

**“Personal service” and “Professional service”: The rigid application of Turnover  
tax and small business corporation legislation**

by

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## **Abstract**

According to the National Treasury's Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008, South Africa's Small, Micro and Medium Enterprises (SMMEs) play a crucial role in the country's economic development since they help to combat poverty and create jobs. But according to research, SMMEs have a lot of challenges, that include complying with tax obligations. To make the process of filing taxes simpler for SMMEs, it was suggested in the 2008 Budget Review to introduce a Turnover tax system for SMMEs with an annual turnover of up to R1 million. Similar to this, section 12E was introduced to further assist SMMEs by providing them with income tax relief to SMMEs. Section 12E(4)(a)(iii) and (d) and paragraph 3(b) of the Sixth Schedule exclude certain types of businesses from making use of these tax incentives. This mini dissertation analyses the criteria that determines which SMMEs are to be excluded from the ambit of these tax incentives, the consequences of such criteria, and explores foreign law for possible solutions.

## Chapter 1 Research Proposal

### 1.1 Introduction and Background

South Africa has made multiple conscious efforts to improve the economy over the years, some of which have been more successful than others. Like many foreign countries, South Africa recognizes that providing support for Small, Medium and Micro Enterprises (SMMEs) is an excellent way to improve the economy.<sup>1</sup> The National Development Plan (NDP) states that:

*‘Small and expanding firms will become more prominent and generate the majority of new jobs created. They will also contribute to changing apartheid legacy patterns of business ownership. They will be stimulated through public and private procurement, improved access to debt and equity finance, and a simplified regulatory environment.’<sup>2</sup>*

This demonstrates that SMMEs, especially in South Africa, have the potential to assist in correcting past imbalances by accelerating inclusivity with regard to economic participation, and help the country move forward by providing breeding ground for globally competitive companies. Moreover, the NDP estimates that by the year 2030, SMMEs will form 90% of the country’s gross domestic product (GDP).<sup>3</sup> The NDP further proposes that these small and medium businesses will form innovation centres, that will provide solutions to many of South Africa’s issues by using SMMEs as instruments of economic growth that will nurture and cultivate a culture of globally competitive businesses.<sup>4</sup>

In line with the goal of targeting small businesses as instruments of economic growth in South Africa, the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 acknowledged SMMEs as sources of job creation and a countermeasure to poverty.<sup>5</sup>

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<sup>1</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 page 56.

<sup>2</sup> National Planning Commission ‘National Development Plan: Vision for 2030’ page 144.

<sup>3</sup> National Planning Commission ‘National Development Plan: Vision for 2030’ page 119.

<sup>4</sup> National Planning Commission ‘National Development Plan: Vision for 2030’ page 119.

<sup>5</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 page 56.

However, in practice, small businesses face a variety of obstacles, which include, amongst others, the high costs associated with tax compliance.<sup>6</sup>

Notably, a number of tax incentive provisions have been implemented to assist in alleviating some of the tax burdens carried by small businesses.<sup>7</sup> Many small businesses in South Africa do not account for income tax, either because their profits are smaller than the prescribed minimum taxable income, or they are overwhelmed by the South African tax system and opt to simply not register for said taxes to sustain their businesses.<sup>8</sup> Following the 2008 Budget Review, the Turnover tax system was implemented to help micro businesses with a turnover of less than R1 million to submit their tax returns in terms of a simplified tax system.<sup>9</sup> This system substitutes Capital Gains Tax (CGT), Corporate Income Tax, Value Added Tax and Dividend Withholding Tax, which are taxes a typical South African company could be liable for.<sup>10</sup> The Turnover tax system is provided for in Part IV<sup>11</sup> of the Income Tax Act 58 of 1962 (the Income Tax Act) and the Sixth Schedule of the Income Tax Act, as amended and were inserted in said Act by section 54(1) of the Revenue Laws Amendment Act, 2008.<sup>12</sup>

Another incentive for small businesses, which was introduced prior to the implementation of the Turnover tax system, is the Small Business Corporation (SBC), which was implemented in 2000.<sup>13</sup> An SBC is defined as a private company, close corporation or a cooperative whose shareholders are all-natural persons, and the gross income of the

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<sup>6</sup> L Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the sixth schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 528.

<sup>7</sup> S12E & Sixth Schedule of Act 58 of 1962.

<sup>8</sup> L Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the Sixth Schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 528.

<sup>9</sup> Part I of the Sixth Schedule in Act 58 of 1962 defines qualifying turnover as 'the total receipts from carrying on business activities, excluding any amount of a capital nature; and amount exempt from normal tax in terms of section 10(1)(zK) or 12P.

<sup>10</sup> L Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the Sixth Schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 527.

<sup>11</sup> Ss 48 – 48C of the Income Tax Act 58 of 1962.

<sup>12</sup> Income Tax Act 58 of 1962 as amended.

<sup>13</sup> S12 of the Revenue Laws Amendment Act 19 of 2011 as amended by s31(1)(a) of the Revenue Laws Amendment Act 45 of 2003.

entity does not exceed R20 million.<sup>14</sup> The shareholders (natural persons) of such an entity may not be shareholders of any other company, with limited exceptions listed in section 12E(4)(a)(ii) of the Income Tax Act.<sup>15</sup> The SBC legislation firstly provides special progressive tax rates, which are lower than the normal progressive tax rates, and these rates apply to taxable income not exceeding R550 000.<sup>16</sup> Secondly, the SBC legislation provides for special capital allowances, such as the accelerated depreciation allowance which, under certain conditions, allows for a 100% write off of the manufacturing asset in the year of assessment that the asset is brought into use by the taxpayer, who qualifies as an SBC.<sup>17</sup> SBC legislation was implemented as a way to encourage the establishment of start-up businesses and the creation of jobs.<sup>18</sup>

## 1.2 Motivation

Tax relief incentives were introduced by the South African government to enable growth and sustainability amongst businesses.<sup>19</sup> However, despite the multiple small business tax incentives introduced, the failure rate of South African small businesses (70%-80%) ranks amongst the highest in the world.<sup>20</sup> This high failure rate can be attributed to multiple obstacles; and such obstacles can generally be categorized into internal and external obstacles.<sup>21</sup>

Included in the external obstacles faced by SMMEs are tax compliance issues. With so much of Treasury's attention focused on implementing tax incentives for small

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<sup>14</sup> S1 of the Income Tax Act 58 of 1962.

<sup>15</sup> Income Tax Act 58 of 1962.

<sup>16</sup> <https://www.sars.gov.za/tax-rates/income-tax/companies-trusts-and-small-business-corporations-sbc/> (Accessed 20 January 2022).

<sup>17</sup> S12E(1) of the Income Tax Act 58 of 1962; SARS Interpretation Note 9 (Issue 7) page 22. There are certain limitations placed on these accelerated allowances provided for in section 12E(1) and section 12E(1A). These limitations apply, for example, where an SBC is funded by a government grant as defined in section 12P or by an amount from a small business funding entity.

<sup>18</sup> S12E of the Income Tax Act 58 of 1962.

<sup>19</sup> SARS Interpretation Note 9 (Issue 7) page 14.

<sup>20</sup> National Treasury, 2019. *Economic transformation, inclusive growth, and competitiveness: Towards an Economic Strategy for South Africa*. [http://www.treasury.gov.za/comm\\_media/press/2019/Towards%20an%20Economic%20Strategy%20for%20SA.pdf](http://www.treasury.gov.za/comm_media/press/2019/Towards%20an%20Economic%20Strategy%20for%20SA.pdf) (Accessed 18 February 2022).

<sup>21</sup> F Olawale & D Garwe 'Obstacles to the growth of new SMMEs in South Africa: A principal component analysis approach' 2010 4 page 729. Examples include Management (internal) and Infrastructure (external).

businesses, it may come as a shock that tax compliance still remains an obstacle for small businesses in South Africa.<sup>22</sup>

Evidently, a shortage of tax incentives is not the issue. However, the content of said incentives may hold answers to the high failure rate of South African small businesses. Although tax incentives are available for SMMEs, the requirements for qualifying for these incentives are highly stringent; therefore, many SMMEs are unable to qualify for the incentives in the first place. Many of the tax incentives have been implemented with strict requirements, and the strictness of legislation is determined through the terminology used. The requirements for qualifying for Turnover tax incentives and SBC tax incentives exclude 'personal service' and 'professional service' respectively.

Although, on the face of it, all tax incentives must have measures in place to prevent potential abuse, I am of the view that the limitations of Turnover tax and SBC legislation as mentioned are unfair and unjust. The consequences of which are that entrepreneurs, in my opinion, are deterred from starting their own SMMEs, because they are not incentivized by the government from a tax perspective. Therefore, the definitions of 'personal service' and 'professional service' will be examined, and arguments presented for said definitions being unfairly and unjustifiably limiting. This approach may sound limited; however, it unravels the different components that make up the legislative text, which are complex. As a result, the definitions of 'personal services' and 'professional services' as used by these two tax incentive legislations, Turnover tax and SBC, will be analyzed to reveal, in my view, the injustice and unfair treatment it brings to SMMEs.

### **1.3 Problem Statement**

The main purpose of this research study is to evaluate the reasons and effects of the definitions and inclusion of the terms 'personal service' and 'professional service' as part of the criteria of paragraph 3(b) of the Sixth Schedule and section 12E(4)(a)(iii) and (d) of the Turnover tax and SBC legislation, respectively. Moreover, I will critique the limitations

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<sup>22</sup> F Olawale & D Garwe 'Obstacles to the growth of new SMMEs in South Africa: A principal component analysis approach' 2010 4 page 730.



as being too extensive and vague, almost to a point of arbitrariness. The proposed criticism will be substantiated through legislation, literature, and case law.

#### **1.4 Limitations of the study**

Although South Africa has a variety of SMME tax incentive provisions, only the Turnover tax and SBC legislation will be discussed as they are most relevant to the study. The focus of this study is deliberately narrow to provide an in-depth analysis of the topic, thus some aspects distantly related to the topic will not be dealt with.

For instance, the term ‘investment income’ also forms part of the exclusionary criteria for certain types of SMMEs for the application of both Turnover tax and SBC legislation. If more than 20% of a taxpayer’s total receipts comes from ‘investment income’, then such taxpayer will not fall under the ambit of the Turnover tax and/or SBC legislation. Although the term ‘investment income’ is related to the focus of the study, it will not be discussed in-depth, as it is based on similar principles to those of ‘personal service’ and ‘professional service’.

#### **1.5 Research questions**

##### **1.5.1 Main research question**

Are sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the Sixth Schedule of the Income Tax Act constructive to the purposes of the SBC and Turnover tax legislation, respectively?

##### **1.5.2 Sub-research questions**

- a) What are the purposes of the SBC and Turnover tax legislation?
- b) What barriers to entry are imposed by the SBC and Turnover tax legislation?
- c) Are the barriers to entry imposed by the SBC and Turnover tax legislation legally justifiable?
- d) Can the foreign tax laws of Australia and the United Kingdom (UK), specifically tax incentives for SMMEs, provide solutions in the South African context?

## 1.6 Literature review

The Turnover tax and SBC were both implemented with good intent for SMMEs.<sup>23</sup> However, certain criteria have to be met, as set by the relevant sections of the Income Tax Act. For Turnover tax, a micro business must exist.<sup>24</sup> Paragraph 2(1) of the Sixth Schedule sets out the requirements as follows:

*'2(1) A person qualifies as a micro business if that person is a –  
(a) natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency); or  
(b) company,  
where the qualifying turnover of that person for the year of assessment does not exceed an amount of R1 million.'*<sup>25</sup>

The requirements for SBC tax incentives are set out in section 12E(4)(a), which defines an 'SBC' as *'any close corporation, co-operative or any private company whose shareholders are all natural persons, and whose gross income does not exceed R20 million during the year of assessment'*.<sup>26</sup>

In addition to these requirements, both Turnover tax and SBC have limitations to their applications. Paragraph 3(b) of the Sixth Schedule gives a list of taxpayers explicitly prohibited from the recognition of micro businesses as it relates to the application of Turnover tax. Similarly, section 12E(4)(a)(iii) and (d) of the Act lists the types of taxpayers excluded from qualification as SBCs.<sup>27</sup>

Paragraph 3(b) of the Sixth Schedule reads as follows:<sup>28</sup>

*'3. A person does not qualify as a micro business for a year of assessment where*

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<sup>23</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 page 56.

<sup>24</sup> Part II of the Sixth Schedule of the Income Tax Act 58 of 1962.

<sup>25</sup> Income Tax Act 58 of 1962.

<sup>26</sup> Income Tax Act 58 of 1962.

<sup>27</sup> Income Tax Act 58 of 1962.

<sup>28</sup> Income Tax Act 58 of 1962.

*(b) more than 20% of that person's total receipts during that year of assessment consist of –*

*(i) where that person is a natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency), income from the rendering of a **professional service**; and*

*(ii) where that person is a company, investment income and income from the rendering of a **professional service**;*

Paragraph 1 of the Sixth Schedule defines 'professional services' as services in the fields of:

- a) accounting,
- b) actuarial science
- c) architecture,
- d) auctioneering,
- e) auditing,
- f) broadcasting,
- g) consulting,
- h) draftsmanship,
- i) education,
- j) engineering,
- k) financial service broking,
- l) health,
- m) information technology,
- n) journalism,
- o) law,
- p) management,
- q) real estate broking,
- r) research,
- s) surveying,
- t) translation,

- u) valuation or
- v) veterinary science.<sup>29</sup>

It can be argued that this definition is vague and potentially unfair. The definition merely gives examples of what it deems 'professional services' but does not define the actual term. It leaves the taxpayer wondering how professional a service needs to be for purposes of the Sixth Schedule and section 12E of the Income Tax Act. Because the definition is so vague, it becomes unclear whether it should be interpreted narrowly or widely. When interpreted widely, taxpayers who are intended beneficiaries could possibly be excluded, which would be unfair. Moreover, taxpayers would have to invoke interpretation principles and argue their individual claims through litigation, which would be impractical. This is further explained in Chapter 2.

Section 12E(4)(a)(iii) provides that a taxpayer does not qualify as an SBC if more than 20% of their total receipts and accrual of the corporation consists collectively of investment income and income from the rendering of **personal services**.<sup>30</sup> According to section 12E(4)(d), 'personal services' refer to services in the fields of:

- a) accounting,
- b) actuarial science,
- c) architecture,
- d) auctioneering,
- e) auditing,
- f) broadcasting,
- g) consulting,
- h) draftsmanship,
- i) education,
- j) engineering,
- k) financial service broking,
- l) health,

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<sup>29</sup> Income Tax Act 58 of 1962.

<sup>30</sup> Income Tax Act 58 of 1962.

- m) information technology,
- n) journalism,
- o) law,
- p) management,
- q) real estate broking,
- r) research,
- s) surveying,
- t) translation,
- u) valuation or
- v) veterinary science.

where such services are performed by a person, who holds an interest in an SBC, and the business does not employ three or more employees on a full-time basis throughout the year of assessment.<sup>31</sup>

The definitions of 'professional service' and 'personal service' have significant similarities. The difference being that personal services limit the number of employees to two full-time employees and professional services do not limit the number of employees.<sup>32</sup>

Although some amendments to the sections have been implemented, the general criterion of the exclusion remains the same. The definition of personal service in section 12E was substituted in 2011 by section 34(1)(b) of Act 24 of 2011, which merely added 'co-operatives' to the definition.<sup>33</sup> Similarly, section 85(1)(b) of Act 7 of 2010 substituted the definition of 'professional service' as it relates to the Sixth Schedule, while keeping the general criteria of exclusion intact.<sup>34</sup>

These provisions have been defended in explanatory memoranda, as anti-avoidance measures aimed at protecting the tax base because professional services are generally

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<sup>31</sup> Income Tax Act 58 of 1962.

<sup>32</sup> L Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the sixth schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 530.

<sup>33</sup> Income Tax Act 58 of 1962.

<sup>34</sup> Income Tax Act 58 of 1962.

more sophisticated, and yield profits greater than those prescribed by Turnover tax and SBC legislation.<sup>35</sup> Additionally, case law has concurred that:

*‘section 12E was enacted for the specific purpose of encouraging new ventures and employment creation, i.e. active small businesses. The provisions relating to SBCs are therefore not intended to benefit any professional person such as, for example, an architect or a lawyer who renders his/her service by means of a company or close corporation.’*<sup>36</sup>

This paper aims to investigate, by way of legislation, case and literature, the effects and reasoning behind the limitation imposed by the definition of the words ‘personal service’ and ‘professional service’ as used by Turnover tax and SBC legislation. These limitations result in some service providers being excluded based on the type of service they provide; consequently, it shall be determined whether this differentiation between service providers constitutes discrimination, and if it does, the fairness of such discrimination will be considered. Moreover, the study looks to the foreign tax law of Australia and the United Kingdom (UK) to find alternative ways of defining SMME criteria in a way that fits the socio-political context of South Africa and is also fair to start-ups across the board.

The Australian Income Tax Assessment Act categorizes small businesses according to aggregated turnover and the carrying on of a business.<sup>37</sup> The UK on the other hand uses a criterion that includes turnover, net asset value, number of vehicles and profit to classify small businesses. These categories of classification used by these foreign jurisdictions are viewed to be more straightforward, and fair.<sup>38</sup>

## **1.7 Research Methodology**

The study is conducted by way of a literature review. A literature review surveys scholarly articles, books, and other published works that are relevant to an area of research. This provides a critical evaluation, description, and summary of these works as they relate to

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<sup>35</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 page 60.

<sup>36</sup> *TML Consultancy CC v CSARS* [2012] ZATC 1 par 24.

<sup>37</sup> Income Tax Assessment Act 1997 Act No. 38 of 1997 of Australia as amended.

<sup>38</sup> L.J. Filion ‘*The need for a definition of small business*’ 1990 page 37.

the area of research. Literature reviews provide an overview of the sources consulted while researching a certain topic to demonstrate how one's research fits into a field of study.<sup>39</sup>

Another aspect of the study is a comparative analysis, in which the limitation criterion for SMMEs as set out in the Income Tax Act is compared to those of Australian and UK tax legislation. The Australian and UK's tax legislation will be used to propose solutions where it is determined that South African legislation is lacking.

Australia is used in the comparative analysis because its criteria for what constitutes an SMME for tax purposes is similar to that of South Africa, both countries use the business turnover figures to determine what should constitute an SMME.<sup>40</sup> Thus, taxation methods are more likely to be similar in countries that define SMMEs in similar ways.

The UK forms part of this study because of the history it shares with South Africa. As South Africa's former colonial master, the UK and South Africa have similar tax codes.<sup>41</sup> Both countries determine income tax treatment based on the residency status of a person and are commonwealth member states.<sup>42</sup> Additionally, the UK's economy consists largely of small and medium-sized businesses.<sup>43</sup> Thus, South Africa can incorporate some of the UK's tax incentives to the extent that they fit well into the local context.

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<sup>39</sup> L, Cook. and Murowchick, E. 'Do Literature Review Skills Transfer from One Course to Another' 2014 page 9.

<sup>40</sup> Davis Tax Committee. 2014. *Small and Medium Enterprises: Taxation considerations, interim report* page 8.

<sup>41</sup> P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa page 17.

<sup>42</sup> P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa page 17.

<sup>43</sup> P, Ssenyonjo P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa page 18.

## Chapter 2 Definitions of SMMEs and their limitations across South African legislation

### 2.1 Introduction

SMMEs are defined differently by different legislation in South Africa. In these definitions, criteria are set out that exclude certain types of entities from the ambit of SMMEs. This chapter explores the different definitions and their exclusions to outline the differences in definitions across different legislation.

### 2.2 Definitions of Small Businesses in South Africa

#### 2.2.1 General

The concept of SMMEs is broad and multifaceted when looked at from a literature point of view, as opposed to an economic point of view.<sup>44</sup> In some cases, the focus of attention is on the entrepreneurial dimension, whereas in other cases, ownership and management are the distinguishing characteristic, while other studies concentrate on whether a business operates in the formal or informal sector.<sup>45</sup> On a global scale, the criterion most frequently used to classify SMMEs is the size of the business enterprise.<sup>46</sup> In South Africa, SMMEs are sometimes classified according to a gross income or turnover threshold.<sup>47</sup> In addition to the classification criteria mentioned thus far, the NDP and National Small Business Act as amended, have their own criteria that are significantly different.<sup>48</sup> Definitions are set out below to illustrate their variety.

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<sup>44</sup> Department of Small Business Development 'Small business and cooperatives in South Africa, 2016/2017 annual review' page 13 (Accessed 12 February 2022).

<sup>45</sup> Department of Small Business Development 'Small business and cooperatives in South Africa, 2016/2017 annual review' page 12 (Accessed 12 February 2022).

<sup>46</sup> Department of Trade and Industry 'Annual review of small business in South Africa, 2005-2007' page 2.

<sup>47</sup> Department of Trade and Industry 'Annual review of small business in South Africa, 2005-2007' page 2.

<sup>48</sup> Ssenyonjo 'A comparative study of tax incentives for small businesses in South Africa, Australia, India, and the United Kingdom' page 20.



## 2.2.2 Non-tax definitions of Small Businesses in South Africa

The Davis Tax Committee (DTC), from a non-tax point of view, classifies SMMEs into three distinct groups namely, survivalist, lifestyle, and entrepreneur businesses.<sup>49</sup>

### 2.2.2.1 *Survivalist businesses*

Survivalist businesses are either home-based or operate on the streets.<sup>50</sup> These businesses predominantly use cash and are not capital intensive.<sup>51</sup> According to the DTC, such businesses only keep basic financial records- examples of these entities include taxi operators, tuck shops, hawkers, taverns, and gardeners.<sup>52</sup>

### 2.2.2.2 *Lifestyle businesses*

Lifestyle businesses refer to businesses that are either home-based or have a single office, usually found in middle and upper-class areas. Examples include a plumber, engineer, broker, doctor, artisan, accountant, and consultant.<sup>53</sup>

### 2.2.2.3 *Entrepreneurial businesses*

According to the DTC, these types of businesses are mainly focused on expansion.<sup>54</sup> Entrepreneurial businesses normally aim to develop an exclusive brand, increase their share in the market, or start a franchise, with the leadership of an ambitious entrepreneur.<sup>55</sup> These types of businesses deal in new processes, products, or markets. The DTC states that such businesses

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<sup>49</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

<sup>50</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6

<sup>51</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

<sup>52</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

<sup>53</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

<sup>54</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

<sup>55</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6.

are often successful in attracting investment from venture capitalists and creating employment opportunities.<sup>56</sup>

#### 2.2.2.4 *National Small Business Act*

The National Small Business Act 102 of 1996 (NSB Act) also gives a non-tax definition of a small business. It defines a small business as *‘a separate and distinct business entity, including co-operative enterprises and non-governmental organizations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector of the economy...’*<sup>57</sup> The Small Business Amendment Act 29 of 2004 (SBA Act) essentially keeps this definition the same as in the NSB Act but refers to a ‘small business enterprise’ as opposed to a ‘small business’ as stated in the NSB Act.<sup>58</sup> The SBA Act goes further to categorize small business enterprises into micro; very small; small; or medium enterprises.<sup>59</sup>

Although the National Small Enterprise Amendment Bill, 2020 has been submitted to Parliament, its potential promulgation will not affect the definition of small businesses as it stands.

#### 2.2.3 South African tax law definitions of small businesses

South African tax legislation defines SMMEs differently.<sup>60</sup> For purposes of this study, only definitions stated in section 12E and paragraph 2 of the Sixth Schedule of the Income Tax Act will be discussed.

Paragraph 2(1) of the Sixth Schedule sets out the requirements as follows:

*‘2(1) A person qualifies as a micro business if that person is a –*

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<sup>56</sup> Davies Tax Committee *‘Small and medium enterprises: taxation considerations, interim report 2014’* page 6.

<sup>57</sup> National Small Business Act 102 of 1996.

<sup>58</sup> Small Business Amendment Act 29 of 2004.

<sup>59</sup> Small Business Amendment Act 29 of 2004.

<sup>60</sup> See s12E, Paragraph 2 of the Sixth Schedule, and Paragraph 57 of the Eighth Schedule of the Income Tax Act 58 of 1962.

*(a) natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency); or  
(b) company,  
where the qualifying turnover of that person for the year of assessment does not exceed an amount of R1 million.’<sup>61</sup>*

The requirements for SBC tax incentives are set out in section 12E(4)(a), which defines an SBC as *‘any close corporation, co-operative or any private company whose shareholders are all natural persons, and whose gross income does not exceed R20 million during the year of assessment’.*<sup>62</sup>

Turnover tax and SBC both have restrictions on how they can be applied in addition to these prerequisites. A list of taxpayers who are expressly forbidden from being recognized as micro enterprises for the purposes of applying Turnover tax is provided in paragraph 3(b) of the Sixth Schedule. Similar to this, the Act's section 12E(4)(a)(iii) and (d) outlines the categories of taxpayers that are disqualified from qualifying as SBCs.

Paragraph 3(b) of the Sixth Schedule reads as follows:<sup>63</sup>

*‘3. A person does not qualify as a micro business for a year of assessment where–  
(a) ...  
(b) more than 20% of that person’s total receipts during that year of assessment consist of –  
(i) where that person is a natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency), income from the rendering of a professional service; and*

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<sup>61</sup> Income Tax Act 58 of 1962.

<sup>62</sup> Income Tax Act 58 of 1962.

<sup>63</sup> Income Tax Act 58 of 1962.

*(ii) where that person is a company, investment income and income from the rendering of a **professional service**;*

Paragraph 1 of the Sixth Schedule defines 'professional services' as services in the fields of:

- a) accounting,
- b) actuarial science
- c) architecture,
- d) auctioneering,
- e) auditing,
- f) broadcasting,
- g) consulting,
- h) draftsmanship,
- i) education,
- j) engineering,
- k) financial service broking,
- l) health,
- m) information technology,
- n) journalism,
- o) law,
- p) management,
- q) real estate broking,
- r) research,
- s) surveying,
- t) translation,
- u) valuation or
- v) veterinary science.<sup>64</sup>

As preempted in Chapter 1, it can be claimed that this definition is ambiguous and possibly unjust, because it does not define the term but only provides instances of

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<sup>64</sup> Income Tax Act 58 of 1962.

what it considers to be 'professional services'. The Sixth Schedule and section 12E requirements for professional services leave the taxpayer wondering whether the definition should be interpreted narrowly or widely.

Until the provisions are amended and clarified, the best suited interpretation principles, as determined by the courts, must be considered. Previously, numerous interpretation principles have been proposed, some purporting that unless a literal interpretation results in absurdity, legislation provisions must be construed according to the grammatical or common meaning of their language. Moreover, courts have deviated from the rigorous literal approach and instead sought to prove the so-called "intention of the legislature" when there was doubt, ambiguity, or absurdity in the wording employed in legislation.

Recently, the Supreme Court of Appeal in *Natal Joint Municipal Pension Fund v Endumeni Municipality* reformulated the approach to interpretation, stating that:

*'The present state of the law can be expressed as follows: Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible, each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document.'*<sup>65</sup>

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<sup>65</sup> *Natal Joint Municipal Pension Fund v Endumeni Municipality* [2012] 2 All SA 262 (SCA) par 18.

The *Natal Joint Municipal Pension Funds* case indicates that the process of statutory interpretation is objective and independent of the subjective intention of those responsible for the terms at the time they selected them.

Additionally, the court in *Marshall and Others v CSARS* ruled that explanatory notes by the South African Revenue Services (SARS) need not be considered in the objective, independent interpretation process of finding the purpose of legislation.<sup>66</sup> This will, most likely, be the approach adopted by the courts in interpreting Sixth Schedule and section 12E requirements.

Section 12E(4)(a)(iii) provides that a taxpayer does not qualify as an SBC if more than 20% of their total receipts and accrual of the corporation consists collectively of investment income and income from the rendering of **personal services**.<sup>67</sup> According to section 12E(4)(d), 'personal services' refer to services in the fields of:

- a) accounting,
- b) actuarial science
- c) architecture,
- d) auctioneering,
- e) auditing,
- f) broadcasting,
- g) consulting,
- h) draftsmanship,
- i) education,
- j) engineering,
- k) financial service broking,
- l) health,
- m) information technology,
- n) journalism,
- o) law,

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<sup>66</sup> *Marshall and Others v Commissioner, South African Revenue Service* [2018] ZACC 11 par 10.  
<sup>67</sup> Income Tax Act 58 of 1962.

- p) management,
- q) real estate broking,
- r) research,
- s) surveying,
- t) translation,
- u) valuation or
- v) veterinary science,

where such services are performed by a person who holds an interest in an SBC, and the business does not employ three or more employees on a full-time basis throughout the year of assessment.<sup>68</sup>

#### 2.2.4 International definitions of small businesses

Internationally, small businesses are defined in many different ways. International bodies, national legislation, and industries cannot reach consensus on what criteria is best for SMME classification.<sup>69</sup> A brief discussion of the definition of SMME as given by various international bodies will be provided below, and an in-depth discussion of the definition of SMMEs as given by the UK and Australian tax legislation shall follow in Chapter 4.

The European Union (EU) defines an SMME as an enterprise employing not more than 250 employees, with either an annual turnover not exceeding EUR 50 million or an annual balance sheet total not exceeding EUR 43 million.<sup>70</sup> The Organization for Economic Cooperation and Development (OECD) essentially defines SMMEs in the same manner as the EU; however, it goes further to acknowledge the varying thresholds across different countries.<sup>71</sup>

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<sup>68</sup> Income Tax Act 58 of 1962.

<sup>69</sup> Ssenyonjo 'A comparative study of tax incentives for small businesses in South Africa, Australia, India, and the United Kingdom' page 24.

<sup>70</sup> European Commission 'User guide to the SMME definition' page 12 (Accessed: 12 February 2022).

<sup>71</sup> OECD 'SMME and Entrepreneurship outlook' page 17 (Accessed 15 February 2022).

One the other hand, the World Bank does not have a definition for SMMEs; it follows country standards, which are inconsistent, and generally accepts the criteria of employees, assets, and sales.<sup>72</sup> Nonetheless, the World Bank acknowledges that support for SMMEs is heavily reliant on targeted development assistance, which depends on the clear differentiation between large enterprises and SMMEs.<sup>73</sup>

### 2.3 Conclusion

The aforementioned definitions of SMMEs are evidence that there is a variety of definitions for the SMME concept. Whereas the definitions are different, the categories of classification have significant similarities and differences.

The non-tax classifications of SMMEs (Survival, Lifestyle, and Entrepreneurial businesses) by the DTC are fundamentally classified according to how the owner runs them and the type of environment they operate in.<sup>74</sup> Additionally, the NSB Act and the SBA Act also categorize SMMEs according to their structural organization, and further acknowledge the classification of businesses into micro, very small, small, or medium enterprises.<sup>75</sup> However, these classifications would not fit well as fiscal classifications as they do not deal with monetary thresholds and the size of an enterprise, which are important factors in tax legislation.

The Income Tax Act not only utilizes the structural organization and the form of ownership to categorize SMMEs, but it also includes the types of services offered (i.e., personal, and professional services) as part of the classification criteria.<sup>76</sup> This is a significant difference from all SMME definitions discussed. The Act seems to make a correlation between the types of services offered and the potential success of a business, without considering the economic factors that affect every business. For this

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<sup>72</sup> IEG 'World Bank Group support small and medium enterprises: a synthesis of evaluative findings' page 5 (Accessed 15 February 2022).

<sup>73</sup> IEG 'World Bank Group support small and medium enterprises: a synthesis of evaluative findings' page 5 (Accessed 15 February 2022).

<sup>74</sup> Davies Tax Committee 'Small and medium enterprises: taxation considerations, interim report 2014' page 6

<sup>75</sup> Section 1 of the National Small Business Act 102 of 1996.

<sup>76</sup> Section 12E & Paragraph 2 of the Sixth Schedule of the Income Tax Act 58 of 1962.



reason, it can be argued that the Income Tax Act is arbitrarily and unfairly overreached in this aspect, when designing the exclusionary criteria of SMMEs. This will be further be expounded upon when dealing with the justifications stated by the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 in the next chapter.

From the international bodies discussed, only the EU and the OECD give practical criteria for the definition of SMMEs. The criteria used by the EU and the OECD strictly look at the size of an enterprise in terms of number of employees, annual turnover, or annual balance sheet total, which I argue are fair criteria for determining what constitutes an SMME because the size of a business is a reasonable indicator of an enterprise's need for financial assistance through tax incentives.

## Chapter 3 Analysis of the reasons and effects of the exclusion of certain types of businesses

### 3.1 Introduction

The differentiation of SMME classification and definitions mentioned in Chapter 2 show that the Income Tax Act's inclusion of personal and professional services makes its limitations more extensive relative to other legislation. It is now befitting to examine the reasoning behind the inclusion of 'personal and professional services' in the limitation criteria to find out if any legally justifiable reasons exist.

### 3.2 Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008

#### 3.2.1 Personal service

National Treasury, through the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008, justifies the exclusion of personal service providers by stating that:

*'a person that is a 'personal service provider' or a 'labour broker' (defined in the Fourth Schedule to the Act)<sup>77</sup> that has not been issued with a tax exemption certificate by SARS is disqualified. These entities have been [subject to] specific anti-avoidance measures. The definitions in paragraph 1 of the Fourth Schedule now include the terms 'personal service provider' and 'labour broker' as a result of the need to develop stronger anti-avoidance measures for employees' tax purposes as a result of the use of terms like 'independent contractor' and 'service company' and the perception that these were acceptable ways to avoid the deduction of employees' tax. The definition of 'employee' in paragraph 1*

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<sup>77</sup> 'Personal service provider' means any company (other than a company which is a labour broker), where any service rendered on behalf of such company to a client of such company is rendered personally by any person who is a connected person in relation to such company.

'Labour broker' means any person who conducts or carries on any business whereby such person for reward provides a client of such business with other persons to render a service or perform work for such client, or procures such other persons for the client, for which services or work such other persons are remunerated by such person.

*covered both as employees.<sup>78</sup> As a result, it is not the intention for them to obtain benefits from the Turnover tax system'.<sup>79</sup>*

Essentially, the specific anti-avoidance measure expressly includes personal service providers in the definition of 'employee' and requires the remuneration of said personal service providers be withheld for purposes of employees' tax.<sup>80</sup> As a result, an employer must deduct or withhold employees' tax for all expenses (remuneration in particular) paid or payable to a personal service provider. The specific anti-avoidance measure aims to curb businesses avoiding the responsibility of deducting and accounting for employees' tax by labeling their employees as outsourced or contracted juristic persons i.e., personal service providers.<sup>81</sup> Evidently, the specific anti-avoidance measures have no relation to Turnover tax.<sup>82</sup>

I argue that it is unfair for 'personal service providers' to be denied of Turnover tax incentives on the basis of being subject to anti-avoidance measures which are not related specifically and directly to SMMEs.<sup>83</sup> Put differently, 'personal service providers' seem to be collateral to the limitations of Turnover tax, considering the fact that the term was not properly defined, and was poorly justified. It stands to reason that the exclusion of 'personal service providers' is an across-the-board punitive measure against same for being subject to an unrelated specific anti-avoidance measure.

### 3.2.2 Professional service

Moreover, the exclusion of professional service providers is explained in the Explanatory Memorandum by stating that:

*'a person that renders a 'professional service' as defined is disqualified. Such services are generally rendered by more sophisticated, high income earning*

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78 SARS IN 35(4) page 1.

79 Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 pages 59-60.

80 SARS IN 35(4) page 2.

81 S23(k) of the Income Tax Act 58 of 1962.

82 SARS IN 35(4) pages 2.

83 SARS IN 35(4) pages 2.

*taxpayers, with profit margins that are significantly higher than those assumed in the design of the Turnover tax. Professional services include, amongst others, any service in the field of accounting, broking, consulting, engineering, law, management, real estate, surveying, or veterinary science*.<sup>84</sup>

This limitation results in certain service providers being excluded based on the type of service they provide, and on the assumption that the services they provide guarantee their business' success, an assumption that does not consider a multitude of factors that can affect a business' success in the practical world.<sup>85</sup> A case in point would be the Covid 19 pandemic.<sup>86</sup> When lockdown restrictions were implemented in March of 2020, many businesses could not operate as only businesses providing 'essential services' were allowed to operate in person.<sup>87</sup> Although some professional service providers are also essential service providers, many are not. Whereas professional services are '*generally rendered by more sophisticated, high income earning taxpayers*', as justified by the explanatory memorandum, many did not survive the pandemic within its first year.<sup>88</sup> Out of the 4.9% of professional, scientific and technical businesses surveyed, Finfind reports that 2.4% of such businesses had closed down by November of 2020.<sup>89</sup> Notably, the type of service a business renders has no significant bearing on its possible success.

### 3.3 Analysis

#### 3.3.1 Harksen v Lane

The arguments made against the defenses invoked by the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008, have unfair discrimination as the common and underlying issue. Unfair discrimination as an argument has been the subject of many court cases in South Africa, so much so that

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<sup>84</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008 page 60.

<sup>85</sup> Willemse '*A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and Paragraph 3(B) of the Sixth Schedule of the Income Tax Act, No 58 of 1962*' page 530.

<sup>86</sup> Finfind '*The SA SMME Covid -19 impact report*' page 1.

<sup>87</sup> Finfind '*The SA SMME Covid -19 impact report*' page 1.

<sup>88</sup> Finfind '*The SA SMME Covid -19 impact report*' page 10.

<sup>89</sup> Finfind '*The SA SMME Covid -19 impact report*' page 10.

a test has been formulated to prove or disprove same argument.<sup>90</sup> Consequently, the argument will be put against the unfair discrimination enquiry test as formulated in the case of *Harksen v Lane*,<sup>91</sup> which was heavily influenced by the judgments in *Prinsloo*<sup>92</sup> and *Hugo*<sup>93</sup> cases. *Harksen v Lane* went on to influence other groundbreaking decisions, such as the one in *Pretoria City Council v Walker*.<sup>94</sup> The enquiry is two-staged:

*'Firstly, does the differentiation amount to "discrimination"? If it is on a specified ground, then discrimination will have been established. If it is not on a specified ground, then whether or not there is discrimination will depend upon whether, objectively, the ground is based on attributes and characteristics which have the potential to impair the fundamental human dignity of persons as human beings or to affect them adversely in a comparably serious manner'*.<sup>95</sup>

In the matter at hand, SMMEs that are classified as 'personal service' providers, or 'professional service' providers are excluded from the ambit of SBC and Turnover tax incentives, while other SMMEs are afforded same tax incentives. As a result, I am of the opinion that the exclusion of 'personal service' providers and 'professional service' providers from Sixth Schedule and section 12E incentives respectively, amounts to a differentiation between SMME's that are classified as personal/professional service providers and other SMMEs. The type of services a business provides forms the essence of said business and being differentiated on the basis of the types of services provided can affect a business adversely in a comparably serious manner because a business cannot, in many circumstances, effortlessly change the types of services it provides; consequently, differentiation on the basis of the types of services provided by a company amounts to discrimination.

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<sup>90</sup> *Harksen v Lane* NO 1998(1) SA 300(CC).

<sup>91</sup> *Harksen v Lane* NO 1998(1) SA 300(CC).

<sup>92</sup> *Prinsloo v Van der Linde*[1997] 6 BCLR 759 (CC).

<sup>93</sup> *President of the RSA v Hugo*(1997)6 BCLR 708 (CC).

<sup>94</sup> *Pretoria City Council v Walker* 1998 (2) SA 363 (CC).

<sup>95</sup> *Harksen v Lane* NO 1998(1) SA 300(CC), par 51.

Secondly:

*'If the differentiation amounts to 'discrimination', does it amount to 'unfair discrimination'? If it has been found to have been on a specified ground, then unfairness will be presumed. If on an unspecified ground, unfairness will have to be established by the complainant. The test of unfairness focuses primarily on the impact of the discrimination on the complainant and others in his or her situation'.<sup>96</sup>*

Since limitations to tax incentives are set out to ensure that only the intended beneficiaries, i.e., businesses, that need assistance are encompassed and covered by the application of the incentives, I argue that the exclusion of personal service providers and professional service providers, is misguided, as it does not further the purposes of the SBC and Turnover tax. The limitations result in some service providers being excluded based on the type of service they provide, and on the assumption that the services they provide guarantee their business' success.

Moreover, 'personal services' are only excluded from the tax incentives in question because they are the subject to another unrelated specific anti-avoidance legislation.<sup>97</sup> As the reasons given for the exclusion of personal services and professional services from SBC and Turnover tax incentives have been found to be based on poorly substantiated assumptions and blanket generalizations, they have elements of arbitrariness without a legitimate purpose, which makes the discrimination against personal service providers and professional service providers unfair.

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<sup>96</sup> *Harksen v Lane* par 51.

<sup>97</sup> As discussed in FN84 above.

Botha, Meyer, and Kok<sup>98</sup> agree with the approach of *Harksen v Lane*, and consequently can, in my view, be considered to concur with my argument. They set out to determine whether or not the differentiation created by section 23(m)<sup>99</sup> of the Income Tax Act is constitutionally permissible using section 9(1) of the Constitution of the Republic of South Africa, 1996 as the standard of measure. To be constitutionally permissible, the differentiation by section 23(m) by the ITA must be rationally connected to a legitimate government purpose.<sup>100</sup> Goldswain also acknowledges that section 9 of the Constitution and the landmark cases mentioned above, most of which are from other branches of the law, can be applied to the interpretation of fiscal legislation.<sup>101</sup> As discussed above, the Explanatory memorandum's justifications for excluding 'personal service' and 'professional service' from the ambit of Turnover tax and SBC provisions were found wanting. Consequently, I argue that the exclusion of said terms is inconsistent with section 9(1) of the Constitution, because the exclusion cannot serve a legitimate government purpose, when the very existence of the exclusion is questionable.

### 3.4 Professional service

#### 3.4.1 General

To better understand the error in exclusion of 'personal service' and 'professional service' by paragraph 3 the Sixth Schedule and 12E(4)(a)(iii) respectively, the definitions of these terms must be investigated. As mentioned in the literature review, the definitions of 'professional service' and 'personal service' have significant similarities. The difference being that personal services limit the number of

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<sup>98</sup> Botha et al. *'Tax legislation and the right to equality: Does section 23(m) of the Income Tax Act 58 of 1962 rationally differentiate between salaried individuals and individuals who earn their income mainly from commission?'* page 7.

<sup>99</sup> Section 23(m) is applicable to taxpayers in receipt of remuneration resulting from employment or being an office bearer. The section limits the deductions of such taxpayer to those '*allowable under section 11 (a) or (d) in respect of any rent of, cost of repairs of or expenses in connection with any dwelling house or domestic premises, to the extent that the deduction is not prohibited under paragraph (b) ...*'

<sup>100</sup> Botha et al. *'Tax legislation and the right to equality: Does section 23(m) of the Income Tax Act 58 of 1962 rationally differentiate between salaried individuals and individuals who earn their income mainly from commission?'* page 14.

<sup>101</sup> Goldswain *'Are some taxpayers treated more equally than others? A theoretical analysis to determine the ambit of the constitutional right to equality in South African tax law'* page 22.

employees to two full-time employees and professional services do not limit the number of employees.<sup>102</sup> If it is assumed that the terms ‘professional service’ and ‘personal service’ have the same meaning (bar the exclusion relating to the number of employees), as will be done in this paper, the significance of the terms and the fundamental principles associated with them can be investigated more efficiently.<sup>103</sup> Thus, henceforth the terms ‘professional service’ and ‘personal service’ will collectively be referred to and discussed under the umbrella term ‘professional service’ for the sake of convenience.

### 3.4.2 Dictionary definitions of ‘professional service’

As the South African Income Tax Act does not adequately define ‘professional’, the meaning of this term, and associated terms such as ‘profession’ must be determined from outside the legislation. Firstly, the definitions from some of the most authoritative dictionaries will be examined.

The Oxford Paperback Dictionary:<sup>104</sup>

‘Professional’ *adjective* 1. of or belonging to a profession or its members.

2. having or showing the skill of a professional.

3. doing a certain kind of work to make a living.

*Noun* 1. a person working or performing for payment.

2. someone highly skilled.

Collins English Dictionary:<sup>105</sup>

‘Professional’ *adjective* 1. of, relating to, suitable for, or engaged in as a profession.

2. engaging in an activity for gain or as a means of livelihood.

3. extremely competent in a job, etc.

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<sup>102</sup> Mkhize ‘A critical analysis of the tax implications for small and micro businesses’ page 36.

<sup>103</sup> Willemse ‘A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and Paragraph 3(B) of the Sixth Schedule of the Income Tax Act, No 58 of 1962’ page 530.

<sup>104</sup> The Oxford Paperback Dictionary, 4th edition (Accessed 4 March 2022).

<sup>105</sup> Collins English Dictionary, 13th edition (Accessed 4 March 2022).



4. undertaken or performed for gain or by people who are paid.

*Noun* 1. a person who belongs to or engages in one of the professions.

2. a person who engages for his livelihood in some activity.

3. a person who engages in an activity with great competence.

The Cambridge Online dictionary:<sup>106</sup>

*'Profession'* *Noun* 1. Any type of work that needs special training or a particular skill, often one that is respected because it involves a high level of education.

2. The people who do a particular type of work, considered as a group.

It is further stated that a suitable and appropriate definition of the *profession* is '*an occupation with an elevated status which requires a degree of theoretical and practical training, knowledge and skills and whose members are subject to a code of ethics and that is governed by a professional body*'.<sup>107</sup>

When analyzing the abovementioned definitions from dictionaries and scholarly text, it is evident that there exists a broad spectrum within which a taxpayer can be classified as a professional or a member of a profession. However, the Income Tax Act does not account for this, because it does not define what a *professional service* is, it merely provides examples of the activities that constitute a *professional service* which are also not defined in the Act.<sup>108</sup> The broad spectrum of professionalism discovered in the abovementioned dictionary and scholarly text,

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<sup>106</sup> Cambridge Online Dictionary, 2022.

<sup>107</sup> Strauss, Jansen & Lubbe '*Professionele aanspreeklikheid van ouditeure teenoor derdes op grond van nalatigheid*' page 92.

<sup>108</sup> Willemse '*A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and Paragraph 3(B) of the Sixth Schedule of the Income Tax Act, No 58 of 1962*' page 530.

exposes the uncertainty in the provisions of the Sixth Schedule and section 12E of the Income Tax Act.

A good example of such uncertainty is one of a traditional healer (*sangoma*).<sup>109</sup> Traditional healers administer traditional medicine and offer advice in exchange for money and, as a result, this occupation can be deemed to be a health service.<sup>110</sup> Because traditional healers provide a health service, do they automatically qualify as professional service providers in terms of the Sixth Schedule and section 12E, or is some form of professional qualification required?<sup>111</sup> If a professional qualification is required, can such qualification be equated to that of a psychologist or a neurosurgeon, thus classifying traditional healers in the same category as psychologists and neurosurgeons?

### 3.4.3 South African Case law: Definition of 'professional services' and associated terms.

In *Kadalie v Hemsworth* Grindley Ferris J said:

*'I find that 'profession' has been defined as 'a calling superior to that of a mere trade or handicraft,' and also as any calling or occupation involving special mental and other attainments or discipline, as editing, acting, engineering, authorship, etc'.*<sup>112</sup>

President Smith J, in the case of *ITC 1664*, gave his input on how the definition of 'professional services' should be approached. The court, on page 388, stated that:

*'when one has to determine whether or not a service has been provided by someone 'in his professional capacity', one has to look at the person who provided the services and ascertain whether he or she has the necessary*

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<sup>109</sup> *Sangoma* is a term originating from the isiZulu language in South Africa, and it refers to a traditional healer or diviner.

<sup>110</sup> Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and Paragraph 3(B) of the Sixth Schedule of the Income Tax Act, No 58 of 1962' page 532.

<sup>111</sup> Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and Paragraph 3(B) of the Sixth Schedule of the Income Tax Act, No 58 of 1962' page 532.

<sup>112</sup> *Kadalie v Hemsworth* NO 1927 TPD 862 at par 866.

*qualifications or skills to be able to say that he or she was acting in a professional capacity*.<sup>113</sup>

According to President Smith J, *'judicial discussion about the nature of professions occurs principally in tax cases, where the issue is whether or not the taxpayer is carrying on a profession'*.<sup>114</sup> He goes on to quote the judgment by Scrutton LJ in *Commissioners of Inland Revenue v Maxse* (Maxse case) to illustrate his point. The court in the Maxse case proposed that:

*'A 'profession' in the present use of language involves the idea of an occupation requiring either purely intellectual skills, or of manual skill controlled, as in painting and sculpture, or surgery, by the intellectual skill of the operator, as distinguished from an occupation which is substantially the production or sale or arrangements for the production or sale of commodities. The line of demarcation may vary from time to time. The word 'profession' used to be confined to the three learned professions, the Church, Medicine and Law. It has now, I think, a wider meaning'*.<sup>115</sup>

The matter arose again in *Carr v Inland Revenue Commissioners*.<sup>116</sup> In that case Du Parcq LJ, in upholding a finding that an optician was carrying on a profession, said:

*'I think that everybody would agree that, before one can say that a man is carrying on a profession, one must see that he has some special skill or ability or some special qualifications derived from training or experience. Even then one has to be very careful, because there are many people whose work demands great skill and ability and long experience and many qualifications who would not be said by anybody to be carrying on a profession'*.<sup>117</sup>

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<sup>113</sup> ITC 1664 61 SATC par 383.

<sup>114</sup> ITC 1664 61 SATC par 383.

<sup>115</sup> *Commissioners of Inland Revenue v Maxse* [1919] 1KB 647.

<sup>116</sup> *Carr v Inland Revenue Commissioners* [1944] 2 All ER 163.

<sup>117</sup> *Carr v Inland Revenue Commissioners* [1944] 2 All ER 163 page 166.

From the rulings of the case law discussed above, it stands to reason that a taxpayer renders a professional service when he/she applies and possesses special knowledge and experience which the layman would normally not possess.

The definition of professional service as currently contained in Section 12E and the Sixth Schedule deviates from the ordinary and accepted meaning of the term as set out above and is so vague and inadequate that it does not allow for comprehensive interpretation. The definition of professional service in Section 12E and the Sixth Schedule does not account for the broad range that the term professional service encompasses. Therefore, alternative criteria of exclusion in the definition of small business will be investigated that can be applied to the South African context.

## Chapter 4 Definition and exclusions of SMME in the Australia's Income Tax legislation

### 4.1 Income tax legislation in Australia

#### 4.1.1 General

As the South African income tax legislation originates from the Australian New South Wales Act of 1895, South Africa and Australia have various similarities in their income tax legislation.<sup>118</sup> The court in *CIR v Manganese Metal Co (Pty) Ltd* also emphasized the comparability of the South African and Australian income tax legislation.<sup>119</sup> As a 'first world country' and member state of the Organisation for Economic Cooperation and Development (OECD), a leading organization in economic uniformity measures and progressive economics, taxation and accounting, Australia presents itself a good model for South African income tax legislation to follow.<sup>120</sup> Thus, an investigation of the definition of a small business for Australian tax purposes could prove insightful and provide alternative measures that can translate and apply to the South African context.

#### 4.1.2 Income Tax Assessment Act 1997

The Income Tax Assessment Act 1997 (ITAA97) is the Australian equivalent of the Income Tax Act; as a result, this will be the legislation of interest in identifying how a small business is defined for Australian tax purposes. Section 328-110 defines a small business as follows:<sup>121</sup>

##### **'328-110 Meaning of small business entity**

(1) *You are a small business entity for an income year (the current year) if:*

- (a) *you carry on a business in the current year; and*
- (b) *one, or both of the following applies:*

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<sup>118</sup> Huxham & Haupt 'Aantekeninge oor Suid-Afrikaanse Inkomstebelasting' page 6.

<sup>119</sup> *CIR v Manganese Metal Co (Pty) Ltd* [1996] 58 SATC1 para 33-36.

<sup>120</sup> Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the sixth schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 540.

<sup>121</sup> Section 328-110 of ITAA97.

- (i) you carried on a business in the income year (the previous year) before the current year and your aggregated turnover for the previous year was less than \$10 million;*
- (ii) your aggregated turnover for the current year is likely to be less than \$10 million.*
- (2)...
- (3) *However, you are not a small business entity for an income year (the current year) because of subparagraph 1(b)(ii) if:*
- (a) you carried on a business in each of the 2 income years before the current year; and*
- (b) your aggregated turnover for each of those income years was \$10 million or more.*
- (4) *You are also a small business entity for an income year (the current year) if:*
- (a) you carry on a business in the current year; and*
- (b) your aggregated turnover for the current year, worked out as at the end of that year, is less than \$10 million.'*

Section 995-1 of the ITAA97 defines a business as including any profession, trade, employment, vocation or calling; however, it excludes occupation as an employee.<sup>122</sup> Section 328-115 defines aggregated turnover, and states that it includes all income received by a taxpayer.<sup>123</sup> Section 328-120 lists the amounts excluded from aggregated turnover, and none of the excluded amounts are based on the type of service offered by a taxpayer, as is the case with section 12E and the Sixth Schedule.<sup>124</sup> of the Income Tax Act. In contrast to the exclusions listed in section 12E and the Sixth Schedule, the list of exclusions in section 328-120 is succinct, clear, and unambiguous.

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<sup>122</sup> S995-1 of the ITAA97.

<sup>123</sup> S328-115 of the ITAA97.

<sup>124</sup> S328-120 of the ITAA97.

## 4.2 Analysis

When analyzing section 320-110 further, two elements of classification become evident: Namely, a qualitative one, which requires a taxpayer to be carrying on a trade, and a quantitative one, which looks at the whether the taxpayer's trade falls under the prescribed aggregated turnover threshold. These elements of classification are very comprehensive and extremely user-friendly.

The Australian criteria of classification, in addition to the reasons mentioned in the first paragraph of this chapter, can in my view be implemented in the South African context because similar criteria are already being used in other fiscal legislation i.e. the South African Value Added Tax Act 89 of 1991 (VAT Act). Section 23(1) of the VAT Act determines whether a taxpayer has to register for Value-Added Tax or not using similar criteria employed in section 320-110 of the ITAA-97. I am of the view that implementing the Australian criteria of classification in the South African context, could help bring a sense of efficiency and practicality to SMME tax incentives, which would greatly aid the country's ailing SMME sector, by ensuring that most, if not all, SMMEs in need of tax incentives are encompassed.

Willemse is of the opinion that following the example set by Australian legislation:

*'might allow previously excluded small businesses to make use of the income tax incentives intended for small business, [which] could possibly lead to more small businesses becoming part of the income tax system, economic growth, and job creation and could ultimately result in an increase in income tax revenue for the South African government'*<sup>125</sup>

I concur with Willemse's abovementioned opinion because Australia, as a first world country with a thriving economy, could provide South Africa with the blueprint it needs to

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<sup>125</sup> Willemse 'A critical analysis of the barriers to entry for small business owners imposed by sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the sixth schedule of the Income Tax Act No.58 of 1962' 2011 5 *Journal of Economic and Financial Sciences* page 543.

nurture its SMMEs and grow its economy, and what better way to do so than follow a country that has already seen success from the classification criteria it uses. Additionally, South Africa's tax legislation originating from the Australian New South Wales Act of 1895, means Australia's classification criteria will translate with relative ease into the South African context.



## Chapter 5 Definition and exclusions of SMME in the UK's Income Tax Legislation

### 5.1 Income Tax legislation in the UK

#### 5.1.1 General

The UK and South Africa both have comparable tax laws because the UK is a former colonial master to South Africa.<sup>126</sup> Both nations are members of the Commonwealth and base their income tax treatment on residency.<sup>127</sup> The UK, a developed nation whose economy is mostly made up of SMMEs,<sup>128</sup> may have some useful alternatives to the definition of SMMEs that could aid South Africa in achieving developed country status. Like South Africa, the United Kingdom has multiple applicable definitions for SMMEs.<sup>129</sup> Because of the limitations of this study, only the tax definition is of importance to this paper.

#### 5.1.2 Corporate Tax Act 2009

In the UK, the Corporation Tax Act 2009 (CTA 2009) provides SMMEs (and large businesses) with Research and Development (R&D) tax incentives. R&D incentives *'enabl[es] a company carrying on a trade to make a claim for an amount in respect of expenditure on research and development to be brought into account as a receipt in calculating the profits of the trade for an accounting period...'*<sup>130</sup> As R&D tax incentives provide specific tax relief for SMMEs, they also give a definition that qualifies a company as an SMME for R&D purposes.

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<sup>126</sup> P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa 17.

<sup>127</sup> P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa page 17.

<sup>128</sup> P, Ssenyonjo. 2019. *A comparative study of tax incentives for small businesses in South Africa, Australia, India and the United Kingdom*. MPhil dissertation. University of South Africa page 17.

<sup>129</sup> The Department for Business defines an SMME as a company with less than 250 employees for purposes of statistics

<sup>130</sup> The Companies House also has a separate definition of SMME relevant for accounting purposes. S1040 of Chapter 4 of the CTA 2009.

Chapter 9 of Part 13 of the CTA 2009 states that SMME means micro, small or medium sized enterprises as defined in Commission Recommendation (EC) No 2003/361 read with the amendments given in section 1120 of same chapter.<sup>131</sup> Examined further, the Commission Recommendation (EC) No 2003/361 provides the constituent components for the definition of an SMME.

Title I of the Annex to the Commission Recommendation (EC) No 2003/361 specifically deals with the definition of Micro, Small and Medium-Sized Enterprises. Furthermore, Article 1 of the Annex to the Commission Recommendation defines an enterprise as *'any entity engaged in an economic activity, irrespective of its legal form. This includes, in particular, self-employed persons and family businesses engaged in craft or other activities, and partnerships or associations regularly engaged in an economic activity'*.<sup>132</sup> Article 2 gives the staff headcount and financial ceilings determining enterprise categories. Sub article 1, as qualified by section 1120 of CTA 2009, states that *'the category of micro, small and medium-sized enterprises (SMMEs) is made up of enterprises which employ fewer than 500 persons and which have an annual turnover not exceeding EUR 100 million, and/or an annual balance sheet total not exceeding EUR 86 million'*.<sup>133</sup> Subsequently, sub article 2 proceeds to explain that *'within the SMME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million'*.<sup>134</sup> Lastly, sub article 3 concludes Article 2 by stating that *'within the SMME category, a micro-enterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million'*.<sup>135</sup>

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<sup>131</sup> S1119 of Chapter 9 of the CTA 2009.

<sup>132</sup> Article 1 of the Commission Recommendation.

<sup>133</sup> Article 2(1) of the Commission Recommendation.

<sup>134</sup> Article 2(2) of the Commission Recommendation.

<sup>135</sup> Article 2(3) of the Commission Recommendation.

## 5.2 Analysis

Article 1 of the Commission Recommendation (EC) No 2003/361 defines an enterprise as an entity that is regularly engaged in economic activity regardless of its legal form. Article 2 states that the qualifying criteria for R&D incentives are staff headcount and financial ceilings. The remainder of the Commission Recommendation (EC) No 2003/361 continues to give specifics on the provisions of Articles 1 and 2.

Article 1 has a very wide interpretation of what an enterprise is, and it mentioning the phrase 'irrespective of its legal form' can be interpreted as also saying that the type of service an enterprise offers is immaterial to whether the enterprise qualifies for R&D incentives or not. The criteria of exclusion provided by Article 2 is based on an enterprise's staff headcount and its annual turnover. The criteria in Article 2 makes no mention and has no effect on the type of service an enterprise offers.

The Commission Recommendation (EC) No 2003/361, under Articles 1 and 2, does not exempt businesses from a specific tax incentive based on the type of service they provide, in contrast to Section 12E and the Sixth Schedule of the Income Tax Act. Additionally, Articles 1 and 2 are concise, plain, and clear about what qualifies or disqualifies a company from a specific tax benefit. The European Commission emphasizes that the definition of SMME by the Commission Recommendation (EC) No 2003/361 *'[...]is an important tool for implementing efficient measures and programmes to support the development and success of SMEs. Therefore Member States, together with European Investment Bank and the European Investment Fund are invited to apply it as widely as possible'*.<sup>136</sup>

A testimony to the efficiency of the SMME definition as provided by the Commission Recommendation (EC) No 2003/361 was given by the European Builders

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<sup>136</sup> Enterprise and Industry Publications *'The new SME definition'* page 26.

Confederation (EBC).<sup>137</sup> The EBC '*is a European professional organisation representing national associations of micro, small and medium-sized enterprises working in the construction sector*'.<sup>138</sup> It remarks that the SMME definition by the Commission Recommendation (EC) No 2003/361 remains fit for purpose, as it applies particularly to micro and small businesses since they face the same difficulties as other market actors (such as administrative hurdles, access to financing, innovation, or public markets) but lack the resources to address them.<sup>139</sup> So, the current thresholds ought to stay in place.<sup>140</sup> A testimony of this nature from the intended recipients at the ground level, speaks volumes in my opinion. It shows how easily efficient legislation can be implemented when a practical and sincere nexus exists between the legislature and those at the ground level.

Further investigation revealed that the UK tax definition of a SMME has two obvious criteria of classification, as determined with Australian tax law. There are two types of audits, a quantitative one that determines whether a taxpayer's business comes under the set financial and employee headcount ceilings and a qualitative one that determines whether a company is routinely engaged in economic activity. These classification criteria are quite thorough and very simple to utilize.

In addition to the reasons listed in the opening paragraph of this chapter, the South African context can employ the UK categorization criteria because other fiscal legislation, such as the South African Value Added Tax Act 89 of 1991 (VAT Act), which uses similar factors in section 23(1) to assess whether or not a taxpayer must register for Value-Added Tax, as are Articles 1 and 2 of the Commission Recommendation (EC) No 2003/361.

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<sup>137</sup> EBC '*EBC position on Recommendation 2003/361/EC concerning the definition of micro, small and medium sized enterprises*' page 1.

<sup>138</sup> EBC '*EBC position on Recommendation 2003/361/EC concerning the definition of micro, small and medium sized enterprises*' page 1.

<sup>139</sup> EBC '*EBC position on Recommendation 2003/361/EC concerning the definition of micro, small and medium sized enterprises*' page 1.

<sup>140</sup> EBC '*EBC position on Recommendation 2003/361/EC concerning the definition of micro, small and medium sized enterprises*' page 1. Referring to the thresholds of staff headcount and financial ceilings as provided by Article 2 of the Commission Recommendation (EC) No 2003/361.

By theoretical extrapolation, it can be concluded that the possible benefits that South African could reap from following the Australian method categorization, could also result from following the classification criteria of the UK tax legislation.

## Chapter 6 Conclusion

The main goal of this research study was to assess the justifications for and implications of the inclusion of the terms ‘personal service’ and ‘professional service’ as requirements of sections 12E(4)(a)(iii) and (d) of the Turnover tax and SBC legislation, respectively, as well as their definitions in those sections. This paper has criticized the limitations for being excessively broad and ambiguous, nearly to the point of arbitrariness. Law, literature, and case law were used to support the suggested criticism. In furthering this goal, the first chapter posed a research question through four sub-research questions, and all four sub-research questions have been substantially answered.

It is first established that the purpose of Turnover tax and SBC legislation, like many other SMME tax incentive, is to help SMMEs overcome the many obstacles that they face with limited resources. Subsequently, in the literature review, the terms ‘personal service’ and ‘professional service’ were analyzed as barriers to entry for Turnover tax and SBC legislation, and their pitfall of being poorly substantiated was put forth.

Multiple definitions of the term ‘SMME’ were examined to highlight the variety in such definitions and explore the significant similarities and differences. However, because said definitions do not address monetary thresholds and the size of an organization, which are crucial in tax legislation, these categories would not work well as fiscal classifications. Thus, the fiscal definitions of ‘personal service’ and ‘professional service’ as provided in the Income Tax Act were criticized in isolation from definitions of other branches of law.

The justifications of the inclusion of ‘personal service’ and ‘professional service’ in the limitation criteria, as provided by the 2008 Explanatory Memorandum on the Revenue Laws Amendment Bill, were found to be lacking and poorly substantiated. This is mainly on the grounds of ambiguity, as determined through the *Harksen v Lane* case and other scholarly text, which led to my conclusion of the unfair treatment of many SMMEs deserving of the SBC and Turnover tax incentives.

Alternative criteria of classification were proposed from the Australian and UK tax legislation perspective. The Australian barriers to entry for SMME qualification only look at whether an entity carries on a business, and that entity's aggregated turnover. While on the other hand, the UK classification criteria for SMMEs only looks at whether a business is engaged in regular economic activity, staff headcount and financial ceilings. From both the Australian and UK criteria of classification, qualitative and quantitative elements of classification were observed in the UK and Australian tax legislation classification, and it has been argued that these elements would provide a more comprehensive and user-friendly in the South African context as opposed to the current method of classification. Both the UK and Australia are first world countries whose economies thrive on the success of SMMEs through tax incentives.

Ultimately, the study has found that sections 12E(4)(a)(iii) and (d) and paragraph 3(b) of the Sixth Schedule of the Income Tax Act are not constructive to the purposes of the SBC and Turnover tax legislation, through the discussions detailed throughout the paper.

In conclusion, I recommend that simpler parameters that explain the SMME concept better should be utilized, which leave no space for doubt in the mind of the taxpayer as to whether their entity qualifies as an SMME for purposes of Turnover tax and SBC legislation. This might make it possible for small enterprises who were previously barred from receiving the tax incentives to then qualify. This might also result in more small enterprises being tax registered, an economic expansion, the creation of new jobs, and ultimately higher income tax revenue for the South African government.

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