

Reimagine the possible
2018 budget highlights





Major announcements

1% VAT increase to 15%

The Minister of Finance announced in his Budget speech that the VAT rate will be increased by 1 % to 15% with effect from 1 April 2018. This increase is expected to raise additional revenue of 22.billion.

This will result in additional costs for consumers as they will now have to pay an additional VAT on any purchases of goods or services from VAT vendors. This will have a major impact on households' already tight budget. The implementation of the VAT increase for certain business will also be complex, and the implementation date of 1 April does not leave much time to allow businesses to effect the necessary system changes and enhancements.

This is the correct approach as we see further reliance on indirect taxes. This raises large amounts of revenue with relatively small increases in rates due to its broad base and economic efficiency. The effect that there is no amended list of zero rated foodstuffs is positive as it maintains the integrity and efficiency of the South African VAT system.

Lesley O'Connell, PwC VAT partner

Extensive reform for E-Services

In a nutshell, the draft Regulation effectively repeals the current Regulation that sets out those services that are regarded as "electronic services". It is proposed to expand the current ambit of "Electronic services" to include "any services supplied by means of an electronic agent, electronic communication or the internet for any consideration". The result is that non-resident suppliers of electronic services, except telecommunication services and educational services supplied by a person regulated by an educational authority in a foreign country, are required to register for VAT in SA where the value of the sales exceeds R50 000 in any consecutive 12-month period.

In light of the fact that SA has not implemented the B2B and B2C distinction in line with current international best practice, the impact will in all likelihood be substantial for foreign suppliers who supply any services electronically.

It is however pleasing to note that amendments are proposed for intermediaries and platforms to register as vendors and to account for the VAT on sales made through such platforms provided that the platform/intermediary facilitates the supply and is responsible for issuing the invoice and collection of the payment.

These amendments are proposed to come into effect on 1 October. Public comments on the draft amendments must be submitted by 22 March 2018.

Charles de Wet, Head of Indirect Tax, PwC Africa



Personal Income Tax

When looking at the changes to personal income tax in isolation (i.e. ignoring the increase in the VAT rate and the usual increases in 'sin taxes'), the news in today's budget was probably as good as could have been expected. Prior to today, the most widely predicted changes in some quarters was that there would be an increase in the maximum marginal tax rate as well as the scrapping of the medical tax credit. Fortunately, neither of those have occurred. What has happened, however, is that the full effects of inflation have not been taken into account in making adjustments to the personal income tax rates or the medical tax credit. It is predicted that this will result in additional collections of R6.8 billion.

Barry Knoetze, Associate Director, PwC Tax

Regarding personal income tax rates, no adjustments have been made to the top four income tax brackets and below inflation adjustments have been made to the bottom three income tax brackets. In addition, the medical tax credit has been increased from R303 to R310 per month for the first two beneficiaries and from R204 to R209 per month for the remaining beneficiaries. The primary, secondary and tertiary rebates have also been adjusted, with the result that the tax threshold for taxpayers under 65 years of age increases from R75, 750 to R78, 150.

The changes to the personal income tax rates will have the following effect at the various taxable income levels for taxpayers under 65:

Taxable Income	2018/2019 Tax Due	Change from 2017/2018	% Change
R100,000	R3,933	-R432	-9.9%
R200,000	R22,265	-R910	-3.9%
R500,000	R113,807	-R2,017	-1.7%
R1,000,000	R312,973	-R2,017	-0.6%
R1,500,000	R517,973	-R2,017	-0.4%
R2,000,000	R742,973	-R2,017	-0.3%

In addition to the above, there has also been an announcement that the estate duty rate will increase from 20% to 25% for estates in excess of R30 million as well as an increase in the donations tax rate to 25% for donations in excess of R30 million in one tax year. Both of these increases will be effective from 1 March 2018.

From an employer's perspective, it has been announced that there will be slight increases in the tax free subsistence allowances that can be paid to employees as well as in the tax-free reimbursement travel claim that can be paid to employees for business travel. It is also proposed that the official rate of interest applicable to soft loans to employees by employers will be amended to bring it closer to the prime rate rather than the current repo rate plus 1%.

This latter change could have a negative impact on employees in receipt of soft loans from their employer since the rate at which fringe benefits will be determined could increase. On the positive side, however, it seems that for loans provided by employers to employees solely for housing purposes, relief from fringe benefits tax in respect of loans of less than R450, 000 will also be provided.

Barry Knoetze, Associate Director, PwC Tax



Amendments to debt relief rules

Taxpayers recently noted that the new debt relief rules introduced during 2017 result in adverse income tax implications. For example, where a taxpayer raises additional share capital and applies the funding so obtained to settle debt, such settlement of debt could result in an increased tax bill if the debt settled is not with a South African tax resident group company. This is specifically the case where a South African taxpayer wishes to settle debt with an offshore holding company or treasury company. In such a case, the taxpayer would be required to obtain external/third party funding to settle the debt if it does not want to fall foul of the current debt relief rules. In addition, any amendment to the terms of certain loans may also trigger adverse tax consequences.

The Minister of Finance announced that the Government noted concerns about unintended consequences that may arise from the current debt relief rules and it is proposed that further amendments be made to address these concerns. Although it is uncertain which concerns the Minister referred to, a review of the debt relief rules would be welcomed by business as the legitimate restructure of debt may presently result in adverse income tax consequences which may impede business growth.

Alwina Brand, Tax Partner PwC

Clarity expected to bad debt allowances

An amendment to the doubtful debts allowance under section 11(j) of the Income Tax Act was made in 2015, with the intention that the allowance would be claimed according to criteria set out in a public notice issued by the Commissioner. The criteria has nevertheless not been formulated and it is now proposed that the criteria for determining the allowance should instead be included in the Income Tax Act. A specific amendment to the Income Tax Act would result in more clarity to business and will be good news.

Alwina Brand, Tax Partner PwC

Tax rules affecting short-term insurers

The much anticipated new Insurance Act (2017) permits foreign re-insurers to conduct reinsurance business in South Africa through a branch of an offshore company. A number of offshore insurance companies are considering opening up operations in South Africa under this new rule.

However, the income tax treatment of such branches appeared to be a draw back as the Income Tax Act provisions regulating the taxation of short-term insurance apply only to short-term insurers resident in South Africa and not to foreign short-term insurers operating through a branch. This would result in an uneven playing field as South African insurers are allowed certain tax allowances in respect of technical insurance reserves which would not be available to the foreign insurers.

It has nevertheless been announced that the income tax provisions applying to South African resident short-term insurance companies will be extended to apply to non-residents operating short-term insurance business through branches in South Africa. This announcement will create clarity with regard to the tax position of foreign reinsurers wishing to operate through branches in South Africa.

It is not clear though whether the announcement in this regard would also extend to controlled foreign companies (so-called CFCs) of a South African resident who operate as licensed short-term insurers in their country of tax residency. At present, the legislation with regard to the income tax treatment of licensed short-term CFCs seems to have the unintended consequence of excluding these entities from claiming allowances in respect of technical insurance reserves.

Alwina Brand, Tax Partner PwC

Boost for electronic communication providers

At present companies that provide telecommunications infrastructure are allowed to write off lines or cables used for the transmission of electronic communications over a period of 15 years under section 11D of the Income Tax Act.

These entities will certainly welcome the announcement that the Government proposes reducing the period over which electronic communication lines and fiber optic cables are written off, in a bid to align the tax system with technological advances and international practice.

A more beneficial tax allowance system would hopefully boost additional investment in fiber optic infrastructure which in turn would stimulate business growth.

Alwina Brand, Tax Partner PwC

Tax treatment of collective investment schemes

It is proposed that the tax treatment of amounts realised by portfolios of collective investment schemes as a result of the trade in underlying assets may no longer purely be taxed as gains of a capital nature. National Treasury notes that some collective investment schemes are trading frequently and arguing, contrary to current case law, that the profits are of a capital nature. Investors are currently benefiting from this tax treatment as the overall return in respect of the collective investment scheme would be enhanced due to the lower effective tax rate.

A move by National Treasury to tax regular trades in collective investment schemes as gains or a revenue nature, would therefore increase the overall tax bill of the collective investment scheme.

Alwina Brand, Tax Partner, PwC

International Tax

South Africa has specific anti-tax avoidance legislation aimed at South African owned foreign companies. This so-called controlled foreign company tax legislation in essence aim to tax the notional taxable income of a foreign company in the hands of its South African shareholders. However an exemption is provided from such taxation if the foreign entity is regarded as sufficiently taxed abroad - the threshold is currently set at 75% of the tax that would have been due had the foreign company been a South African tax resident. The rationale for this exemption is that if the foreign company is sufficiently taxed abroad, no or little anti-tax avoidance risk should exist.

In light of the global trend of lowering corporate tax rates, the Minister of Finance proposed that the current 75% “high tax” exemption threshold will be reconsidered. This proposal implicitly recognise that legitimate business may be conducted offshore whilst incurring significantly less foreign tax compared with South Africa. Although a lowering of the 75% threshold would be in line with the global trend, equally important is the manner in which the amount of taxes to be compared are calculated. South Africa’s current “high tax” exemption is not consistent with the global norm (as advocated by the Organisation for Economic Cooperation and Development (“OECD”)) and a simple threshold adjustment alone will have little practical impact in respect of foreign companies operating as part of a tax group.

A threshold adjustment (lowering) may still result in the South African shareholders of a foreign company being subject to tax on the notional taxable income of the foreign companies, even though economically the foreign company is subjected to foreign taxes at an effective rate in excess of the “high tax” threshold.

Cor Kraamwinkel, International Tax Partner, PwC



Indirect taxes



Updated regulation for foreign electronic services

The 2017 Budget Review announced that regulations prescribing foreign electronic services subject to VAT would be broadened to include cloud computing and other online services.

Updated draft regulations prescribing foreign electronic services and supporting amendments to the VAT legislation are to be published on Budget Day for public comment. It is disappointing that the regulations dealing with foreign electronic services have not kept up with international best practice.

Clarification on brown bread

Following recent uncertainty regarding the zero-rating of basic food items, government proposes an amendment to reflect the original policy intent that only brown bread and whole wheat brown bread will be zero-rated, and will not extend to rye or low GI bread.

Cryptocurrency

The VAT and Income tax treatment of cryptocurrencies will be clarified.

Insertion of the definition of “face value of a debt transferred”

A VAT-registered vendor is permitted to claim a deduction for VAT on taxable supplies that have to be written off. If the vendor cedes or sells the debt that has been written off on a non-recourse basis for an amount that is less than the amount owing, then the sale of the debt is exempt from VAT and the vendor is not required to make any adjustments to the previous VAT deduction. Certain vendors that buy book debt then attempt to claim a further VAT deduction if they write off all or part of this debt in future. This results in a double VAT deduction, which is against the intention of the legislation.

To prevent this double VAT deduction, it is proposed that the term “face value of a debt transferred” be defined in the VAT Act to take into account the policy rationale explained in the explanatory memorandum.

Postponing the abolishment of the zero-rating of the supply of goods and services for the national housing programme

In 2015, amendments were made to the VAT Act to abolish the zero-rating of the supply of goods and services for government’s national housing programme, with effect from 1 April 2017. In 2017, the legislation was amended to postpone the abolishment date for a further two years to 1 April 2019.

Due to budgetary constraints, it is now proposed to postpone the effective date for this amendment indefinitely.

Charles de Wet, Head of Indirect Tax, PwC Africa

Economic Commentary

Commitment to fiscal consolidation likely enough to appease rating agencies

Finance Minister Malusi Gigaba delivered his Budget Speech 2018 to Parliament on Wednesday, February 21st. South Africans had high expectations of the event following the tone set by President Cyril Ramaphosa's maiden State of the National Address (SONA) 2018, delivered less than a week earlier at the same venue. The SONA reflected President Ramaphosa's desire to turn around the South African economy, while Minister Gigaba's speech was expected to provide the hard numbers to realise these plans.

Key takeaways

1

Upwardly revised economic growth projections of 1.5% and 1.8% in 2018 and 2019, respectively, as investor and business confidence improves

2

Budget deficit to decline from 4.3% of GDP in 2017/18 to 3.6% of GDP in 2018/19, with commitment to narrow the fiscal deficit further over time

3

Gross public debt to peak at 56.2% of GDP during 2022/23 after the medium-term budget (October 2017) failed to plan for a stabilisation

4

Exposure to contingent liabilities increased in 2017/18, with government planning a holistic reform programme for state-owned enterprises (SOEs)

5

Departmental budget cuts of R85.7bn over the next 3 years, with allocations to all layers of government

6

Added special economic zones (SEZs) and industrialisation incentives will boost investment in job-creating manufacturing and tradable services

7

Value-added tax (VAT) rate increased by one percentage point to 15% (still below the global average). The impact for consumers is partially offset by above-average increases in social grants.

8

Government revenue getting boost from health promotion levy ("sugar tax"), tax on carbon emissions and changes to medical aid tax credits

9

Biggest reallocation in expenditure will be R57 billion over three years for fee-free higher education, with first year students benefitting from 2018

PwC's interpretation of the Budget Speech of 2018 is that it should be enough to keep Moody's Investors Service from making another cut in South Africa's sovereign rating. Various rating agencies will likely welcome the improved economic growth projections, a narrowing fiscal deficit trajectory, and plans for a turnaround in public debt, which Minister Gigaba presented today.

Improved outlook for economic growth

The National Treasury is forecasting an improved economic outlook for the country, and has revised higher its projections for economic growth. The government now sees the South African economy growing by an average of 1.65% during 2018-19 compared to an estimate of only 1.3% reported some five months ago in the Medium-Term Budget Policy Statement (MTBPS). Similarly, the South African Reserve Bank (SARB) revised upward its economic growth projections to 1.5% for 2018-19 in its January monetary policy statement. These upward adjustments are premised partly on a perceived improvement in business and investor confidence over the past few months.

Minister Gigaba is hoping that this growth performance will contribute towards the state's plans for radical socio-economic transformation. Other measures include a planned R2.1 billion fund shared between several ministries and aimed at boosting small- and medium-sized enterprises (SMEs) during their start-up phase. This will add to some R1.4 billion in private sector commitments toward a business-led fund that will aim to support high-potential SMEs.

In order to boost economic growth over the medium- to long-term, the finance minister has approved six special economic zones (SEZs) in order to encourage investment in manufacturing and tradable services; sectors that encourage exports, job creation and economic growth, Industrialisation incentives worth R18.8 billion over the medium term will also help in realising President Ramaphosa's desire to see the manufacturing sector lead the job creation agenda that he envisions over the next five years.

A narrowing deficit path returns

While drafting the medium-term plans that were released in October last year, the National Treasury was experiencing a challenging period both from an economic as well as political perspective. The outlook for both was uncertain towards the end of last year and the beginning of 2018, thereby constricting the ability of fiscal planners to plot a trajectory for the budget deficit. The results of the MTBPS were disappointing: the deficit was planned to plateau instead of shrink. National Treasury appeared to be in a holding pattern until there was more certainty about the country's political outlook.

Moving to the present, the Budget Speech of 2018 was delivered in a much more constructive political environment and an improved outlook for the economy. As a result, Minister Gigaba and his team were able to reintroduce into their plans a long-held commitment to narrow the fiscal deficit over the next three years. From a large shortfall of R204.3 billion in the 2017/18 financial year, the deficit is planned to narrow to R180.5 billion in the coming 2018/19 year.

This year's budget deficit is expected to reach an equivalent of 4.3% of GDP – in line with the MTBPS statement. This will be followed by a notable decline to 3.6% of GDP in the 2018/19 and 2019/20 fiscal years. Both expenditure and revenue is expected to rise in these periods, in nominal terms and as percentage of GDP.



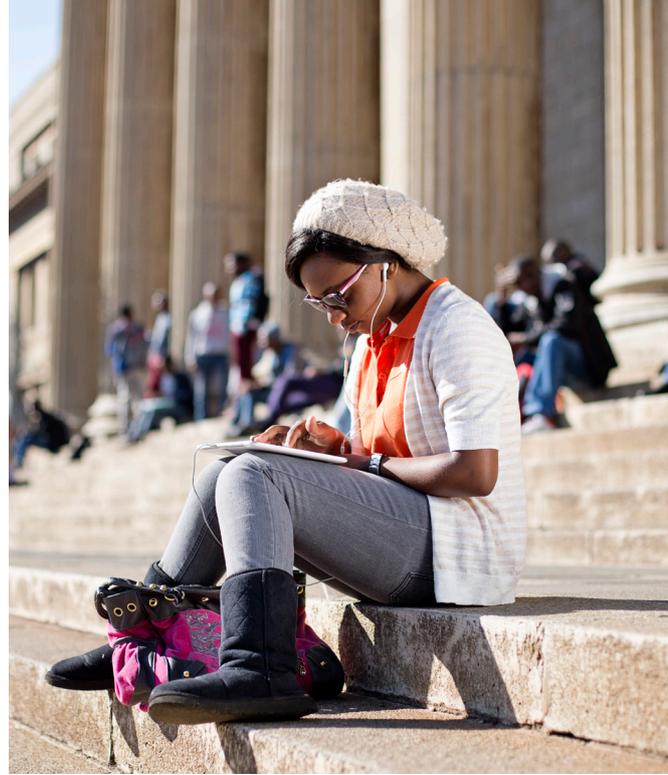
VAT and other tax increases to bolster revenues

In order to fund these deficit-narrowing aspirations, the National Treasury has to make plans both on the income and expenditure sides of its responsibilities. Regarding revenues, it was widely expected that some tax rate increases would be announced in Budget Speech 2018. Indeed, the value-added tax (VAT) rate was increased by one percentage point to 15%, with zero-ratings continuing on essential food items. The regressive nature of this tax type has led National Treasury to postpone increases in VAT until now, after keeping the VAT rate stable for the last 25 years. Poorer households are more exposed to changes in the prices of consumption goods, like food. Low-income households will be compensated to a degree through above-average increases in social grants.

The government considered alternatives to a VAT increase, for example higher personal income and capital gains taxes, but assessed that these “would have greater negative consequences for growth and investment”. The VAT rate has not been changed since 1993 despite significant changes elsewhere in the tax basket. A higher corporate tax rate would also be counter to global trends of easing corporate tax rates. South Africa’s VAT rate will however still be below the global average of 15.7%, and will be at a similar level to the average of African countries at 14.8%.

Elsewhere, the National Treasury is increasing the ad valorem excise duty rate on luxury goods from 7% to 9%, while a higher estate duty tax rate of 25% will be levied on estates greater than R30 million. These two components will have an impact on middle to high income earning households. Two additional revenue-raising measures will impact a wider spectrum of South Africans: a 52c/liter increase in fuel levies and a 6%-10% increase in alcohol and tobacco excise duties. The normal inflation-related adjustments are also being made to personal income tax brackets, though with some drag at the bottom end to widen the coverage.

Minister Gigaba believes that these and other measures will result in government revenue rising by 10% in 2018/19 to R1.491 trillion. Some R36 billion will come from the above-mentioned tax increases, with R22.9 billion expected from the higher VAT rate. The health promotion levy – more commonly known as the sugar tax for being levied on sugar-sweetened beverages (SSBs) – will be implemented from April this year. The levy will amount to 2.1 cents per gram of sugar in every 100ml, with the first 4 grams per 100ml being exempt from the tax. PwC estimations suggest the tax burden is approximately 10% given current levels of sugar content in popular SSBs. A tax on carbon emissions will also be effective from January 2019 while below-inflation increases in medical aid tax credits are also being implemented.



Large reallocation of expenditure to higher education

Government expenditure will increase by 7.3% in 2018/19 to R1.67 trillion. Apart from normal adjustments made to spending lines, the biggest reallocation in expenditure will be an additional R57 billion channelled to fee-free higher education over the medium term. From 2018, all first-year students at universities and Technical and Vocational Education Training (TVET) colleges from a household earning less than R350 000 per annum will be funded for the full cost of study. This will be rolled out in subsequent years until all academic years are covered.

Post-school funding will be the fastest growing expenditure item over the medium term alongside the cost of servicing the state’s debt obligations. Debt servicing costs will total R180 billion in 2018/19 and is expected to grow by an average of 9.4% per annum over the next three years. Healthcare spending will increase by an average of 7.8% per annum in coming years as the government allocates more money to the National Health Insurance (NHI). Some of this money will come from the amendment to medical aid tax credits. While Budget Review 2018 provided the usual information on healthcare spending, it gave very little in terms of new details about the NHI. Nuclear energy is absent from spending plans.

State-owned enterprises (SOEs) still a heavy burden

The SONA made an unequivocal commitment that government will intervene in turning around the deteriorating governance and finances of SOEs. Minister Gigaba underscored the progress to date, including key leadership appointments at South African Airways (SAA) and Eskom. He added that SOEs are expected to fund their own operations, but admitted that government recognises that the current business models of some SOEs are unsustainable. He indicated that a holistic reform programme will work to develop and implement robust turnaround plans for these troubled entities, but did not really provide any details. Reforms could include the participation of private entities in some build projects, e.g. port terminals.

The burden of SOEs on the fiscus is a key challenge for the government due to the large volume of contingent liabilities - commitments by the state to cover the costs of financing of SOEs if these entities are unable to repay debt. On a positive note, government guarantees declined from R476 billion in 2016/17 to R466 billion in 2017/18. However, guarantees to troubled SOEs like Eskom and SAA did not decline, while total exposure to guarantees, that is, borrowing by SOEs against the guarantees, increased by 3.4% in 2017/18 to R300 billion. Some SOEs struggled over the past year to sell bonds due to hesitance amongst investors, thereby forcing them to resort to guaranteed loans.

What will the rating agencies say?

The MTBPS provided no answers to concerns over rising public debt levels apart from indicating that a ministerial committee would be established to develop proposals on how to stabilise national debt over the medium term. Thankfully, the Budget Review of 2018 showed progress in this area, with National Treasury planning for gross public debt as percentage of GDP to peak at 56.2% during the 2022/2023 financial year. This debt ratio will also rise more slowly over the next few years compared to recent history. The turnaround in public debt is facilitated by departmental budget cuts of R85.7bn over the next 3 years, with allocations to all layers of government.

Minister Gigaba admitted that the income and expenditure measures needed to narrow the fiscal deficit and limit growth in public debt “will cause economic discomfort, but they are necessary to protect the integrity of the public finances”. Indeed, the decisions announced on February 21st are important steps towards improving the country’s fiscal dynamics and, in turn, the sovereign’s creditworthiness. Rating agencies will have to decide if the minister’s view that “we have made the tough calls and decisions” holds true.

These agencies are expected to welcome improved economic growth projections, a narrowing fiscal deficit trajectory, and plans for a turnaround in public debt. They would certainly have wanted more detail on the planned reform programme aimed at turning around SOEs. Nevertheless, their view of the required political will to make the necessary changes should also have improved over the past two months, and over the past week in particular.

Overall, PwC believes that this year’s Budget Speech should be enough to keep Moody’s Investors Service from making another cut in its rating of the South African sovereign, with an evaluation due over the next few weeks. This is very good news: another downgrade would result in South Africa being excluded from the Citi World Global Aggregate Bond Index (WGBI). Exiting the WGBI could result in more than R100 billion in foreign money exiting the domestic capital market.

The success of this budget will be very dependent on the positive political momentum currently being built by President Ramaphosa. His first two months as leader of the African National Congress (ANC) and first week as national president has engendered a hope that business, investor and consumer confidence will rise significantly during 2018 as he sets about making necessary changes to reignite the South African economy. His success will be critical in turning around the economic, fiscal and political decline seen in South Africa over the past several years.

*Christie Viljoen, Economist at PwC
Lullu Krugel, Chief Economist and Partner at PwC
Maura Feddersen, Economist at PwC*





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