overtime and annuities accounted for 91.6% of total taxable income.

Additionally, in 2020/21, 79.3% of active VAT vendors were companies or close corporations, which contributed 92.9% to domestic VAT payments and accounted for 91.2% of VAT refunds. Although individuals, namely sole proprietors, comprised 15.3% of VAT vendors, they contributed 2.4% of domestic VAT payments and received 1.2% of VAT refunds.
Further, import VAT and customs duties accounted for 13.3% and 3.8% respectively of the year's total tax revenue collected, resulting in a 17.1% aggregate which was slightly below the 17.5% average over the preceding five fiscal years.

The share of these taxes to GDP decreased to 3.8% from the preceding five-year average of 4.1%, with import VAT recording 3% and customs duties 0.8%.

In 2020/21, capital gains tax (CGT) of R16.4-billion was raised, of which R8.4-billion was attributable to individuals and trusts and R7.9-billion to companies. An aggregate of R173.1-billion has been raised since the introduction of CGT in October 2001, with R80.9-billion from individuals and trusts and R92.1-billion from companies.

The largest contributing Harmonized System sections to customs duties in 2020/21 were vehicles, aircraft and vessels at 20.1%, textiles and clothing at 19%, machinery and electronics at 13.8%, as well as food, beverages and tobacco at 13.4%.

The sections of vehicles, aircraft and vessels, at 56.7%, as well as machinery and electronics, at 38.6%, were the largest contributors to the ad valorem duty total, with 30.1% of the former's total comprising luxury vehicles from Germany, while 63.2% of the latter's total made up by electronic devices mainly from China.

Imports under the food, beverages and tobacco section made up 97.5% of the specific excise duty total, largely driven by cigarettes, at 37.1%, and sourced mainly from Switzerland, and whiskies, at 35.4%, and imported mostly from the UK.
"The overall effective customs duty rate in 2020/21 was 2.8% compared with the 3.2% in the previous year. Key commodities with the highest effective duty rates were footwear and accessories at 24.5%, hides, skins and leather at 19.5%, textiles and clothing at 14.5%, food, beverages and tobacco at 9.8%, as well as vehicles, aircraft and vessels at 6.9%. (South African Revenue Service, 2022)

# CHAPTER 5: WHAT IS THE IMPACT OF THE TAX AVOIDANCE PRACTICES ON TAX REVENUE?

## 5.1 An analysis of the tax avoidance practices in a South African context

Tax avoidance is a complex concept that creates uncertainty in the South African tax law system and results in revenue loss. Tax avoidance is a broad concept that constitutes permissible tax avoidance and impermissible tax avoidance. The main difference between impermissible tax avoidance and permissible tax avoidance is that the former is illegal and the latter is legal. To deal with, amongst other problems caused by impermissible tax avoidance, revenue loss, South Africa introduced the GAAR to curb impermissible tax avoidance. In doing so, the GAAR rejects tax avoidance arrangements that are found to be abusive and allows permissible tax avoidance. The South African GAAR is aimed at curbing impermissible tax avoidance arrangements that, inter alia, result in tax benefits with the sole or main purpose to obtain that tax benefit.

## 5.2 The harms caused by the impermissible tax avoidance practices

The harms caused by impermissible tax avoidance are varied and pervasive (SARS 2005, p. 9). They include short-term revenue loss, growing disrespect for the tax system and the law, increasingly complex tax legislation, the uneconomic allocation of resources, an unfair shifting of the tax burden, and a weakening of the ability of Parliament and National Treasury to set and implement economic policy.

### *5.2.1 Short-Term Revenue Loss*

The most immediate harm caused by impermissible tax avoidance is short-term revenue loss. Accurate estimates of the size of the problem are difficult to make, whether in South Africa or elsewhere. In part, these difficulties are due to disagreements about what constitutes impermissible tax avoidance; in part, to the fact that many schemes are deliberately designed to avoid detection. There is no question, however, that the amounts at stake are substantial.

The Tax Justice Network estimates that South Africa alone is losing R55 billion a year – around 1% of the country's total GDP. The majority of this lost money – around R 45 billion – is lost through multinational corporations exploiting loopholes and utilizing tax haven. (Tax Justice Network, 2021)

### *5.2.2 Disrespect for the Tax System and the Law*

While short-term revenue loss may be the most immediate problem, it is by no means the most serious. Impermissible tax avoidance also encourages "disrespect for the tax system – both by the people who participate in the tax shelter market and by others who perceive unfairness". Even the New York State Bar Association – hardly a "pro-tax" organization – has decried this "corrosive effect": "The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions". The result is an ugly "race to the bottom". The proliferation of arbitrary and contrived schemes also leads to a perception that the "system" is unfair. This may in turn discourage compliance, even by taxpayers that had not previously engaged in impermissible tax avoidance.

### *5.2.3 Increasing Complexity*

Another harm manifests itself in increasingly complex tax laws. This problem has two aspects: one, a proliferation of specific anti-avoidance measures that are enacted in response to particular schemes that are discovered on audit; the other, a tendency to try to pre-empt possible avoidance through increasingly complex and detailed legislation in the first instance. While this complexity may sometimes be self-defeating, it invariably increases the compliance burden upon all taxpayers.

### *5.2.4 Costs to the Economy*

Tax avoidance and evasion are economically costly. These costs arise in a number of ways. At a basic level, to the extent that impermissible tax avoidance inevitably results in new amendments, more complex legislation and increasingly comprehensive and detailed reporting requirements, administrative costs and compliance burdens swell for both taxpayers and the government. Additional costs are reflected in the resources that are diverted from productive investment to the development, marketing, implementation and subsequent defense of impermissible tax avoidance schemes. These so-called "avoidance costs" can be substantial.

Professional fees can often amount to a significant percentage of the promised tax benefits, especially in situations involving contingent fee or "value billing" arrangements. At a deeper level, impermissible tax avoidance creates significant deadweight losses for the economy by distorting trade and investment flows. In particular, avoidance schemes often involve a re- or misallocation of resources from productive investments to activities that are, at best, marginally profitable on a pre-tax basis. These distortions reduce economic efficiency and impede growth.

Promoters often try to justify their actions by claiming that they benefit the South African economy by providing borrowers with reduced financing costs through their schemes. In the case of various offshore schemes, such as schemes involving foreign films, these claims simply do not withstand scrutiny. These schemes drain capital from the South African economy, often in contravention of the spirit if not the letter of prevailing exchange control regulations. Even in the case of purely domestic transactions, pre-tax financing costs actually increase as a result of these schemes – an increase that is only masked by the artificial tax “savings” that are generated. Indeed, most impermissible tax avoidance schemes in the structured finance area amount to nothing more than elaborately disguised forms of inflating and trafficking in tax losses and other tax attributes – activities that are plainly contrary to basic policies embodied in the Act and that have been widely condemned by tax and policy experts worldwide.

### *5.2.5 Unfair Shifting of the Tax Burden*

Impermissible tax avoidance has a tremendous impact upon the equity and fairness of the tax system. At the most basic level, it creates “a form of subsidy from those paying their fair share of tax according to the intention of the law to those shirking their similar obligations”. Taxpayers engaging in such impermissible tax avoidance have thus been seen as a “particular aspect of the free rider problem”.

At a more systemic level, impermissible tax avoidance, particularly in the context of globalization and harmful tax competition, may severely constrain the ability of governments to tax income from capital and other relatively mobile sources. These forces, in turn, have tended to result in a shift of the tax burden to less mobile factors, such as labor and consumption. At the same time, by eroding the tax base, impermissible tax avoidance exerts an artificial upward pressure on marginal rates.

### *5.2.6 Weakening the Ability of Parliament and National Treasury to Set and Implement*

**National Economic Policy**

The basic goals of any tax system include revenue raising, equity, efficiency and simplicity. As discussed above, impermissible tax avoidance directly undermines each of these goals. In addition, in South Africa as elsewhere, revenue legislation has become an increasing “mix of fiscal, social and economic policy objectives”. By manipulating the tax laws through artificial and contrived schemes that have little economic substance, impermissible tax avoidance severely undermines the ability of Parliament and National Treasury to set and implement economic and social policy for the country. At a basic and obvious level, aggressive schemes can precipitate severe short-term revenue losses that limit government’s ability to pursue its economic and social agenda. In addition, various “tax shelter” schemes divert scarce resources from their intended targets. The film and plantation schemes of the late 1980s are classic examples of such abuse. South Africa and the world have changed enormously since Lord Tomlin made his famous statement in the Duke of Westminster case 70 years ago. South Africa is now a broad-based democratic society and government plays an increasingly vital role in securing the economic and social well-being of its citizens and while some may still prefer to view government as nothing more than a revenue-maximizing “Leviathan”, research and analysis have generally moved toward a more balanced and sophisticated view of the role of taxation in modern society. The right of taxpayers to minimize their liabilities within the bounds of the law is not to be denied indeed, it is a principle found in democratic societies throughout the world, one that may well provide a healthy counterweight to the power of the “Taxman”. At the same time, it is a right that still must be balanced against other rights and obligations. Impermissible tax avoidance may not be a crime, but it is certainly not victimless.

### *5.2.7 Abusive Avoidance Schemes*

In a sense, impermissible tax avoidance can thus be seen as an attempt to defer or eliminate a potential liability by manipulating or exploiting perceived “inconsistencies” or “discontinuities” in the tax system through various “tax arbitrage” techniques. This section focuses specifically upon features and characteristics that can be found in many of the most aggressive schemes.

### *5.2.8 No Mechanical Definition or Bright-Line Test*

Following a tremendous amount of study and critical analysis devoted to this topic internationally, there has been a growing realization that a single mechanical definition of abusive avoidance schemes is simply not possible. Such schemes "appear in the guise of Proteus".

### *5.2.9 Common Characteristics*

Nonetheless, there has been a growing recognition that many of the most abusive avoidance schemes share common attributes – what have sometimes been called the "hallmarks" or "badges" of avoidance. These characteristics include: (1) the lack of economic substance (usually resulting from pre-arranged circular or self-cancelling arrangements); (2) the use of tax-indifferent accommodating parties or special purpose entities; (3) unnecessary steps and complexity; (4) inconsistent treatment for tax and financial accounting purposes; (5) high transaction costs; and (6) fee variation clauses or contingent fee provisions. Schemes possessing most, if not all, of these characteristics are referred to herein as "abusive avoidance schemes".

**Lack of Economic Substance**

One of the most important characteristics of abusive avoidance schemes is the lack of economic substance. In many abusive avoidance schemes, the taxpayer purports to make a substantial investment. This investment, however, is largely an illusion. Through various devices, the taxpayer remains insulated from virtually all economic risk, while creating a carefully crafted impression to the contrary. In any investment, risk and return are related – the greater the risk, the greater the return. As a consequence, in so far as most abusive avoidance schemes typically involve little or no economic risk, they typically offer little or no opportunity for pretax gain rather, the "return" to the "investor" takes the form of the significant tax benefits promised by the arrangement. In this manner, "a negligible pre-tax profit is transformed into a significant after-tax return". Indeed, the mismatch between a limited (or non-existent) potential for pre-tax profit and the promise of very significant tax benefits is often a good indicator of an abusive avoidance scheme.

**Use of Tax-Indifferent Accommodating Parties or Special Purpose Entities**

Most abusive avoidance schemes also involve the use of accommodating parties or special purpose entities. Thus, as Lord Diplock has observed: "The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years

. . . involve inter-connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master-mind".

In the context of an abusive avoidance scheme, the accommodating party is typically "tax indifferent". Such parties may include foreign persons, partnerships, trusts, pension funds, and taxpayers that can either generate offsetting deductions to absorb any income they derive from their participation in a scheme or utilize existing assessed losses. In practice, these parties typically receive a fee (often in the form of an above-market return on investment) for the service of absorbing income or otherwise "selling" their tax-advantaged status to the other participants in the scheme. The role played by these tax-indifferent parties becomes clear when it is recognized that "the tax system has a built-in sort of fail-safe mechanism that stems from the fact that the parties to an agreement often find themselves in an adversary position when it comes to tax planning". A larger deduction for one party, for example, typically means greater income for the other. Tax-indifferent parties, by design, work to disable and defeat that mechanism. In South African planning circles, these tax indifferent parties are sometimes referred to as "washing machines", an apt description of their true role in these schemes.

**Unnecessary Steps and Complexity**

Abusive avoidance schemes are often mind-numbingly complex. There are several reasons for this. These schemes often require the completion of certain formalistic steps to claim the desired tax result. In so-called "bare dominium" schemes, for example, promissory notes evidencing future rental obligations are typically discounted through a tax indifferent party in order to enable the financing party to avoid tax on the full amounts received (while the borrower in the transaction continues to claim deductions for the full amount of the "rent"). Steps may also be inserted to prop up a claim of business purpose. Similarly, a complex structure may be used to disguise the true nature of a scheme or "as a device to cloak the tax shelter transaction from detection". More cynically, promoters may even deliberately add complexity for its own sake in order to justify higher professional fees.

The complexity of these schemes, coupled with the lack of any realistic possibility of a meaningful pre-tax profit, has led one expert to describe the typical abusive avoidance scheme as nothing more than "a deal done by very smart people that, absent tax considerations, would be very stupid".

**Inconsistent Treatment for Tax and Financial Accounting Purposes**

In keeping with global trends, listed companies in South Africa appear to be placing a larger premium on tax savings, at least to the extent that these savings result in an increase in reported earnings per share. A corollary of this development has been a tendency by management to view the tax department as a "profit center" within the firm. In short, there has been an increasing emphasis on keeping a company's reported effective tax rate (i.e., the ratio of its income tax liability to its profits for financial accounting purposes) low and in line with the rates reported by competitors. In order to do this, it is necessary to invent transactions in which the tax treatment varies from the financial accounting treatment. Thus, "structuring a transaction that results in either a deduction [for tax purposes] without a financial accounting charge or financial accounting revenue without the concomitant imposition of tax can be viewed as a real coup by the tax manager". This trend has clear implications for corporate governance. SARS' experience has been that shareholders rarely understand how far their companies are going to avoid and, in extreme cases, evade tax. Even more concerning are those cases where members of the board either did not know or did not wish to know how far their financial colleagues were going.

**High Transaction Costs**

Given the Byzantine complexity of many abusive avoidance schemes and the development and marketing costs often incurred by promoters, it is not surprising that fees tend to be extremely high. In a recent film scheme, for example, the fee paid to the promoter actually exceeded the amount that went to the film producer. In other financing transactions, fees can easily run into the millions.

**Fee Variation Clauses and Contingent Fee Arrangements**

In addition to the high fees, many promoters, particularly in the structured finance area, include fee variations clauses in their agreements in order to insulate themselves from any tax risk. Thus, for example, one scheme involved a R145 million sale and leaseback financing arrangement with a five year term. This relatively straightforward transaction ultimately came to involve at least seven major participants, multiple special purpose vehicles (including a trust, a special purpose company, and a partnership), more than a dozen pre-arranged and interlocking steps, each represented by a detailed and lengthy legal agreement, and multiple circular flows of cash – all in order to generate inflated capital allowances of some R95 million for the promoter. If successful, part of the value of these allowances was to be passed on to the seller/lessee in the form of lower interest rates; if not, the rates were to be reset to market. There has been less and less tolerance for such schemes alternatively, firms may enter into contingent fee arrangements with their clients. In these arrangements, the size of the fee depends upon the size of the tax benefits. Thus, for example, a promoter might arrange to receive a fee equal to 30% of the net tax benefits generated by a scheme. If the scheme generates tax savings of R10 million, the promoter would receive a fee of R3 million.

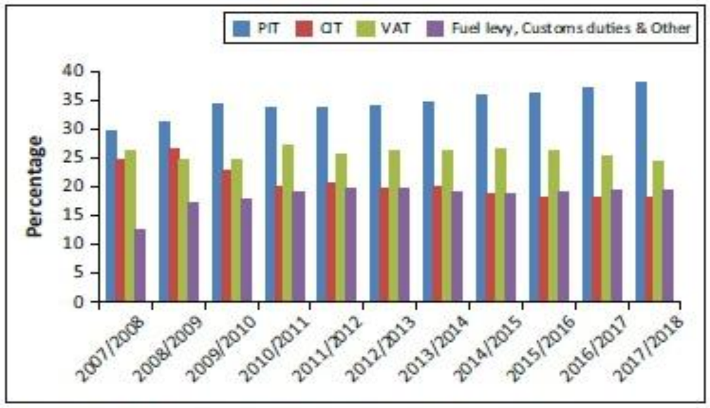
## 5.3 Taxation Gaps in South Africa

Tax revenue plays an integral role in the fiscal space to ensure the provision of public goods and services. Indeed, it is a major source of public revenue for most countries including South Africa. Tax revenues also finance redistribution initiatives. Hence, an efficient tax system is a precursor for inclusive and sustainable growth. While taxes are crucial to mobilize public revenue, they generally place a burden on taxpayers. The behavioral response of taxpayers reflects in attempts to evade and avoid taxes, which lead to significant losses of revenue. Even though efforts to improve tax compliance are mounting, the extent of taxpayers' non-compliance (or the tax gap) and the nature thereof remain fairly unknown in many (developing) countries. For South Africa, it is only the value added tax (VAT) gap that has so far been established. Less attention has been given to the tax gap in respect of personal income tax.

There are basically two broad categories of the tax gap, the compliance gap and the policy gap. The compliance gap refers to the amount forgone by the authorities due to compliance-related issues (Ahmed & Rider 2013:335). In contrast, the policy gap captures the amount of revenue forgone by the government due to the impact of the policy. The International Monetary Fund (2015:3) refers to the policy gap as the difference between theoretical revenue, given a hypothetical policy framework and potential revenue, given the current policy framework. Knowledge about the extent and scope of the tax gap is a useful first step towards controlling non-compliance and preventing its occurrence (European Commission 2016:13). For instance, it may serve as a tool to measure the effectiveness of a tax policy. It may also serve as a measure of administrative efficiency, as a higher tax gap may indicate poor administrative performance. Tax gap estimates can provide information on the sources of the tax losses, which may assist in enforcing compliance more effectively. Considering fiscal constraints in South Africa, knowledge on the extent and nature of the tax gap will aid authorities to raise additional revenue. It is against this backdrop that this study estimates South Africa's personal income tax (PIT) gap (compliance gap and policy gap), with a particular focus on the sources of the tax gap.

*Personal income tax in the South African tax system*

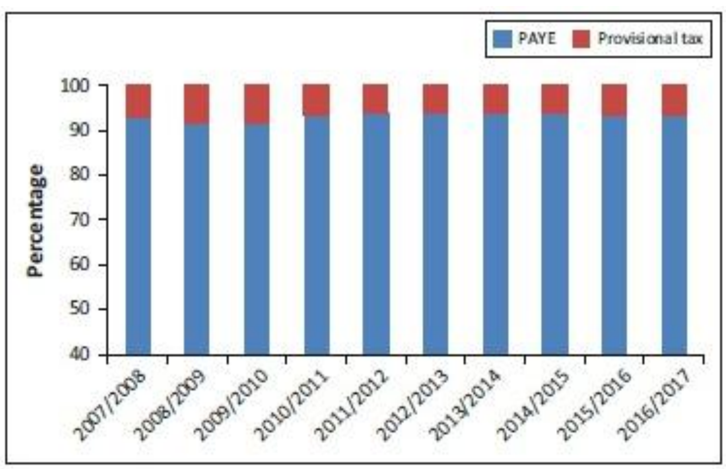
Tax revenues finance approximately 87% of South Africa's national budget, the bulk of which comprises PIT, which contributes over 30% of the total tax revenue (see Figure 1). PIT is applied using a progressive structure, with the highest marginal tax rate for the 2018 fiscal year set at 45% (National Treasury 2019:193). Most individuals receive their income in the form of wages or salaries, annuity payments or pensions, and investment income (National Treasury [NT] & South African Revenue Service [SARS] 2018:31). Hence, PIT paid stems from salaried or non-salaried income. Employees' income tax liabilities are calculated on employees' salaried income and are withheld by the employer (PAYE). Thus, settlement of income tax liabilities on remuneration income is done through third-party reporting. This mechanism is credited for minimizing non-compliance since employers have little incentive to under-report employees' taxes (Paulus 2015:9). PAYE contributes over 90% of the total PIT revenue. (South African Revenue Service, 2022)




PIT, personal income tax; CIT, company income tax; VAT, value added tax.
*Source*: National Treasury (NT) & South African Revenue Service (SARS), 2018, *2018 Tax statistics*, p. 9, National Treasury and SARS, Pretoria

***Figure 3: Composition of main sources of tax revenue***

Unlike salaried income, non-salaried income earners pay taxes through the method of provisional tax payment. This method allows the taxpayer to pay income tax across the relevant assessment year, as two advance payments are expected, with a possible third payment at the end of the tax year, if required (South African Revenue Service [SARS] 2018). Non-salaried income earners are suspected to be the main source of non-compliance within the South African PIT system (see Marcus 2007:156). In South Africa, provisional taxes constitute on average 7% of the total PIT collections. Figure 2 shows the trend of PAYE and provisional tax payments for the period 2007/2008 to 2016/2017.




PAYE, pay as you earn.
*Source*: National Treasury (NT) & South African Revenue Service (SARS), 2017, *2017 Tax statistics*, p. 21, National Treasury and SARS, Pretoria

***Figure 4: PAYE and provisional tax payments 2007/8 - 2016/17***

## *Tax Gap by definition*

Taxpayers tend to adopt measures that reduce their tax liabilities. For instance, taxpayers take advantage of legal loopholes within the tax system to reduce their tax liabilities, a phenomenon called tax avoidance. On the other hand, taxpayers may, in contravention of the law, intentionally under-report their taxable income - an act referred to as tax evasion. Tax evasion includes under-reporting taxable income, overstating deductions, and late and non-filing of tax returns (Gcabo & Robinson 2007:358). In some instances, governments may introduce tax expenditures (e.g. exemptions, special credits, rebates and preferential tax rates) to reduce taxpayers' liabilities, to better align the income tax with the ability to pay principle. All these measures reduce the tax liabilities, which reduce the revenue yield below its potential which creates a tax gap (Alm & Martinez 2003:1). As outlined previously, the tax gap is the difference between the potential tax revenue and the actual collections, where potential revenue is the amount of tax that the government should collect if every taxpayer complies with the tax legislation (Toro et al. 2013:14). It is classified into the compliance gap and the policy gap: the former denotes the value of revenue losses due to the impact of compliance-related issues (such as deliberate evasion, tax losses due to taxpayers' misunderstanding of tax legislation, tax authorities' poor record-keeping and other errors (Ahmed & Rider 2013:335). The policy gap reflects the amount of revenue forgone by the government due to the impact of the policy (Toro et al. 2013:11), and includes tax forgone due to tax avoidance and tax expenditures. Put succinctly, the policy gap is just a normalized measure of tax expenditures (Keen 2013:436). (Gcabo & Robinson, 2021)

## *Tax gap methodologies*

There are broadly two approaches to measure the tax gap, namely the top-down and the bottom-up approaches. The top-down (or macro-) approach relies on macro-economic data and the theoretical (or potential) tax liability is calculated from a single estimate of the tax base (Rubin 2011:109). Toro et al. (2013:33) indicate that to estimate reliable tax estimates using this approach, data must be representative enough of the tax base, and it must be derived from sources other than taxpayers' records. The advantage of such data is the independence from intentional misreporting by taxpayers. Other benefits of this approach include its simplicity, and the timeous release (or production) of national data, which allows for the release of timely estimates.

Despite these strengths, the top-down approach has two fundamental shortcomings. Firstly, it provides a single broad estimate of the tax gap, thereby providing little insight into the nature and causes of the tax gap. More precisely, the top-down approach is not capable of estimating the tax gap by its components. Such an estimate does not adequately capacitate the government to assess its performance in the collection of revenue and provides little guidance on how to reduce the tax gap. In fact, tax gap estimates from the macro-approach provide little insight into how to improve compliance.

To circumvent the shortcomings of the top-down approach, many researchers prefer the bottom-up approach (micro-approach), which uses individual-level (i.e. (micro-) data to determine the tax gap. This approach 'does not depend on the value of a single estimate of the tax base' (Rubin 2011:111), nor does it rely on macro-economic data (Fuest & Riedel 2009:20), but uses data obtained from tax audit records and surveys. The main advantage of this technique is that it establishes the tax gap by its components (i.e. by type of income, sector of the economy and in some instances, by the causes of the gap).

*Calculating South Africa's personal income tax gap*

A bottom-up approach is employed to estimate South Africa's personal income tax gap. For a reliable estimate of the potential tax liability, an objective measure of the tax base is required (Ahmed & Rider 2013:339-340). It is in this regard that survey micro-data, that is nationally representative, are most ideal for estimating the personal income tax gap. However, such data are susceptible to under-reporting, especially with regard to high income earners. This is generally because people (particularly high income earners), prefer their income worth to be a secret (see Ahmed & Rider 2013:343).

*Data and methodology*

Following the methodology of Ahmed and Rider (2013), this study uses the Income and Expenditure Survey (IES) data of the 2005/2006 and 2010/2011 surveys to estimate South Africa's personal income tax gap. Statistics South Africa (Statistics SA) conducts the IESs every 5 years and its primary task is to capture household consumption data to update the consumer price index (Statistics SA 2012:1). The 2005/2006 and 2010/2011 data sets include samples of 21 144 and 25 328 households respectively, collected nationwide (Statistics SA 2008, 2012). The study is limited to these two data sets as they used the same data collection methods (i.e. the diary and recall methods), and both surveys used the same classification of expenditure items: the Classification of Individual Consumption by Purpose (COICOP).

A static micro-simulation model is applied to estimate the PIT gap. This methodology allows us to incorporate the progressive nature of the tax rate structure, a critical aspect in estimating individual tax liabilities. The income tax liability is determined from the taxable income that includes remuneration income, business income, fringe benefits, taxable capital gains, interest and rental income (Black, Calitz & Steenekamp 2015; SARS 2016a). More specifically, to determine the tax liability, exclusions (e.g. in-kind income, unrealized capital gains and imputed rent) are removed from the total comprehensive income to arrive at gross income. Exemptions such as the tax-free portion of income (i.e. amount below taxable threshold), the tax-free portion of interest, and some pension income (e.g. war veteran's pensions and disability pensions) are deducted from the gross income, after which allowable tax deductions (such as pension contributions, medical contributions, depreciation allowances and donations to an approved public benefit organization) are subtracted from the income balance, to produce the taxable income (Black et al. 2015:256).

The tax due is determined by applying the tax rate schedule to the taxable income. The tax threshold (i.e. the taxable income at which a taxpayer starts to pay taxes) will generate a tax liability equivalent to the rebate (SARS 2016a:9). Table 4 summarizes how the tax liability is calculated.

***Table 4: Calculation of personal income tax liability***

| Variable | Value |
|---|---|
| Total (comprehensive) income | XXXX |
| Less: Exclusions | XXXX |
| Gross (cash) income | XXXX |
| Less: Exemptions | XXXX |
| Deductions | XXXX |
| Taxable income | XXXX |
| Multiply by tax rate (%) | XXXX |
| Tax amount | XXXX |
| Less: Rebate | XXXX |
| Tax payable | XXXX |

*Source*: SARS, 2010, *Notes on South African Income Tax 2010*, South African Revenue Authority, Pretoria

A micro-simulation model is constructed in STATA (software), in line with the tax calculation illustrated in Table 1. Using a tax calculator2, a line by line estimation of the tax liabilities is performed on all positive taxable income. The estimated tax amounts are then grossed up to national levels using household weights, where the weight is an inverse of the household's probability of selection. Grossed up tax liabilities are added together to produce the total amount of tax revenue that the state should collect if every taxpayer complies with the tax legislation.

In this study, the calculation of the PIT gap is carried out in three phases. First, the tax calculator is applied to gross income (income inclusive of tax expenditures, which is a hypothetical policy framework). This gives the amount of tax revenue the state would collect in the absence of tax expenditures such as rebates or deductions for medical expenses. Second, the potential tax liability is calculated from the total taxable income. The discrepancy between these two theoretical tax liabilities (i.e. from the gross income and the total taxable income) gives an estimate of the policy gap. The theoretical tax liability derived from the total taxable income is then compared to the personal income tax collections (obtained from SARS). The difference between the estimated potential tax liability from taxable income and the actual collections represents the compliance gap. Third, the tax calculator is applied to salaried income to estimate the theoretical tax liability for this income source. The estimated potential tax liability is matched against the actual PAYE collections and the difference gives the salaried income tax gap (Ahmed & Rider 2013:340). The theoretical tax liability for non-salaried income is calculated by subtracting the salaried tax liability from the total theoretical tax liability. The estimated potential tax liability for the non-salaried income is then compared with the actual tax collections from provisional taxpayers, and the discrepancy between these two figures is the tax gap in respect of non-salaried income earners. However, it is important to note that the actual collections may not be what is expected for a particular tax period, given that the current year's collections would exclude late payments for the (current) year while including late payments for previous years. Furthermore, as outlined previously, this study uses gross household income, and this could lead to variations in the tax gap estimates (as the tax unit is the individual and not the household). Other causes of variations include the fact that the IES data is not equivalent to the tax year - hence income estimations in the survey data are not equivalent to what one would expect in the tax year associated with the particular survey data set. Given the data constraints, the tax gap estimates from this study remain an approximation of the gap and should be treated as such.

For both tax years (2005/2006 and 2010/2011), the major exemptions and deductions included war veterans' and disability pensions, medical expenses and medical aid contributions, donations to public benefit organizations, pension fund contributions, retirement annuity fund contributions, legal fees, doubtful debts and wear and tear (SARS 2010:220-221). However, war veterans' and disability pensions, donations to public benefit organizations, legal fees, doubtful debts and wear and tear were not used in the study's calculations as they were not captured in the survey data sets. Deductions in respect of pensions and retirement contributions were limited to 7.5% and 15% of the taxable income. However, in both survey data sets, pensions and retirement annuity fund contributions were combined with provident fund contributions, which are not deductible. To separate provident fund contributions, the study assumed that one-third of the combined funds constitutes contributions to the provident fund. The tax calculators for the micro-simulation models were constructed, based on the guidelines for the 2005/2006 and 2010/2011 tax years, in accordance with the Income Tax Return for Individuals (the ITR12).

Personal income tax brackets for the 2005/2006 and 2010/2011 tax years are shown in Table 2.

***Table 5: 2005/6 and 2010/11 personal income tax brackets***

| Tax year | 2005/2006 | 2010/2011 | Marginal PIT rates (%) |
|---|---|---|---|
| Taxable income brackets (Rand) | 0–80 000 | 0 – 132 000 | 18 |
| | 80 001–130 000 | 132 001–210 000 | 25 |
| | 130 001–180 000 | 210 001–290 000 | 30 |
| | 180 001–230 000 | 290 001–410 000 | 35 |
| | 230 001–300 000 | 410 001 –525 000 | 38 |
| | 300 001 and above | 525 001 and above | 40 |
| **Rebates** | | | |
| Primary | 6300 | 9756 | - |
| Secondary | 4500 | 5400 | - |
| **Tax thresholds** | | | |
| Below age 65 | 35 000 | 54 200 | - |
| Age 65 and above | 60 000 | 84 200 | - |

PIT, personal income tax.

*Source*: SARS, 2006, *Guide on income tax and the individual (2005/06)*, viewed 10 September 2016, from https://www.sars.gov.za/AllDocs/Pages/default.aspx; and National Treasury (NT) & South African Revenue Service (SARS), 2011, *2011 Tax statistics*, National Treasury and SARS, Pretoria

(South African Revenue Service, 2022)

In calculating the taxable income, it is worth mentioning that both the 2005/2006 and 2010/2011 data sets do not reveal how medical expenses were settled. Thus, it is not explicit whether the payment was done by the employer, household member or by a medical aid. The data do, however, reveal that approximately 25% of household income was spent on medical aid contributions. The analysis therefore assumed that 75% of medical expenses were paid by medical aid insurers. Deductions for medical expenses and medical aid contributions' deductions were each limited to R500 and R625 per month in 2005/2006 and 2010/2011. In the event that the medical aid contributions made by the employer exceeded these thresholds, the excess amount was taxed as a fringe benefit. This excess amount is presumed to be a medical expense paid by the employer and, as such, it is deducted from the medical aid contributions made by the employee (SARS 2010:221). However, as outlined previously, this study used household survey data (to proxy individual data), as the data sets do not specify the main member of the fund. Medical deductions were therefore calculated from the household medical contributions, which may overestimate the expenditures.

### *Quantifying the Tax Gap in South Africa*

The National Treasury's economists and actuaries were at full steam preparing the country's medium-term budget that was presented by Finance Minister Enoch Godongwana in November 2021.

That meant preparing spending estimates for the first half of the current year (2021/22) and adjusting the proposed revenue and spending estimates for the second half of the current year.

Godongwana has indicated he will follow the path of prudent fiscal policy set by his predecessor, Tito Mboweni, and cut public debt. But the demands are huge.

His team was working to accommodate billions of new spending, including the R26.5-billion needed for the Social Relief of Distress Grant, the R700-million for the SA National Defence Force to cover the costs of deployment during the July public disorder that hit KwaZulu-Natal and parts of Gauteng, and other financial demands.

The fiscus has benefitted from the record commodity prices, but the economy is struggling to gain the momentum necessary to sustain the better-than-average tax inflows of this year. South Africans know that the budget is under pressure and that social and development needs are overwhelming current income.

But there is one obvious way to help fund spending that will not raise anyone's taxes and will not shrink any spending programs. It is called closing the tax gap. This was the theme of Tax Indaba 2021, an annual conference presented by the South African Institute of Taxation (Sait).

The tax gap is the difference between the taxes people and businesses theoretically owe and how much they pay. That amount is massive. Some studies put it at R200-billion or more, which is 10% of taxable revenue or 4% of GDP, says Kyle Mandy, a partner and head of national tax technical at PwC SA.

South Africa is not alone in dealing with this challenge. "Every country has one; it's a perennial problem," he said.

Some of this gap results from honest mistakes but some is flagrant tax cheating and outright fraud. In today's numbers you are looking at R40-billion-plus on the VAT side, while on the corporate tax side the gap for non-financial services is north of R100-billion, around 2% of the GDP, " he told delegates. "When it comes to personal income tax, a study done by Stellenbosch estimates the gap at about R50-billion. That takes us to R200-billion just for those three.

To put that in perspective, R200-billion is enough to pay for half of Eskom's debt, or to significantly narrow the country's budget deficit, which sits at 11% of GDP or R552-billion. It is more than government budgeted for social grants in this financial year and for basic education in the 2021 financial year.

Of course, eliminating the tax gap in full is not simple. The first step is to accurately assess the size of the gap and pinpoint problem areas. "Estimates will not take us forward –if you want a coherent policy to address compliance you need to build capacity to do so," says Professor Ada Jansen, associate professor at Stellenbosch University. This assumes that the capability, processes and technologies necessary are in place. It also requires access to third-party data – for instance which was held by the South African Reserve Bank, for comparative purposes.

SARS has many imperatives, chief of which is restoring the organization to past levels of competence. When it comes to closing the tax gap, where should it focus first? SARS chief revenue officer Johnstone Makhubu said SARS is focused on the priority areas of personal income tax, VAT and corporate tax. Excise tax is also a problem, he says.

> Tax avoidance by multinationals, in the form of base erosion and profit-shifting, is an issue that has hogged headlines and dogged global tax collectors for years. "We love to throw that out. But if you look at Her Majesty's Revenue and Customs (HMRC) latest report on avoidance, only 4% of the total gap is attributable to that. Anecdotal evidence suggests that the issue lies with SMEs that are privately, not publicly owned. HMRC attributes that SMEs are responsible for 57% of the tax gap. (National Treasury, 2022)

## 5.4 The impact of tax havens on collection of tax revenues in South African

This research focused mainly on comparative analysis of foreign owned firms operating in South Africa to show that firms with a parent registered in a tax haven tend to report 80% less in profits than similar firms without a parent in a tax haven. This is highly suggestive, but not conclusive, evidence of profit shifting.

When broken up by firm size, the data shows that the smallest half of multinationals with tax-haven affiliations do not engage in profit shifting. It is the top 10% of firms that account for 98% of the estimated volume of profit shifting. The total estimated loss represents 4% of annual corporate income tax receipts, equivalent to R 7 billion or €400 million a year. Tax havens, tax avoidance, profit shifting, and corporate tax planning have been a part of the modern lexicon ever since the leaking of the now infamous Panama Papers.

These practices have only increased with the continuing globalization of the modern economy, raising important questions about fairness and economic development. For example, do tax havens make it easier for multinational corporations to pay less than their fair share in the nations where they operate? How does that impact nations who need tax revenue to develop their economies and improve the lives of their citizens? And, if we could identify the companies that shift profits would it be easier for governments to collect revenue from them?

South Africa has about two thousand foreign owned firms operating in its economy, but these firms represent nearly 30% of total sales. These companies are big players in the economy, having doubled their share of the economy over the last 25 years. Globally, the standard method for estimating profit shifting applies an average rate of profit shifting to all firms in order to estimate the aggregate loss caused by offshore tax havens. In this study, the methodology was updated to reflect the finding that different sized firms behave differently. The method used adjusts the rate applied according to the actual frequency of profit shifting indicated by tax data for firms of different sizes.

Doing this reveals that research using overall averages might underestimate the scale of the problem globally by as much as 80%. For states in the Organization of Economic Co-operation and Development (OECD), previous studies may have underestimated the scale of profit shifting by about 40% on average. OECD estimates from the Base Erosion and Profit Shifting (BEPS) initiative, which aims to reduce revenue losses that result from international tax leaks, could be improved by accounting for how different sized firms behave differently.

In South Africa, 19% of tax revenues come from corporate income taxes. Addressing the underreporting of corporate income by large multinationals with offshore affiliations could increase these tax receipts by 4% of their total, a benefit to the South African fiscus of approximately R7 billion a year.

## 5.5 Transfer pricing and its impact on the tax revenue collection in South Africa

### *5.5.1 What is transfer pricing*

The phenomenon of transfer pricing falls within the broader category of capital flight, illicit financial flows and the Base Erosion and Profit Shifting phenomena, which have received substantial attention from various organisations.

Transfer pricing is usually utilised by multinational corporations as a form of tax avoidance through doing the following:
Selling the goods and services (particularly commodities) at a lower price than would be at arm's length in order to pay lower taxes than in the country of production.
Overpricing the services a multinational corporation receives for intangible services from its subsidiary corporation located in a tax haven.

Transfer pricing happens as a means of manipulation of the international trade system in order to transfer huge amounts of money to tax havens or jurisdictions without, or very low taxes.

### *5.5.2 Transfer pricing in South Africa*

In 1994, the Minister of Finance in South Africa instituted a Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa chaired by Judge Katz (The Katz Commission). The Katz Commission issued and submitted a total of nine Reports, which were submitted to the Joint Committee on Finance for consideration between 1996 and 1999. In virtually all the interim reports, the question and phenomenon of transfer pricing was highlighted.

The Katz Commission 3rd report issued in 1997 said,

> During his 1995 Budget speech, the Minister of Finance drew attention to the high level of tax avoidance, much of it implemented by means of sophisticated financing structures. The Commission was requested by the Minister to investigate the question of tax avoidance. In complying with this request, the Commission has given particular attention to:
>
> - the need for a general tax anti-avoidance provision;
> - the efficacy of the existing legislation contained in section 103 of the Income Tax Act ("the Act"); and
> - The desirability or otherwise of the imposition of penalties in the case of avoidance" (Katz Commission, 1997).

In the then recurrent submissions to the Portfolio Committee on Finance, South Africa's Finance Intelligence Centre has illustrated that over the last decade, South Africa has lost in excess of R600 billion in illicit financial flows, and transfer pricing plays a major role in this instance.

Importantly, the High Level panel uses a case study in South Africa wherein:

> The South African authorities informed the Panel about a case in which a multinational corporation was found to have avoided $2 billion in taxes by claiming that a large part of its business was conducted in the United Kingdom and Switzerland, which at that time had lower tax rates for their business, and moving the legal site of their business to these jurisdictions. When the South African authorities investigated the case, they found that the UK and Swiss subsidiaries/branches had only a handful of low-paid personnel with relatively junior responsibilities, and that these offices did not handle any of the commodities in which the company dealt (nor were they legally able to take title to those commodities). The company's customers were often in South Africa, but for each transaction, a paper trail was created that would route the transaction through the Swiss or UK offices to give the impression that these offices were critical to the business. The South African authorities were able to reclaim the tax that was avoided because it was clear that the substance of the company's activities was conducted in South Africa. (High Panel on IFF Report, 2015).

### *5.5.3 The consequences of transfer pricing in South Africa*

There are varying degrees of the consequences of illicit capital flight and/or transfer pricing in South Africa and the following point to the possible degree of what this could have caused South Africa:

The High Panel on Illicit Financial Flows from Africa convened by former President Thabo Mbeki observed that "Illicit financial outflows

- drain hard currency reserves,
- heighten inflation,
- reduce tax collection,
- cancel investment,
- undermine trade,
- worsen poverty,
- Widen income gaps" (High Panel on IFF Report, 2015).

### *5.5.4 How does South Africa respond to transfer pricing*

It is important to highlight the reality that in his response to the question posed by the Economic Freedom Fighters to the President Cyril Ramaphosa, in the National Council of Provinces on transfer pricing, this is what he had to say,

"Honourable Member, there is currently no plan to establish a commission to investigate tax evasion and capital flight from South Africa.

Tax evasion and the illegal transfer of capital across borders is dealt with by relevant authorities, which include the South African Revenue Service, the South African Reserve Bank, and the law and prosecuting authorities.

As part of their routine activities, the South African Revenue Service and the South African Reserve Bank continually assess taxpayers and significant financial transactions where they believe that such activities are not declared or are not legitimate.

This is a global problem, and for this reason, the Organisation for Economic Co-operation and Development has commenced a major research project to sharpen the mechanisms to deal with transfer pricing and base erosion" (Ramaphosa, 2014).

# CHAPTER 6: RESEARCH FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

## 6.1 RESEARCH FINDINGS

### *6.1.1 Tax Avoidance*

Tax avoidance can be summed as doing everything possible within the law to reduce your tax bill.

A taxpayer may lawfully arrange her affairs to minimise taxes by such steps as deferring income from one year to the next. It is lawful to take all available tax deductions. It is also lawful to avoid taxes by making charitable contributions.
Tax evasion, on the other hand, is a crime.

Two general points can be made about tax avoidance and evasion. First, tax avoidance or evasion occurs across the tax spectrum and is not peculiar to any tax type such as import taxes, stamp duties, VAT, PAYE and income tax.
Secondly, legislation that addresses avoidance or evasion must necessarily be imprecise. No prescriptive set of rules exists for determining when a particular arrangement amounts to tax avoidance or evasion.

It is impossible to express a precise test as to whether taxpayers have avoided, evaded or merely mitigated their tax obligations. As Baragwanath J said in *Miller v CIR; McDougall v CIR:* What is legitimate 'mitigation' (meaning avoidance) and what is illegitimate 'avoidance' (meaning evasion) is in the end to be decided by the Commissioner, the Taxation Review Authority and ultimately the courts, as a matter of judgment. Please note in the above statement the words are precisely as stated in judgment. However there is a mix-up of words which have been clarified by the words in the brackets by me. Tax mitigation (avoidance by planning) taxpayers are entitled to mitigate their liability to tax and will not be vulnerable to the general anti-avoidance rules in a statute.

A description of tax mitigation was given by Lord Templeman *in CIR v Challenge Corporate Ltd*: "Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability".( *C of IR v Challenge Corp Ltd 2 NZLR 513)*

Tax mitigation is, therefore, behaviour which, amounting to tax avoidance (by planning), and it also serves to attract less liability than otherwise might have arisen.

### *6.1.2 General Anti-Avoidance Rule*

Section 103(1) contained the acts' general anti-avoidance rule (GAAR) for a number of years. This provision did, however, contain certain inherent weaknesses with the result that a new GAAR was incorporated within the Act. These new provisions were inserted in sections 80A to 80L and apply to any arrangement entered into on or after 2 November 2006.

Section 80A describes what an "impermissible avoidance arrangement" is. The powers that the Commissioner has with respect to an impermissible avoidance arrangement are set out in s 80B. The remaining provisions expand on these first two provisions and deal with certain procedural issues that arise.

Section 80L defines the terms "arrangement", "avoidance arrangement", "impermissible avoidance arrangement", "party" and "tax benefit" for use in the GAAR. It is important to note that these terms draw heavily on the provisions and interpretation of the previous s 103(1), with the exception of the new terms "impermissible avoidance arrangement" and "party".

The general anti-avoidance rule can be applied if an avoidance arrangement (in other words, an arrangement that results in a tax benefit) is an "impermissible avoidance arrangement"

The general rule is that an avoidance arrangement lacks commercial substance if it results in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flow of that party (s 80C). Examples of indicators of a lack of commercial substance, according to s 80C (2), include: situations where the legal substance of a transaction differs from the legal form, or round trip financing is present, as described in s 80D, or a tax-indifferent party, as described in section 80E, is introduced as part of the arrangement, or elements are present that have the effect of offsetting or cancelling each other. These elements are typically present when one transaction creates a significant tax benefit while another transaction effectively neutralises the undesired consequences of the first transaction.

Section 80D provides a non-exclusive description of round trip financing. This essentially relates to a transfer of funds between parties that results in a tax benefit and a significant reduction, offset or elimination of business risk.

### *6.1.3 Collection on tax revenue*

Despite the slowdown in the economic recovery in the third quarter of 2021, tax collections since the publication of the 2021 Medium Term Budget Policy Statement (MTBPS) have strengthened. Tax revenue for 2021/22 has reached the R 1.55 trillion, surpassing the pre-pandemic forecasts. This substantial improvement is projected to result in the tax-GDP ratio reaching 24.7 per cent in 2021/11. Understood in the context of South Africa's GDP, this exceeds previous highs reached in 2007/08 and 2019/20. Revenue estimates have also been revised higher in 2022/23 and 2023/24.

The characteristics of the economic recovery from the pandemic have been markedly

different to previous negative shocks. After the global financial crisis, it was several years before major tax category collections recovered to pre-crisis levels as a proportion of income and consumption. Tax resiliency in this recovery has been far stronger, potentially due to the artificial nature of the downturn through lockdowns and enforced restrictions on activity, rather than damage inflicted by a recession.

The revenue performance is largely attributable to elevated commodity prices. Additionally, corporate income and profits have been more resilient than anticipated, with tax collections benefiting from strong but temporary increases in the prices of exports relative to imports.

The personal income tax collection has been buoyed by a recovery earnings. Domestic value added tax (VAT) collections grew significantly as household consumption was supported by stronger earnings and low interest rates. The easing of the pandemic related restrictions supported a return to economic growth in 2021, commodities traded at elevated levels and, despite a slowdown in the second half of the year, drove a significantly improved in-year revenue performance. Tax revenue collections for 2021/22 have exceeded the 2021 budget estimates by R 181.9 billion and the 2021 MTBPS estimate by R 61.7 billion.

Tax collections for 2021/22 are slightly higher compared to those projected in the 2020 Budget, before COVID-19, albeit in a context of higher-than- projected spending, especially on health, compensation, social grants and debt-service costs. Commodity prices have declined since November 2021 but remain above pre-pandemic levels. At the same time, provisional corporate income tax collections from the mining, finance and manufacturing sectors have accelerated. The positive performance of finance and manufacturing, which historically accounted for close to 60 per cent of total provisional corporate income tax collections, indicates a wider revenue recovery.

### *6.1.4 Impact of tax avoidance on tax revenue collection.*

In the absence of tax expenditures, the South African government could collect potential tax revenue of R382.3 billion from individual taxpayers in 2005/2006, and R449.6 billion in 2010/2011. The granting of tax expenditures reduced it to R276.4 billion and R316.6 billion. This implied that the policy gaps (the amount of revenue forgone due to the impact of policy) for the 2005/2006 and 2010/2011 tax years were R105.9 billion and R133 billion. In both years, approximately 30% of PIT revenue remained uncollected due to tax expenditures. Relative to the total PIT gap, it is estimated that the policy gap constituted about 64% in 2005/2006, an estimate that increased to 84% in 2010/2011. These are definitely very large policy gaps, implying that the government has been losing significant amounts of revenue in its effort to reduce taxpayers' burdens.

The authority (SARS) had the potential of collecting R276.4 billion worth of PIT revenue in 2005/2006. However, only R216.3 billion was collected, producing a compliance gap of R60.1 billion. This implied a compliance rate of 78.3%. The tax revenue forgone (due to non-compliance) is equivalent to 21.7% of the potential tax revenue. In 2011, the government lost R26.2 billion worth of revenue, which is 8.3% of the potential tax revenue. Although this is a commendable improvement from the 2005/2006 tax year, the extent of evasion is still significant.

In 2005/2006, of the R276.4 billion potential PIT revenue, R218.2 billion should have been raised from employed individuals' taxes (i.e. PAYE). However, PAYE collections amounted to R201 billion, implying a PAYE tax gap of R17.2 billion and a compliance rate of 92.1%. In 2010/2011, instead of raising R265.1 billion worth of PAYE, the government managed to collect R264.8 billion and lost R0.3 billion through non-compliance (a 99.9% compliance rate).

The potential tax liability (from taxable income) for provisional taxpayers was found to be R58.2 billion for the 2005/2006 tax year. However, the actual payments were R15.3 billion in total, thus creating a compliance gap of R42.9 billion and a compliance rate of 26.3%. In 2010/2011, instead of collecting R51.5 billion from this same group of taxpayers, only R25.6 billion was collected, thus implying a tax gap of R25.9 billion and a compliance rate of 49.7%. Although this is an improvement compared to the 2005/2006 tax year, it is worth noting that over 50% of the non-salaried potential tax revenue remained uncollected in 2010/2011.

In terms of the composition of the total PIT compliance gap, the gap by salaried income contributed 28.5% in 2005/2006, an estimate that declined to 1.1% in 2010/2011. In 2010/2011, and despite a significant improvement in their compliance rate (from 26.3% to 49.7%), the share of the gap emanating from non-salaried income (as a percentage of share of the total tax gap) increased from 71.5% to 98.9%.

The significant improvement in the compliance of salaried individual taxpayers could be ascribed to reforms the tax authorities introduced in the tax system, in particular modernization initiatives (see SARS 2016b). For instance, SARS introduced an electronic queue management system, the Branch Queue Management System (BQMS) - a system that is meant to improve the administration of queues at branch offices during tax seasons. The BQMS uses 'mobile smart devices to issue tickets to the queuing taxpayers' (SARS 2016b:406).

The system reduced the average queuing times by 57% in 2010 (Rasool, 2011). Furthermore, the tax authority introduced an e-filing facility, which has made the submission and processing of tax returns more efficient. These reforms made it relatively less costly to comply, which motivated taxpayers to oblige with the requirements of the tax legislation. The cost of collecting tax revenue decreased from 1.5% of total revenue in 2005/2006 to 1.1% in 2010/2011 (National Treasury and SARS 2011).

A further initiative that can explain the significant increase in compliance rates of salaried taxpayers is the government's rollout of an Individual Taxpayer Policy Registration program in 2010, which required all formal employees to be registered as taxpayers regardless of their tax liabilities. The program led to an increase in the number of individual registrants to 10.3 million in 2010, up from 5.9 million in 2009. This compulsory registration of employees could be one of the main explanatory factors of the significant increase in salaried taxpayers' compliance rates.

Non-salaried taxpayers' compliance can also be attributed to SARS's educational campaigns, strengthened deterrent measures and the 2010 reprieve (the Voluntary Disclosure Program). The higher non-compliance rate of non-salaried income earners in both years (2005 and 2010) supports the hypothesis that self-reporting of non-salaried income is more prone to non-compliance than salaried income (submitted through third-party reporting). Paulus (2015:9) highlights that because there are fewer incentives for employers to misreport employees' income, employees would have to collude with the employers to evade taxes. Depending on the availability of such opportunities, it is more difficult to evade salaried income tax than non-salaried income tax (Paulus 2015:24). Ahmed and Rider (2013:343) also argue that a withholding tax regime is an effective revenue mobilization technique.

## 6.2 CONCLUSIONS

### *6.2.1 Tax Avoidance*

All future transactions should be considered for abnormality, lack of commercial substance or misuse of the Income Tax Act. Any of these factors may result in the application of the new general anti-avoidance rules.

### *6.2.2 General Anti-Avoidance Rules in South Africa*

Estimates of revenue collection have risen significantly relative to the 2021 MTB PS, due to high commodity prices, and a broad recovery in tax bases. Government wil l continue to adjust the design of the tax system to ensure that it is efficient, fair and f lexible.

### *6.2.3 Impact of Tax Avoidance Practices on Tax Revenue Collection*

This study provides some fundamental insights into the performance of South Africa's PIT system. The granting of tax expenditures reduced revenue from R382.3 billion to R276.4 billion in 2005/2006 and from R449.6 billion to R316.6 billion in 2010/2011, creating policy gaps of R105.9 billion and R133 billion. This is approximately 30% of PIT revenue for both years and 64% and 84% of the total PIT gap for 2005/2006 and 2010/2011.

These are definitely very large policy gaps, implying that the government has been losing significant amounts of revenue in its effort to reduce taxpayers' burdens. Although tax expenditures play an important role in reducing tax burdens, there is a need to examine the possibility of reducing the policy gap as its reduction may raise a significant amount of revenue.

The authority (SARS) had the potential of collecting R276.4 billion worth of PIT revenue in 2005/06, if everyone complied with the legislation. However, R216.3 billion was collected in 2005/06 and R290.4 billion was collected in 2010/2011, producing compliance gaps of R60.1 billion and R26.2 billion - implying compliance rates of 78.3% and 91.7% in that order. In terms of the composition of the PIT compliance gap, the gap by salaried income constituted 28.5% in 2005/06, an estimate that decreased to 1.1% in 2010/2011, while the balance constituted the gap by non-salaried income. Thus, non-salaried income constituted the bulk of South Africa's PIT compliance gap.

Overall, South Africa has a well-functioning PIT system (with a compliance rate of 91.7%). However, its compliance rate is lower than that observed in developed countries, such as the UK and Sweden where PIT compliance rates are around 95% (Bäckman 2014; Whicker & White 2015).

It would be even more insightful to compare South Africa's PIT gap with other developing countries'. Unfortunately, knowledge about tax gaps in developing countries is limited (aside from the Pakistan study which reported a compliance PIT gap of 41.1%; [see Ahmed & Rider 2013:339]).

Although the South African tax system has a high compliance rate, further measures are required to stimulate increased compliance of provisional taxpayers. These measures may include formalizing the underground economy, further strengthening deterrent measures and building taxpayers' trust in the authorities (i.e. improving citizens' perception of the government).

It would even be more enlightening to estimate the tax gap following the Her Majesty's Revenue and Customs (HMRC) approach, which uses audited data (that correspond to the tax year) made available by the tax authority.

However, owing to confidentiality of taxpayers' information, such data is not easily accessible for academic research, particularly in South Africa. Given the data constraints, the tax gap estimates from this study remain an approximation of the gap and should be treated as such.

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