# Interface

## The likely future tax structure in the RSA and urgently required tax reform

Michael P. Menof

Specialist lecturer in Taxation at the Graduate School of Business Administration, University of the Witwatersrand, Johannesburg

Address delivered to the Regional Congress of the Orange Free State of the Association of the Chambers of Commerce of South Africa at Welkom, June 18, 1980

Received October 1980

Before we can comment on the likely tax structure and tax reform in South Africa we must briefly look at the economic and political situations and predict what is likely to happen. The economic and political situations will determine the financial requirements of the country.

### Economic and political situation

The economic situation will be governed largely by the political situation in South Africa which inter alia will be directly affected by internal events and the outcome of events in Namibia — South West Africa and our relationship with countries neighbouring or close to our borders i.e. Angola, Zimbabwe and Mozambique, where anything could happen. While the Republic has a certain amount of breathing space, it is desperately trying to get its own house in order by more effective and fairer administration and by attempts to raise the standard of living of the under-privileged and to remove discriminatory practices. Defence spending and expenditure on the less privileged will be reflected in a heavy drain on State coffers for many years to come.

Curbing the high rate of inflation is another problem with which the Government has to contend in an environment further complicated by a high rate of unemployment, escalating oil prices, the threat of embargoes necessitating stock-piling of strategic materials and a significant emigration of skilled and professional people. On the credit side, a high price for gold, a rich supply of strategic materials and a healthy agricultural sector should result in the country's holding its own and, political upheaval aside, the continuation of the present boom well into the 80's.

### Capital funding

At present the country is flush with funds but there can be little doubt that increasing pressure on the Republic from outside its borders and gold price uncertainty could leave the country short of capital. Loans from overseas could be hard to obtain for any reasonable period as threats to the stability of the country mount. Hence any shortfall of funding will be largely financed from internal sources unless outside borrowings on the long term can be obtained.

It is interesting to note how Government funding and spending has increased over the last eight years and how a shortfall has been experienced each year.

| | Total Government Receipts (Millions) | Total Government Spending (Millions) | Deficit (Millions) |
|---|---|---|---|
| Year ended March 1973 | R3 182 | R3 824 | R642 |
| Year ended March 1974 | 4 202 | 4 607 | 405 |
| Year ended March 1975 | 4 983 | 5 799 | 816 |
| Year ended March 1976 | 5 661 | 7 017 | 1 356 |
| Year ended March 1977 | 6 505 | 8 475 | 1 971 |
| Year ended March 1978 | 7 261 | 9 270 | 2 009 |
| Year ended March 1979 | 8 514 | 10 603 | 2 089 |
| Year ended March 1980 | 9 797 | 11 480 | 1 683 |
| Year ended March 1981 Budgeted | 10 856 | 13 083 | 2 227 |
| When comparing 1973 to 1980 an increase of | 208% | 200% | |

The expected shortage of capital has already resulted in the Government effectively planning ahead by looking critically at its investments. Iscor disposed of a part of its unprofitable Metkor Ltd. which has been taken over by Volkskas Limited. It was cautious about funding Sasol II and III projects by getting the Institutions (R495 million) and the man-in-the-street (R17,5 million) to provide some of the necessary capital.

The potential shortage of capital and the recognition that this is likely to become a realistic problem in the future has resulted in the Government:

- Introducing the Bonus Defence Bond (really a disguised lottery) primarily to subvent increased defence spending.
- Introducing the General Sales Tax where amounts are collected monthly. In addition this tax has resulted in the Black population of 20 million, with their important and increasing spending power, contributing to the welfare of the country. Also the introduction of this tax had the effect of implementing the principle of applying indirect rather than direct taxation.
- Seeking alternative methods of indirect taxation by looking critically at introducing amendments to tax fringe benefits which in the past have resulted in a loss of revenue to the fiscus each year, and by the planned introduction of a limited capital gains tax. Both these areas have administration problems but we should nevertheless find legislation introduced during the early 1980's.
- Giving consideration to revising and updating the Bantu Taxation Act with a view to both removing discrimination and netting those income-earners at present not being taxed.
- Encouraging the independant homelands towards self-sufficiency by introducing their own tax system. Once the new independant homeland states become self-supporting, they will be less of a financial

burden on the Government. The double tax conventions with the Transkei, Bophutatswana and Venda will result eventually, it is hoped, in the new homelands funding their own internal requirements and taxing their own people and businesses within their own jurisdiction.

## Institutional funding

During the last decade the institutions have become major investors and already their influence on the Johannesburg Stock Exchange has become apparent. This trend should continue during the next five to ten years as the major institutions' assets show growth. Their position in the economic field will be that of a major capital supplier. Their objectives differ from the man-in-the-street who requires a return on his investment via dividends whereas the Institutions look to capital growth in the medium to long term. The Institutions — mainly the insurance companies — are forced by law to invest a substantial part of their funds in Government Securities which yield low returns. To attract funds, they look to the man-in-the-street via their pension, retirement annuities and other forms of insurance. To encourage investment in retirement annuities, the fiscus has allowed an increasing deduction of annual premiums against income. The deduction limits have increased substantially since first introduced in 1959.

The Government is presently considering legislation to force individuals to plough back more funds indirectly into the economy through pension funds. At present, where an employee resigns from employment, he received a refund of his contributions. The refund is rarely saved and is usually dissipated into domestic expenditure. Then at the age of 60 – 65, when the employee retires, sometimes without adequate planning for retirement, he is forced to seek support via the State old age pension. To combat this tendency, the fiscus and insurance companies are considering legislation to provide that where an employee terminates his employment before a retirement age of 55, he will not receive a refund of his pension contributions, which will instead be transferred to another fund thus ensuring adequate cover at the age of retirement. The proposed new legislation will ensure that:

- The major institutions controlling pension funds do not have to refund pension monies and can plan for their growth more effectively.
- The employee is forced by legislation to plan for his retirement.
- The funds remain in the economy and with the institutions, and thus provide a base for increased institutional profit and State revenue.
- The Government can employ its own funds more effectively and reduce certain funds that previously were required for old age pensions.
- At present, an employee will never receive in cash more than one third of the pension amount that he has saved leaving two thirds to be paid as an annuity on his retirement. This new method of ploughing back pensions will ensure increased taxation on higher pensions paid after retirement.

## Summary

Political factors and problems, the energy crisis and increasing threats of boycotts will prevent the Government from planning ahead for the next 10 years with any degree of certainty. Most economists agree that while the Government is often criticized for lack of foresight, it is not entirely to blame because of the imponderables with which it is faced.

Providing capital for inevitably increasing Government expenditure during the next 10 years will be of prime importance and the Government will increasingly rely on the Institutions to come to their assistance. Increased Government spending to train, develop and to raise the standard of living of urban Blacks and to develop the homelands will be largely met by entrepreneurs, and where available, outside loans. The oil crisis will increase and continue to hamper and retard economic growth. The Government will continue with its search for oil.

Defence costs will increase and the continued Marxist threat and onslaught will place a tremendous burden on the economy of the country.

The Government will continue with efforts to make the country more self sufficient and less dependent on imports. This will include strategic stockpiling of vital materials to cushion the effect of any boycotts.

The gold price will fluctuate between $600 – $700 and will provide the major share of the inflow to the balance of payments while increased profits earned by the gold mining industry will increase taxes collected. Greater emphasis will be placed on savings and investment to combat inflation and greater responsibilities will be placed on the private sector to fund Government commitments.

Recognition of the country's future problems has resulted in the Government turning to the private sector to enlist their support in working together during the difficult period ahead.

## Likely tax structure

The Revenue authorities predict that the tax structure during the next 10 years will be concentrated in the following major areas:

- Increased incentives to stimulate the economy and to ensure an annual growth rate up to 5% per annum. This will include the promotion of foreign investment in the country.
- Increased incentives to save, for example, in the area of pension, provident and retirement annuity funds, and other forms of defined investments e.g., housing loans.
- Further introduction of indirect taxation i.e., introduction of a limited Capital Gains Tax and the increase of the present General Sales Tax from 4% to either 5% or 6%, and after the introduction of the dreaded fringe benefits tax, a further toughening up in this area.

Other amendments could include the following:

- A further reduction in the marginal rate of tax for individuals from 50% to the maximum rate of Company tax of 40% before any surcharge or loan levy.
- An increase in the individual's rebates to combat inflation.

- Increasing the present maximum marginal limits for the rates of taxation at present R40 000 for married and R28 000 for unmarried taxpayers to between R40 000 – R60 000.
- A reduction in gold mining taxes and because of the increase in State revenue from mining tax, a lowering of tax for certain other classes of taxpayers.
- Estate Duty legislation could be scrapped and replaced by a Capital Gains Tax which could also result in a revision of the present Donations Tax which has had the sole purpose of guarding against the spreading of wealth amongst taxpayers to minimize their tax situations. It is interesting to note that Estate Duty, Donations Tax and GST have not been introduced into the tax systems of the independent homelands.
- The inclusion of all population groups under a modified, uniform South African Tax Act.
- The separate taxation of married women.
- Changing to the 'Domicile' or 'Residence' method rather than the 'Source' method as practiced by other major countries.

### Tax reform required

Following on from what is likely to happen to the country within the next 10 years it follows that the present system of taxation and legislation governing it should be revised to meet new challenges.

### The reasons for such Tax Reform

- *To clarify definitions.* The present Income Tax Act is deficient in a number of areas. This includes the absence of adequate definitions, e.g. 'source of income', whether a receipt is of a 'capital or revenue nature', 'ordinarily resident' and 'carrying on business in South Africa'. Hence litigation is often resorted to in order to obtain clarification. Litigation is costly and time-consuming. Most cases reach the Appellate Division 4 – 6 years later. In most instances, the taxpayer gives up due to the high costs involved.
- *To avoid manipulation of the profit figure.* To calculate taxable income of companies and businesses, the net profit must be determined at the end of the accounting period before adjustments are made to arrive at the taxable income. There are many interpretations of net profit and how the amount is derived, e.g. valuation of closing stocks can be determined by numerous methods, work in progress may or may not include overheads, and expenses can be accrued for different periods and provisions for future losses may have to be made. Hence net profit can be manipulated by unscrupulous businessmen. In other circumstances expenses that should be considered by a prudent businessman or his accountant are ignored by the Revenue authorities because of existing legislation.
- *To lessen the burden on the high income taxpayer.* During the 50's, 60's and 70's the present system of taxation in South Africa was largely based on the White lower income earner being appeased at the expense of the higher income earner. The higher income earners were in the minority at approximately 5% and contributed the most taxation. The lower income earners represented almost 95% and contributed very little. This situation is not fair if we consider that as South African citizens we are all in the same boat, keen to assist in protecting our country.
- *To increase productivity.* The high and ever increasing cost of living and high cost of inflation has resulted in little incentive to work hard. The reasons for this are: uncertainty whether we will reap the rewards of our efforts in the future; the fact that the more we earn the more we pay proportionately in taxes as a result of our falling into the higher tax brackets. Hence there is little incentive to work hard. This must inevitably be a factor contributing to the high inflation rate.
- *To increase departmental efficiency.* The emphasis on quicker and more effective collection of taxes and easier administration will be a key issue especially as all able men will be expected to guard our borders much in the same way that the Rhodesians were called on to do.
- *To buttress strategic workers.* Upgrading the conditions of service of the staff of the Revenue department will be necessary to encourage them to make a more meaningful contribution to the economy of the country. Upgrading would mean paying higher salaries and promotion on ability from within which would mitigate against the loss of good staff to private enterprise.

  Certain classes of taxpayers may be regarded as 'strategically important', in e.g. Mining and Agricultural sectors around which our economy is built.
- *To expedite the submission of tax returns.* Tax returns must be completed timeously. At present the Department of Inland Revenue is more than kind in allowing extensions of up to 15 months without penalties, provided prior approval is sought. In addition, companies have problems in getting their financial statements audited soon after the tax year-end in consequence of ever increasing shortage of skilled professional auditors and accountants. These delays prevent the Fiscus obtaining all the revenue due as soon as possible.

Though present legislation is certainly sound these are all good reasons prompting a more streamlined system of taxation easier for all to understand, easier to pay and to collect.

### The nature of the reform

I want to stress that the suggestions submitted below are ideas needing further investigation. Considerable thought must also be given to the most effective ways in which they can be introduced, the timing, which must ensure that the economy suffers no harm and above all, to ensure that changes will benefit all.

My recommendations are:

*Individuals*

- One flat rate of tax for all individuals whether married or single. The present system of taxing a family

through the father or male as the taxpayer should be abolished. All salary earners should be treated as individual taxpayers.

The definition of 'married' has had a chequered career. The question of taxing divorced persons with children has had its difficulties. Married women have a case in point when they say that when their salaries are added to their husbands', they are taxed at the highest possible rate. This certainly has frightened them off from accepting employment. In some cases employers have resorted to paying them in cash to retain their valuable services. Their pleas during the last 10 years have resulted in little more than allowing an increased deduction from earnings of up to R1 200 per tax year, and then not in all instances, as husband-and-wife teams receive no compensation where the husband is a partner or shareholder in the company which also employs the wife. The SWA Tax Act recently has come to the assistance of married women by allowing a woman's employment income to be taxed separately, without allowing her any abatement relief.

In addition, there is no incentive to work harder. How often have we heard the remark 'The more I earn, the more tax I pay or the higher tax I pay'. There is no encouragement to put in a greater effort. Yet the more we can contribute, the lower the rate of inflation and the more we contribute to the country's welfare. But as things stand, increased earnings succeed in pushing the taxpayer into a higher tax bracket. His income is quickly dissipated in taxes and the high cost of living. If he is lucky enough to save, his savings are ever-increasingly gnawed away. In a country like ours with such an abundance of opportunities, individuals must have the incentive and encouragement to work hard with the knowledge that they are improving their lot.

The change to a standard tax rate for all classes of taxpayers, Whites and Blacks, married or single, will ultimately mean more revenue to the State and should be generally acceptable. After all, the GST system applies to all without much dissension. A flat tax rate will ensure that a taxpayer is not penalized through his greater earning potential while the lower-earning groups will have the incentive to contribute more effort.

*Companies*

One rate of tax for all companies including Gold and Diamond Mines. The present set-up is much too cumbersome. Much should be learned from the GST legislation which is working like a dream. The previous month's GST is paid by the 20th of the following month as penalties, i.e. 10% flat plus 7½% interest, are extremely onerous. At present the company rate of tax of 42% is applied to the net profit of the company after adjustment for certain expenditure, incentive and location allowances, and quality of the income. The revenue authorities require audited financial statements and audited reports should be free of major disclaimers. Since the audit profession cannot be expected to check all income and expenditure, we must assume that unscrupulous businessmen will hide vital information. When it comes to the valuation and existence of stocks at the year-end, figures which are directly linked to the net profit can be manipulated. All this is extremely difficult to guard against.

At present the rate of company tax is 42%. This is calculated on the taxable income. Let's assume the rate could be equated to turnover, e.g.

| | | |
|---|---|---|
| Turnover | | R1 000 000 |
| Less cost of sales and expenses, (say) | | (900 000) |
| Net Profit | | R100 000 |
| Tax at 42% | = | 42 000 |
| (ignoring any allowances) | | |
| Tax as a percentage of turnover | = | 4,2% |
| Say 5% | | |

If we applied this rate to turnover on a monthly basis the following would result:

- The Company would pay its tax monthly or quarterly much along the same lines as the payment of the GST. In fact the same or similar return form could be used for this purpose.
- The State would not be penalized if the company failed to make profits before tax was payable. In addition, the use of assessed losses would fall away as the State would not suffer if the company was badly run as tax now would be based on sales. A problem would only arise if sales were not accurately reported. (See below.)
- Arguments between the Revenue Authorities and the company would not arise since expense deductions, bona fide expenses, valuing closing stock accurately and correctly, determining work in progress, etc. would not feature in determining the taxable income. Audit certificates would only be required by the Revenue Authorities for sales amounts reported. The auditor's certificate could further be extended to cover the reporting on fringe benefits and possible capital gains.
- Companies could calculate their costs more accurately as they would simply add the tax to their prices and quotes and know for certain the tax payable.
- Tax would not be based on a receipt of income. Allowances could be made for outstanding receivables at the end of the month during which the sale took place. Hence companies would have to be more efficient in collecting their receivables. This would help companies survive and assist in preventing liquidation. In consequence, tax would not be dependent on a profit which could be manipulated and calculated by various methods.
- The GST collected on a monthly basis now exceeds R100M per month. The paying of tax on the same basis would ensure easy collection, administration and payment and leave more time for Revenue officials to do field work, e.g. visiting company's premises, and meeting the persons running the business. This would improve communication since both parties would then come to appreciate each other's difficulties. They would obtain a thorough knowledge of the procedures and systems for recording and collecting sales. This would broaden their knowledge and enable them to get a better feel for business. Also, they would be on the spot to gather

information rather than by the present correspondence method which frequently incurs the wrath of the taxpayer. By upgrading the work of revenue officials in this manner, assessors could become inspectors and auditors in the Revenue Department while improving the revenue officials' knowledge of business and the taxpayers' problems, would make a more meaningful contribution to the economy, promote goodwill and entitle all staff in the Department to be remunerated far better than at present.

The next question is how to give a deduction for (a) Fixed Assets Allowances, namely, plant and machinery, buildings, etc., (b) Exporter's Allowances, (c) Training Allowances, and (d) Capital Expenditure in the case of mining and farming companies. This could be dealt with as follows:

**New Plant** say costing R50 000. The present investment allowance of 30% could be increased to say 40% to include the initial allowance. This would mean an allowance of R20 000. This amount could be deducted from the monthly tax and carried forward month by month until used up.

**Exporter's Allowance.** Rather than based on expenditure, export sales should be taxed at a lower rate than local sales.

**Training Allowance.** Allow training expenses or a percentage, as a deduction from the monthly tax payable.

**Bad Debts** can be adjusted from the following month's sales provided the amount was originally included in sales.

**Capital Expenditure.** Mining and farming companies should be allowed a percentage of the amount expended as a deduction from the monthly tax payable.

*Dividends*

Presently Undistributed Profits Tax is the only incentive to induce companies to remit sufficient dividends to escape this meagre tax. Companies should still be required to produce audited financial statements to protect the shareholders. Based on the net earnings of the company after tax, a straight mandatory percentage should be declared during the following 12 months to the shareholders as a dividend. Assume the following example:

| | |
|---|---|
| Net profit before tax | R100 000 |
| Less taxes paid (say) | (50 000) |
| Net earnings after tax | R 50 000 |

A percentage, say 40%, of R50 000 should be declared as a dividend during the next 12 months, i.e. R20 000. Stiff

ly this could be extended to other forms of interest where the investment is for a medium to long-term duration.

In many cases, interest paid on deposits is paid to the investor free of any tax deduction. This in most instances means the taxpayer must pay in an amount of tax as his PAYE will not cover the interest received. A similar PAYE deduction should be made before the interest is paid, similar to the non-resident tax on interest. This will ensure that the interest has been subject to tax instead of interest possibly not being declared by individuals in their tax return.

*Share investments*

Arguments as to whether a taxpayer is a share dealer or investor should be settled by a capital gains charge on the selling price by merely increasing the brokerage. On this basis the taxpayer is saved the embarrasment of arguments with the revenue authorities whether the profit is of a capital nature or not. Exemptions could be granted to, say, cover inheritances etc. The tax could be deducted from the selling price and the responsibility placed on the seller or broker to remit the amount to the Revenue Department.

*Farmers*

This class of taxpayer needs encouragement as he will be supplying the total food and certain other essential requirements of South Africans in the event of any boycotts, etc. Events in neighbouring countries, i.e. Angola, Zaire, Zambia, Zimbabwe and Mozambique, have shown that previously wealthy agricultural countries have deteriorated to such an extent during the last decade that they now have to fall back on importing basic foodstuffs. Care should be taken to ensure this never happens to our farmers. Lets give them all the assistance and encouragement they need and deserve. Individual farmers and their companies should be taxed at lower rates of tax, or be given more incentives, *inter alia* a generous deduction for interest paid, an increase in housing allowances, and exempting all subsidies and rebates received and capital expenditure, perhaps even granting them as allowances.

*Foreign companies*

To encourage investment in South Africa, these companies could be taxed at lower rates than their South African counterparts, provided that a certain percentage of profits is ploughed back. In addition, investment in fixed assets should qualify for more generous deductions. There appears to be no reason why the non-resident tax on interest, dividends and royalties should apply where such amounts are declared but not remitted, before say, two years have elapsed, thus leaving the amount in South Africa as working capital or for training purposes. These companies have to withstand the outside onslaught on them to withdraw their investments from South Africa. Let's assist them to show good cause why they should remain.

*Self-assessment*

To save time, all taxpayers should prepare their own assessments showing the amount due or payable. Proof of all earnings or deductions claimed should accompany such assessment. In addition, each taxpayer should submit a yearly statement of assets and liabilities to explain the change in their net asset position from year to year. This would enable the revenue department to quickly check and audit such assessments. Fines could be imposed for any income left out or deductions unfairly claimed. This method would ensure that assessments are made quicker, with the result that tax is collected faster and refunds made sooner. To care for our aged, not only taxpayers over the age of 60 should pay at reduced rates of tax, but additional relief should be granted to those over 70 years of age.

*Estate duty and donations tax*

If we are to have a Capital Gains Tax then are these two taxes still necessary? They both act as 'watch dogs' to ensure that a taxpayer does not dispose of his wealth and hence pays tax at reduced rates. If one rate of tax was introduced together with a Capital Gains Tax, then are these two taxes really necessary?

At present, the two homelands — Bophuthatswana and Venda — do not have an Estate Duty Tax (neither do they have GST). Does this mean that South Africa is shortly to follow suit and abolish its Estate Duty Act? In addition, the cost of administering such Acts should be carefully considered as this could prove whether they are really worthwhile.

*Home owners*

During the 50's and early 60's, part of taxes levied included a personal tax and provincial tax. At present, the cost of rates and taxes is placing an ever-increasing burden on homeowners. Consideration should be given to increasing the rate of GST to say 6%, and to abolishing local municipal rates and taxes. Alternatively, the rate of normal tax paid should make provision for the Fiscus to remit a part to the municipalities to replace rates and taxes.

*Building societies*

The wisdom of making Building Societies pay tax at normal company rates is to be queried. Their objective is to provide a service to the community. Any interest they receive is automatically ploughed back to assist home owners. Should they ever declare amounts other than in the form of interest or dividends, then perhaps such amounts should be looked at critically to determine whether they should qualify as income subject to tax.

## Conclusion

It can be said that South Africa's situation is such that the Fiscus' approach to taxation must remain open-ended: tax concessions, though welcome for a variety of reasons, must at all times be viewed against a political scenario that will place heavy financial burdens upon the State for decades to come, a burden that must be all the more onerous should the gold price fail to maintain the spectacular levels attained in recent years. What is sure however, is that tax reform leading to greater efficiency of administration, fewer anomalies in its incidence and higher productivity within the economy is never out of season.