

**A QUALITATIVE LITERATURE REVIEW OF THE DIFFERENTIATED TAX  
POLICIES FOR SMALL AND MEDIUM ENTERPRISES IN SOUTH AFRICA**

by

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## ABSTRACT

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The first differentiated tax policies for small and medium enterprises (SMEs) in South Africa were introduced in 2001. Several relief measures have followed, the most recent being the introduction in the 2008/9 budget of a presumptive turnover tax system and venture capital incentives for investments in high-growth and high-tech SMEs.

The present study uses a qualitative systematic literature review to assess the effectiveness of using differentiated tax policies to address the constraints that have been imposed on South African SMEs. It draws on international experiences in the use of differentiated tax policies to address constraints imposed on SMEs. Thereafter it focuses on differentiated tax policies in South Africa and considers the effectiveness of using differentiated tax policies to address constraints that have been imposed on SMEs.

Research in other countries indicates that when differentiated tax policies are used in isolation, they are not very successful in bringing about changes in the level of entrepreneurial activity. However, these policies can assist in creating an environment that is conducive to the growth of SMEs and can alleviate the constraints faced by SMEs. The effectiveness of differentiated tax policies in the alleviation of the constraints imposed on small and medium enterprises can be improved by means of various non-tax policy measures.

The National Treasury has used differentiated tax policies to target two specific constraints for SMEs, namely access to equity finance and easing of the tax compliance burden. This study concludes that the current differentiated tax policies for small and medium enterprises that are articulated in tax legislation do not address the constraints identified by the National Treasury effectively.

The findings of this study cast doubt on the ability of the differentiated tax policies in South Africa to alleviate the constraints that SMEs face in this country. Furthermore, it poses the question whether the main objective of the policies is not to collect more revenue by broadening the tax base.

The study focuses on the differentiated tax policies that came into effect before August 2008. The effectiveness of the differentiated tax policies that were proposed in the 2008/2009 budget (venture capital incentives and presumptive turnover tax) will depend on the details of the tax legislation that is promulgated. Future research could determine the effectiveness of these differentiated tax policies in addressing the constraints with which SMEs are faced.

Keywords:

*differentiated tax policies*

*small and medium enterprises*

*SMEs or SMMEs*

*taxation*

## OPSOMMING

# **‘N KWALITATIEWE LITERATUUROORSIG VAN DIE GEDIFFERENSIEERDE BELASTINGBELEID VIR KLEIN EN MEDIUM ONDERNEMINGS IN SUID AFRIKA**

deur

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Die eerste gedifferensieerde beleidstellers oor belastingverligting vir klein en medium ondernemings (KMOs) in Suid-Afrika is in 2001 in werking gestel. Sedertdien het verskeie ander belastingverligtingmaatreëls gevolg. Die mees onlangse belastingbeleid in hierdie verband is in die 2008/9 begroting aangekondig. Dit handel oor “presumptive turnover tax” en aansporingsmaatreëls vir die belegging van waagkapitaal in hoë groei en tegnologies intensiewe KMO’s. (‘n Algemeen aanvaarde Afrikaanse benaming vir “presumptive turnover tax” is op die stadium nog nie bekend nie. Die benaming sal in die wetgewing wat later in 2008 verwag word, vervat wees. )

Hierdie ondersoek maak gebruik van ‘n kwalitatiewe, sistematiese literatuuroorsig om die effektiwiteit van die gebruik van ‘n gedifferensieerde belastingbeleid vir KMOs in Suid Afrika vir die verligting van die beperkinge waaraan KMOs onderworpe is, te bepaal. Daar word eerstens ondersoek ingestel na die ervaring van ander lande in die gebruik van ‘n gedifferensieerde belastingbeleid om die beperkinge te verlig waaraan KMOs onderworpe is. Daarna word die fokus verplaas na die mate waartoe die Suid-Afrikaanse gedifferensieerde belastingbeleid vir KMOs daarin slaag om hierdie beperkinge te verlig.

Navorsing in ander lande het bevind dat ‘n gedifferensieerde belastingbeleid nie op sigself daarin slaag om verandering in die aktiwiteitsvlakke van entrepreneurs te weeg te bring

nie. Sodanige belastingbeleid slaag wel daarin om 'n omgewing te skep wat groei by KMOs stimuleer en verligting ten opsigte van die beperkinge waaronder hulle gebuk gaan bring. Die effektiwiteit van 'n gedifferensieerde belastingbeleid vir KMOs kan deur die gebruik van verskeie ander nie-belastingbeleid maatreëls verhoog word.

Die beperkinge wat deur die Nasionale Tesourie geïdentifiseer is, is toegang tot ekwiteitsfinansiering en verligting van die hoë belastingnakomingslas van KMOs. Die bevindinge van hierdie ondersoek dui aan dat die huidige gedifferensieerde Suid-Afrikaanse belastingbeleid vir KMOs nie 'n effektiewe instrument is om die spesifieke beperkinge wat deur die Nasionale Tesourie geïdentifiseer is aan te spreek nie.

Die bevindinge lei tot die vraag of die gedifferensieerde belastingbeleid vir KMOs nie eerder gerig is op die verhoging in Nasionale Tesourie se inkomste deur die vergroting van die belastingbasis nie.

Hierdie ondersoek is beperk tot die wetgewing op gedifferensieerde belastingbeleid wat voor Augustus 2008 in werking getree het. Die effektiwiteit van die gedifferensieerde beleid wat in die 2008/9 begroting voorgestel is, naamlik aansporingsmaatreëls vir waagkapitaal en "presumptive turnover tax", sal afhang van die besonderhede wat in die betrokke wetgewing later in 2008 vervat sal word. Toekomstige navorsing sal verdere lig kan werp oor die effektiwiteit van die voorgestelde gedifferensieerde belastingbeleid vir KMOs om die beperkings geplaas op KMOs te verlig.

Sleutelwoorde:

*gedifferensieerde belastingbeleid*

*klein en medium ondernemings*

*KKO (kwalifiserende klein ondernemings)*

*KMO (klein, medium ondernemings)*

*KMMO (klein, medium en mikro ondernemings)*

*belasting*

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## CHAPTER 1

# INTRODUCTION AND PROBLEM STATEMENT

### 1.1 BACKGROUND

The development of tax policies for small and medium enterprises (SMEs) in South Africa commenced after the release, in March 1995, of a White Paper on a national strategy for the development and promotion of small business in South Africa (Government of South Africa, 1995). In 2001, tax provisions were introduced for the first time to provide for a lower income tax rate and accelerated depreciation for incorporated SMEs. Various tax relief measures have followed, including capital gains tax relief for SMEs (2001 and 2006); relief in respect of skills development levies (2005); small business tax amnesty (2006/2007); VAT relief in the form of reduced annual VAT returns (2005); introduction of the small retailers VAT package (2005/6); raising of VAT registration thresholds (2008); and the introduction of a simplified VAT registration process (2008). In the 2008/9 budget, two additional tax-relief incentives for small businesses were proposed, namely the introduction of a simplified turnover-based tax system and incentives in respect of the investment of venture capital in high-growth and high-tech SMEs (Manuel, 2008:21).

According to Jousten (2007:17), certain differentiated tax policies for SMEs may not be desirable from an economic point of view. A variety of reasons is advanced for the justification of differentiated tax policies for SMEs, but there is scant scientific evidence to support these claims.

The underlying rationale for a differentiated tax policy is that it is justified to move away from tax neutrality only when market failures or compelling equity considerations prevail and the only way available to rectify the situation is to introduce special tax provisions (Chen, Lee & Mintz, 2002:28). In addition, differentiated tax policies should be simple, fair and conducive to economic growth (Chen *et al.*, 2002:28).

The introduction of differentiated tax legislation for SMEs in South Africa resulted in an increase in the number of studies and surveys that have been undertaken in the field since

2006. Most of these studies have concerned various aspects of tax compliance costs, as is illustrated by the studies and surveys listed below:

- a survey of tax practitioners undertaken by FIAS (2007:1-189) with the objective of identifying and measuring tax compliance costs for SMEs in SA and developing recommendations to reduce compliance cost and encourage formalisation;
- a survey undertaken by Venter and De Clerq (2007a:131-151) on the tax compliance burden of SMEs in the business service industry in Gauteng. The objective was to determine whether the size of a business has an effect on the management of its tax-compliance burden;
- a survey conducted by Venter and De Clerq (2007b:72-88) on the effect of taxation on small and medium enterprises in the manufacturing, retail and business services sectors. The objective of the survey was to determine whether the size of an enterprise and the sector in which it operates has an effect on how the enterprise's tax responsibilities are administered and managed;
- a literature review undertaken by Chamberlain and Smith (2006:1-55) on the effect of tax-compliance cost on SMEs. The three studies used in their literature review were *Counting the cost of red tape for business in SA* by SBP (2005); *Measurement of VAT Act and RSC Act induced administrative burdens for SA SMMEs* by Upstart Business Strategies as commissioned by the DTI (2004) and the *SMME facilitation programme* that was undertaken by SARS (2005);
- a survey by Abrie and Doussy (2006:1-13) on the tax-compliance obstacles that are encountered by small and medium entrepreneurs in South Africa. The objective was to report on obstacles that SMEs encounter when attempting to comply with tax requirements and to suggest possible ways of overcoming the obstacles; and
- a sector study of the effective tax burden in South Africa that was conducted by FIAS (2006:1-107) to determine whether the tax-policy and tax-administration

regimes are conducive to economic growth in the following sectors: small businesses, agriculture, manufacturing, tourism and mining.

There are, however, several questions that remain unanswered, for example:

- are the differentiated tax policies achieving their objectives?
- what is the perceived effect of these policies on small businesses? and
- are differentiated tax policies for SMEs the most effective way of addressing the constraints that are imposed on SMEs?

## **1.2 PROBLEM STATEMENT**

The aim of the present research project is to reach an objective conclusion on the effectiveness of the use of differentiated tax policies for small and medium enterprises to address the constraints that are imposed on these enterprises.

## **1.3 RESEARCH OBJECTIVES**

This study is guided by the following specific research objectives:

- to review the differentiated tax policies for SMEs in other countries to determine the effectiveness of the use of these tax policies to address the constraints imposed on SMEs in these countries;
- to identify the objectives of the National Treasury with regard to differentiated tax policies for SMEs and to determine whether it is aligned with the perception of tax practitioners and SME business owners; and
- to identify the constraints that are imposed on SMEs in South Africa as perceived by tax practitioners and SME business owners and to determine whether these constraints could be addressed by means of differentiated tax policies.

It is envisaged that, from a theoretical perspective, this research project could make two valuable contributions to the existing literature on the subject. Firstly, unlike previous studies that tend to focus on specific aspects of tax compliance costs, this project could

provide a holistic view of differentiated tax policies for SMEs. Secondly, the project will incorporate the findings contained in studies undertaken in other countries and apply them within the South African context.

As the differentiated tax policies for SMEs that are proposed in the budget for 2008/9 are implemented, the gap between standard tax legislation and differentiated tax legislation for SMEs will increase. This dual system should be managed in terms of effort, time and resources. From a practical point of view, this study aims to determine the objectives that are stated for differentiated tax policies and to question whether these tax policies are effective in achieving the objectives that are stated by the National Treasury.

Minister Trevor Manuel (2008:8) made a very relevant remark when introducing his budget for 2008/9, namely *"...this House and every taxpayer shares with us a responsibility to question continuously whether our incentives are based on sound policies and criteria, not on favours or special interests masquerading as the public good."*

## **1.4 DELIMITATIONS AND ASSUMPTIONS**

### **1.4.1 Delimitations**

Small businesses, such as mining and exploration companies; recruitment companies; personal service companies (and labour brokers); and farming enterprises, are excluded from this study, because specific tax policies apply to such businesses. Due to the complexities surrounding trusts, they are also excluded from the study.

The discussion in this study of the legislation and initiatives that are aimed at alleviating the constraints that are placed on small businesses are limited to the following legislation and initiatives: the Income Tax Act no. 58 of 1962; VAT Act no. 89 of 1991; Skills Development Levies Act no. 4 of 2000; Unemployment Insurance Contribution Act no. 4 of 2000; Stamp Duty Act no. 77 of 1968; Securities Transfer Act no. 25 of 2007; Transfer Duty Act no. 40 of 1949; and the initiatives initiated by the South African Revenue Service (SARS).

The changes to the relevant legislation that were proposed in the 2008/9 budget speech had not yet been promulgated when this study commenced. A review of these changes has been based on the information that was provided by SARS; the views of the public that were expressed in articles after the release of the budget; and research undertaken in other countries on venture capital funds and presumptive tax systems.

### **1.4.2 Assumptions**

For the purposes of this study, the term *small and medium enterprise (SME)* could be substituted by *small business or small, medium and micro enterprise (SMME)*. As there is no consistent definition of *small business* in South Africa or elsewhere, all documents that refer to small business, SBC, SMME or SME were included in the study. It is acknowledged that this approach does place a limitation on the comparability and usefulness of the information presented in this dissertation.

## **1.5 DEFINITION OF KEY TERMS AND ABBREVIATIONS**

### **1.5.1 Definition of key terms**

- **Constraints**

In this study, the term constraints refers to the restrictions or limitations placed on small and medium enterprises by the market or by legislation, namely the legal and regulatory environment with which SMEs are confronted; access to markets; finance and business premises (at affordable rentals); acquisition of skills and managerial expertise; access to appropriate technology; quality of the business infrastructure in poverty-stricken areas; and, in some cases, the tax burden (The Government of South Africa, 1995: § 2.3.1).

- **Formal and informal businesses**

For the purpose of this study, businesses are divided into two categories, namely formal businesses that are registered as taxpayers and informal businesses that are not registered as taxpayers.



- **Marginal effective tax rate (METR)**

The marginal effective tax rate (METR) is a measure used by economists to describe the extent, expressed in percentage, with which the tax system reduces the real rate of return (ROR) on investment (before tax) to the real rate of return on an investment (after tax). The real rate of return equals the present discounted value of annual net earnings divided by capital expenditure. (FIAS, 2006:84.)

The METR measure the extent to which the tax system reduces the real rate of return (ROR) on investment, at margin (FIAS, 2006:84).

Formula =  $(\text{ROR before Tax} - \text{ROR after Tax}) / \text{ROR before Tax}$

ROR =  $\text{Present discounted value of annual net earnings} / \text{Capital Expenditure}$

- **Perception**

Perception is derived from the Latin words *perception* and *perceptio*, which mean receiving, collecting, acting of taking possession of or apprehending with the mind or senses. In its common usage, perception is applied to the evidence that a person has of external objects by means of his or her senses. (Dictionary.com, Not dated.)

- **Regulatory compliance**

In this study regulatory compliance refers to the steps taken by business owners, managers or members of staff of small and medium enterprises to comply with the relevant tax laws and regulations.

- **Tax compliance cost**

In this study, tax compliance cost includes the following elements: the value of time spent by business owners, managers and members of staff on understanding the tax rules and applying them; record-keeping costs, that is the cost of compiling the necessary receipts and other records and the costs incurred in respect of the preparation of tax returns; the remuneration of professional advisors such as consultants, lawyers and accountants; and

incidental costs in respect of postage, telephone calls and travelling in order to communicate with advisers and tax authorities (FIAS, 2007:7).

### 1.5.2 Abbreviations

The following abbreviations are used in this document:

Abbreviation	Meaning
ADR	Alternative dispute resolution
A\$	Australian Dollar
CAD	Canadian Dollar
CC	Close Corporation
CIT	Corporate income tax
DTI	Department of Trade and Industry
IFC	International Finance Corporation, part of the World Bank Group
Income Tax Act	Income Tax Act no. 58 of 1962
FIAS	Foreign Investment Advisory Service (A joint service of the International Finance Corporation, the Multilateral Investment Guarantee Agency and the World Bank)
FIFO	First in, first out (method of inventory accounting)
LIFO	Last in, first out (method of inventory accounting)
METR	Marginal effective tax rate.
NGO	Non-governmental organisation
NPV	Net present value
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay As You Earn
PIT	Personal income tax
R&D	Research and development
SA	South Africa
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service

Abbreviation	Meaning
SBC	Small Business Corporation
SBP	Strategic business partnership(s)
Securities Transfer Act	Securities Transfer Act no. 25 of 2007
SITE	Standard Income Tax on Employees
SDL	Skills development levies
Skills Development Levies Act	Skills Development Levies Act no. 4 of 2000
SME	Small and medium enterprise
SMEDP	Small Medium Enterprise Development Programme
SMME	Small, medium and micro enterprise
Stamp Duty Act	Stamp Duty Act no. 77 of 1968
STC	Secondary tax on companies
Transfer Duty Act	Transfer Duty Act no. 40 of 1949
UNISA	University of South Africa
UK	United Kingdom
US	United States
Unemployment Insurance Contribution Act	Unemployment Insurance Contribution Act no. 4 of 2000
VAT	Value added tax
VAT Act	Value Added Tax Act no. 89 of 1991
www	Word Wide Web

## 1.6 RESEARCH DESIGN AND METHODS

### 1.6.1 The research design used in this study

The research design used in the study is a qualitative systematic literature review.

The use of a systematic review approach ensures that bias is reduced in the selection and inclusion of the literature data items and that only high-quality literature data items are selected and are analysed objectively.

In summary, a detailed search of the literature was undertaken, guided by the research objectives. Criteria were developed to determine whether a literature data item is to be included in the final synthesis. An attempt was made to obtain all the literature published on the topic by searching multiple databases and analysing the references that appeared in the selected literature data items. Each document was then reviewed in a systematic and consistent manner to assess the validity and reliability of the literature data items.

The chosen research design is considered the most appropriate design for obtaining information on the differentiated tax policies for SMEs in other countries. Due to the number of recent surveys conducted in respect of South African SMEs, the chosen research design is also considered the most appropriate for obtaining information on the South African SMEs from the perspective of the tax practitioner and the SME business owner. The information provided by respondents in previous surveys was considered sufficient to provide for a secondary interpretation of the results from a different perspective and with a different objective.

### **1.6.2 Data collection: identification of the literature**

In line with the research objectives, various electronic databases were searched with the use of the following keywords: *taxation and SMMEs*; *taxation and SMEs*; *taxation and small business*. The databases that were used are Blackwell Synergy, EBSCOHost, Emerald, Proquest, ScienceDirect, Springerlink, Google Scholar, SAePublications and Google.

The relevant published literature data items were selected with the use of the “advanced search” option. The search was refined by using the following criteria:

- research published in peer-reviewed scholarly journals (EBSCOHost, Proquest, and Springerlink);
- all relevant research published from 2005 to June 2008;

- only research undertaken in the fields of business economics, finance and accounting (Blackwell Synergy, ScienceDirect, and Google Scholar); and
- South African literature (Google).

During the initial stages of the study, random searches on small businesses and taxation were conducted. The literature data items that were identified in these searches were also included for analysis.

The literature data items obtained include surveys, conference papers, working papers and journal articles. In total, 21 literature data items were included for analysis.

In addition, the SAICA and SARS websites were scrutinised to obtain additional information on South African SMEs and tax. The information obtained varies from articles that appear in Integritax (SAICA) to media releases and SARS publications.

### **1.6.3 Assessing and demonstrating the quality and rigour of the proposed research design**

The following actions were performed in order to assess the validity and reliability of the literature data items:

- a data extraction form was designed with the use of a concept matrix. The literature data items were listed on the vertical axis and the source details, features of the study and emerging themes of each literature item were listed on the horizontal axis; and
- evaluation criteria were developed and used to assess the validity and reliability of the literature data items. The evaluation criteria were compiled with the assistance of criteria identified by Saunders, Lewis and Thornhill (2007:270); Hofstee (2006:106) and Green, Johnson and Adams (2006:115). The 23 evaluation criteria items that were developed were intended to assess *inter alia* the authority or credibility of the source; whether it was published in the course of the past 3 years; whether the source provided information on the research methods with which it could be determined whether the research was conducted in

a systematic manner; and whether it provided conclusions that are supported by the evidence presented.

The overriding impression that was gained was that reliance could be placed on the validity and reliability of the collected literature data items.

## **1.7 SUMMARY**

In this chapter, the problem statement and the research objectives are defined. The research design that was selected to ensure that the research objectives are achieved is a qualitative systematic literature review. The literature data items were collected in an unbiased manner and assessed for validity and reliability. In addition, this chapter defines the limitations and assumptions that underlie the research project and lists the key terms and abbreviations that are used in the dissertation.

The next chapter contains a brief overview of the definitions of small and medium enterprises. It is followed by an overview of the differentiated tax policies for SMEs in South Africa.

Chapters 3 and 4 address the specific research objectives by means of an analysis of the literature data items that are specific to the research objectives. Chapter 5, the final chapter, provides a summary of the findings and presents conclusions.

## **CHAPTER 2**

# **THE DEVELOPMENT OF DIFFERENTIATED TAX POLICIES FOR SMEs IN SOUTH AFRICA**

### **2.1 INTRODUCTION**

In order to determine whether a differentiated tax policy is applicable to a particular small and medium enterprise (SME), the SME concerned should be evaluated in terms of the criteria that define an SME in the relevant tax act. Therefore the definition of an SME provides the basis for the application of differentiated tax policies for SMEs. This definition has created a dilemma for governments, international bodies and business enterprises all over the world, because the criteria that are used to define an SME are varied and are applied inconsistently.

In this chapter, the dilemma concerning the definition of SMEs is considered briefly. Thereafter an overview of the differentiated tax policies for SMEs in South Africa is presented.

### **2.2 THE DEFINITION OF SMALL AND MEDIUM ENTERPRISES**

Small and medium enterprises are small businesses that are classified as either small, medium or micro enterprises (SMME) or as small and medium enterprises (SME). In differentiating these enterprises, various criteria are applied, namely the number of employees, ownership structure, turnover, balance sheet total, capital base, legal form as well as the type of activity of the enterprise (Jousten 2007:14).

In the literature of various countries, including South Africa, many definitions of SMEs are to be found. The definitions vary in terms of the emphasis that is placed on an economic perspective or a taxation perspective.

Governments and international bodies have attempted to address the problem of varying definitions of SMEs. The efforts of the European Commission to standardise a definition

resulted in the issuing of Recommendation 2003/361/EC on 6 May 2003, which came into effect on 1 January 2005. The recommendation defines micro, small and medium-sized enterprises for EU countries (European Commission, 2008). The Australian federal government's proposed legislation to standardise the criteria in terms of which small businesses would be eligible for tax concessions was commended by Pizzacalla as a (small) step in the right direction (Pizzacalla, 2007:19).

Similar attempts have been made in South Africa. The National Small Enterprise Act no. 102 of 1996 provides guidelines for the classification of enterprises as micro, very small, small and medium for each sector or subsector in accordance with the standard industrial classification. Its classification uses the following criteria: number of employees, total annual turnover and the gross asset value of the enterprise.

However, various government departments in South Africa still use different definitions for SMEs. For example, the definition used in the Black Economic Empowerment Codes of Good Practice (FIAS, 2007:101) and the various definitions of SMEs that are contained in the Income Tax Act which determine the specific tax relief that is granted to SMEs.

The use of different definitions by the various taxes could be a valid approach as each tax has a different objective. However, the use of several definitions complicates compliance considerably (FIAS, 2007:108). In addition, Pizzacalla (2007:19) states that the implication of the multiplicity of definitions is that policy makers fail to properly identify and target relevant tax concessions in the small business sector.

The inconsistent use of definitions of an SME has been revealed in the various surveys that have been conducted on the cost of compliance in South Africa. Venter and De Clerq (2007a:134 and 2007b:73) used the broader definition of an SME definition that is contained in the National Small Enterprise Act, whereas the FIAS survey (FIAS, 2007:7) focused on SMEs by using the definition that is contained in section 12E(4)(a) of the Income Tax Act. This difference between the surveys complicates the comparability of their results.



## 2.3 THE DIFFERENTIATED TAX LEGISLATION FOR SMES

Small businesses in South Africa could be liable for up to 11 taxes (income tax (normal tax); capital gains tax (CGT); provisional tax; secondary tax on companies (STC); value added tax (VAT); employees' tax; employment-related levies; customs and excise duties; transfer duty; donation tax; and stamp duty). The result of these tax obligations is that a vast amount of time is spent on administration. In addition, the late submission of specific forms or information results in the imposition of fines, penalties or the levying of interest. (Abrie & Doussy, 2006:5.)

The differentiated tax legislation for SMEs attempts to provide some relief to SMEs in respect of income tax, CGT, VAT and skills-development levy concessions.

### 2.3.1 Income tax (normal tax) relief for incorporated SMEs

#### 2.3.1.1 Reduced rate on normal tax for incorporated SMEs

A reduced rate on normal tax for incorporated SMEs was introduced for the first time in 2001. Since then regular adjustments to the monetary thresholds have been made.

This relief is only available to SMEs that meet the definition of a *Small Business Corporation* as contained in section 12E (4) (a) of the Income Tax Act.

A *Small Business Corporation* (SBC) means a close corporation, co-operative or private company that meets the following requirements (De Koker, 2005: § 8.39D):

- all the shareholders or members should be natural persons (individuals);
- the gross income for the year of assessment should not exceed R14 million;
- the shareholders or members should not, at any time during the year of assessment, hold any shares nor have any interest in any company. There a number of exceptions regarding the holding of shares, namely:
  - shares or interest in other listed companies;
  - participatory interest in an equity-collective investment scheme; shares or interest in a body corporate that was established in terms of the Sectional

Titles Act no. 95 of 1986; interest in a share-block company that was established in terms of the Share Blocks Control Act no. 59 of 1980; and interest in any other association of persons that was formed solely for the purposes of managing the collective interests of all members;

- interest in a social or consumer co-operative or a co-operative burial society as defined in section 1 of the Co-Operatives Act no. 14 of 2005, or any similar co-operative, if all the income that it derives from trade during any year of assessment is derived solely from its members;
- interest in a friendly society as defined in section 1 of the Friendly Societies Act no. 25 of 1956;
- not more than 20% of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company or close corporation should consist collectively of investment income and income derived from the rendering of a personal service; and
- such company should not be an employment company.

If the enterprise can be classified as an SBC, then the tax rates are reduced as indicated in the following table.

**Table 1: Tax rates for SBCs for the year of assessment ending 28 February 2009**

Taxable income	Rates of tax on taxable income (%)
R0 – R46 000	0%
R46 001 – R300 000	10%
R300 0001 and above	28%

*Source:* SARS (2008a:2).

### **2.3.1.2 Enhanced relief for incorporated SMEs in respect of depreciation**

The enhanced depreciation regime for incorporated small businesses was introduced in 2001 and extended in 2005. It is contained in sections 12E (1) and 12E (1A) of the Income Tax Act.

In terms of section 12E(1) of the Income Tax Act, 100% of the cost of any plant or machinery brought into use in the tax year for the first time and used for manufacturing is deductible (after 1 April 2001). The assets should be owned by the taxpayer or should be acquired by the purchaser in terms of an instalment credit agreement, as defined in the VAT Act.

This is in contrast with the standard legislation that applies to non-SBC enterprises in respect of which new or unused manufacturing assets that were acquired on or after 1 March 2002 are subject to a wear and tear allowance of 40% in year 1 and 20% in the subsequent three years (section 12C(1) of the Income Tax Act).

In terms of section 12E(1A) of the Income Tax Act, 50% of the cost of machinery, plant, implements, utensils, articles, aircraft or ships, other than plant and machinery that is used in the process of manufacturing, is permissible as a deduction in the year of assessment during which that asset is taken into use for the first time; thereafter 30% of that cost is deductible in the year immediately succeeding the year of assessment and, finally, 20% of that cost is deductible in the year thereafter (on or after 1 April 2005).

### **2.3.2 Relief in respect of capital gains tax for incorporated and non-incorporated SMEs**

In terms of the definition of a small business that is contained in paragraph 57 of the Eighth Schedule of the Income Tax Act, a small business is a business of which the market value of all its assets, at the date of disposal, does not exceed R5 million.

In terms of paragraph 57 of the Eighth Schedule of the Income Tax Act the capital gain on the disposal of the assets of a small business should be disregarded if:

- it is a disposal by a natural person;
  - who is trading as a sole proprietor, of an active business asset of a small business;
  - who is a partner in a partnership on withdrawal from the partnership, of an interest in the active business assets of a partnership, which qualifies as a small business, to the extent of that partner's interest in the partnership; or

- who is a shareholder or member (natural person) of a company or close corporation, of the entire direct interest in a company, comprising at least 10% of the equity of the company, to the extent that the interest relates to active business assets of the company, which must qualify as a small business;
- the asset, interest in the partnership or interest in the company should have been held for a continuous period of five years prior to the disposal;
- the natural person has attained the age of 55 years or the disposal is a consequence of ill health, other infirmity, superannuation or death;
- all the capital gains should be realised within a period of 24 months after the date of the first disposal; and
- the total capital gain that is disregarded may not exceed R750 000 over the lifetime of the natural person.

A natural person who operates more than one small business is obliged to include all qualifying disposals for each such small business when determining the capital gain that is to be disregarded. For these purposes, the assets of a small business are limited to a cumulative total of R5 000 000, in terms of the market value of the assets.

### **2.3.3 Relief in respect of value added tax for incorporated and non-incorporated SMEs**

#### **2.3.3.1 Reduced number of tax returns per year**

SMEs have the option to file VAT returns every four months, instead of every two months, if their turnover is below R1.5 million per year (prior to 1 March 2008 the limit was R1.2 million per year)(SARS, 2008c:67).

#### **2.3.3.2 Introduction of high compulsory registration thresholds**

Relief is provided to SMEs in the form of a high compulsory registration threshold. However, an SME has the option of voluntary registration for VAT.

The following table provides details of the voluntary and compulsory registration requirements.

**Table 2: VAT registration for the year of assessment ending 28 February 2009**

Turnover	Tax period
Compulsory registration	Income earned from the selling of goods or from fees earned for services rendered is more than R300 000 (R1 million from 2009) per annum (section 23(1) of the VAT Act) ( <i>Note 1</i> ).
Voluntary registration	<p>Income earned from the selling of goods or from fees earned for services rendered is more than R20 000, but less than R1 million per annum (section 23(3) of the VAT Act).</p> <p>Voluntary registration could be refused if (section 23(7) of the VAT Act) :</p> <ul style="list-style-type: none"> <li>• the person has no fixed place of residence or business in the RSA;</li> <li>• does not keep proper accounting records;</li> <li>• has not opened a bank account in the RSA;</li> <li>• has previously been registered as a vendor in terms of VAT or GST requirements and failed to perform the duties of a vendor; or</li> <li>• has not met the minimum threshold requirement of a turnover of R20 000 over the preceding 12 months.</li> </ul>

*Source:* Section 23 of the VAT Act

*Note 1:* A SARS media release of 28 May 2008 (SARS, 2008d:1) indicates that the intention of raising the threshold from R300 000 to R1 million is due to the fact that the increase will coincide with the introduction of simplified presumptive turnover tax for very small businesses in 2009. Furthermore, the media release states that draft legislation regarding the increase, presumptive tax and related matters will be released later in the course of 2008.

### **2.3.3.3 The payment basis or the cash basis of accounting for VAT is available to certain SMEs.**

The South African VAT system is an invoice-based system. This means that vendors are generally required to account for VAT based on the invoices that have been issued or received (section 15(1) of the VAT Act).

However, certain vendors may use the payment basis or cash basis of accounting. This basis refers to the time when the actual payment is made or the actual payment is received. The payment basis is only available to:

- vendors who are natural persons (or to partnerships comprising natural persons only) whose taxable supplies, at the end of a tax period, have not exceeded R2.5 million in the preceding 12 months or are not likely to exceed R2.5 million in the next 12 months; and
- public authorities, municipalities, associations not for gain or welfare organisations, irrespective of the value of their taxable supplies (section 15(2) of the VAT Act).

### **2.3.3.4 The Small Retailers VAT package provides a simpler VAT option for small retailers**

In order to use the Small Retailers VAT package, the taxpayer should submit an application to become an approved vendor. The vendor should fulfil the following requirements (SARS, 2007a:41):

- the vendor should supply both standard-rated and zero-rated goods from the same premises;
- the vendor should not have adequate point-of-sale equipment (electronic scanning systems, touch screen registers or product-specific cash registers); and
- taxable supplies should not exceed R1 million in any 12 month period.

The sum of all zero-rated purchases for the tax period is calculated and an industry mark-up percentage is applied to calculate the total zero-rated sales. The vendor is required to calculate the daily gross takings for the same tax period and thereafter deduct the total

zero-rated sales from it to determine the total of the standard-rated sales. The tax fraction is then applied to the total of the standard-rated sales to determine the VAT due on sales. (SARS, 2005:2.)

#### **2.3.4 Relief in respect of skills development levies for incorporated and non-incorporated SMEs**

SMEs are exempted from the payment of the skills development levy if their payroll is less than R500 000 per year (from 2005) (section 4 of the Skills Development Levies Act).

#### **2.3.5 The 2006 small business tax amnesty**

In February 2006, the Minister of Finance announced a once-off tax amnesty for SMEs that have a turnover of less than R10 million for the 2006 year of assessment. The amnesty commenced on 1 August 2006 and was scheduled to end on 31 May 2007 (SARS, 2007b:49). The period was extended and businesses were permitted to submit the required documents until 31 August 2007 (SARS, 2007g:1). During the amnesty period, businesses could apply to be registered without having to be concerned that tax liabilities would ultimately arise from their non-compliance in previous tax periods (SAICA, 2006:1).

The amnesty applied to the following taxes: income tax, employees' tax, VAT, withholding tax on royalties, STC, UIF and SDL (FIAS, 2007:106).

In order to qualify for the granting of tax amnesty, the following requirements were to be fulfilled (SAICA, 2006:1):

- the small business should be an individual, unlisted company, close corporation, trust, co-operative or the insolvent estate or deceased estate of an individual;
- the individual or entity should have carried on a business;
- the gross income or turnover of the business (or businesses, if the individual or entity carried on more than one business) during the 2006 year of assessment should not be more than R10 million;

- in the case of a company or close corporation, all the shares or members' interests should have been held directly by individuals throughout the 2006 year of assessment; or
- in the case of a trust, all the beneficiaries of the trust should have been natural persons throughout the 2006 year of assessment.

The amnesty levy payable was calculated on a sliding scale. The rate was applied to the taxable income of the applicant in the 2006 year of assessment to the extent that the taxable income was attributable to any amount derived from the carrying on of business. (SAICA, 2006:1.)

The rates for the calculation of the amnesty levy on taxable income are contained in the following table.

**Table 3: Levy payable by applicants for amnesty**

Taxable income	Amnesty levy
R0-R35 000	No levy payable
R35 000 – R100 000	2% of the amount above R35 000
R100 000 – R250 000	R1 300 + 3% of the amount above R100 000
R250 000 – R500 000	R5 800 + 4% of the amount above R250 000
More than R500 000	R15 800 + 5% of the amount above R500 000

*Source: SAICA (2006:1).*

In addition, small businesses could apply for a waiver of the additional tax, interest and penalties (excluding the underlying tax portion of the tax debt owed). Such businesses may already have been registered taxpayers and this category of businesses was initially excluded from the amnesty legislation. The amount of the additional tax, penalty and interest that could be waived, was the amount that related to the qualifying period that was covered by the amnesty legislation and that was still outstanding on 31 July 2006. The maximum amount that could be waived was R1 million, an amount that covered the vast majority of small businesses. (SARS, 2007i:1.)



According to the medium-term budget policy statement made by Minister Trevor Manuel on 30 October 2007 in Cape Town, approximately 299 000 small businesses applied for tax amnesty while 54 574 applied for the waiver of additional taxes, penalties and interest. The initial analysis of the applicants revealed that about 22% of the applications were submitted by new registrants. Of the total number of applications received, 24 174 were from the taxi industry. (Hazelhurst, 2007:1.)

## **2.4 CHANGES PROPOSED IN THE BUDGET FOR 2008/9**

In the budget speech for 2008/9, Minister Trevor Manuel (2008:21) proposed two new differentiated tax policies, namely a presumptive turnover tax system and venture capital incentives.

### **2.4.1 A presumptive turnover tax system**

A simplified tax system for small businesses that have a turnover of less than R1 million (SARS, 2008a:3) was proposed... It was proposed that the system should have the following characteristics:

- reduced paperwork (income tax and VAT);
- be applicable to sole proprietors, partnerships and incorporated entities;
- be an elective system;
- applicants should be required to remain in the system for 3 years;
- if applicants leave the system, they may not migrate back within the next 5 years;
- and
- employment companies are to be excluded.

The proposed turnover-based system is intended to reduce the cost of tax compliance for very small businesses, but not necessarily decrease their tax liability. This measure should also support the practice of regular recordkeeping in small businesses, which could in time migrate to the normal income tax system. (SARS, 2008c:63.)

A SARS media release, which appeared on 28 May 2008 (SARS, 2008d:1), states that, although some of the principles of the presumptive tax have been announced, several matters remain to be dealt with and refined after consultation with small businesses. The media release furthermore states that draft legislation will be released for stakeholders' comments later in 2008.

The tax liability will be calculated on the basis that reduced rates will apply to turnover bands below R1 million, as is illustrated in the following table:

**Table 4: Proposed tax rate structure for small businesses for the year of assessment ending 28 February 2009**

Turnover	Tax liability
R0 – R100 000	0%
R100 001 – R300 000	2% of each R1 above R100 000
R300 001 – R500 000	R4 000 + 4% of the amount above R300 000
R500 001 – R750 000	R12 000 + 5.5% of the amount above R500 000
R750 000 – R1 000 000	R25 750 + 7.5% of the amount above R750 000

*Source:* SARS (2008a:3).

#### 2.4.2 Venture capital incentives

The 2008/9 budget review (2008c:64) states that, in order to meet the challenge of access to venture capital for small and medium-sized enterprises, tax incentives will be given to investors in qualifying small enterprises and start-ups. The targeted enterprises are high-growth and high-tech companies that have an annual turnover of up to R14 million or that have gross assets that are valued up to R7 million. A different threshold will be considered for junior mining and exploration companies (gross assets of R30 million to R50 million). The proposed tax incentives will target individual investors, corporate investors and venture capital funds. (SARS, 2008c:64.)

The venture capital tax incentives are summarised in the following table:

**Table 5: Venture capital tax incentives**

Targeted Enterprises	Tax incentive
General venture capital investments (non-mining)	<ul style="list-style-type: none"> <li>• 30% up-front deduction</li> <li>• Annual deductions are capped at R500 000 for individuals, R750 000 for corporations and R7.5 million for venture capital funds</li> </ul>
Junior mining exploration investments	<ul style="list-style-type: none"> <li>• 50% up-front deduction</li> <li>• Annual deductions are capped at R1 million for individuals and R10 million for corporations and venture capital funds.</li> </ul>

*Source: SARS (2008c:64).*

## 2.5 CONCLUSION

The differentiated tax policies in South Africa are based on various definitions of an SME and on the legal form in which the enterprise conducts its business.

It appears that the proposed budget changes envisage a gradual process. An SME could enter the tax net by utilising the relief provided by the presumptive tax system and, as the SME grows, it could become an SBC (utilising section 12 of the Income Tax Act) and it could ultimately be transferred to the standard legislation process.

The relief is intended to alleviate the compliance burden that is faced by SMEs, to encourage SMEs to enter the tax net (broadening the tax base), to lower the tax compliance cost of an SME and to assist SMEs to overcome the financing constraints that they face.

In the next chapter, the focus is placed on the differentiated tax policies in other countries and the effectiveness of the use of such policies to address the constraints imposed on SMEs in those countries.

## **CHAPTER 3**

### **DIFFERENTIATED TAX POLICIES FOR SMEs IN OTHER COUNTRIES**

#### **3.1 INTRODUCTION**

The focus in this chapter is on the research objective “to review differentiated tax policies for SMEs in other countries to determine the effectiveness of the use of differentiated tax policies to address constraints imposed on SMEs in those countries”.

Firstly the reasons for or drivers of the move towards differentiated tax policies for small and medium enterprises (SMEs) and the criteria that govern differentiated tax policies are discussed. Thereafter an overview is presented of the current tax policies that are applied in various countries. These expositions serve as the background for a discussion of the effect of the policies on the SMEs and the experiences of foreign countries concerning differentiated tax policies.

#### **3.2 REASONS FOR DIFFERENTIATED TAX POLICIES FOR SMEs**

##### **3.2.1 Reducing tax costs for SMEs to foster SME competitiveness**

Taxes constitute a large portion of the cost structure of an SME. It is for this reason that smaller businesses engage in tax evasion practices and operate in the informal economy or conceal business transactions. (IFC, 2007:vii.)

Taxes are an important element of the cost structure of SMEs, because SMEs do not have the financial and human capacity to develop sophisticated tax-avoidance strategies (Nam & Radulescu, 2007:101). In contrast, large businesses (and wealthy individuals) have access to sophisticated tax advice to develop tax-avoidance strategies that reduce their tax liabilities by, for example, using transfer-pricing techniques (IFC, 2007: vii).

### **3.2.2 Reducing the tax compliance and administrative costs of SMEs**

The compliance and monitoring requirements in respect of income tax are the same for small taxpayers as for large taxpayers. As a result, the tax compliance and administrative costs that SMEs have to bear are proportionately higher than those for large businesses. (Killian, Karlinsky, Payne & Arendse, 2007:19.)

In addition, compliance with tax legislation is beyond the accounting capabilities of many small businesses (Stern & Barbour, 2005:12).

It is the high compliance and administrative costs in particular that deter informal SMEs from joining the formal sector (Stern & Barbour, 2005:9).

### **3.2.3 Promotion of the growth of SMEs**

Countries that have tax incentives for SMEs claim that preferential tax treatment creates a large number of jobs and enhances the level of entrepreneurship that is associated with flexibility, speed, risk taking and innovation (Chen *et al.*, 2002:6).

Killian *et al.* (2007:16) emphasise the fact that SMEs are key drivers of economic success, because they are job creators, sales generators and the source of tax revenue. These authors base their assertion on the facts that a large percentage of SMEs contribute to the various countries' gross domestic product, they employ a large percentage of the workforce and the high ratios of small businesses to large businesses in the countries concerned.

According to Hendrick (in Nam & Radulescu, 2007:102), SMEs represent fertile ground for the development of large, profitable, tax-paying employers and SMEs experience high growth rates in comparison to large enterprises.

However, tax policies that are aimed at promoting the economic growth of small businesses should be evaluated judiciously, because the inherent characteristics of small

businesses can make a specific differentiated tax policy undesirable. Studies undertaken in this regard have produced the following findings:

- the majority of SMEs have limited growth potential (Chen *et al.*, 2006:6);
- small businesses vary in terms of productivity, job growth, wages, innovation and export performance within the same industry subgroups. Small business also do not all follow the same growth pattern. Certain small businesses will remain small for most of their existence and it is for this reason that it is not obvious why a tax system should influence the growth process. Such intervention, to the extent that it does not act in a lump-sum way, influences marginal decisions and could lead to excessive risk taking and overinvestment. (Jousten, 2007:17.);
- less efficient SMEs tend to have a higher probability of exiting the market than larger firms do. It is for this reason that it is advisable for SMEs to invest gradually over a period. Entry and other investment costs that are made in the setting-up phase are mostly sunk costs. A government subsidy may reduce the differences between the efficient and the inefficient enterprises and consequently disturb the investment decisions taken, the market selection as well as the learning process that entrepreneurs undergo. (Nam & Radulescu, 2007:102.);
- a large SME sector is a characteristic of a fast-growing economy, but it is not a cause of the rapid growth of the economy (Beck & Demirguc-Kent, 2006:2933). Beck and Demirguc-Kent (2006:2933) also did not find any evidence for the association of a large SME sector with faster income growth in the lowest income quintile and faster rates of poverty reduction; and
- according to Jousten (2007:17), there is no statistically significant relationship between the size of enterprises and employment growth. For example, large enterprises in sub-Saharan Africa remain the dominant job creators in the manufacturing sector (Jousten, 2007:17).

#### **3.2.4 Promotion of access to international markets**

SMEs have limited access to international markets, partly as a result of the perception of SME business owners of high-risk, informational barriers that exist and SMEs involvement in smaller projects that result in investments being self-financed. Consequently, SMEs appear to be more directly affected by national corporate tax policy than large

multinationals, because they concentrate their activities on the domestic market. (Nam & Radulescu, 2007:101.)

### **3.2.5 Formalisation of the informal economy**

Formally registered small businesses acknowledge that differentiated tax policies for SMEs have helped instil a culture of compliance and good accounting practices (Stern & Barbour, 2005:9).

When the activities of the informal sector are ignored, tax morale across the entire economy is lowered and the risk of low tax compliance increased (IFC, 2007:31). Torgler (in IFC, 2007:31) found that tax compliance in the formal sector is higher in countries that have a relatively small informal sector.

One apparent disadvantage for SMEs is the presence of a large informal sector that is in direct competition with these small businesses (Jousten 2007:18).

### **3.2.6 Alleviation of the financing constraints experienced by SMEs**

SMEs are often unable to obtain long-term finance in the form of term debt and equity. The larger portion of their investments has traditionally been self-financed. (Nam & Radulescu, 2007:101.)

In their survey of UK and Chinese SMEs, Hussain, Millman and Matlay (2006:595) found that a start-up company relies exclusively on finance obtained from the immediate family and from own savings. After two years of business, a higher reliance is placed on own savings and the financial support of banks and other institutions. At the end of five years, finance is primarily obtained from financial institutions. Less than 25% of the SMEs had attempted to restructure their capital mix, but could not access cheaper sources of finance. (Hussain *et al.*, 2006:595.)

Policies that are intended to foster the access that SMEs have to finance are based on the premise that SMEs are the engine room of economic development, but that market and institutional failures impede their growth (Beck & Demirguc-Kent, 2006:2932).

According to Beck and Demirguc-Kent (2006:2934), existing evidence suggests that finance, crime and political instability are the only obstacles that have a direct impact on the growth of an enterprise and that finance is the most robust of these factors. They conclude (Beck and Demirguc-Kent, 2006:2942) that the relevant literature suggests that the devising of strategies that focus on improving the legal and financial institutions and the overall business environment are probably the most effective way of relaxing the growth constraints that SMEs face and of facilitating their contribution to economic growth. Research findings suggest that a competitive business environment is more important than merely attempting to promote a large SME sector that might be characterised by a large number of small but stagnant enterprises (Beck & Demirguc-Kent, 2006:2941).

However, Jousten (2007:18) states that it is still unclear why a specific tax policy should be used to address a non-tax distortion. The development of micro credit institutions is a policy tool that could be used to address the constraints of the poor more directly. Government action beyond these limitations will lead to a socially dominated outcome, because it will force an inefficient resource allocation onto capital owners. (Jousten, 2007:18.)

### **3.3 CRITERIA FOR A DIFFERENTIATED TAX POLICY**

The research finds in the available literature suggest that tax neutrality should be maintained to ensure that fundamental economic considerations, and not the tax structure, will guide investment and organisational and financial decisions (Chen *et al.*, 2002:28).

Journard (in Chen *et al.*, 2002:28) argues that although SMEs faces particular obstacles in the economy, the roots of these problems should be addressed before turning to special tax provisions.



The favourable treatment of SMEs in respect of taxation can only be justified on the grounds of efficiency if there are spill-over (external) effects for the remainder of the economy. Special tax provisions should only be instituted if there is strong evidence of market failure or it is justified in terms of equity considerations. However, it should be designed to avoid adverse side-effects for the economy (such as discouraging new investment, work effort, skill acquisition and entrepreneurial incentives). (Chen *et al.*, 2002:28.)

A key challenge is therefore to design a tax policy that is efficient, fair and simple, but that is also conducive to economic growth (Chen *et al.*, 2002:6).

In general, tax incentives (such as lower corporate tax rates, investment tax credits, VAT exemptions and other similar incentives) that target small enterprises should be evaluated to ensure that they are addressing market failures and are not inducing economic distortions or encouraging tax evasion (Chen *et al.*, 2002:19).

### **3.4 AN OVERVIEW OF TAX POLICIES FOR SMEs AS APPLIED IN VARIOUS COUNTRIES**

This overview is not intended to be a comprehensive and exhaustive analysis. Rather, it is intended to provide some insight into the various types of tax policies that exist in other countries.

As part of the tax relief legislation for SMEs, legislators have generally used the following provisions to prevent abuse of the tax relief that is provided to small businesses:

- aggregation or affiliated group rules where turnover or asset thresholds are applied across affiliated groups (similar to the South African definition of “connected parties” in section 1 of the Income Tax Act). This provision prevents large businesses from taking advantage of SME tax relief by breaking up a large business into smaller businesses. (Killian *et al.*, 2007:25.);
- phase-out provisions, for example providing differentiated tax relief to small businesses that is based on particular turnover thresholds that have been reached (Killian *et al.*, 2007:28);

- non-availability of the tax relief for activities that are not to be encouraged., for example, most countries do not want to subsidise SMEs that are not generating jobs or that do not contribute to the gross domestic product (Killian *et al.*, 2007:28); and
- tax relief provisions with specific exclusions that are aimed at the abuse of the tax relief to be provided (Killian *et al.*, 2007:32).

The following table summarises the differentiated tax policies for SMEs that are applied in various countries. For comparison purposes, the last column indicates whether the South African legislation provides a similar tax relief incentive.

**Table 6: Differentiated tax legislation for SMEs in other countries**

Legislation	Countries	Similar incentive in SA
Lower corporate tax rates and/or no corporate taxes below a particular monetary threshold.	Belgium, Canada, France, Germany, Ireland, Japan, Korea, Luxembourg, Mexico, the Netherlands, Portugal and Spain (Chen <i>et al.</i> , 2002:12); United Kingdom (Anon, 2007:38); United States and Australia (Killian <i>et al.</i> , 2007:21); and China (Chen, 2006:142).	Yes
Accelerated depreciation and/or immediate expensing of asset cost if the asset cost is below a particular monetary threshold.	Japan, Finland and Spain (Chen <i>et al.</i> , 2002:18) United Kingdom (Anon, 2007:28), Australia, Ireland and the United States (Killian <i>et al.</i> , 2007:22).	Yes
No capital gains at either corporate or individual level.	Belgium and New Zealand (Chen <i>et al.</i> , 2002:22).	No
No capital gains tax on the sale of shares or business assets held by individuals or if the consideration is below a particular threshold.	Greece, Korea, Mexico, the Netherlands, Poland and Switzerland (Chen <i>et al.</i> , 2002:22); Ireland (Killian <i>et al.</i> , 2007:22).	Yes
Capital gains tax rates that decline with the length of the holding period of the investment either for individuals or for incorporated companies.	Spain, United Kingdom, Austria, the Czech Republic, Portugal, Germany, Denmark, Luxembourg and Switzerland (Chen <i>et al.</i> , 2002:23); United States, Ireland and Australia (Killian <i>et al.</i> , 2007:22).	No

Legislation	Countries	Similar incentive in SA
Roll-over relief on capital gains realised on the sale of the SME investment when funds are reinvested in another SME.	Canada and United States (Chen <i>et al.</i> ,2002:24).	No
Favourable loss relief (investment losses considered to be an ordinary loss rather than a capital loss).	United States (Killian <i>et al.</i> , 2007:21).	No
Value-added tax exemptions below a specific turnover threshold in order to lower compliance cost and the administrative burden.	Switzerland, Canada, the Czech Republic, France, Germany, Greece, Japan, New Zealand, Poland, Portugal and the United Kingdom (Chen <i>et al.</i> ,2002:19); Australia and Ireland (Killian <i>et al.</i> , 2007:22), China (Chen, 2006:142).	Yes
Simplified VAT regimes that lower the effective VAT rate below standard rates. For example, simplified accounting systems and reduction of the number of VAT returns per year.	Italy, Mexico, Canada and Sweden (Chen <i>et al.</i> ,2002:19); Ireland (Killian <i>et al.</i> , 2007:22), New Zealand (Chamberlain & Smith, 2006:18).	Yes
Presumptive turnover taxes.	Albania, Armenia, Azerbaijan, Belarus, Bosnia & Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyzstan, Latvia, Lithuania, Macedonia, Moldova, Romania, Russia, Ukraine and Uzbekistan (Engelschalk, 2006:7).	Proposed in the 2008/9 budget

Legislation	Countries	Similar incentive in SA
Specific legislation aimed at reducing the cost of compliance for small businesses.	<p>As an example, New Zealand's tax authorities pay an allowance to payroll agents to manage the payroll for the first five employees of all businesses. This arrangement permits business owners to spend more time on managing their business and it increases the accuracy of the calculation of employees' salaries (Chamberlain &amp; Smith, 2006:18).</p> <p>In Ireland, the estimated tax to be paid by a small business can be calculated as 100% of the prior year's liability, thereby assisting small businesses to manage their cash flow; reducing the risk of penalties and interest for underpayment; and reducing the compliance cost of estimating the tax liability multiple times during the tax year (Killian <i>et al.</i>, 2007:22).</p>	No
Special corporate tax provisions to help SMEs overcome impediments to start-up and growth through the granting of tax holidays (income and other taxes) or generous investment deductions.	Czech Republic, Korea, Japan, Belgium (Chen <i>et al.</i> , 2002:18) ; New Zealand (Chamberlain & Smith, 2006:18).	No
Generous or targeted R&D tax incentive programmes, for example R&D tax credits for small businesses.	Canada, Italy, Japan, Korea, the Netherlands, Norway, and the United Kingdom (Chen <i>et al.</i> , 2002:19).	No
Provisions to increase the supply of equity to small enterprises or the supply of finance to SMEs, for example through venture capital fund tax incentives.	United Kingdom (FinMark Trust, 2006:13); United States (FinMark Trust, 2006:16); France (FinMark Trust, 2006:19), Australia, Turkey, Canada (Chen <i>et al.</i> , 2002:19), China (Chen, 2006:142).	Proposed in 2008/9 budget

Legislation	Countries	Similar incentive in SA
<p>Tax relief to address specific market failures or to direct the market.</p>	<p>Tax relief measures in China (Chen, 2006:143) are aimed at:</p> <ul style="list-style-type: none"> <li>• <i>targeting employment</i>, for example new urban job agencies are eligible for exemption from business taxes for three years if the agency is able to find jobs of which 60% of the total jobs found are for unemployed workers (If it is greater than 30%, the SME receives a 50% discount on income taxes for two years). New businesses in service, commercial and trading enterprises are exempted from urban maintenance and construction tax; additional education fees; and income tax for 3 years if they employ no less than 30% of laid-off workers in the first year of operation and the employment contract is for no less than 3 years. Laid-off workers who start an own business enjoy exemption from various administration fees (registration, certificate and various management fees) for three years;</li> <li>• <i>promotion of high-tech enterprises</i> through exemption from income tax for two years and thereafter a preferential income tax rate of 15%;</li> <li>• <i>promotion of transportation; post and telecommunication; consultation; information industry; and technological services</i> by means of exemption from income tax in the first year and 50% discount in the second year; and</li> <li>• <i>establishment of fiscal funds</i> to encourage technological innovation (Innovation Fund), promote commercialisation and the transfer of sophisticated and practical technologies in high-tech agricultural enterprises (Commercialisation Fund for Agricultural Research) and to encourage SMEs to participate in global competition, explore international markets and expand exports (Fund for International Market Exploitation).</li> </ul>	<p>No</p>

## 3.5 THE EFFECT OF TAX POLICY ON SMES

### 3.5.1 The effect of personal income tax on non-incorporated SMEs

Owner-operated SMEs are subject to personal income tax whereas the earnings of incorporated SMEs are subject to corporate tax. In most OECD countries, income from self-employment is taxed as ordinary income at a progressive income tax rate after deductions for business expenses have been made. (Chen *et al.*, 2002:7.)

Research findings indicate that when personal income tax rates are lower than corporate tax rates, it could have the following consequences (Chen *et al.*, 2002:7):

- induce non-incorporated SMEs to grow faster, hire more workers and invest more heavily in equipment and structures;
- discourage the incorporation of profitable businesses; and
- induce higher self-employment (as non-incorporated SME) than working as an employee.

Research conducted on non-incorporated SMEs in Japan and the United States indicate that high personal income tax and progressive rate schedules could lead to the underreporting of taxable income and to tax evasion (Chen *et al.*, 2002:10).

Chen *et al.* (2002:11) argues that governments should reduce the opportunity for tax avoidance and tax evasion by the self-employed. The decision to become an SME entrepreneur would then be based on perceived economic gains rather than on distortions created by taxes.

### 3.5.2 The effect of reduced tax rates for SMEs

Reduced tax rates for SMEs could:

- increase after-tax earnings, lower the cost of equity funds, increase equity investment and reduce tax distortion in favour of debt. It could therefore influence investment and financing decisions. (Chen *et al.*, 2002:12.);

- encourage underreporting of income. It could furthermore induce business owners to divide their business into separate corporations for tax purposes. (Chen *et al.*, 2002:12.);
- result in inefficiency, because favourable tax provisions benefit existing enterprises as well as new or technology-based enterprises. It should be borne in mind that a large proportion of established SMEs are not significant creators of new jobs or generators of innovation. (Chen *et al.*, 2002:19.);
- discourage SME growth when SME owners attempt to keep reported income below particular thresholds in order to take advantage of the preferential tax treatment that small businesses enjoy (Chen *et al.*, 2002:19);
- possibly not benefit the SMEs, because they have to be profitable before they can make use of tax credits and other measures (Chen *et al.*, 2002:19); and
- encourage the incorporation of SMEs despite the fact that incorporation is not a suitable legal structure for small businesses (Chamberlain & Smith, 2006:13; Monteith 2008:111).

Nevertheless, an enterprise-level survey of 52 countries found that incorporated SMEs reported fewer financing, legal and regulatory obstacles than unincorporated SMEs. It also produced evidence of higher growth of incorporated SMEs in countries that have sound financial and legal institutions. (Beck & Demirguc-Kent, 2006:2933.)

A recent study that was undertaken by Bruce and Mohsin (2006:421) concludes that there is some evidence that tax policies could affect self-employment rates. However, the numbers are typically quite small and suggest that it would take a prohibitively large tax-rate change to generate a noticeable change in self-employment activity. When applied in isolation, tax policies are not particularly successful instruments for generating changes in the level of entrepreneurial activity.

In the above-mentioned study, Bruce and Mohsin (2006:415) also found that an increase in the top corporate income tax rate reduces the extent to which workers report that they are self-employed (the perception), but this trend was not supported by the information that was obtained from the tax returns (the facts).



### **3.5.3 The effect of accelerated depreciation rules for SMEs**

It was found that accelerated depreciation rules increase the investment return that an investor in an SME receives (using a net present value (NPV) model) only when the accelerated depreciation reaches a substantial level (Nam & Radulescu, 2007:113).

However, accelerated depreciation rules do not promote private investment in periods of inflation as they are intended to do. They only compensate for losses caused by inflation, because historic-cost accounting gives rise to fictitious profits that are subject to tax. Only in an exceptional case, when tax depreciation corresponds to true economic depreciation and the calculation is based on the current replacement cost of capital, can tax neutrality be guaranteed in an inflationary phase. (Nam & Radulescu, 2007:103.)

### **3.5.4 The effect of presumptive turnover tax**

Presumptive tax systems have not fundamentally changed taxpayers' perception that the tax system is burdensome or that tax rates are too high when:

- the tax system has not replaced all taxes, but has primarily replaced income tax and/or VAT, thus small businesses must still comply with several filing requirements.(Engelschalk, 2006:27);
- there is a lack of clarity in the definition of taxpayer categories that result in negotiations between taxpayers and tax inspectors and the possibility of corruption (Engelschalk, 2006:19);
- registration requirements are onerous and reduce the incentive to formalise (Engelschalk, 2006:19); and
- the simplified tax system tends to undergo frequent and fundamental change in countries that are in transition (Engelschalk, 2006:27). Frequent changes to presumptive tax systems are often the result of a lack of information on SMEs. Simplified tax regimes require an in-depth analysis of profit margins and of the relationships between business indicators such as the size of a business, activities or location and the profit potential. In practice, the undertaking of such an in-depth analysis is rare. Instead, the calculation of the tax burden is based on rough estimates of business profitability and often results in substantial modifications

being made to the approach to small-business taxation and it is not necessarily limited to simple rate changes. (Engelschalk, 2006:15.) In addition, there is a risk that the simplified system will no longer be perceived to be simple if the taxpayer has to supply the additional information required for the in-depth analysis (Engelschalk, 2006:24).

When tax administrators are not in a position to at least approximate the real turnover of a small business, a turnover-based presumptive tax will not reduce the probability of tax evasion. Instead, it could induce an under-declaration of turnover instead of a net profit (Engelschalk, 2006:22).

Furthermore, presumptive tax systems:

- could provide incentives for larger businesses to structure their operations in such a way that they benefit from presumptive tax regimes (Engelschalk, 2006:23);
- reduce the tax liability for periods of below-average volume of business transactions. This effect also benefits start-up businesses during their initial phases. (Engelschalk, 2006:23.); and
- favour businesses that have high profit margins and fail to consider that profit margins can differ substantially in various business sectors (Engelschalk, 2006:7).

From the perspective of tax administration, presumptive tax systems should:

- be aligned with the standard tax system in order to allow SMEs to grow and to migrate from the presumptive system to the standard system (Engelschalk, 2006:27). This objective could be achieved by using the various turnover bands of a turnover-based tax system (IFC, 2007:62) and by requiring SMEs to keep at least some books or records for the turnover-based tax system, without imposing burdensome accounting requirements on them (IFC, 2007:60);
- be combined with administrative improvements, in particular improvements in tax enforcement and the development of a compliance management strategy (Engelschalk, 2006:25). Experience indicates that the specific policies for SMEs have contributed to the broadening of the tax net in all of the countries concerned. However, a simplified system should be combined with the strengthening of the capacity to detect non-registered SMEs that should pay tax and non-filing tax-

registered SMEs if the system is to become an efficient tool with which to reduce the informal economy (Engelschalk, 2006:27); and

- reduce administrative costs, increase voluntary compliance and yield revenue (Engelschalk, 2006:15). A too generous system harbours the inherent risk that the collection and compliance costs could exceed the amount of tax collected (Engelschalk, 2006:27).

A presumptive tax system was found to reduce the compliance management burden of tax administrators and allow them to focus their attention and capacity on larger taxpayers that have a higher revenue potential (Engelschalk, 2006:11). However, it could increase the tax administration burden if the characteristics of a country's small-business population are not taken into account. For example, in Estonia, Lithuania, Russia and the Slovak Republic, more than 20% of registered SMEs have been in business for less than 3 years. The result of this is that there is very little opportunity to successfully familiarise small business owners with bookkeeping and taxation rules (Engelschalk, 2006:3). The vast majority of SMEs also operate from an address that differs from the official address, which results in a high administrative burden when registered taxpayers have to be traced for the non-filing of returns (Engelschalk, 2006:4).

### **3.5.5 The effect of venture capital incentives**

Research findings on the effect of tax incentives in the United Kingdom, United States and France indicate that the venture capital incentives in those countries:

- improved the post-tax returns for investors, thereby encouraging them to invest in the companies that were targeted by the schemes. Studies undertaken in the United Kingdom indicate that between 52% and 87% of the finance provided through the schemes would not have been invested in small, unlisted companies if the schemes had not existed. (FinMark Trust, 2006:14.);
- enabled companies to use the funds to improve their performance (FinMark Trust, 2006; iv); and
- benefited the national economy by having a more competitive, growing, small-enterprise sector. A study conducted in the United Kingdom in 2003 (in FinMark Trust, 2006:14), indicates that venture capital backed enterprises create jobs at a

considerably faster rate than the more established enterprises. For the years 2001 and 2002, the number of workers employed by these companies increased by an average of 32% per annum compared to a growth rate of just less than 1.5% for employment in the national private sector. A total of 76% of the companies stated that their growth was organic rather than a result of acquisitions. (FinMark Trust, 2006:14.)

Although the tax incentives vary from one country to the next, a recurring theme is the intention to address the quality of investment opportunities by implementing strategies that could ensure that small businesses have access to training and mentoring services. Furthermore, these strategies attempt to address factors that could negatively impact on the development and growth of small businesses. (FinMark Trust, 2006; iv.)

The conclusion of the aforementioned study is that a simple tax incentive, that:

- is easy to implement and understand;
  - provides up-front tax reduction to individuals; and
  - offers a reduction in the tax on income and capital gains from such investments
- will attract additional funding and will have the desired effects on the South African economy (FinMark Trust, 2006,vii). The tax incentive should go hand in hand with the removal of specific prevailing disincentive constraints that are contained in the South African Income Tax Act (FinMark Trust, 2006:68).

### **3.5.6 The negative effect of specific standard legislative provisions**

#### **3.5.6.1 Corporate taxes**

Corporate tax systems contain provisions that discriminate against SMEs as a result of the nature of SMEs. Standard legislation provisions could:

- encourage the financing of debt, because corporate interest payments are tax deductible. The financing of debt favours large enterprises that have easier access to bank loans. (Chen *et al.*, 2002:15.);

- result in double taxing of entrepreneurial profits in cases in which the company is subject to corporate tax while the shareholders are liable to personal income tax on dividends (Chen *et al.*, 2002:14);
- result in a higher tax burden in respect of distributed profits than in respect of retained profits. In some OECD countries, tax systems encourage enterprises to retain their earnings and not to distribute them as dividends. (Chen *et al.*, 2002:15.);
- result in retained earnings being treated more favourably than new equity financing. This effect comes about by the imposition of lower tax rates (or zero rates in some cases) on capital gains at the individual level. This effect may serve to lock profits in corporations and make it more difficult to reallocate funds from mature, established enterprises to fast-growing start-ups, which have to rely on external sources of finance. (Chen *et al.*, 2002:15.); and
- limit the number of years for which operating losses may be carried backward and forward, whereas profits are taxed without exception (Chen *et al.*, 2002:17).

### 3.5.6.2 Capital gains taxes

Chen *et al.* (2002:22) argue that three general features of capital gains tax could discourage risk-taking activities, namely:

- the absence of the deductibility of losses from other sources of income imposes higher effective tax rates on risky investments;
- most tax systems permit capital losses to be applied against future capital gains, provided that the losses are carried forward without interest. The resulting gains are shared in full by governments, while losses, in a present value sense, are only shared partially. This asymmetric treatment of capital gains and losses may discourage risk-taking. Moreover, capital gains taxes could also result in the double taxing of retained profits, because they may be deferred dividends that are reflected in share values; and
- taxes on realised capital gains may create an incentive for asset holders to delay the sale of appreciated assets (referred to as the “*lock-in effect*”). This reaction may tie up valuable assets that could have been used more productively by small enterprises.

### 3.6 EXTENSIVE CO-ORDINATED SME POLICIES

The United Kingdom and New Zealand have realised that specific tax legislation for SMEs should be extended to the level of extensive co-ordinated SME policies in order to create an environment that is conducive to the growth and development of SMEs (Chamberlain & Smith, 2006:9).

#### 3.6.1 Integrated environments for SMEs

In the United Kingdom and New Zealand, environments are created in which all proposed government policies are scrutinised. The scrutiny is undertaken from a small-business perspective and the interest of these businesses is voiced through co-ordinated and centralised small-business advocacy units that are often linked to the government. (Chamberlain & Smith, 2006:9.)

In the United Kingdom, the following small business units have fulfilled a cardinal role in articulating the needs of small businesses. They have also advocated policy changes that could benefit small businesses:

- the *Better Regulation Task Force*, which is empowered to make recommendations to government on how to improve regulations for SMEs;
- the *Regulatory Impact Unit* (which is located at the centre of government in the Cabinet Office), which promotes co-operation between government departments and assists in ensuring that regulations are fair and effective. (Regulatory impact assessments are a requirement for any legislation that is presented to parliament);
- the *Small Business Service* (an agency of the DTI), which provides inputs to all government departments (policy co-ordination); and
- the *Small Business Council* (an advisory non-departmental body, comprising SME representatives, that reports to the Secretary of State for Trade and Industry). This council reports on the needs of existing and potential SMEs. (Chamberlain & Smith, 2006:10.)

In addition, the Regulatory Reform Act of 2001 enables the minister, subject to parliamentary scrutiny, to amend or repeal laws in order to remove or reduce regulatory burdens (Chamberlain & Smith, 2006:10).

Similarly, in New Zealand there are established agencies that protect the interests of SMEs, for example:

- the *Ministerial Panel on Business Compliance Costs*;
- the *Business Advisory Group*, which reports to the Ministerial Group for Small Business on any issue that affects SMEs;
- the *Small Business Directorate* within the Industry and Regional Development branch of the Ministry of Economic Development, which articulates the needs of SMEs and serves as an advocate for these businesses across government; and
- the *Regulatory Impact Assessment (RIA) unit* (in the Ministry of Economic Development), which monitors, evaluates and, if necessary, initiates changes in regulations to minimise negative impacts on businesses. (Chamberlain & Smith, 2006:15.)

### **3.6.2 Improved taxpayer understanding of the tax system**

In the United Kingdom, an improvement of the taxpayer's comprehension of the tax system was achieved by releasing a CD Rom on VAT for small businesses; providing updated tax guides to new SMEs; and providing assistance programmes to newly-formed and small businesses when such assistance is most needed (start-up and registration) (Chamberlain & Smith, 2006:12). In New Zealand, similar incentives were provided to SMEs through business training courses for SMEs, mentoring services and public-private partnerships that were specifically aimed at developing the skills of SME business owners and employees (Chamberlain & Smith, 2006:17).

### **3.6.3 Continuous measuring of the regulatory burden of SMEs**

In the United Kingdom, the Standard Cost Model, which is employed in the Netherlands, is being considered as a model for the measurement of compliance cost (Chamberlain &



Smith, 2006:11). In New Zealand, no benchmark for measuring compliance cost has yet been adopted, because regulators argue that all compliance costs should be reduced continuously, even if such costs are already relatively or absolutely low (Chamberlain & Smith, 2006:18).

#### **3.6.4 Improvements in respect of tax administration**

The following are examples of improvements that have been made in respect of tax administration:

- in the United Kingdom, a single point of contact for tax-related issues has been established by merging HM Customs and the Inland Revenue Authority; reducing the length of tax-return forms from 16 pages to 4; rolling out a programme to assess the impact on SMEs of the operational changes made by the newly-formed revenue department; reducing the time spent on tax inspections by SMEs by gravitating to a risk-based system of assessment; requiring all senior members of staff responsible for policy and operations to spend time with SMEs; and by promoting the use of an e-filing system that enables tax forms to be submitted online in order to further reduce compliance costs (Chamberlain & Smith, 2006:11); and
- in New Zealand, the language used on forms and in legislation has been simplified (Chamberlain & Smith, 2006:18).

### **3.7 CONCLUSION**

Research findings in various countries indicate that differentiated tax policies that are implemented in isolation are not successful instruments for changing the level of entrepreneurial activity. However, these policies can contribute to the creation of an environment that is conducive to SME growth and to the alleviation of the constraints that SMEs face.

The effectiveness of differentiated tax policies to alleviate constraints that are imposed on small and medium enterprises can be improved by means of:



- a combination of differentiated tax policies, integrated government initiatives and inputs made by representatives of small and medium enterprises;
- taxpayers education;
- a thorough analysis of the SME sector (profit margins and other business indicators) together with regulatory impact assessments that are undertaken by the tax legislators before legislation is promulgated;
- continuous measurement of the compliance burden that SMEs have to bear;
- improvement of tax administration and the measurement of the activities and the benefits derived in the form of revenue collection; and
- enactment of changes to the existing standard legislation to simplify it and render it fair to all taxpayers.

This chapter encompasses an examination of the effectiveness of the use of differentiated tax policies in other countries to address constraints imposed on small and medium enterprises. In the next chapter, the focus is placed on differentiated tax policies in South Africa and the effectiveness of these policies in addressing the constraints faced by SMEs in South Africa.

## **CHAPTER 4**

### **THE EFFECT OF TAX POLICY ON SMEs IN SOUTH AFRICA**

#### **4.1 INTRODUCTION**

The focus in this chapter is on the achievement of the following research objectives:

- identification of the objectives of the National Treasury concerning differentiated tax policies for SMEs. This objective also includes the determination of whether the objectives of the National Treasury are aligned with the perception of tax practitioners and SME business owners. These matters are addressed in the first part of this chapter; and
- identification of the constraints that are imposed on SMEs in South Africa as perceived by tax practitioners and SME business owners. The intention of this objective is to determine whether these constraints could be addressed through differentiated tax policies for SMEs. These matters are addressed in the second part of the chapter.

#### **4.2 CONSTRAINTS WITH WHICH SMEs ARE CONFRONTED IN SOUTH AFRICA**

The 1995 White Paper on a national strategy for the development and promotion of small business in South Africa (The Government of South Africa, 1995: § 2.3.1) identified a number of constraints with which SMEs in South Africa are confronted. These constraints include the legal and regulatory environment; access to markets; finance and business premises (at affordable rentals); the acquisition of skills and managerial expertise; access to appropriate technology; quality of the business infrastructure in poverty-stricken areas; and, in some cases, the tax burden.

In 2005, the Department of Trade and Industry (DTI) announced an integrated strategy regarding the promotion of entrepreneurship and small businesses. The strategy is based on three strategic actions, namely to increase the supply for financial and non-financial support services; to create demand for the products and services of small enterprises; and

to reduce the regulatory constraints that small enterprises face (Department of Trade and Industry, 2005:4).

At the core of the DTI's strategy is the principle of integration between government departments and other role players. It was envisaged that the SMME division of SARS would form part of the Small Enterprise Agencies Forum, thereby aligning the DTI's strategy with SARS' initiatives (Department of Trade and Industry, 2005:28).

A review of SARS' documents indicates that its objectives for differentiated tax policies for SMEs are:

- to provide access to equity finance for small and medium-sized enterprises in high-tech sectors and junior mining exploration companies (Manuel, 2008:21);
- to ease the regulatory and compliance burden of small enterprises (Department of Trade and Industry, 2005:8; Manuel, 2008:21) through *inter alia* the implementation of a simplified regime for very small businesses (SARS, 2007c:15), preparation of SMEs for migration to the normal income tax system (Manuel, 2008:21); and reduction of the income tax payable by SMEs (SARS 2008a:3; 2008c:62);
- to increase awareness and compliance among SMEs and the informal sector in order to improve the tax compliance culture (SARS, 2007c:31; SARS, 2007b:49) and to broaden the tax base (SARS, 2007b:49); and
- to encourage job creation (Manuel 2008:8).

## **4.3 PROVIDING ACCESS TO FINANCE**

### **4.3.1 Access to finance as a constraint that is faced by South African SMEs**

Rogerson (2008:63) indicates in his synthesis of published research on finance for SMEs in South Africa that a number of studies point to finance as being a core business constraint that is experienced by, particularly, emerging SME entrepreneurs in South Africa.

Finance is currently available to SMEs in the form of formal finance (bank loans, private equity, angel financing and factoring); NGO micro finance; DTI product offerings (South African Micro-Finance Apex Fund, Khula Enterprise Finance); other government offerings (Industrial Development Corporation; and sector-specific access to credit, for example the Land Bank and Micro-Agricultural Financial Institute of South Africa in the Department of Agriculture) (Rogerson, 2008:67; Department of Trade and Industry, 2005:8).

Various research studies in South Africa have been conducted on the finance offerings available to SMEs. Some of these findings, summarised by Rogerson (2008:63), are highlighted below:

- a study undertaken by the World Bank in 2006 found that South African start-up SMEs use personal savings or borrowings from friends and relatives as funding, as opposed to bank loans. Underpinning the low usage of bank loans is the high interest rates charged, the banks' complex application processes and a lack of collateral and credit history;
- in 2006, the FinMark Trust suggested that, in order to improve the immediate access to finance for the start-up of new enterprises, the government should offer tax incentives to stimulate the supply of capital by friends and family. Such funding by friends and family is, after own savings, the most important source of start-up capital;
- in 2000, Scoombie concluded that, if government cannot succeed in encouraging banks to lend to SMEs by means of market-orientated policy measures, the redirection of credit through legislation should be considered. International experience has, however, revealed that this is not the most appropriate policy;
- Siyongwana's findings in 2004 indicated that, as a result of the disappointments that SME's have experienced in respect of the formal lending supply, potential SMEs turn to informal suppliers of finance (moneylenders). Siyongwana pointed out that, given the extensive nature of moneylending in South Africa, there is a surprising lack of research on informal moneylenders;
- in 2004, Baumann assessed the performance of selected South African micro-credit NGOs that have a poverty-alleviation focus. He questioned whether the supply of micro credit is an appropriate intervention. He based his reservations on the findings that emerged from the comparison with benchmarks in other

countries, namely that the productivity levels of South African micro-credit enterprises are low, the salary burden of the South African micro-credit enterprise is the highest in the world and that several problems would have to be overcome in order to achieve improvement.

- in 2003, the FinMark Trust scoped all DTI product offerings for SME development. It concluded that, overall, the DTI product offerings should move away from a heavy-handed state-led approach towards a financial-market systems approach that involves the promotion of a market-enabling environment (Rogerson, 2008:68). Recent amendments made to the DTI policy on financing support for SMEs and the creation of the Apex lending institution are based on the suggestions that were made by the research of the FinMark Trust, which aimed at creating a financial-market system approach to SME financing in South Africa;
- a study that was undertaken by the World Bank in 2006 on the impact made by Khula Retail Finance Intermediary (RFI) programmes produced insightful results. It found that the initial goals of the RFIs were ambitious and that only a few of the RFIs have as yet achieved the levels of lending that were envisaged. Nevertheless, the World Bank was positive about the job-creation impact of RFIs in comparison with other programmes; and
- FinMark Trust (2006:1) conducted a study in 2006 with the primary aim of determining what the best way is to use tax incentives to encourage individuals to invest in small businesses. The study concluded that there is little private-equity finance available in South Africa for small businesses that require less than R5 million as well as early-stage or start-up funding (FinMark Trust, 2006:7). The study reviewed the tax incentives available in the UK, US and France and the effect that the incentives have on the markets in those countries. It found that the incentives did increase the supply of private-equity finance (FinMark Trust, 2006: 12).

#### **4.3.2 Summary**

Support provided by the government to address the constraint of access to finance comes mainly in the form of DTI programmes that offer finance for SMEs that meet the requirements of the specific programmes. Research (some of which was instigated by the

DTI) has revealed that these programmes are not achieving their objectives and, based on the suggestions that emanated from the research, the DTI has amended the programmes (Rogerson, 2008:69).

Research findings in chapter 3.2.6 (*Alleviation of the financing constraints experienced by SMEs*) revealed that finance is the most robust of the factors that affects the growth of enterprises. The findings suggests that the improvement of the legal and financing institutions and the overall business environment are probably the most effective ways of alleviating the growth constraints that SMEs face.

The approach taken by the South African government therefore appears to be based on sound policy. However, continuous monitoring is required to determine the areas in need of improvement.

For the purposes of private-equity funding, the National Treasury has reverted to the use of differentiated tax policies (venture-capital incentive as proposed in the 2008/2009 budget) to alleviate the equity finance constraint. This focus is in line with the approach that is followed in a number of countries, including France, the United Kingdom and the United States. Research has highlighted the positive effect that venture-capital incentives can have on the growth of SMEs (as discussed in chapter 3.5.5 *The effect of venture capital incentives*).

No proposed legislation on venture capital incentives has yet been promulgated. However, based on the information contained in the budget speech introducing the national budget for 2008/2009, the initial response from business has been as follows:

- FinMark Trust (Napier, 2008:1) welcomed this tax incentive, but its concern is that only investors in high-tech and junior mining companies will benefit from it. FinMark Trust has urged the National Treasury to extend the benefit to a broader range of small businesses in the services, tourism, manufacturing, construction and transport sectors, because these sectors have been proven to have job-creating capacity. (Napier, 2008:1.); and
- Seccombe (2008:1) noted that a strict interpretation of the requirement is that it will only benefit junior mining enterprises that have gross assets of between R30m

and R50m and those that have assets of less than R30m may not be eligible for the incentives. However, the definitions of the National Small Business Act define SMEs in mining and quarrying as small and medium-sized businesses that have gross assets (excluding fixed property) of less than R30m. (Seccombe, 2008:1.)

The effectiveness of this differentiated tax policy will therefore depend on the detail of the tax policy once it is promulgated as law and on future measurement of the effectiveness of this tax policy in addressing constraints in respect of equity finance.

#### **4.4 EASING THE REGULATORY AND COMPLIANCE BURDEN**

##### **4.4.1 Background**

Several research studies have been conducted since 2006 on the tax compliance burden that confronts South African SMEs. The findings of these studies reflect the tax compliance burden as perceived by SME business owners and tax practitioners. Several of the findings have been translated into recommendations.

The following are the main research studies that have been consulted:

- a survey among tax practitioners that was undertaken by FIAS (2007:1-189) with the objective of identifying and measuring tax compliance costs for SMEs in SA and to develop recommendations to reduce compliance costs and to encourage formalisation;
- a survey on the tax compliance burden borne by SMEs in the business service industry in Gauteng conducted by Venter and De Clerq (2007a:131-151). The objective was to determine whether the size of a business has an effect on the management of its tax compliance burden;
- a survey conducted by Venter and De Clerq (2007b:72-88) on the impact of taxation on small and medium enterprises in the manufacturing, retail and businesses services sectors. The objective of the survey was to determine

whether the size of an enterprise and the sector in which it operates has an effect on the manner in which the enterprise administers and manages its tax responsibilities;

- a literature review undertaken by Chamberlain and Smith (2006:1-55) on the impact of tax compliance costs on SMEs. The three studies used in the literature review were *Counting the cost of red tape for business in SA* by SBP (2005); *Measurement of VAT Act and RSC Act induced administrative burdens for SA SMMEs* by Upstart Business Strategies, which was commissioned by the DTI (2004); and the *SMME facilitation program* by SARS (2005);
- a survey undertaken by Abrie and Doussy (2006:1-13) on the tax-compliance obstacles that are encountered by small and medium entrepreneurs in South Africa. The objectives of the survey were to report on obstacles that SMEs encounter when attempting to comply with tax requirements and to suggest possible solutions for overcoming the obstacles; and
- a sector study of the effective tax burden in South Africa that was undertaken by FIAS (2006:1-107) to determine whether the tax-policy and tax-administration regimes are conducive to economic growth in the following sectors: small businesses, agriculture, manufacturing, tourism and mining.

The above-mentioned studies were analysed and the findings and recommendations grouped in accordance with the main drivers of compliance cost, namely non-integration of government departments, tax administration by SARS, current tax legislation, SME level inefficiencies and tax practitioner costs. A discussion of each cost driver appears in the following sections.



#### 4.4.2 Non-integration between government departments as a driver of compliance cost

##### 4.4.2.1 Findings of the studies

In the study entitled *Counting the cost of red tape for business in SA* (in Chamberlain & Smith, 2006:25), it is stated that interfacing and regulations are the most serious obstacles. The second most serious obstacle is the category of labour laws and government regulations in general. Burdensome government regulations constitute the greatest policy obstacle to both growth and the increasing of employment.

The factors that contribute most to the lack of an integrated government policy on SMEs are the lack of a consistent definition of SMEs in government departments (Chamberlain & Smith, 2006:34) and the serious lack of information on SMEs that limits the base for the development of a broad policy on SMEs and for impact assessment (Chamberlain & Smith, 2006:7).

##### 4.4.2.2 Recommendations contained in the studies

Co-operation between government departments should be improved, for example, **the time taken to issue tax compliance certificates should be reduced** to 48 hours through the establishment of an electronic link between tender boards, government departments, parastatals and the private sector (Chamberlain & Smith, 2006:37).

The current policy on SMEs in South Africa is not co-ordinated or aligned. This lack of co-ordination results in duplicated and conflicting efforts and a loss of synergy. A dedicated government unit should be established that focuses on the development of SMEs and that is empowered to effect change within government and conduct regular regulatory impact assessments. (Chamberlain & Smith, 2006:44.)

### **4.4.3 Tax administration by SARS as driver of compliance cost**

All the findings and recommendations that were perceived to concern tasks that are usually performed by SARS or processes and tools that are provided by SARS (for example e-filing) are grouped together in this section.

#### **4.4.3.1 Findings of the studies**

The registration process for taxes is complicated and burdensome (FIAS, 2007:68). An income tax and a VAT registration number are only received 25 days after the application form for them has been submitted (although the SARS Service Charter states that the registration numbers will be issued after 10 days) (FIAS, 2007:75).

The call centre does not operate optimally, because the members of staff are not trained thoroughly or do not have the necessary knowledge. It is often not possible to obtain direct access to the person who is dealing with a particular query or who has the authority to take a decision. The SARS documentation also does not contain the contact details of the person to whom a query should be directed. The call centre staff therefore often direct calls to a person who is unable to respond to the query concerned. (FIAS, 2007:67.)

Regarding the operational processes, it was found that:

- capturing and processing errors that are made by the members of SARS staff and the time taken to correct these errors are the most onerous aspect of income tax and employees' tax. SARS' operational reports indicate that 35% of errors or delays are attributable to omissions or errors made by the taxpayer or the tax practitioner and 65% are attributable to the members of SARS staff. (FIAS, 2007:55.);
- it does occur that members of SARS staff lose documentation (FIAS, 2007:68);
- on occasion, penalties are too high, incorrectly raised and not consistently applied (FIAS, 2007:68); and
- some members of the SARS staff lack the technical knowledge that is required of them (FIAS, 2007:68).

It is necessary to incentivise the formalisation and the growth of small businesses by shortening the tax-processing time (Chamberlain & Smith, 2006:34). Administrative burdens should be alleviated. At present, businesses feel that there are simply too many difficult forms to complete and too many complicated procedures to follow (Chamberlain & Smith, 2006:35).

Only 33.3% of the respondents in the survey conducted by Abrie and Doussy (2006:8) made use of e-filing. The respondents who do not use e-filing gave security or confidence concerns (49%), non-awareness (23%) and no facility (28%) as reasons for not using it.

In general, it was found that SARS does not meet the intended standards that are set out in its Service Charter (FIAS, 2007:87).

#### **4.4.3.2 Recommendations contained in the studies**

Improvements are required in respect of:

- improved registration processes, which include simplified and streamlined registration forms and procedures and prompt notification of taxpayers (FIAS, 2007:88);
- improved functionality of the call centre (FIAS, 2007:88);
- improved technical knowledge on the part of members of staff as well as improved work performance, which includes prompt and accurate responses to written correspondence and telephone calls; rendering of personal assistance; and efficient handling of queries (FIAS, 2007:88); and
- improved internal reliability of SARS' logistics. This category includes making it easier and less time-consuming for a business to effect small changes such as registering a new address (Chamberlain & Smith, 2006:32); simplification of payment procedures and forms to ensure the timeous payment of refunds to taxpayers in order to avoid cash-flow difficulties (FIAS 2007:88); reduction of the number of forms, provision of shorter forms and forms that are easier to complete; reduction of the number of times that forms have to be submitted each year (Abrie & Doussy, 2006:11); and **simplification of the language used on forms (Chamberlain & Smith, 2006:37).**

**Recommendations were also made in respect of:**

- the promotion of the use of electronic invoicing and tax software (bearing in mind that not all SMEs can afford computers and tax software) (Chamberlain & Smith, 2006:32);
- support of e-filing by means of the implementation of an education campaign (Chamberlain & Smith, 2006:32);
- the creation of a small-business centre (FIAS, 2007:88) or small-taxpayer unit with the objective of formalising small businesses. The creation of a unit of this nature would also provide a conduit for the flow of information between small businesses and the government. It was found that SARS passively discourages the participation of small businesses in the creation of tax policy, because such participation is costly in terms of time and money; SARS rather focuses on the larger taxpayers. This attitude results in a high tax burden for small enterprises and discourages them from registering with SARS. Public-private dialogue that is supported by monthly and quarterly meetings could provide small firms with a “voice”. (FIAS, 2006: 13.); and
- increased positive communication on the part of SARS in order to foster in small businesses a trust in and a positive attitude towards SARS. Fear of and apathy towards SARS and the SARS processes should be combated, because these responses cause many business owners to remain outside the tax net. (Chamberlain & Smith, 2006:34.)

SARS has since responded by the following actions:

- the small business tax amnesty process included an extensive education and outreach component (SARS, 2007b:39);
- in the course of 2006/2007 SARS held 2755 workshops. The basic workshop covered topics that ranged from registration as a taxpayer, through recordkeeping requirements for small business, to an introduction to taxes. (SARS, 2007b:42.);
- a Small Business Unit has been set up to assist the small business sector with its tax needs. It also addresses issues of non-compliance. (SARS, 2007b:49.);
- the SARS Small Business Unit has developed a small business package that contains modules on income tax, VAT, registration, record keeping and tax clearance certificates. The intention is to distribute this package to all amnesty

applicants and in future to businesses that are newly registered with CIPRO. An accounting and payroll package has also been developed. (SARS, 2007b:50.);

- in 2005/6, SARS established 18 small business desks at its larger offices. The viability and functions of these desks are being reviewed before similar desks are located in all branch offices. (SARS, 2007b:50.); and
- a simplified and streamlined VAT registration process came into effect on 1 February 2008 (SARS, 2008b:1). The new application form has been reduced from seven pages to four, with a concomitant reduction in the number of supporting documents required to accompany the registration form (SARS, 2008b:1). It is, however, still a prerequisite that the applicant should have a bank account before applying for VAT registration (SAICA, 2008:1). VAT registration numbers are issued over the counter at SARS branches upon the presentation of the completed VAT application form and the required documents (SARS, 2008b:1). Edward Nathan Sonnenbergs Inc. (SAICA, 2008:1) commented that the VAT registration process can be made even more efficient and streamlined if an application for VAT registration could be submitted electronically instead of submitting a hard-copy application form in person to a SARS branch office.

#### **4.4.4 SME level inefficiencies as a driver of compliance cost**

##### **4.4.4.1 Findings of the studies**

A large component of the compliance burden can be ascribed to SME level inefficiencies that will not be addressed by merely making technical changes to the current tax system. It will require more intensive interventions such as education campaigns. (Chamberlain & Smith, 2006:45.) Not all SMEs are aware of the content of the legislation applicable to them (FIAS, 2007:85).

Tax practitioners regard the current tax legislation to be too complex for the majority of taxpayers to understand. In order to avoid complicated calculations and the burden of completing tax returns, SMEs hire accountants to do the work for them. The cost of hiring a tax professional contributes to the difficulties experienced by an SME. (FIAS, 2007:81.)

In cases in which a small business owner cannot handle a tax matter himself and cannot afford to hire a tax practitioner, the person may have no choice but to operate in the informal sector (FIAS, 2007:83).

A total of 60% of the businesses that have a turnover of R300 000 or less have decided to stay in the informal sector. The reasons for this decision are fear and apathy regarding SARS, SARS' processes and the cost burden of compliance. (FIAS, 2007:83.)

#### **4.4.4.2 Recommendations contained in the studies**

The necessity for education regarding tax matters should be targeted by means of:

- educational campaigns in the form of training and mentorship programmes (FIAS, 2007:84);
- tax education at the high-school level (FIAS, 2007:84);
- regular training sessions offered at a nominal fee (FIAS, 2007:88); and
- provision of additional tools to SMEs to assist them to administer taxes. Such tools could include free software packages to calculate their tax liability automatically and free accounting packages that automatically generate completed returns for electronic submission. (Abrie & Doussy, 2006:11.)

Tax laws and the language used in the various tax forms should be simplified (FIAS, 2007:81).

#### **4.4.5 The cost of a tax practitioner as a driver of compliance cost**

##### **4.4.5.1 Findings of the studies**

- **The percentage of SMEs that make use of a tax practitioner**

Upstart Business Strategies CC (2004) (FIAS, 2007:8) estimates that 60% of SMEs make use of a tax practitioner. The FIAS study (2007:65) found that there is a direct correlation between the turnover of an SME and the use of a tax practitioner as indicated in the

following table. The low usage of tax practitioners in the lower turnover brackets may be an indication that the smaller businesses cannot afford the services of a tax practitioner.

**Table 7: Percentage of SMEs that make use of a tax practitioner**

Turnover	% use of tax practitioner
R1 to R300 000	37.6%
R300 000 to R1m	53.7%
R1m to R6m	69.5%
R6m to R14m	78%
R14m and above	82.2%

*Source: FIAS (2007:65).*

The above trend is supported to some extent by the findings of the study undertaken by Venter and De Clerq (2007b:86) in that the value of tax advice decreases as the enterprise grows from micro to small business and increases yet again as the enterprise becomes a medium-sized business. One reason for this trend could be that at the commencement of a business the tax implications are important, because non-compliance could have dire consequences. As the business grows, the initial tax problems are dealt with and are no longer a major issue. However, as the business becomes even larger, taxation becomes important again in the context of attempts to increase the profits of the business.

Tax practitioners reported that 21.19% of their work relates to the reworking of data as a result of the SME business owners' lack of knowledge or understanding of tax compliance requirements (FIAS, 2007:65).

- **Reasons for outsourcing the tax function**

The UNISA study (in FIAS, 2007:9) determined that the reasons for outsourcing the tax function or the use of tax practitioners are that: the enterprise's own staff is unskilled in tax matters (58.7%); there is a lack of time (41.3%) and outsourcing is a cheaper option than doing it internally (8%).

The size of an enterprise has a direct bearing on its ability to administer and manage various tax functions. The larger it becomes, the more administrative members of staff can be appointed and the capability to handle the tax function internally increases (Venter & De Clerq, 2007b:84 and Venter & De Clerq, 2007a:144).

- **Type of work outsourced**

Routine types of tax functions in respect of which the rules remain constant are dealt with internally (RSC levies, UIF, SDL, employees' tax, workmen's compensation levies) (Abrie & Doussy, 2006:7). Venter and De Clerq (2007b:84 and 2007a:144) made a similar finding, namely that routine tax functions are generally performed internally, irrespective of the size of the SME.

Non-routine tax functions are outsourced, which results in outsourcing costs of R13 445 per annum for a small enterprise and R21 462 per annum for a medium enterprise (Abrie & Doussy, 2006:7).

- **Updating of tax knowledge by tax practitioners**

It takes at least seven days per annum on average for a tax practitioner to become familiar with all the obligations in respect of and amendments to income tax laws and regulations. It takes a practitioner three to five days per annum to familiarise himself or herself with new or amended legislation regarding provisional tax, VAT and employees' tax. Practitioners' fees can rise in accordance with the time that it takes to master the new legislation. (FIAS 2007:17.)

- **Tax training for employees**

Taxation is constantly changing and therefore it requires that employees be constantly trained and updated. As a result, SMEs make a limited investment in the tax training needs of employees and managers. (Venter & De Clerq, 2007b:85.)



- **SMEs do not require tax advice for business decisions**

SMEs seldom use tax inputs, advice or information for managerial and planning purposes. This suggests that either SMEs do not have the required skills to utilise tax inputs as a strategic management tool or that they do not see the potential advantages of using an effective tax information system to support business planning and strategising. It could also be that tax functions are considered to be compulsory activities or that tax functions are handled by consultants who have a mandate to deal with tax responsibilities on behalf of SMEs and that that mandate does not include the supply of tax-related management information. (Venter & De Clerq, 2007b:86; Venter & De Clerq, 2007a:147.)

- **Tax practitioners' client profile**

Most of tax practitioners' clients are close corporations. However, a large percentage of the clients conduct business as individuals, as illustrated by the following table.

**Table 8: Tax practitioners' clients differentiated in terms of legal categories**

Legal form	% of tax practitioner clients
Individuals	67%
Companies	52%
Close corporations	86%
Trusts	35%
Partnerships	23%
Non-profit organisations	17%
Other	1%

*Source: FIAS (2007:19).*

*Note: The totals do not add up to 100% as the tax practitioners surveyed may service clients that operate in each of the legal forms.*

#### **4.4.5.2 Recommendations contained in the studies**

The findings of the studies suggest that improving tax skills and knowledge in SMEs would lead to more effective management of tax functions that could result in cost savings

and could contribute to ensuring the long-term survival of the enterprises (Venter & De Clerq, 2007b:87).

Chamberlain and Smith, (2006:30) indicated that **the tax burden may be reduced** by using advanced tax software for recordkeeping and the calculation of the final VAT amount at a cost of R1 476 per annum, compared to R9 051 when the tax function is outsourced.

Tax practitioners have the skills, knowledge and willingness to assist SARS to improve taxpayers' knowledge and to get them tax compliant. The practitioners should be provided with access to SARS systems in order to make enquiries regarding client accounts and details and to request changes through an online facility. This arrangement would decrease SARS' workload. (FIAS. 2007:86.)

#### **4.4.6 Tax legislation as a driver of compliance cost**

All the findings and recommendations that are specifically related to the current tax legislation have been grouped in this section in terms of the various tax categories.

##### **4.4.6.1 Findings of the studies**

- **VAT**

Registering, preparing, completing and submitting VAT returns take longer and cost more than for most of the taxes (possibly due to the length and complexity of the VAT form) (FIAS, 2007:57). Registration as a VAT vendor is the most onerous aspect of VAT (FIAS, 2007:58). This finding is also supported by Chamberlain and Smith (2006:35).

According to Chamberlain and Smith (2006:25) the broad category of taxes was found to be the most time-consuming and onerous obligation for SMEs. Of these tax obligations, VAT requirements are considered to be the most onerous. They are followed by SARS administration, UIF regulations and, finally, PAYE regulations for companies that have fewer than 50 employees. In companies that have more than 100 employees, SARS'

regulations are considered to be more onerous than VAT requirements. (Chamberlain & Smith, 2006:25.)

However, non-registered VAT SMEs cannot claim VAT that is paid on inputs. They therefore have a higher tax burden than VAT-registered SMEs. With a VAT rate of 14%, this fact has a significant impact on the METR of capital. For example, a manufacturing SME in the 0% corporate tax bracket that is registered for VAT has a 0% METR whereas a non-registered SME has a METR of 33.9%. (FIAS, 2006:18.)

- **Income tax**

Capturing and processing errors that are made by SARS and the time taken to correct the errors is the most burdensome aspect of income tax and employees' tax (FIAS, 2007:55).

Formally registered SBCs benefit from the tax concessions for SMEs and face a lower METR than non-registered SMEs or informal businesses. This suggests that the tax incentives encourage investment to be made to a larger extent in the SMEs that meet the requirements of a SBC in terms of section 12E of the Income Tax Act than in those SMEs that do not meet these requirements. (FIAS, 2006:75.)

In the case of large corporations, personal income tax that is levied on the return of capital in the form of taxes on interest, dividends and CGT has no impact on domestic investment, because the required after-corporate-tax rate return on investment is fixed by international financial markets. SMEs are generally unable to access international financial markets and therefore they operate in a "closed market". This means that personal income tax that is paid by SA investors in SMEs may well have a sizable effect on domestic investment by lowering the rate of return after corporate tax and personal tax has been taken into account. The METR on capital rises substantially when the market is closed. This is due to the imposition of taxes on capital at a personal level as well as the impact of STC that is imposed on dividend distributions. This suggests that when the entire tax system is considered, the METR on "entrepreneurial" investment is high. (FIAS 2006:75.)

- **Provisional tax**

The calculation and payment of provisional tax are onerous and complex tasks for SMEs. Provisional tax is the most onerous tax due to the penalties and incorrect calculation of interest by the SARS computer system. The calculation is done without the human intervention that could determine whether the penalties and interest are correctly imposed. (FIAS, 2007:80.)

- **Alternative dispute resolution (ADR) process**

SARS responds to objections within the time period laid down by law. However, the time period together with a lack of acknowledgement of receipt of the objection by SARS are the most burdensome aspects. The most problematic aspects of the ADR process are the time spent on ADR, time taken to finalise the ADR process and the time taken by SARS to respond to the ADR process. (FIAS, 2007:54.)

- **Other**

SMEs in SA could be liable for the payment of up to 11 different taxes (income tax, CGT; provisional tax; STC; VAT; employees' tax; employment-related levies; customs and excise duties; transfer duty; donation tax; and stamp duty). The fulfilment of these administrative obligations requires a vast amount of time. In addition, the late submission of specific forms or information results in the imposition of fines and penalties and the levying of interest. (Abrie & Doussy, 2006:5.)

The perception of respondents is that tax regulations have increased over the past three years and the increase has contributed to an increasingly negative tax morale (Abrie & Doussy, 2006:7).

An SME is obliged to fulfil many legal requirements. The correct application of legislation and compliance with relevant timeframes places a major burden on SMEs. This results into the use of more administrative staff to ensure compliance in respect of tax matters.

Most SMEs find it difficult to comply with the requirements and to keep up to date with amendments. (Venter & De Clerq, 2007b:82.)

Less than 50% of the respondents were not aware of the tax incentives or differentiated tax policies applicable to small businesses. This figure may indicate that the tax system is too complex, that there is often a lack of tax skills and/or that SARS' campaigns are not always successful. (Abrie & Doussy, 2006:6.)

The survey of taxpayers' preferences in respect of SME policies indicated that SMEs have a strong preference for a reduction of penalties and of the interest charged. This preference could be ascribed to the fact that SMEs indicate a lack of time as a reason for completing the tax function on time (Venter & De Clerq, 2007b:86; Venter & De Clerq, 2007a:148). Abrie and Doussy (2006:9) draw similar conclusions from their survey. In that survey, SMEs indicate that their greatest preference is for reduced tax rates for SMEs, reduced penalties/interest charged by SARS and a SARS helpdesk. SMEs prefer simple cuts in tax rates and penalties rather than elaborate tax incentive schemes, which require sophisticated systems and skilled staff and often result in increasing compliance costs rather than providing real tax relief to the SMEs (Abrie & Doussy, 2006:9).

In the survey conducted by Abrie and Doussy (2006:7), 33.3% of the respondents were liable for penalties that averaged R15 146 per SME. A further 10.7% were liable for interest as a result of late payment or late submission.

#### **4.4.6.2 Recommendations contained in the studies**

- **VAT**

It is recommended that high mandatory registration thresholds for VAT be introduced and that inflation be considered in order to ensure that inflation does not erode the threshold over time. (At the time that the survey was conducted, the threshold was R300 000) (FIAS, 2007:81). The *SMME facilitation program* presented by SARS in 2005 (Chamberlain & Smith, 2006:36) suggests that the limit for compulsory registration should be increased from R300 000 to R1 000 000.

Chamberlain and Smith, (2006:37) recommended the introduction of the cash basis of accounting for companies that have a turnover of up to R2.5 million and those SMEs should be permitted to choose between VAT payments on a cash or on an invoice basis. In addition, the submission of VAT returns should be reduced from six times to three times per annum.

Although compliance costs are high for small businesses, it may ultimately be worth their while to register for VAT. Not being able to register for VAT results in the enterprise losing “legitimacy”. The loss of legitimacy has implications for obtaining funding for the business and for obtaining contracts, especially government contracts. (FIAS, 2006: x.)

- **Income tax**

Various suggestions regarding tax legislation are made in the studies, namely:

- the *SMME facilitation program* presented by SARS in 2005 (Chamberlain & Smith, 2006:36) suggested that the limit for the 15 percent cap for the taxable income of SMEs should be increased from R150 000 to R200 000 and, considering the rapid depreciation of assets, it should also apply to companies that have a capital expenditure of less than R5 million. (Since 2005, the 15% tax rate was lowered to 10% on taxable income and the taxable income increased to R300 000); and
- the FIAS study (2006: 78) suggested the transition to a LIFO system for inventories as the FIFO system results in high METRs on inventory capital, as a result of the taxation of inflationary gains. By adopting a declining-balance approach, tax compliance would be easier for an SMEs as there would be no need to keep track of individual capital asset items. It was also found that the accelerated depreciation relief is utilised in some sectors, but, because inflation indexing is not taken into account, these deductions are not as “accelerated” as they may be perceived to be.

- **Provisional tax**

The recommendations suggest the simplification of legislation in respect of the calculation and payment of provisional tax (FIAS, 2007:61).

- **Presumptive tax system**

The *SMME facilitation program* presented by SARS in 2005 (Chamberlain & Smith, 2006:37) suggested that a study should be undertaken into the creation of a special tax regime for SMEs. Consideration should be given to the introduction of a presumptive tax for small businesses in some sectors of the economy.

- **Other**

Other recommendations include:

- establishing a simplified tax regime to reduce the compliance burden (FIAS, 2007:81);
- the creation of a **favourable regime for voluntary disclosure** of unpaid and/or under-paid tax (Chamberlain & Smith, 2006:27);
- exemption of first-time, non-serious offenders from penalties and interest and to provide them with insight into the mistakes that they have made (FIAS, 2007:82);
- the introduction of reasonable thresholds below which no tax return is required to be submitted and no tax is payable (FIAS, 2007:82);
- the reduction of the number of taxes for SMEs as this will reduce the number of forms to be completed as well as the need for training members of staff (Abrie & Doussy, 2006:11); and
- streamlining and simplification of standard legislation, for example there is little need to distinguish between SITE and PAYE on the IRP5 form and in the Fourth Schedule of the Income Tax Act (Abrie & Doussy, 2006:11).

#### **4.4.7 Compliance cost quantified**

In *Counting the cost of red tape for business in SA* by SBP (2005) (Chamberlain & Smith, 2006:27) the total recurring compliance cost for the formal sector in South Africa was estimated at R78.9 billion. This amount is equivalent to 6.5% of the GDP in 2003 and to 18% of SARS' revenue in 2002/3.

In the same source, the regulatory compliance cost for businesses in South Africa was quantified. The average tax compliance cost is 2.9% of turnover for SMEs that have a turnover of less than R1 million, but this figure gradually decreases to 0.003% for enterprises that have an annual turnover of more than R1 billion. (Chamberlain & Smith, 2006:26.) This trend clearly illustrates that compliance costs are regressive: the smaller the business, the heavier the burden.

The average tax compliance cost for SMEs for income tax, provisional tax, VAT and employees' tax, as calculated in the FIAS study (2007:40), is contained in the following table. It is evident from this table that the once-off burden is not the greatest contributor to the total compliance costs. It is the recurring burden, namely the preparation of the tax returns, that is the greatest contributor to the total cost of compliance (FIAS,2007:74).

**Table 9: Tax compliance cost for income tax, provisional tax, VAT and employees' tax**

Services rendered	Note	Average cost R
Registration	<b>1</b>	1 478
Objection: interest and penalties		998
Audit/inspections		3 145
Written queries		1 306
<b>Total once-off burden</b>		<b>6 927</b>
Prepare tax return	<b>2</b>	7 030
Prepare IRP 5 recon		597
<b>Total recurring burden</b>		<b>7 627</b>
<b>Total tax cost</b>		<b>14 554</b>

*Source: FIAS (2007:40).*

**Note 1:** The average cost for registration comprises VAT registration of R510, income tax registration of R356, employees' tax registration of R376 and provisional tax registration of R236 (FIAS, 2007:23).

**Note 2:** The average cost for preparing tax returns are as follows: VAT return (bi-monthly), R2 975; employees' tax return (monthly), R2 880; provisional tax return (biannually), R388 and the annual income tax return, R787 (FIAS, 2007:29).



An additional R12 185 per annum is payable for the completion or maintenance of the accounting records (required by a quarter to almost one-third of a tax practitioners' clients) (FIAS 2007:35).

#### **4.4.8 Summary**

The use of differentiated tax policies to address the tax compliance burden effectively is not supported by the findings and recommendations contained in the studies and surveys on tax compliance costs.

The drivers of compliance cost can be addressed effectively through measures other than differentiated tax policies.

The non-integration of government departments as a cost driver is currently being addressed by the government through the various efforts that are being guided by the DTI's integrated strategy regarding the promotion of entrepreneurship and small businesses (as discussed in chapter 4.4.2).

The measures introduced by SARS regarding tax administration and SME's level inefficiencies in order to address the constraint of compliance cost are directed at improving procedures and providing education and tools for SMEs (as discussed in chapters 4.4.3 and 4.4.4).

Tax practitioner costs, as a driver of compliance cost, is a result of the complexity of the South African tax legislation such as the number of taxes and the constantly changing tax laws. Small business owners are not skilled in tax matters, lack the time to attend to tax matters and find it cheaper to use tax practitioners than to do it internally. Measures proposed to address this issue focus on the education of SMEs and on the provision of tax software (as discussed in chapter 4.4.5).

Recurring costs (preparation of the tax returns) are the greatest contributor to the total compliance cost. This suggests that the role of the tax practitioner should be taken into account in the development of differentiated tax policies. Differentiated tax policies

provide more options to small business owners to alleviate the constraints imposed on SMEs. The general types of tax policies are not suited to all SMEs as each of the differentiated tax policies comes with benefits and disadvantages that must be considered by small business owners before they make their choice. An SME business owner has a right to make an informed choice. As many SME business owners lack the tax knowledge required, the differentiated tax policies for SMEs could add to the constraints already experienced by SMEs rather than to alleviate the constraints imposed on SMEs by the standard legislation. For example, the New Zealand tax authorities pay an allowance to payroll agents to manage the payroll for the first five employees of all businesses. This arrangement permits business owners to spend more of their time on managing their business and increasing the accuracy of employees' salary calculations (as discussed in chapter 3.4).

The obstacles presented by current legislation, specifically legislation on income tax, provisional tax and employees' tax, could be addressed through the improvement of procedures, education and the simplification of standard legislation (as discussed in chapter 4.4.6).

The studies do indicate that VAT compliance costs can be addressed by means of differentiated tax policies. It could be done by reducing the number of VAT returns per year for SMEs, raising the compulsory threshold for registration and providing a small retailer package. This is the approach taken by SARS in the 2008/9 budget.

However, the differentiated tax policies with regard to VAT have the following disadvantages (as discussed in chapter 4.4.6.):

- a non-VAT registered vendor (including SMEs) cannot claim for input VAT. The input VAT then becomes an actual cost for the vendor. The FIAS study (2006:18) indicates that the METR for a non-registered SME in the 0% income tax bracket is 33.9%. This situation raises serious doubts about whether the benefit of reduced compliance cost outweighs the total input VAT that could have been claimed. The following illustration puts this matter in perspective: the total compliance cost in respect of *four* taxes is R14 554, which equates to the input tax on R103 885

taxable supplies. If the SME purchases more than R103 885 taxable supplies in a year, it is more beneficial for it to register for VAT; and

- not being able to register for VAT results in the loss of an SME's "legitimacy" as an enterprise. This loss has implications for obtaining funding for the business and for obtaining contracts, especially government contracts (FIAS, 2006: x).

The benefits of differentiated tax policies, in the form of reduced tax rates and special capital allowances, to compensate for the tax compliance burden only benefits SMEs that qualify as an SBC in terms of the requirements of section 12E of the Income Tax Act. This effectively excludes a large proportion of the SMEs: individuals (67% of tax practitioners' SME clients are individuals) and close corporations or companies in respect of which the SBC requirements are not met (for example a member or shareholder who also holds shares in a dormant close corporation or company). Registration as a close corporation or a company also places a compliance burden in terms of the Corporate Laws Amendment Act 24 of 2006. It was also found that inflation erodes the benefit of the accelerated depreciation afforded to SBC's in terms of section 12E(1) and 12(E)(1A) of the Income Tax Act.

The benefit to be derived from the proposed presumptive turnover tax will depend on the still to be determined detail of the tax policy. Research in other countries reveals that there are certain benefits associated with this type of differentiated tax policy, but that it requires an in-depth analysis of profit margins and of the relationship between business indicators, such as the size of the business, its activities or location and its profit potential (see chapter 3.5.4: *The effect of presumptive turnover tax*).

## 4.5 CONCLUSION

The objectives of the National Treasury concerning differentiated tax policies for SMEs (as identified in chapter 4.2) are three-fold, namely:

- to address the following constraints faced by SMEs: access to equity finance and the tax compliance burden;
  - to improve the tax compliance culture among SMEs and to broaden the tax base;
- and

- to encourage job creation.

The second and third objectives of the National Treasury are not addressed in this study. Limited research has been conducted in South Africa on these aspects and only further research could reveal whether differentiated tax policies are the most effective measure for the achievement of these objectives.

The objectives of the National Treasury and the perception of tax practitioners and business owners are aligned to the extent that the latter also perceive access to equity finance and the tax compliance burden as constraints that are imposed on SMEs.

Access to finance is addressed by government through the DTI programmes. The venture capital tax legislation proposed in the 2008/9 budget speech will only address equity financing. Research in other countries indicates that venture capital incentives are effective in addressing the equity financing constraints that are experienced by SMEs. However, from a South African perspective, the effectiveness will only be assessed by future research.

The use of differentiated tax policies to address the tax compliance burden effectively is not supported by the findings and recommendations contained in the studies and surveys on compliance costs. The drivers of compliance cost can be addressed effectively through measures other than differentiated tax policies. The benefits of differentiated tax policies to compensate for the tax compliance burden, in the form of reduced tax rates and special capital allowances, was found to benefit only a small percentage of SMEs in South Africa due to the inherent limitations contained in the specific tax legislation. It was also found that inflation erodes the benefit of the accelerated depreciation that is afforded to SBCs in terms of section 12E(1) and 12(E)(1A) of the Income Tax Act.

Chapter 2 provided an overview of the current South African differentiated tax legislation. Chapter 3 investigated the effectiveness of the use in other countries of differentiated tax policies for SMEs to address constraints. The current chapter focused on the effectiveness of South African differentiated tax policies to address the constraints that are

faced by SMEs. The next chapter presents the findings and conclusions of this study into the effectiveness of using differentiated tax policies for SMEs.

## **CHAPTER 5**

### **SUMMARY AND CONCLUSIONS**

#### **5.1 INTRODUCTION**

This study concerns the effectiveness of using differentiated tax policies to address constraints imposed on SMEs in South Africa.

The first differentiated tax policies for SMEs in South Africa were introduced in 2001. Thereafter several relief measures followed, the most recent being the introduction, in the 2008/9 budget, of a presumptive turnover tax system and venture capital incentives for investments in high-growth and high-tech SMEs.

This chapter summarises the findings and conclusions of the study. Firstly, a summary of the findings and conclusions relating to the research objectives are provided. Thereafter follows a brief review of the limitations of the study and recommendations for future research. In the final section, the conclusion on the problem statement of the study is presented.

#### **5.2 SUMMARY OF THE FINDINGS AND CONCLUSION**

##### **5.2.1 Differentiated tax policies for SMEs in other countries**

The reasons and criteria for the use of differentiated tax policies in other countries and the various types of differentiated tax policies applied in these countries form the background against which the effect of differentiated tax policies on SMEs was investigated and the experiences of other countries concerning differentiated tax policies were noted.

The following findings and conclusions were drawn from this information:

- the aim of criteria for differentiated tax policies, as discussed in chapter 3.3, is to maintain tax neutrality by addressing the root causes of the constraints before

using differentiated tax policies to alleviate the constraint. Only when market failure or equity considerations cannot be addressed by means of specific measures can differentiated tax policies be applied, if there is a spillover (external effect) to the rest of the economy. Differentiated tax policies should not induce economic distortions or encourage tax evasion and should be fair, efficient and simple;

- various reasons, as discussed in chapter 3.2, were advanced for the use of differentiated tax policies. Research findings in other countries indicate that not all the reasons advanced or claims made can be substantiated and that certain constraints faced by SMEs can be addressed more effectively through measures other than differentiated tax policies, for example specific areas of financing constraints;
- the effect of tax policies on SMEs (as discussed in chapter 3.5) illustrate that differentiated tax policies could:
  - affect decisions made by SMEs regarding organisational form, investment, financing, growth, risk taking, tax avoidance and tax evasion; and
  - result in inefficiencies when the characteristics of a specific SME sector is not known or when economic indicators (for example inflation) are not taken into account; and
- research findings indicate that when differentiated tax policies are applied in isolation, they are not successful instruments for bringing about changes in the level of entrepreneurial activity. However, they could assist in creating an environment that is conducive to the growth of SMEs and could alleviate the constraints faced by SMEs. The effectiveness of differentiated tax policies to alleviate constraints imposed on small and medium enterprises could be improved (as discussed in chapter 3.6) by:
  - using a combination of differentiated tax policies, integrated government initiatives and the input of representatives of small and medium enterprises;
  - taxpayer education;

- undertaking a thorough analysis of the SME sector (profit margins and other business indicators) together with regulatory impact assessments that are executed by the tax legislators before legislation is promulgated;
- continuous measurement of the compliance burden with which SMEs are confronted;
- improvement of tax administration and the measurement of the activities and the benefit derived in the form of revenue collection; and
- enactment of changes to the existing standard legislation, simplifying it and making it fair for all taxpayers (as discussed in chapter 3.5.6).

## **5.2.2 Differentiated tax policies for SMEs in South Africa**

### **5.2.2.1 Constraints addressed by differentiated tax policies**

The objectives of the National Treasury in respect of differentiated tax policies for SMEs, as discussed in chapter 4.2, are threefold, namely:

- to address the following constraints faced by SMEs: access to equity finance and the tax-compliance burden;
- to improve the tax compliance culture of SMEs and broaden the tax base; and
- to encourage job creation.

The focus of this study centered on the two specific constraints that have been targeted by National Treasury through differentiated tax policies, namely access to equity finance and easing the tax compliance burden for SMEs.

The objectives of the National Treasury and the perception of tax practitioners and business owners are aligned to the extent that the latter also perceive access to equity finance and the tax compliance burden as constraints that are imposed on SMEs (as discussed in chapters 4.3 and 4.4).



### **5.2.2.2 Access to finance as a constraint faced by SMEs**

The government has addressed access to finance, as discussed in chapter 4.3, through the DTI programmes. It is only equity financing that is to be addressed by the proposed venture capital tax legislation that was envisaged in the 2008/9 budget. Research undertaken in other countries has indicated that venture capital incentives are effective in addressing the equity financing constraints that are experienced by SMEs. However, from a South African perspective, the effectiveness will only be measured by future research.

### **5.2.2.3 The tax compliance burden as a constraint faced by SMEs**

The findings of specific studies that concern the tax compliance-cost burden were analysed and the findings and recommendations were grouped in accordance with the perceived main drivers of compliance cost, namely non-integration between government departments, tax administration by SARS, current tax legislation, SME level inefficiencies and tax practitioner costs.

The findings and recommendations of the studies and surveys on tax compliance cost do not support the use of differentiated tax policies to address the tax compliance burden effectively (as discussed in chapter 4.4). The drivers of compliance cost can be addressed effectively by means of measures other than differentiated tax policies.

Non-integration between government departments is a cost driver that is currently being addressed by the government through the DTI's integrated strategy on the promotion of entrepreneurship and small business (as discussed in chapter 4.4.2).

Tax administration by SARS and the SME's levels of inefficiencies have given rise to measures to address the associated compliance cost constraint, namely improvement of procedures, provision of education and provision of tools designed specifically for SMEs (as discussed in chapter 4.4.3 and 4.4.4).

Tax practitioner costs, as a cost driver of compliance cost, results from the complexity of the South African tax legislation, which is characterised by a large number of taxes and

constant changes to tax legislation. Small business owners are not skilled in tax matters, lack the time to attend to tax matters and find it cheaper to use a tax practitioner than to do the tax administration internally. Measures that are aimed at addressing these constraints focus on the education of SMEs and on tax software (as discussed in chapter 4.4.5).

Obstacles that arise from current legislation, specifically legislation regarding income tax, provisional tax and employees' tax, could be addressed through the improvement of procedures, education and the simplification of standard legislation (as discussed in chapter 4.4.6).

The various studies (as discussed in chapter 4.4.6) have indicated that VAT compliance cost can be addressed in the following ways through the use of differentiated tax policies: reducing the number of VAT returns per year required of SMEs, raising the compulsory threshold and providing a small-retailer package. This is also the approach taken by National Treasury in the 2008/9 budget speech.

However, the differentiated tax policies with regard to VAT have the following disadvantages (as discussed in chapter 4.4.6):

- a non-VAT registered vendor (including SMEs) cannot claim input VAT. The input VAT then becomes an actual cost for the vendor. The FIAS study (2006:18) indicates that the METR for a non-registered SME in the 0% income tax bracket is 33.9%. These comparisons cast serious doubt on whether the benefit of the reduction in compliance cost does in fact outweigh the total input VAT that could have been claimed ; and
- not being able to register for VAT results in the loss of "legitimacy" for an enterprise. This loss has implications for obtaining funding for the business and for obtaining contracts, especially government contracts.

The benefits of differentiated tax policies in respect of compensating for the tax compliance burden, in the form of reduced tax rates and special capital allowances, only benefits those SMEs that qualify as a SBC in terms of the requirements in section 12E of the Income Tax Act. These requirements effectively exclude a large proportion of the SMEs, namely: individuals (the FIAS study (2007:19) indicates that 67% of a tax

practitioner's SME clients are individuals), close corporations and companies in respect of which the SBC requirements are not met (for example, a member or shareholder who also holds shares in a dormant close corporation or company). Registration as a close corporation or a company also places a compliance burden in terms of the Corporate Laws Amendment Act no. 24 of 2006. In addition, inflation erodes the benefit of the accelerated depreciation that is afforded to SBC's in terms of section 12E (1) and 12(E)(1A) of the Income Tax Act.

The envisaged benefit that SMEs will derive from the proposed presumptive turnover tax will depend on the detail of the relevant tax legislation when it is promulgated later in 2008. Research in other countries has revealed that there are certain benefits associated with this type of differentiated tax policy, but that the application of this tax policy requires an in-depth analysis of profit margins and the relationship between business indicators, such as the size of a business, its activities or location and its profit potential.

### **5.3 LIMITATIONS OF THE STUDY AND RECOMMENDATIONS FOR FUTURE RESEARCH**

The study focused only on differentiated tax policies that were legislated before August 2008. The effectiveness of the differentiated tax policies that were proposed in the 2008/2009 budget (venture capital incentives and presumptive turnover tax) will depend on the detail of the tax policy once it is promulgated. Further research should investigate the effectiveness of these differentiated tax policies in addressing the constraints that are faced by SMEs.

The National Treasury's other objectives with the introduction of differentiated tax policies, namely to encourage the tax compliance culture among SMEs, to broaden the tax base and to encourage job creation, were not addressed in this study. Little research has been conducted in South Africa on these matters and only further research could reveal whether differentiated tax policies are the most effective measure for achieving these objectives.

The study revealed areas in which standard legislation discriminates against SMEs. Further research could provide more clarity on this matter.

## 5.4 CONCLUSION

This study suggests that, based on the findings and conclusions in terms of the research objectives, the current differentiated tax policies for small and medium enterprises do not address the constraints identified by the National Treasury effectively.

This study casts doubt on whether differentiated tax policies are capable of alleviating the constraints faced by SMEs. It furthermore questions whether the main objective of these policies is not to collect more revenue by broadening the tax base.

In summary, in considering the research objectives stated in chapters 3 and 4, the findings and conclusions of this study suggest that differentiated tax policies could be applied more efficiently and effectively if the following conditions are met:

- regulatory reviews are conducted before (retrospectively) and after (prospectively) legislation is promulgated. This process should be clearly defined, based on specific differentiated tax policy criteria, incorporate an in-depth analysis of the affected SME sector, incorporate the input of SME business owners, evaluate other non-tax options and be justified financially (cost-benefit analysis) from the perspective of tax administration as well as from the perspective of an SME;
- an open communication channel exists between the various role players (SME business owners; SARS' Small Business Unit, SARS' small business help desks and representatives of other government departments);
- the role of the tax practitioner is taken into account. Recurring costs (preparation of the tax returns) are the greatest contributors to the total compliance cost. Differentiated tax policies provide more options to small business owners to alleviate the constraints imposed on SMEs. The general types of tax policy are not suited to all SMEs as each of the differentiated tax policies comes with advantages and disadvantages, which must be considered by small business owners before they make a choice. An SME business owner has a right to make an informed choice. As SME business owners lack the necessary tax knowledge, the differentiated tax policies for SMEs could increase the constraints experienced by SMEs rather than decrease the constraints imposed by standard tax legislation. As an example, the New Zealand tax authorities pay an allowance to payroll

agents to manage the payroll for the first five employees of all businesses, allowing business owners to focus more of their time on managing their business and increasing the accuracy of employees' salary calculations (as discussed in chapter 3.4)

The findings and conclusions regarding the research objectives stated in chapters 3 and 4 also suggest that the current constraints could be addressed more effectively through other measures before the use of differentiated tax policies is considered. These other measures include:

- improving SARS administrative processes;
- providing tax education and tools to assist SMEs (for example software);
- ensuring that the tax information that is conveyed to SMEs does reach the target market;
- simplifying the standard tax legislation;
- reviewing standard tax legislation and removing provisions that prove to be discriminatory in respect of SMEs;
- addressing integration of government processes and procedures; and
- incorporating the experiences of other countries to ensure that the costs of regulations are justified by the benefits obtained; undertaking frequent regulatory cost surveys and regulatory reviews; and facilitation of the communication process between the various role players.

The present study supports the view of Chamberlain and Smith (2006:47) that much more than differentiated tax policies is required to unlock the potential of the South African SME market.

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