

# Is SARS really empowering Small Business? Effectiveness of Section 12e

Sharon Smulders | Department of Taxation, University of Pretoria  
 Prof Ruanda Oberholzer | Department of Taxation, University of Pretoria



Sharon Smulders



Prof Ruanda Oberholzer

*As mentioned in our previous article (The Professional Accountant, May 2006) Government is continuously targeting small businesses as future growth and employment generators. Section 12E of the Income Tax Act provides for a special dispensation applicable to Small Business Corporations.*

Section 12E has been amended on various occasions. For the purposes of this article the section will be considered in respect of years of assessment ending on or after 1 April 2005. The details of the section as well as possible concerns in relation thereto will be the focus of the rest of the article.

A Small Business Corporation is limited to a private company registered in terms of the Companies Act or a close corporation registered in terms of the Close Corporation Act. Any reference to a 'company' and 'shareholder' includes a 'close corporation' and a 'member of a close corporation' respectively. In addition, it is important to highlight that an "employment company" as defined in section 12E and a "personal service company" as defined in the Fourth Schedule to the Act will not be regarded as a Small Business Corporation (SARS, 2006).

The requirements that have to be met in order to be classified as a Small Business Corporation can be divided into the following three categories, all of which will be dealt with separately:

- (1) Ownership requirement
- (2) Turnover requirement
- (3) Business activity requirement

## (1) Ownership requirement

Natural persons must at all times during the year of assessment hold the entire share capital of the company.

The shares must be held for their own benefit and not as a nominee (SARS, 2006).

Shareholders or members may not at any time during the year of assessment hold any shares or have any interest in the equity of any other company. The reference to "any other company" includes a close corporation, a dormant company and a co-operative. Any shares or any interest in such other company, albeit for one day during the year of assessment will disqualify such taxpayer notwithstanding the fact that all the other requirements have been met.

Exceptions to this general rule, which will not lead to the disqualification as a Small Business Corporations, are shares held in:

- Listed companies
- Portfolio of collective investment schemes in securities
- Body Corporates, Share block companies, other association of persons, Co-operatives, CC's, trusts and section 21 companies as contemplated in section 10(1)(e)(i), (ii) or (iii).

## (2) Turnover requirement

Monetary tax thresholds for small business were introduced in the 2005 budget, and were adjusted in the 2006 budget as follows (SARS, 2005 & 2006):

Small Business Corporation Parameters	2005 legislation	2006 budget – For tax years ending on or after 1 April 2006
Maximum turnover to qualify*	R6m per annum	R14m per annum
Tax Free Income	First R35 000	First R40 000
Preferential Tax Rate	10%	10%
Preferential Tax Rate Bracket	R35 000 – R250 000	R35 000 – R300 000
Wear & Tear write off – Manufacturing assets	Accelerated 100%	Accelerated 100%
Wear & Tear write off – All other assets	Accelerated 50:30:20	Accelerated 50:30:20

\* Where the small business corporation commenced trading during the year, the R6 million or 14 million, whichever is applicable for the specific year of assessment, should be reduced proportionately in order to determine whether the gross income received or accrued for the relevant period in question would

have exceeded the limit of R6 million or R14 million, had the taxpayer been trading for the full year of assessment.

### (3) The business activity requirement

Not more than 20% of the company's total receipts and accruals, (including capital gains but excluding amounts of a capital nature), may consist collectively of "investment income" (as defined) and income from the rendering of a "personal service" (as defined). The aggregate income from investment and personal services, should therefore not exceed 20% of the 'total receipts' and accruals of the small business corporation.

Where a taxpayer, for example, has no investment income, the personal service income may not exceed 20% of the 'total receipts and accruals' and vice-a-versa.

Thus, where the services rendered by a company are not regarded as a personal service, the investment income may not exceed 20% of the company's total receipts and accruals. However, where the service rendered is regarded as a personal service, the 20% limitation must be applied to the income attributable to the personal service and the investment income collectively.

The definition of investment and personal service income as set out in section 12E will now be investigated.

#### (a) Investment income

*"Dividends, royalties, rentals, annuities, interest as contemplated in section 24J of the Income Tax Act, any amount contemplated in section 24K of the Income Tax Act as well as any other income subject to the same treatment as income from money lent is regarded as investment income".*

The investment income listed in section 12E refers mainly to amounts, which represent the return on investments. Any proceeds derived from investment or trading in financial instruments, marketable securities or immovable property is however, for the purposes of section 12E, also regarded as investment income (SARS, 2006).

#### (b) Personal service

*"any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, broking, commercial arts, consulting, draftsmanship, education, engineering, entertainment, health, information technology, journalism, law, management, performing arts, real estate, research, secretarial services, sport, surveying, translation, valuation or veterinary science, which is performed personally by any person who holds an interest in the company or close corporation AND that company or CC does not throughout the year of assessment employ at least four full-time employees (other than*

*any employee who is a shareholder of the company or member of the close corporation, or is a connected person in relation to a shareholder or member) who on a full-time basis engaged in the business of that company or CC of rendering that service".*

With the current provisions of section 12E (years of assessment ending on or after 1 April 2005), a qualifying company can therefore qualify as a small business corporation even if they render personal services. The only two qualifying criteria are as follows:

- The company, throughout the year of assessment must employ at least four full-time employees (other than a shareholder or connected person to the shareholder) who are engaged on a full-time basis in the business of that company rendering that service; and
- The investment income of such company does not exceed 20% of the company's total receipts and accruals.

The taxpayer must be able to substantiate by means of a charge out system per hour/per job or any other method that the personal service income does not exceed 20% as the Act is silent on this matter (SARS, 2006).

It should however, be noted that a small business corporation which has complied with all the requirements of an small business corporation in one year does not necessarily indicate compliance in respect of any subsequent year of assessment. The facts of each case will therefore have to be considered for every year of assessment in order to determine whether the small business corporation complies with all the requirements for the specific year under review. Non-compliance with any one of the requirements will result in such company not qualifying as a small business corporation and tax being levied at the normal company rate of 29%.

### Possible concerns regarding section 12E

#### 1. Definition of personal service

Uncertainty exists whether certain activities might fall within this definition. An example of this might be the production of the production of wildlife movies. This activity is not specifically mentioned in the definition but could potentially fall under "broadcasting" or "commercial arts". The actual meaning of each of these words would need to be determined from a dictionary. This would then be applied to the facts to determine if the activity is a personal service, before establishing whether the company meets all the other requirements of a small business corporation.

From this it can therefore be deduced that where any uncertainty regarding an activity undertaken by a business exists, it is necessary to analyse this activity by referring to its ordinary meaning. Depending on this analysis, the activity might or might not be classified as a personal service.

## 2. Shareholding requirement

No explanation could be found in the explanatory memorandums that introduced and subsequently dealt with Small Business Corporations to explain why the shareholders are not permitted to hold any shares or have any interest in the equity of any other company. Neither does Interpretation Note No. 9 (SARS, 2006) shed any light on this matter. Whatever the reason/s might be, this requirement could lead to discriminatory treatment, as set out in this situation below:

### Example:

Let's take the scenario of two qualified CFA's (CFA 1 and CFA 2) that decided to start up their own transport businesses. They each incorporate a private company through which they will perform their transporting services. They are the sole shareholders of their own companies and they both render accounting services to clients and certain of their friends and family. Both companies are registered as VAT vendors. Other information relating to these two CFA's companies is as follows:

Description	CFA 1	CFA 2
Gross income – transporting operations (excl VAT)	R350 000	R350 000
Accounting service income (excl VAT)	R 75 000	R 75 000
Investment income	R nil	R nil
Computer equipment purchased (excl VAT)	R 42 000	R 42 000
# of employees (admin)	1	1
Equity shares held in other companies by CFA	None	100% in a dormant company*

\* CFA 2 used this company five years ago for his consulting business that he conducted but has since ceased. CFA 2 never got round to deregistering the company after his consulting activities stopped.

### Calculation of tax payable by above companies

If the tax payable by each of the CFA's companies were to be calculated, it would become evident that the company of CFA 1 meets all the requirements of s12E, that is:

- it is a private company registered in terms of the Companies Act,
- all the shareholders are natural persons
- the shareholder does not hold any shares in another company
- the gross income of the company does not exceed R14m
- the personal service income (R75 000 – the transport services rendered do not appear to meet the definition of 'personal service' however the accounting services rendered do) does **not exceed** 20% of the companies total receipts and accruals.

However, CFA 2 is not so lucky. The fact that he owns shares in another company, albeit at the end of the year of assessment and in a dormant company, disqualifies him from the benefits provided for in section 12E.

It is interesting to note that the taxpayer does not have to apply or register for this section to apply. The taxpayer only has to comply with all the requirements of the section and then the provisions and benefits of s12E will be applicable to him.

The tax calculation (assuming for illustrative purposes only that no other income or expenses, were received or incurred respectively, by the taxpayers) for the first year of operation of each of the CFA's companies is tabled below:

Taxpayer company	CFA 1 Section 12E is applicable	CFA 2 Section 12E is not applicable
Gross income – transport services	R300 000	R300 000
Gross income – accounting services	R 75 000	R 75 000
Total receipts and accruals for the year	R375 000	R375 000
Less: Wear & Tear on computer equipment		
: s12E (R42 000 x 50%)	(R21 000)	
: s11(e) (R42 000 x 33,33%)		(R14 000)
Taxable income	R354 000	R361 000
Tax payable on taxable income		
: s12E (reduced rates)	<b>(R51 660)</b>	
First R35 000 @ 0%	-	
(R250 000 – R35 000) @ 10%	R21 500	
(R354 000 – R250 000) @ 29%	R30 160	
: R361 000 @ 29%		<b>(R104 690)</b>
Net income after tax	R302 340	R256 310

Assuming the income of the companies remained constant for the next three years and assuming that no other assets were purchased during this period, the tax payable by each CFA company is set out in the following table for illustrative purposes:

	Year 1		Year 2		Year 3	
	CFA 1	CFA 2	CFA 1	CFA 2	CFA 1	CFA 2
Taxable income	R354 000	R361 000	R354 000	R361 000	R375 000*	R361 000
Tax payable	(R51 660)	(R104 690)	(R51 660)	(R104 690)	(R57 750)	(R104 690)
Net income after tax	R302 340	R256 310	R302 340	R256 310	R317 250	R256 310
Total tax payable over three years					<b>R161 070</b>	<b>R314 070</b>

\* No wear and tear is claimed in this year as the asset is fully depreciated during year 1 and 2

From the above table, it is clear that notwithstanding that both the CFA's render the same service, earn the same income and incur the same expenses, due to the fact that one of the CFA's holds shares in another company, **additional tax of R53 030** (R104 690 – R51 660) is payable during the first two years respectively and **R46 940** (R104 690 – R57 750) in the third year.



Thus, from a timing perspective, the accelerated wear and tear write off benefits the taxpayer's cash flow up front as the larger deduction is provided for over a shorter period. The ultimate benefit, however, lies in the reduced tax payable by a small business corporation. In this example, the tax payable (over the three year period) by the company qualifying as a small business corporation would amount R161 070 and R314 070 by the company not qualifying as a small business corporation. This is a total saving of **R153 000** in tax.

## Conclusion

The benefits of complying with section 12E are clearly illustrated above. It would, however, appear that the application of section 12E has various problems. The first of which is the entry criteria as there are potentially various uncertainties with regards to the definition of 'personal service'. Furthermore, the shareholder requirements appear in certain cases to be biased and could lead to abnormalities merely due to 'old' shareholdings in other dormant companies.

Other problems areas, which are not covered in this article, such as the turnover level of R14m, the annual determination of who qualifies as a small business corporation and the annual disclosure thereof, also need further consideration by SARS. We therefore propose that small business corporations be attentive as there clearly needs to be some changes to section 12E in the very near future. ■

## References

South African Revenue Services. (2006). Interpretation Note No.9 (Online) Available: ([http://www.sars.gov.za/incometax/interpretation notes](http://www.sars.gov.za/incometax/interpretationnotes)).

Date accessed: 2 March 2006

South Africa. Minister of Finance. (2005). 2005 Budget Speech Background briefing for journalists: Empowering small businesses. (Online) Available: ([http://www.sars.gov.za/media/media budget 2005](http://www.sars.gov.za/media/media%20budget%202005))

Date accessed: 15 February 2006

## Legislation

Income Tax Act 58 of 1962

Close Corporation Act 69 of 1984

Companies Act 61 of 1973