



SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE NO. 9 (issue 2)

DATE: 29 March 2004

ACT : INCOME TAX ACT, 1962 ("the Act")
SECTION : SECTION 12E
SUBJECT : SMALL BUSINESS CORPORATIONS

1. Background

It is internationally recognised that small and medium enterprises have an important role in economic development and employment creation. In view of this sector's capacity to create employment, a special dispensation was introduced for such enterprises with effect from years of assessment commencing on or after 1 April 2000. Section 12E was enacted in order to regulate the relief granted to Small Business Corporations (SBC's) in terms of this special dispensation.

The benefits that emanate from qualifying as an SBC are:

- An SBC which carries on a process of manufacture (or any other process which in the opinion of the Commissioner is of a similar nature), may write off expenditure incurred on or after 1 April 2001 in respect of the acquisition of plant and machinery (also referred to as investment expenditure) in full in the year in which the assets are brought into use for the first time by the taxpayer for the purposes of manufacture. The allowance is not reduced if the asset is used for less than 12 months during the tax year.
- The rate of tax for an SBC on its taxable income below a specified amount is considerably lower than the normal rate of tax for companies in general. Whereas a company pays tax at the rate of 30% on its taxable income, an SBC's tax is levied at a rate of 15% on the first R100 000 of taxable income for tax years commencing on or after 1 April 2000. For years of assessment ending on/after 1 April 2002 the taxable income limit of R100 000 is increased to R150 000. Tax is levied at the normal company rate of 30% on the portion of the taxable income exceeding the aforementioned amounts of R100 000 or R150 000, as the case may be.

This note serves to provide guidance as to the application of the provisions of section 12E with reference to the requirements of a qualifying SBC. Any reference to a 'company' or 'shareholder' in this note includes a 'close corporation' and a 'member of a close corporation' respectively.

2. The law and application

Section 12E lays down all the requirements of a qualifying SBC. Non-compliance with any one of the requirements will result in such company not qualifying as a SBC and tax being levied at the normal company rate.

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

- Ownership requirement
- Gross Income requirement
- Business activity requirement

2.1 Ownership requirement

Natural persons must at all times during the year of assessment hold the entire share capital of the company. The(se) shares must be held for their own benefit and not as a nominee. Shareholders or members may not at any time during the year of assessment hold any shares or have any interest in the equity of any other company. Any shares or any interest in such other company, albeit for one day during the year of assessment will disqualify such taxpayer notwithstanding the fact that all the other requirements have been met. The reference to 'any other company' includes a close corporation, a dormant company and a co-operative.

Shares or interests held in the following entities are, however, excluded from this limitation -

- (a) a company contemplated in paragraph (a) of the definition of 'listed company', i.e. a company of which the shares or depository receipts in respect of its shares are listed on a stock exchange as defined in section 1 of the Stock Exchanges Control Act, No. 1 of 1985, i.e. JSE Securities Exchange SA [section 12E(4)(a)(ii)(aa)];
- (b) any portfolio in a collective investment scheme contemplated in paragraph (e) of the definition of 'company', i.e. any portfolio comprised in any collective investment scheme in securities as contemplated in Part IV of the Collective Investment Schemes Control Act, No. 45 of 2002 or any arrangement or scheme carried on outside the Republic where investors hold a participatory interest through shares, units or any other form of participatory interest [section 12E(4)(a)(ii)(bb)], or
- (c) a company contemplated in section 10(1)(e)(i), (ii) or (iii) [section 12E(4)(a)(ii)(cc)], that is -
 - (i) a body corporate established in terms of the Sectional Titles Act, No. 95 of 1986;

- (ii) a share block company established in terms of the Share Block Control Act, No. 59 of 1980; or
- (iii) any other association of persons (excluding any co-operative formed/incorporated under the Co-operatives Act, No. 91 of 1981, any close corporation or any trust, but including a company incorporated under section 21 of the Companies Act, No. 61 of 1973 ([i.e. associations not for gain])).

2.2 Gross income requirement

The gross income of the SBC may not exceed R1 million for the years of assessment commencing on or after 1 April 2000. The limitation of R1 million was increased to R3 million for years of assessment ending on or after 1 April 2002 and to R5 million for years of assessment ending on or after 1 April 2003. [Section 12E (4)(a)(i)]

The limitation on the gross income refers to the gross income received or accrued for a full period of 12 months, i.e. a full year of assessment. Where the SBC commenced trading during the year, the R1 million, R3 million or R5 million, whichever is applicable for the specific year of assessment, should be reduced proportionately in order to determine whether the gross income received or accrued for the relevant period in question would have exceeded the limit of R1 million, R3 million or R5 million, had the taxpayer been trading for the full year of assessment.

Example:

An SBC with a financial year-end of 30 June commences trading activities on 1 December 2002. The gross income for the seven-month period 1 December 2002 to 30 June 2003 amounts to R1, 9 million.

As the SBC's financial year-end is on or after 1 April 2002, the limitation of R3 million is applicable in this instance. This gross income must be reduced proportionately in order to determine what the company's gross income limit for the seven-month period should be.

R3 million x months actually traded/twelve months.

R3 million x 7mths/12mths = R1 750 000.

The gross income of the SBC may therefore not exceed an amount of R1 750 000 for the seven months in which it traded. The gross income for the period, however, amounts to R1, 9 million and notwithstanding the fact that the SBC complies with all the other requirements of an SBC, the non-compliance with the gross income requirement disqualifies such SBC for the relevant year of assessment.

In calculating the gross income of a taxpayer, all income received or accrued, excluding capital gains, should be included. Capital gains made by a taxpayer are included in taxable income in terms of the provisions of section 26A of the Act, and such gains are therefore excluded in determining

the gross income. Since gross income includes exempt income (such as SA dividends), exempt income should be included in calculating the R1 million, R3 million and R5 million limitation.

2.3 The business activity requirement

An 'employment company' as defined in section 12E and a 'personal service company' as defined in the Fourth Schedule to the Act will not be regarded as an SBC.

Not more than 20% of the taxpayer's gross income, excluding any capital gain, may consist of 'investment income' (as defined) and/or income from the rendering of a 'personal service' (as defined). The aggregate income from investment and personal services, should therefore not exceed 20% of the gross income. Where a taxpayer, for example, has no investment income, the personal service income may not exceed 20% of the gross income. Where the investment income, for example, constitutes 6% of the gross income, the personal service income may not exceed 14% of the gross income.

It should be noted that with effect from years of assessment commencing on or after 22 December 2003, the 20% limitation is calculated on the total of all receipts and accruals (excluding receipts/accruals of a capital nature), but including any capital gains of the company or close corporation. [Section 12E(4)(a)(iii)]

Example

Determine what percentage of the SBC's total receipts/accruals constitutes investment income and/or income from the rendering of a personal service so as to ensure that the 20% limitation is not exceeded for its year of assessment 1 January 2004 to 31 December 2004.

	R
SBC Trade Income*	800 000
Royalties received	23 000
Benefit received under a will (capital receipt)	150 000
Capital Gain on sale of an SBC asset	<u>40 000</u>
Total Receipts/Accruals	<u>1013 000</u>

* Included in the R800 000 above, is a receipt of R195 000, which is attributable solely to 'personal service' performed by a shareholder.

The total receipts/accruals for the purposes of calculating the 20% limitation are R863 000 (R1013 000 - R150 000). The capital receipt is excluded.

The investment income and income from the rendering of personal service expressed as a percentage of the total receipts and accruals (including capital gains) is R218 000 (23000 + 195 000)/R863 000 x 100 = 25.260%.

Investment income and income from the rendering of a personal service exceed the 20% limitation for the relevant year of assessment and the

company will not be regarded as an SBC notwithstanding the fact that the other requirements may have been met.

It is important to note the difference in the calculation of the gross income and business activity requirements (par 2.2 and 2.3 above). These two calculations differ as follows: -

Gross Income requirement: All receipts/accruals (including exempt income) excluding capital gain.

Business activity requirement: All receipts/accruals (excluding capital receipts), including capital gain.

(a) Investment income

Investment income includes income from dividends, royalties, rentals, annuities, interest as contemplated in section 24J, any amount contemplated in section 24K as well as any other income subject to the same treatment as income from money invested.

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

(b) Personal service

'Personal service' is broadly defined, but the definition is however not exhaustive.

'Personal service' means any service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, broking, commercial arts, consulting, draftsmanship, education, engineering, entertainment, health, information technology, journalism, law, management, performing arts, real estate, research, secretarial services, sport, surveying, translation, valuation or veterinary science, which is performed personally by any person who holds an interest in the company or close corporation.

The gross income attributable to the performance of any 'personal service' by any person who holds an interest in the SBC, is limited, in view of the fact 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 SBC's 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. Where a service is rendered by any person who holds an interest in the SBC, the gross income attributable to such service, combined with any investment income may not exceed 20% of the SBC's gross income.

The Act does not prescribe a method of record keeping but where any person who has an interest in the SBC is of the opinion that that portion of the SBC's gross income which is attributable to the personal service rendered by such person does not exceed the 20% limitation, such person is required to substantiate this fact, either by means of a charge out system per hour/per job or any other method used by the taxpayer.

3. SBC Deductions

3.1 Plant and machinery

An SBC that carries on a process of manufacture or a process which in the opinion of the Commissioner is of a similar nature, may write off the full cost of its investment in assets during the year of assessment in which such assets are brought into use for the first time. The allowance is not apportioned, but in order to qualify, the asset must be brought into use for the first time by the SBC on or after 1 April 2001 and such asset must be used directly in a process of manufacture or a process regarded by the Commissioner as being of a similar nature. The asset does not need to be a new asset. Any asset qualifying for an allowance in terms of section 12E, will not qualify for any other allowances available in terms of the Act.

In view of the fact that the full cost of an asset is deducted when brought into use for the first time, such asset will not qualify for a scrapping allowance in terms of section 11(o) of the Act.

Any amount recovered or recouped in respect of a asset which is disposed of, is however subject to the recoupment provisions in terms of section 8(4)(a) of the Act.

In the case of a damaged or destroyed asset, any amount recovered or recouped can be deferred in terms of the provisions of section 8(4)(e) and such amount can be set off against the cost of an asset acquired as a replacement for the damaged or destroyed asset. The section 12E deduction is therefore, in such instance, determined on the adjusted cost i.e. the actual cost less the amount recovered or recouped which was not included in income in terms of section 8(4)(e) for the current or any previous year of assessment.

Example:

A small business corporation with a 28/29 February financial year-end, acquires a machine costing R320 000 on 1 August 2001 and immediately brings the machine into use for manufacturing purposes. The machine is however damaged in a fire on 31 May 2002 and an amount of R200 000 is paid out in terms of a contract of insurance.

Notes: The taxpayer has indicated that -

- a replacement machine will be acquired within a period of one year subsequent to the event in which the original machine was damaged; and
- the replacement machine will be brought into use within a period of three years from the date on which the original machine was damaged.

Calculate the following:

- 1) The 12E allowance for 28 February 2002.
- 2) The amount recovered or recouped for 28 February 2003.
- 3) The allowance for 29 February 2004 assuming that a replacement machine was acquired for R450 000 on 31 May 2003 and immediately brought into use.

28 February 2002

12E allowance (100% of the cost) R320 000

28 February 2003

Insurance proceeds of R200 000 are under ordinary circumstances subject to section 8(4)(a) recoupment provisions. The recoupment is however deferred as the taxpayer complies with the requirements of section 8(4)(e).

Amount recouped for year ended 28 February 2003 is therefore R Nil

29 February 2004

	R
Cost of replacement machine	450 000
Less: Deferred recoupment 8(4)(e)	<u>200 000</u>
"Cost" of new machine for 12E purposes	<u>250 000</u>
12E allowance 100% of cost	R250 000

The recoupment will however not be deferred until such time as a new machine is acquired should any circumstances arise indicating that the taxpayer did not comply with the provisions relating to the application of such deferral in terms of section 8(4)(e). The recoupment will be included in the income of the taxpayer for the year of assessment during which such circumstances arise.

The "cost" of the asset to the taxpayer, for the purposes of section 12E(2) is deemed to be the lesser of -

- the actual cost to the taxpayer;
- the direct acquisition cost that a person would have incurred if the asset had been acquired under an arm's length cash transaction on the date on which the transaction was in fact concluded; or
- the actual cost less the deferred recoupment in terms of section 8(4)(e).

The above cost excludes interest and finance charges, but includes the direct cost of installation or erection of the asset. The allowance will not be available where the taxpayer acquired an asset for no consideration, for example by means of a donation or as a dividend *in specie*.

In terms of section 12E(3) expenditure (other than expenditure that qualifies as a deduction under section 11(a) of the Act) incurred by an SBC during a year of assessment in moving an asset from one location to another will be allowed as a deduction in that year of assessment. This deduction is subject to the requirement that a deduction for the specific asset was, or is, allowable.

3.2 Additional deduction in first year of trading

In terms of section 12E(3A), a qualifying SBC that commences trading and has a year of assessment ending on/after 1 January 2004 will be allowed an increased deduction in respect of any expenditure and losses actually incurred during its first year of trading. The additional deduction is limited to R20 000. Where, for example, the SBC's total receipts/accruals are R680 000 and expenditure incurred amounts to R340 000, a deduction of R360 000 will be allowed against the receipt of R680 000. Should an SBC, however, have incurred expenditure of only R14 000 in its first year of trading, the additional deduction will be limited to R14 000 and a total deduction of R28 000 will be allowed. The expenditure and losses referred to in this section, relate to expenditure and losses which are deductible in terms of the ordinary provisions of the Act.

4. Tax periods and rates

The commencement date in respect of the provisions of SBC's is 1 April 2000 and the lower rate of tax will only be applicable with effect from the year of assessment that commences on or after 1 April 2000. A company with a year of assessment commencing prior to 1 April 2000 will not qualify for that tax year, but would get the benefit of the lower rate as from the 2002 year of assessment, provided all the requirements have been met.

The examples in the following table indicate which rates are applicable where a company has any one of the reflected financial year-ends. The examples are based on the assumption that all the companies do meet the relevant requirements relating to ownership and business activities as well as the gross income limitation.

Company Year End	Does year of assessment commence on or after 1/4/2000?	15% on R100 000 (2001)	15% on R100 000 (2002)	15% on R150 000 Applicable for years of assessment <u>ending</u> on/after 1/4/2002 (2002/2003/2004)
1 28/29 /02	No, commences 1/3/2000	1/3/2000 - 28/2/2001 No, normal company rates apply	1/3/2001 - 28/2/2002 Reduced rates apply	1/3/2002 - 28/2/2003 1/3/2003 - 28/2/2004 Reduced rates apply
2 31/03	Yes, commences 1/4/2000	1/4/2000 - 31/3/2001 Reduced rates apply	1/4/2001 - 31/3/2002 Reduced rates apply	1/4/2002 - 31/3/2003 1/4/2003 - 31/3/2004 Reduced rates apply
3 30/06	Yes, commences 1/7/2000	1/7/2000 - 30/6/2001 Reduced rates apply	1/7/2001 - 30/6/2002 No, year ends on or after 1/4/2002 and new limits apply	1/7/2001 - 30/6/2002 1/7/2002 - 30/6/2003 1/7/2003 - 30/6/2004 Reduced rates apply
4 31/12	Yes, commences 1/1/2001	1/1/2001 - 31/12/2001 Reduced rates apply	1/1/2002 - 31/12/2002 No, year ends on or after 1/4/2002 and new limits apply	1/1/2002 - 31/12/2002 1/1/2003 - 31/12/2003 1/1/2004 - 31/12/2004 Reduced rates apply

The gross income limitation of R3 million came into operation on 1 April 2002 and applies for any year of assessment ending on or after 1 April 2002. For years of assessment ending on or after 1 April 2003, the gross income limitation is increased to R5 million. The increase of taxable income to R150 000 (refer to paragraph 1 above) applies in respect of years of assessment ending on/after 1 April 2002.

An SBC which has complied with all the requirements of an SBC in one year does not necessarily indicate compliance in respect of any subsequent year of assessment. The facts of each case will therefore have to be considered for every year of assessment in order to determine whether the SBC complies with all the requirements for the specific year under review.

5. Objection and appeal

Any decision made by the Commissioner under the provisions of section 12E, is subject to objection and appeal.

Law Administration
SOUTH AFRICAN REVENUE SERVICE

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