

A COMPARATIVE STUDY OF INCOME TAX LEGISLATION FOR SMALL AND MEDIUM ENTERPRISES IN SOUTH AFRICA AND THE UNITED KINGDOM FROM A NAMIBIAN PERSPECTIVE

by

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ABSTRACT

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Since Namibia's independence in 1990, various changes were introduced to the Namibian Income Tax Act. None of these changes were specifically targeting small and medium enterprises although the majority of entities in Namibia can be classified as small and medium enterprises. Recognising the contribution made by small and medium enterprises, Government recently indicated that tax reform for small and medium enterprises should be treated as a priority.

Differentiated tax treatment is applied in the United Kingdom and South Africa and aims to reduce the tax burden. Although previous studies have been carried out on differentiated tax treatment for small and medium enterprises, none of these studies were done from a Namibian perspective.

The aim of this study is to analyse literature on taxation for small and medium enterprises in the United Kingdom and South Africa to recognize the advantages and disadvantages of tax policies aimed at the small and medium enterprises sector. The study also compared tax policies for small and medium enterprises in the United Kingdom and South Africa to recommend possible implementation for the Namibian tax system. Namibia should learn from these countries and apply the best practices.

The study reached the conclusion that tax reform in Namibia for the small and medium enterprises sector is desperately needed and recommends that tax policies aiming at reducing the tax compliance burden should receive preference over those reducing the tax rate burden. This research may serve as the starting point for revised tax policies and legislation specifically aiming at small and medium enterprises.

Key words:

Small and medium enterprises

Tax burden

United Kingdom

South Africa

Namibia

Tax reform

ABSTRAK

‘N VERGELYKENDE STUDIE TUSSEN SUID AFRIKA EN DIE VERENIGDE KONINGKRYK AANGAANDE DIE BELASTING GEHEF OP KLEIN EN MEDIUM SAKE ONDERNEMINGS UIT ‘N NAMIBIESE PERSPEKTIEF

deur

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Verskeie wysigings is aangebring in die Namibiese Inkomstebelastingwet sedert Namibië se onafhanklikheidswording in 1990. Geen van hierdie wysigings is spesifiek gemik op die belastingverligting van klein en medium sake ondernemings nie alhoewel die meerderheid ondernemings in Namibië geklassifiseer kan word as klein en medium sake ondernemings. As gevolg van die ekonomiese bydrae wat deur klein en medium sake ondernemings gelewer word, het die Regering aangedui dat belastinghervorming vir klein en medium sake ondernemings 'n prioriteit is.

Suid Afrika en die Verenigde Koninkryk het reeds 'n geruime tyd gelede differensiële belastingstelsels geïmplementeer om die belastinglas te verminder. Namibië is in die posisie om die beste praktyke van die twee lande met betrekking tot klein en medium sake ondernemings te identifiseer en te implementeer.

Alhoewel die belastingstelsels wat betrekking het op klein en medium sake ondernemings reeds bestudeer is, het geen studie die Namibiese belastingstelsel ontleed nie. Hierdie studie het die voor- en nadele van die gedifferensieerde belastingstelsels in Suid-Afrika en Verenigde Koninkryk ondersoek. 'n Vergelyking is getref tussen die belastingstelsels van die twee lande en Namibië ten einde moontlike wysigings aan die belastingstelsel op klein en medium sake ondernemings aan te beveel.

Die studie het bevind dat Namibië inderdaad die belasting op klein en medium sake ondernemings as 'n prioriteit moet beskou. Die studie beveel aan dat belastingwysigings eerder moet fokus op die koste om te voldoen aan wetgewing en nie sodanig op 'n laer belastingskoers nie. Aanbevelings vir moontlike implementering wat as 'n basis vir

wysigings in die belastingwetsontwerp vir klein en medium sake ondernemings, is gemaak.

Sleutelwoorde:

Klein en medium sake ondernemings

Belastinglas

Verenigde Koninkryk

Suid-Afrika

Namibië

Belastinghervorming

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

“Is it really so hard to tax the hard-to tax?” (Bird & Wallace, 2003:1). Taxation of small entities is not an easy and costless process. Freedman (2008:26) remarked that “small businesses give rise to big tax issues”. Small businesses have the opportunity to make substantial contributions towards tax revenue and are recognised for the vital role they have in the economy of a country. Countries around the globe have introduced tax policies for small and medium enterprises (SMES). For the purpose of this study the term SMES includes SMME (small, medium and micro enterprises) and SBC (small business corporation). It is, however, evident that the situation in Namibia is very different, as no work had been done on tax legislation for SMES.

Prior to the independence of Namibia in 1990, the South African government dictated the regulation and legislation of income tax in Namibia in line with that of South Africa (SA). After 1990, South Africa implemented a number of changes in South African income tax focussing on SMES. For all practical purposes, Namibian income tax did not keep up with tax changes in the SME sector. Although sections of the Income Tax Act of Namibia have been amended from time to time, none of these affected SMES.

Although a study was carried out by Smulders (2006) into taxation compliance for small business, this focussed on South Africa, The present research fulfils the need for a study from a Namibian perspective.

1.2 PURPOSE STATEMENT

This study is of particular importance and significance to Namibia since Government has, as part of its National Development objectives, identified the SMES sub-sector as one of the key pillars of growth and is in the process of strengthening strategies to actively promote the growth of SMES.

Although great strides have been made in areas such as the access to finance through a special fund created by the Development Bank of Namibia and in building institutional facilities to strengthen entrepreneurship, there was no indication that government was considering tax reform as part of the range of options to assist SMES. Government recently in 2013 started with tax reform and hopefully consider the taxation on SMES during the process.

Taking account of the vital role that SMES play in the achievement of a country's economic objectives of growth and poverty reduction, this study may provide policy analysts with alternative options that can be considered as part of a comprehensive strategy aimed at strengthening the contribution of SMES to Gross Domestic Product (GDP), through the creation of a more favourable environment for SMES to flourish.

This study is intended to provide insight into best practices in the area of tax reform, specifically relating to the improvement of the competitiveness of the SMES sub-sector nationally and internationally. This research thus supports Namibian development objectives and might influence and shape the debate surrounding future changes to Namibia's tax policy by providing alternative strategies in support of SMES. This approach supports Government's commitment to a progressive, economically efficient and non-discriminatory tax system that promotes industrialization as articulated in Namibia's 4th National Development Plan (Namibian 4th National Development Plan, 2013). The research will benefit the SMES sub-sector by increasing competitiveness through the introduction of tax benefits aimed at reducing cost to market. Finally, the research will describe the use and significant effects of different approaches adopted by countries, thus contributing to the Namibian tax policy research literature.

Although previous studies have been done on tax policies for the SME sector, none of these studies were done with the Namibian legislation in mind.

The purposes of this study are therefore to analyse the literature on tax legislation applicable to SMES in the United Kingdom (UK) and South Africa (SA) and to advise on possible tax reform for the SMES sub-sector in Namibia.

1.3 RESEARCH QUESTIONS

The research questions guiding this study are:

- What are the differences and similarities between the tax legislation of the UK and SA and what is the impact thereof on creating a conducive environment for SMES?
- What lessons can be learned from the income tax practice in the UK and SA for implementation in Namibia?

1.4 RESEARCH OBJECTIVES

The objectives of this study are therefore:

- To critically analyse the existing literature on income tax legislation governing SMES in the UK and SA and to identify the advantages and disadvantages of the legislation.
- To compare the income tax legislation for SMES in South Africa and the UK with Namibia and to identify implementation possibilities for Namibia.

1.5 DELIMITATIONS

The delimitations of this study are discussed below.

Small businesses such as farming operations, trusts, personal service companies and mining companies are governed by specific legislation and are therefore excluded from this study.

SMES in SA can be liable for 11 taxes. These taxes include income tax, capital gains tax; value added tax, skill levy development, donations tax, secondary tax on companies, provisional tax, transfer duty, stamp duty, customs and excise duties and employees' tax.

This study will however only focus on income tax and value added tax (Sieberhagen, 2008:14).

This study will only make reference to tax policies governing SMES in the UK, SA and Namibia.

The constraints relating to tax are the tax rate, tax burden and law and order (Bali, Cheema & Haque, 2005:36). The latter constraint will not form part of this study.

1.6 ASSUMPTIONS

While the terms enterprise, business and entity are used in this study, all refer to the same type of business, namely a smaller or medium sized business.

Although the definition for an SME is not used consistently, all information relating to SMME, SBC and SMES are included in this study.

1.7 DEFINITION OF KEY TERMS

The following key terms are used in this study and explained below.

Capital Allowances:

Capital allowances are allowances deductible from profit and result in a reduced tax liability.

Constraints

Limitations placed on small and medium enterprises. The constraints can be market or legislation related and includes such factors as access to finance, access to the international market, lack of skills and technology and a heavy regulatory burden.

Informal Sector

Businesses can be divided into an informal sector and formal sector. The informal sector consists of businesses that are not registered as taxpayers, while formal sector businesses are registered taxpayers.

Tax Compliance Burden

The tax compliance burden includes costs incurred in order to comply with tax regulations and include the following:

- The time needed by the entities' staff to understand tax legislation and comply with the tax regulations.
- Time spent in negotiations with the staff of authorities.
- Fees incurred for professional services such as accountants.

Tax Rate Burden

The tax rate burden refers to the tax rate being charged by the authorities on SMES.

Venture Capital

Small businesses may experience funding constraints. Venture capital refers to a well-managed pool of capital that is invested in equity securities of smaller ventures during its development stages (Lerner and Tag, 2013: 1).

1.8 ABBREVIATIONS

The following abbreviations are used in the study:

Table 1: Abbreviations used in this document

Abbreviation	Meaning
ARDR	American Research & Development Corporation
AIA	Annual Investment Allowance
BoN	Bank of Namibia
B-BBEE	Broad based black economic empowerment
CC	Close Corporation
CVS	Corporate Venture Scheme
EC	European Commission
FYA	First Year Allowance
GDP	Gross Domestic Product
HMRC	Her Majesty's Revenue and Customs
MTI	Ministry of Trade & Industry
NDP3	Namibia National 3 rd Development Plan
NDP4	Namibia National 4 th Development Plan

N\$	Namibian Dollar
OTS	Office of Tax Simplification
£	Pound (UK)
R&D	Research and Development
SA	South Africa
SARS	South Africa Revenue Services
SBC	Small Business Corporation
SME	Small and Medium Enterprise
SMES	Small and Medium Enterprises
SMME	Small, Medium & Micro Enterprises
UK	United Kingdom
VAT	Value Added Tax
VCC	Venture Capital Company
ZAR	South African Rand

1.9 RESEARCH DESIGN

The design used in this study is a pure literature review. A systematic review approach, explained below, ensures that only high-quality literature sources are selected and analysed. This also ensures that bias is reduced when selecting and including literature items, so that the selection of data is more objective.

A detailed literature search was undertaken, guided by research objectives. Criteria were developed to determine if literature data items can be used in the final synthesis. By searching multiple databases, an attempt was made to obtain all literature published on the chosen topic. The reliability and validity of each document was reviewed in a consistent and systematic manner.

This design is regarded to be the best to obtain data on tax policies for SMES in the UK, SA and Namibia. Information from previous studies and legislation provides a different perspective on SME legislation.

1.10 SUMMARY OF THE CHAPTERS

This study is organized into six chapters and can be summarized as follows:

Chapter 1: Introduction

The first chapter explains the background and aims to give the reader an insight into the importance of the research. The research objectives which form the backbone of the research, are also formulated in this chapter.

Chapter 2: Overview of the Namibian SME sector and current Namibian legislation

Chapter 2 addresses the tax policies in place in Namibia and the SME environment.

Chapter 3: SME sector in South Africa

This chapter discusses the tax policies targeting the SME sector in South Africa.

Chapter 4: SME sector in UK

This chapter reviews work done on tax reform for SMES in the UK.

Chapter 5: International comparison

A comparison is made between the income tax legislation applicable to the SME sector in SA and the UK. A table is compiled to summarise and highlight the comparison.

Chapter 6: Conclusion

Chapter 6 recommends possible ways to develop a tax framework for the SME sector in Namibia.

CHAPTER 2

OVERVIEW OF THE NAMIBIAN SME SECTOR AND CURRENT NAMIBIAN LEGISLATION

2.1 INTRODUCTION

This chapter provides information on the importance and main challenges faced by SMEs in Namibia and the Government's efforts in creating an enabling environment to support the sector's further development. It will conclude with a brief overview of the current legislation for the SME sector.

2.2 IMPORTANCE OF SME SECTOR IN NAMIBIA

Namibia has a population just exceeding two million, of which approximately 860 000 are economically active (employed and unemployed). Among the economically active population 630 000 (73%) are employed and of these approximately 100 000 work for the public service (NLFS 2012). The Agricultural sector employs around 53 000 while the wholesale and retail trade accounts for 50 000 employed people.

Although specific statistics are not available in terms of employment within the SME sector, using the NDP4 (2013) estimate that the SMES employment share is about 30%, it is estimated that the SME sector employs around 180 000 persons. It is thus clear that a healthy and expanding SME sector is a vital determinant of the well-being of the Namibian economy. According to NDP4 (2013), the SMES contribution to gross domestic product (GDP) in Namibia was about 30%. NDP4 (2013) however indicated some concerns over the accuracy of the figures.

Jauch (2010:2) explains that it is only since independence that the SME sector established itself as a key pillar of the economy. He pointed out that before independence the focus was towards larger business and therefore Namibia's SME sector (both formal and informal) remained very small. Since independence however, the sector has grown substantially. According to this report, the SME sector was estimated to grow by approximately 16 500 jobs per year compared to only 3000 – 4000 jobs per year in the

larger businesses sector. Jauch (2010:2) reasons that this growth cannot necessarily be attributed to government interventions or policy initiatives. It came about as a result of the failure of the formal sector of the economy to create jobs for the ever increasing number of school leavers.

Jauch (2010:3) found the following types of businesses within Namibia's SME sector:

- “informal trade (cuca shops, informal cross-border trade and informal meat markets);
- small scale construction (building, brick making, plumbing, welding, carpentry and electricity);
- subsistence farming;
- crafts (woodwork, pottery, handicraft, basketry, jewellery making, leather working, weaving, furniture making and sewing);
- small scale mining;
- small scale manufacturing (bread making, tailoring, food catering, candle making and confectionary); and
- informal services (transport services, repairs of cars, shoes, electric household appliances, gardening, and domestic work)”.

These types of businesses can be found in both the formal and informal parts of the SME sector.

2.3 EFFORTS BY GOVERNMENT TO CREATE A CONDUCIVE ENVIROMENT

The private sector is the engine for sustainable economic growth. The role of the public sector is to create an enabling environment in which entrepreneurs can explore opportunities and thus increase productivity, contribute to economic growth and create jobs (NDP4:2013).

The Namibian Government has recognised this aspect and has integrated specific strategies for the achievement thereof in its National Development Plan (NDP4:2013). The Namibian Government believes that full developed SMES have the potential to significantly contribute to the creation of employment and the eradication of poverty. NDP4 (2013) mentioned SMES as a key pillar in achieving Namibia's development objectives.

The Namibian government is continuously promoting SMES development through a number of efforts, including the establishment of a dedicated department in the Ministry of Trade and Industry to deal specifically with SME development; efforts to provide financing to the SME sector; and the establishment of physical infrastructure to provide an enabling environment for SMES to flourish (Jauch, 2010:8). These efforts by Government ought to be applauded. There are however a number of challenges remaining.

2.4 CHALLENGES FACED BY SMES IN NAMIBIA

SMES in Namibia, as in most other countries face unique challenges which hamper development and the realisation of their full potential as a key contributor to the Namibian economy. Studies by MTI (Ministry of Trade and Industry) in 1998, showed that the majority of SMES had less than 3 employees and are very small. Although this research was carried out in 1998, it still gives an indication of the SME sector in Namibia. Jauch (2010:7) argues that SME owners started trading not by choice, but because of the unavailability of job opportunities. These studies further found that financial assistance, especially through regulated financial institutions, was badly needed by SMES. Limited business support services and entrepreneurial skills are other impediments identified. These challenges therefore suggest that more needs to be done or perhaps alternative strategies need to be developed.

Many of these challenges are non-financial. Government should acknowledge the existence of a wide range of non-financial barriers that disproportionately affect SMES. Considering the “Ease of doing business in 2012” World Bank report (NDP4, 2013:36), Namibia is ranked 94th overall (out of 183 countries) compared to 11th for UK and 41st for SA. The doing business measure is based on the number of procedures, time and cost to comply with regulatory requirements and laws. However in the same report, two important areas – starting a business and paying taxes – Namibia ranks much lower (125th and 102nd respectively). This indicates that compared to other countries paying taxes the Namibian processes have too many formalities. According to the report, businesses made 37 payments and spent on average 375 hours per year on tax processes. This might actually encourage SMES to remain in the informal sector.

These rankings are relevant insofar as they suggest that more needs to be done in Namibia to facilitate the growth of the formal sector (high barriers to entry and taxes will tend to push business into the informal environment). The lack of finances and expertise means that SMES often have less capacity than larger firms to deal with the complexities of regulatory and bureaucratic procedures. High tax rates and heavy regulation are thus key challenges that need to be addressed as part of Government efforts.

According to Jauch (2010:7) the size of the informal sector is directly linked to the conduciveness of the formal business environment. The easier it is to run a business the smaller the informal sector will become. The challenge in Namibia is not to regulate the informal economy but to let it evolve into formal business activities. It follows that increasing the conduciveness of the formal business environment is an essential step to achieve this.

Formal SMES are better in terms of their contribution to the economy, including the fact that they create sustainable jobs and contribute to state revenues. Namibia needs to create incentives for SMES to register with the relevant authorities and become formal businesses so that their value and contribution can be determined and developmental measures can be channelled effectively.

According to the results of the Namibian Chamber of Commerce and Industry business climate survey (BoN, 2010:11) smaller informal firms find it more difficult to comply with the regulatory requirements compared to larger ones. It is clear that in Namibia huge steps have been taken to support the SME sector, but the slow progress is also indicative that a number of challenges remain, especially in terms of providing a sound regulatory environment (tax regime). The following section will give an overview of the current status of Namibian legislation.

2.5 LEGISLATION APPLICABLE IN NAMIBIA

Namibia has fallen behind with introducing special reliefs for SMES in terms of its income tax policy. The study will now focus on the key provisions of the Namibian Income Tax Act applicable to businesses, regardless of size.

2.5.1 Income Tax Rates

The following table will show the tax rates as it apply to individuals and trusts for the tax year ending on 28th February 2013.

Table 2: Rates of normal tax for individuals and trusts for the year of assessment ending 28th February 2013

Taxable amount	Rates of Tax
Where the taxable amount does not exceeds N\$40 000	No tax payable
Exceeds N\$40 000 but not N\$80 000	27% of the amount by which the taxable amount exceeds N\$40 000
Exceeds N\$80 000 but not N\$200 000	N\$10 800 plus 32% of the amount by which the taxable amount exceeds N\$80 000
Exceeds N\$200 000 but not N\$750 000	N\$49 200 plus 34% of the amount by which the taxable amount exceeds N\$200 000
Exceeds N\$750 000	N\$236 200 plus 37% of the amount by which the taxable amount exceeds N\$750 000

Source: Ministry of Finance, Namibia (2013)

Table 2 applies to businesses that are not incorporated. Sole proprietors will therefore be taxed according to the above tax rates. Incorporated businesses such as Close Corporations and Companies are taxed according to the following rates.

Table 3: Rates of normal tax applicable to Close Corporations and Companies for the year of assessment ending 28th February 2013

Type of entity	Rates of Tax
Mining Companies, excluding diamond companies	34%
Diamond Mining Companies	37.5%
Oil & Gas Extraction Companies	35%
Registered manufacturing Companies	18% for the 1 st 10 year period, thereafter 34%

Source: Ministry of Finance, Namibia (2013)

Most of the SMES in Namibia is formed in response to the unavailability of paid employment and is not registered as a company or CC. The majority of the SMES in Namibia is therefore taxed at the same rates as individuals as illustrated in Table 2. The

few SMES that is registered as a CC or company are taxed according to Table 3. The next paragraph will discuss the applicable capital allowances.

2.5.2 Capital Allowances

Wear and Tear is currently the only capital allowance provided for in Namibian income tax and is deductible according to Section 17 of the Namibian Income Tax Act. The allowance depends on:

- the cost of the asset, for example, motor vehicles, machinery, implements, utensils, aircraft and sea-going craft; and
- the asset being used by the taxpayer in his trade.

The deductible capital allowance is one-third of the cost of the asset per annum, provided that no allowance will be granted in the year of disposal. These capital allowances apply to sole traders and any incorporated business, irrespective of size. Manufacturing businesses qualify for more favourable allowances. The next paragraph will discuss the allowances available for manufacturing entities.

2.5.3 Manufacturing Allowances

Any person, who is of the opinion that they are a manufacturer, may apply to the Minister of Finance to be recognised as an approved manufacturer. Once the Minister of Finance is satisfied that the manufacturing process is beneficial to the economy of Namibia, the business may be granted approved manufacturer status. An approved manufacturer is entitled to various allowances.

Taking into consideration the challenges inherent in the geographic of Namibia, transport makes up a huge cost to the entity. The study will now focus on the allowances applicable to land based transport costs incurred by an approved manufacturer.

2.5.3.1 Allowance in respect of land based transport

The Namibian Income Tax Act, in terms of section 17D, provides for an allowance of 125% on land-based transportation costs in respect of material and components for direct use in the manufacturing process. This allowance also applies to the land based transportation of manufacturing equipment imported by a taxpayer to be used directly in the manufacturing process. This allowance is only granted for the first 10 years after registration of the entity.

Building allowances are another benefit to the approved manufacturer. The following paragraph will deal with building allowances.

2.5.3.2 Building allowances

The Namibian Income Tax Act, section 17(1)(f) provides for a taxpayer to deduct 20% of the cost of a building in the tax year the building was brought into use and 4% of the cost for the following 20 years. This allowance is available on any buildings used by the taxpayer for trade purposes. In the case of an approved manufacturer, an accelerated allowance of 8% instead of 4% applies.

Skilled labour is essential in the manufacturing industry. For this reason training costs and remuneration are considerable. The following allowances therefore apply to remuneration and training costs.

2.5.3.3 Remuneration and training allowances

Section 17A of the Namibian Income Tax Act provides for an allowance of 25% for the following expenditure incurred in respect of employees engaged in the manufacturing process:

- remuneration to any employee engaged in the manufacturing process;
- contributions to a pension fund, provident or benefit fund;
- expenses related to training provided that the training program has been approved by the Permanent Secretaries of Finance and Labour.

The only provision is that this allowance may not cause an overall assessed loss for the taxpayer. As a motivation to get engaged in exportation, the Act also provides for an exporter's marketing allowance. This allowance will be discussed in the next paragraph.

2.5.3.4 Exporter's marketing allowances

Section 17B of the Namibian Income Tax Act, allows for the deduction of 25% of the marketing costs incurred exporting goods to another country. As with all the previous provisions, SMES are not treated any different from larger entities.

Another tax imposed in Namibia, is Value Added Tax (VAT). The study will now consider the key elements of the VAT Act of Namibia.

2.5.4 Value Added Tax

VAT is charged at 15% on the supply of taxable goods or services (VAT Act nr 20 of 2000). VAT replaced General Sales Tax in the early 1990's. The Namibian VAT Act is still using the same principles as those of South Africa. With the implementation of VAT, the threshold was set as N\$200 000 turnover per annum. The Act is still using the same threshold, although 13 years later. Indications were there of an increase in the threshold to N\$500 000 but this was not approved. This is a major obstacle for SMES.

The majority of VAT registered vendors are liable to submit a VAT return every second month, except farmers and some other entities who submit a VAT return once a year. A study done in SA by FIAS (2009:4) reveals that from a cost and time point of view, businesses find VAT returns to take the longest time and be the most expensive to comply with.

2.6 CONCLUSION

Namibian tax legislation does not contribute much towards the growth and sustainability of SMES. Workable solutions should be found to deal with this challenge. Only then would SMES assume their rightful place in the Namibian economy and contribute significantly to the three related challenges of poverty, unemployment and income equality. This can only happen if SMES received the necessary support. There is still room to further develop the Namibian SME sector for it to contribute meaningfully to the economy.

Smorfitt (in BoN, 2010:7) argues that market failure is the most important reason for government intervention in the funding for SMES. He cautions that funding should not be provided in isolation, but should be linked to other interventions, such as preferential tax treatment, that will ensure that SMES are sustainable and profitable.

Countries such as the UK and SA which have introduced preferential tax treatment for SMES argue that reduced tax rates and differentiated tax policies should have a positive effect on job creation and will enhance the level of entrepreneurship. A further reason for preferential tax treatment is that SMES are believed to be an excellent breeding ground for individual tax payers and future corporate taxpayers.

The main objective of this study is to consider the work done in the UK and SA, in order to comment on possible strategies which Namibia may implement. The next chapter will consider the development of tax policies for SMES in SA.

In an attempt by the South African government to reduce the tax burden for SMES, development started 1995 on differentiated tax policies for the SME sector. This was done after the release of a White Paper on a national strategy for the development and promotion of small businesses in South Africa (Sieberhagen, 2008:1). The next chapter discusses the tax policies for SMES in South Africa.

CHAPTER 3

SME SECTOR IN SOUTH AFRICA

3.1 INTRODUCTION

Small and medium enterprises play a vital role in any country's economy, in areas such as poverty reduction and employment creation (Abor and Quartey, 2010:170). SMES in SA represent 91% of the formal entities; their contribution to total GDP is as much as 36%, while 56% of employment in the private sector is offered by SMES. With a total unemployment rate of 25.5% for 2012, it is evident that as the largest employer, growth in the SME sector will reduce unemployment and increase GDP (Neneh & Van Zyl, 2012:120).

Various constraints are crippling the success rate of SMES. Constraints experienced by SMES include a lack of financial assistance, a poor regulatory framework and a lack of management skills and knowledge (Neneh & van Zyl, 2012:120). The poor regulatory framework includes aspects such as taxation and the process of registering a business. In an attempt by the South African government to reduce the tax burden for SMES, development started during 1995 on differentiated tax policies for the SME sector. This came after the release of a White Paper on a national strategy for the development and promotion of small businesses in South Africa (Sieberhagen, 2008:1).

When considering tax reform, the policy maker should be clear and certain of the category of businesses it is proposed to benefit. The following paragraph will shed some light on the criteria used to classify small and medium enterprises.

3.2 DEFINITION OF A SMALL OR MEDIUM ENTERPRISE

Prior to the implementation of Recommendation 2003/361/EC, the National Small Enterprise Act nr 102 of 1996 provided guidelines for the classification of micro, very small, small and medium sized enterprises operating in different sectors of the economy of South Africa (Sieberhagen 2008:13). Despite these efforts to standardize the definition for SMES,

a standard definition is still not being used as there are different definitions in different Acts. To confuse the issue even further, the different Acts name small businesses in unique ways, for example: SBC, SMME, etc. The only definition applicable to this study is of a small business corporation (SBC) as found in the SA Income Tax Act no 58 of 1962. A small business corporation is defined in Section 12E of the Income Tax Act. A business should meet the following requirements to be classified as a SBC:

- “the entity must be a private company registered in terms of the Companies Act or a Close corporation (CC) – but not an employment company;
- all its shareholders/members are natural persons;
 - its entire shareholding/members interest is held at all times during the year of assessment
- by shareholders/members who are natural persons;
- the shareholders/members do not hold or have any interest in any shares, at any time
- during the year of assessment of the company/CC, in another company;
- the gross income of the company/CC for the year does not exceed R20 million (previously R14 million) and,
- the personal service income does not exceed 20% of the companies’ total receipts and accruals and all its capital gains.”

The next section will discuss the methods implemented by the SA government to reduce the tax burden.

3.3 REDUCED TAX RATES

Reduced tax rates entails a lower tax rate being charged on SMES compared to larger entities. According to the latest SA legislation, profits lower than R67 111 are not taxed, while profits above R67 111 but lower than R365 000 are taxed at 7%, profits exceeding R365 000 but not R550 000 are taxed at 21% and profits above R550 000 are taxed at the normal corporate rate of 28% (SARS, 2013a). Table 4 illustrates the sliding scale used for SMES in SA.

Table 4: Illustration of the sliding scale used to calculate income tax on SMES

Financial Performance	Company A taxed according to SME rates (Amounts in Rand)	Company B taxed at corporate rates (Amounts in Rand)
Taxable profit	500 000	500 000
Tax payable	49 202	140 000
Effective rate	9.8%	28%

Source: SARS, 2013a

The reduction in tax liability is clearly illustrated in the example in Table 4. The effective rate will gradually increase with profits. Another attractive relief measure is the accelerated capital allowance available for SMES. The next section will briefly discuss the capital allowances applicable to SMES.

3.4 ACCELERATED CAPITAL ALLOWANCES

Capital allowances refer to deductions against an entities' net profit. This allowance is calculated on the cost price of capital assets. Accelerated capital allowances have the effect that the taxable income, when compared to a larger entity, will be lower. SMES in SA are allowed to deduct the full acquisition cost of assets used in a manufacturing or similar process from their income during the first year. Assets include machinery, furniture, equipment and vehicles. Any other assets which are not used in a manufacturing process qualify for a deduction of 50:30:20 over 3 years. This percentage is calculated on the acquisition cost of these assets. (Section 12 E (1A) of the Income Tax Act nr 58 of 1962).

The situation with larger entities is very different. Larger entities are allowed a deduction of 40:20:20:20 on the cost price of assets used in a manufacturing or similar process. This means a deduction of 40% in the first year followed by a deduction of 20% in the next three years after acquisition (SARS, 2008a:39). Assets which are not used in a manufacturing process qualify for an allowance of 20% over five years, with the first being in the year of acquisition (Section 11e of the Income Tax Act nr 58 of 1962). The difference in these allowances can best be explained by using Tables 5 and 6. Table 5 illustrates the normal income tax liability of a SME with a taxable income of R1 m before allowing for a capital allowance on a asset with a cost of R100 000.

Table 5: Illustrative example of accelerated capital allowances and reduced tax rates for SMES.

Year	Net profit	Allowance for an asset of R100 000	SMES Taxable income (R)	Tax payable (R)	Effective rate (%)
1	1 000 000	50 000	950 000	171 702	18.07
2	1 000 000	30 000	970 000	177 302	18.28
3	1 000 000	20 000	980 000	180 102	18.38
4	1 000 000	0	1 000 000	185 702	18.57
5	1 000 000	0	1 000 000	185 702	18.57

Table 5 shows that the tax liability gradually increases with higher profits. Table 6 illustrates the normal income tax liability of a larger entity with a taxable income of R1 million before allowing for a capital allowance on a asset with a cost of R100 000.

Table 6: Illustrative example of capital allowances and tax rates for larger entities.

Year	Net profit	Allowance for an asset of R100 000	Taxable income (R)	Tax payable (R)	Fixed & Effective rate (%)
1	1 000 000	40 000	960 000	268 800	28%
2	1 000 000	20 000	980 000	274 400	28%
3	1 000 000	20 000	980 000	274 400	28%
4	1 000 000	20 000	980 000	274 400	28%
5	1 000 000	20 000	980 000	274 400	28%

The effect of reduced tax rates and accelerated capital allowances are twofold. The positive result is that investment costs made at commencement of the entity are usually sunk costs. A government subsidy in the start-up phase can thus reduce the gap between the struggling enterprise and the successful enterprise. By reducing tax liability through accelerated allowances and lower tax rates, SMES can report a higher profit (Sieberhagen, 2008:36).

Tax relief concentrates on the tax rate burden, the compliance burden or both. The reduced tax rate and accelerated capital allowances effectively reduce the tax payable but do not contribute towards the compliance burden. As part of government's commitment to

reduce the compliance burden, the turnover tax system was implemented by SARS in 2009 (SARS, 2009a). The aim of this system was to reduce the compliance cost burden for SMES. SMES with a turnover of less than R1 million, regardless of business form, could elect this simplified system. The next paragraph gives an overview of the presumptive turnover tax system.

3.5 PRESUMPTIVE TURNOVER TAX

3.5.1 Overview of the presumptive turnover tax

The following criteria are being used to determine if a business is allowed to switch to the turnover tax system (SARS, 2013c):

- “Annual turnover should not exceed R1 million.
- Estimated professional services rendered should not exceed 20% of the total receipts for the year of assessment. Professional services include services such as lawyers, doctors and accountants. This list is not exhaustive.
- Business should not be a “personal service provider” or a “labour broker”.
- Business should be a sole proprietor, close corporation, partnership, cooperation or a company.
- If the business is a partnership, the partners are not allowed to be partners in other partnerships.
- All partners in a partnership should be natural persons.
- If the business is a close corporation, company or cooperation, all the members should be natural persons.
- The business should not be a public benefit organisation (PBO) or a recreational club.
- The financial year of the business should end on the last day of February.
- No member or shareholder should hold shares in another company or close corporation.
- Investment income of the business should not exceed 10% of total income.

- The income from disposal of assets in the current year and past two years should not exceed R1.5 million.”

Turnover tax is a simple tax calculated using the turnover of the business for a year. No deductions are taken into account, therefore the business owner does not need to be knowledgeable about tax deductions. A detailed bookkeeping system is also not necessary for turnover tax, unlike in the standard tax system.

A CC has to submit at least 9 returns during a year. These include six VAT returns, two provisional tax returns and one final income tax return. As turnover tax is replacing income tax, value added tax (if so elected), provisional tax, capital gain tax and secondary tax, the compliance burden will be substantially reduced with the election of the turnover tax as only two interim and one final return need to be lodged (SARS, 2009a).

The turnover tax should not be seen as a way to reduce tax liability but as a means to reduce the compliance burden. However in some instances where a business has a low turnover but high profit margins, it is possible to reduce its tax liability also (SARS, 2009a).

Table 7 indicates the latest rates of turnover tax.

Table 7: Turnover Tax Rates for financial year 1st April 2013 to 31st March 2014

Turnover in Rand	Rate
0-150 000	No tax payable
150 001 – 300 000	1% of the amount above R150 001
300 001 – 500 000	R1 500 and 2% of amount above R300 001
500 001 – 750 000	R5 500 and 4% of amount above R500 001
750 001 and above	R15 500 and 6% of the amount above R750 001

Source: SARS (2013b)

The rates are substantially lower than the normal rates on SMES, as the tax is levied on turnover and not profit.

3.5.2 Impact of turnover tax

Small and upcoming businesses which do not use sophisticated accounting systems, due to their complexity or for financial reasons, will benefit by changing to turnover tax (Sieberhagen: 2008:39). Businesses that outsource the tax function can save, as the time needed to prepare the relevant information is less than the time needed for normal income tax (SARS, 2009a). Initially, it was a prerequisite that a business should remain on turnover tax for at least 3 years. This restriction was due to the costly implementation process and to prevent qualifying SMES from switching from one tax system to another but was removed in 2012 (SARS, 2012b). The requirement to remain on the turnover tax system can be seen as a tremendous disadvantage as the ultimate goal of tax interventions for a certain type of taxpayer, such as SMES, should be a transition to the standard system (International Tax Dialogue, 2007:4).

As VAT is replaced in the implementation of turnover tax, a huge administrative burden is removed. While the turnover system has enormous benefits, the disadvantages should also be considered. The replacement of VAT brought about serious disadvantages. A business is still charged with VAT on purchases and services from registered entities. (International Tax Dialogue, 2007:4). Due to the consequence of paying VAT and not being allowed to claim back, from 1st March 2012 businesses were allowed to register for both VAT and Turnover tax (SARS, 2012b). Engelschalk (2006:19) argues that the policy requires a detailed analysis of profit margins and the relationship between these margins and business conditions, such as size, location and business activities. In the absence of this analysis, the tax rate is based on estimates and is not necessarily beneficial to the taxpayer. In the scenario where the taxpayer has to submit all the information needed to do the detailed analysis, the system will not be regarded as simple any more.

This research deals with tax policies aimed at SMES to ease the tax compliance burden. Apart from the income tax as discussed in the previous paragraphs, this study will also consider VAT. VAT is an indirect tax levied “on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him; on the importation of any goods into the Republic by any person on or after the commencement date; and on the supply of any imported services by any person on or after the commencement date” (Value Added Tax Act

89/1991). The next section will deal with an overview of the current VAT systems applicable in SA.

3.6 VALUE ADDED TAX

VAT is an indirect tax included in the selling price of taxable goods or services supplied by a person registered for VAT. Although VAT is charged throughout the cycle of purchasing and selling, the VAT is borne by the end user. SA implemented a number of changes to the VAT system in the last few years. As from 2009, the threshold for compulsory registration was increased from R300 000 to R1 million, with a voluntary registration still available. A VAT return is rendered every 2 months for most businesses, with the exception of SMES with a turnover less than R1.5 million which had the option to render returns on a 4 month basis (SARS 2013 d). SA uses the invoice system for VAT, but made the 'payment basis' available for certain businesses and SMES. The payment basis is available for natural persons or an unincorporated group of natural persons, with a turnover of less than R2.5 million in the preceding year of application. Certain conditions apply to the payment basis but it means that vendors have the benefit of accounting for VAT, only when payment takes place (SARS 2013 d).

Recognizing the efforts of taxpayers to stay VAT compliant, South African Revenue Services implemented the Small Retailer VAT system. The next paragraph will discuss the Small Retailer System.

3.6.1 Small Retailer VAT

The Small Retailer VAT package was a simplified system aimed at the small retailer doing business without comprehensive point of sale equipment. Businesses using this system did not calculate VAT as before but used a simplified method. The total zero rated purchases were added up, after which a market average was used to calculate the zero rated sales. The total standard rated sales were then calculated by deducting the zero rated sales from the total sales. The tax fraction was then applied to the standard rated sales to determine the VAT liability (Sieberhagen, 2008:19). According to records from SARS, only a few businesses registered under this tax system and it was therefore

withdrawn from 1 March 2010 (SARS 2010). The system is now incorporated under the turnover tax regime.

As seen throughout this study, huge strides have been made to reduce the tax burden on SMES. Assistance includes reduced tax rates, accelerated capital allowances and simplified tax systems which ease the tax compliance burden. Apart from having to deal with the tax burden, obtaining finance is reported as a major constraint. A lack of finance, together with other obstacles certainly contributes towards the high failure rate of this sector (Mazanai and Fatoki, 2011:1). Investing in SMES should therefore also be addressed. To assist the SME sector in funding, SARS implemented tax incentives for investments in an approved Venture Capital Company (VCC) (SARS, 2009b). The next section will discuss the role of the VCC. This incentive is not targeted at SME tax liability, but rather on funding and consequent growth of the SME.

3.7 VENTURE CAPITAL INCENTIVES

The first two VCC's, namely the American Research and Development Corporation (ARDR) and J.H. Whitney & Company were formed in 1946 in the USA. This was only the start, with many more companies of this kind to follow (Powers, 2012:1). VCC's can be seen as managers of someone else's funds with the purpose of investing the funds for obtaining the best results possible. Investors can benefit from the VCC as the VCC manager spends a great deal of effort in evaluating different opportunities.

The role of the VCC is to act as a vehicle that will attract potential investors and then gradually pull away and hand over control to the SME (HMRC:2013). The most common risk identified by VCC managers are those related to the management. During the very effective screening process, many potential problems and risks are addressed. Each proposal for funding is thoroughly screened to ensure that only the most promising entities receive funding in the form of investments. Giovannini (2010:11) showed that only 3% of the initial proposals received finance after going through the screening process.

SARS followed the international trend in 2009 and introduced a tax incentive to encourage prospective investors to invest through a VCC regime. From 2009 investors in SA could claim an income tax deduction for investments made with a VCC. Individuals could claim

a 100% deduction of the expenses incurred on this investment, up to R750 000 per annum. Listed companies qualify for a 100% deduction, subject to these investments, plus any investment by the group of companies, not exceeding 40% of the equity of the VCC. (SARS 2012a).

3.7.1 Effect of venture capital incentives

VCC's are successful in attracting potential investors. The effective screening process makes it a safer option and the tax incentive produces an improvement in after-tax returns. (Sieberhagen, 2008:40). The effectiveness of the VCC in SA is unclear, as only three companies have so far been approved (SARS 2013e). A huge marketing effort will be necessary to put it on the radar for prospective investors and put SA on par internationally.

3.8 CONCLUSION

A tremendous effort has been made by SARS to benefit SMES. Chamberlain and Smith (2006:47) nonetheless claimed that reducing the tax burden should be seen as a facilitator for development, rather than the driver for development. The reductions in the tax compliance burden will not necessarily result in dramatic growth and employment but together with improvements in the general economy should at least assist individuals to become entrepreneurs.

The main objective of this study is to compare the tax legislation applicable to SMES from SA and the UK and to find a workable solution for tax reform in Namibia. The study so far discussed the legislation applicable in SA and will consider the applicable legislation in UK in the next chapter.

CHAPTER 4

SME SECTOR IN UK

4.1 INTRODUCTION

This chapter will discuss the tax relief applicable to SMES in the UK. SMES in the UK refers to small and medium enterprises or small, medium and micro enterprises (SMME) or small business corporation (SBC).

The contribution of SMES towards GDP in 2012 was 49%, while 99% of all enterprises fell within the category of SMES. Statistics also revealed a contribution of 48.6% towards total turnover in the private sector. To analyse these statistics further, 32% of all employment offered and 20% of total turnover in the private sector, was contributed by the small enterprises with less than 10 employees (Business Statistics, 2013:4). Table 8 illustrates the SMES situation in the UK.

Table 8: SMES importance in the UK

Criteria	Percentage
SMES in UK	99
SMES: Employment	59
SMES: Turnover	49
Micro business (less than 10 employees)	96
Micro business: Employment	32
Micro business: Turnover	20

Source: Business Statistics (2010)

It is evident from Table 8, that SMES can be seen as the engine of the UK economy for their role in job creation, economic growth, entrepreneurial spirit and innovation.

Before this study considers the tax policies aiming at the SME sector, it is necessary to have a clear understanding of the type of businesses included as SMES. The next paragraph aims to give an overview of the type of the businesses qualifying as SMES.

4.2 DEFINITION OF A SMALL OR MEDIUM ENTERPRISE

Taking into account the importance of SMES, one of the priorities of the European Commission has been to support SMES through financing and tax policies. These programs can only be effective if the measures are based on a common definition (Verheugen, 2005:3).

Section 382 and 465 of the UK Companies Act of 2006 defines SMES for accounting purposes, while the British Banking Code of 2008, uses yet another definition (University of Strathclyde, 2009:1). Criteria such as balance sheet total, staff headcount and turnover are common in the definitions used by different entities and countries, with only different levels of these criteria being indicated. Headcount may have benefits in some sectors while using turnover in other sectors may be more appropriate. (Business Statistics, 2013:1).

The criteria as set out in the UK Companies Act 2006 are being used for income tax purposes, while it is seen that other taxes uses different criteria. Section 382 of the UK Companies Act 2006 contains the definition for SMES. The requirements effective as from 6th April 2008, state that a micro business is seen as a very small incorporated entity (companies and qualifying partnerships) which meets two of the following three criteria :

- “An annual turnover lower than £578 830;
- Total assets not more than £289 415; and
- An average of not more than 10 employees during the financial year (UK Company Act)”.

The following conditions must be met to qualify as a small company:

- “A company with an annual turnover lower than £6.5 million,
- Total assets not exceeding £3.26 million, and
- Total employees not exceeding 50”.

The following criteria apply to a medium sized company:

- “A company with an annual turnover lower than £25.9 million,

- Total assets not exceeding £12.9 million, and
- total employees not exceeding 250”.

With a clear understanding of the type of businesses that are categorized as SMES, this study will now consider tax legislation aimed at SMES.

4.3 LEGISLATION APPLICABLE TO SMES

Tax policies with the aim of assisting SMES were developed from the early 1980’s. These policies and tax reliefs are being updated to cater for the needs of the modern SME. A special task force, Office of Tax Simplification (OTS) was formed during 2010 to perform a tax review on small businesses. Following this report in 2012, the UK government started to implement a cash basis tax system for SMES. The aim was to implement the changes during the three years following 2012 (HMRC: 2012).

4.4 CASH BASIS TAX SYSTEM

An extremely important aspect in small business taxes, the obligation to incorporate, was discussed in the report by OTS (Office of Tax Simplification) (HMRC: 2012). Under the previous tax system, only incorporated businesses could benefit from the tax benefits for SMES. A vast number of limited companies were formed over the years as the limited company in the UK is available for very small entities, even a one man business. With the incentives being only available to incorporated businesses, Chamberlain and Smith (2006:48) argued that entrepreneurs therefore might select a business form which is inappropriate. By incorporating, the limited company has to calculate profits using the same accounting rules as used by large entities. The compliance burden for SMES in relation to profits is therefore much higher than in larger entities (HMRC, 2012). In an attempt to overcome the heavy compliance burden associated with the incorporated entity status, the 2013 Budget announced that, the cash basis tax system will be effective as from 1st April 2013 and is available for all small businesses, including unincorporated businesses. Entities with a turnover of at least £77 000 are allowed to register under the new scheme. These entities can use the cash basis scheme until the receipts are £150

000 after which they become taxable under the normal corporate tax. Entities in the old system have the choice to move to the new cash basis scheme and if circumstance change, to move back to the old system (HMRC, 2012). Incorporated entities registered under the old system still qualify for tax reliefs. This study will now discuss the tax relief available for SMES using the old system.

4.5 OLD SYSTEM RELIEF FOR SMES

4.5.1 Reduced tax rates

According to the 2011 Budget speech, corporate taxes were reduced from 28% to 26% with a further reduction every year of 1% until 2014, when it will be 23%. The Budget Speech in 2012 announced another 1% cut, with the result of corporate taxes being 23% in 2013 and 22% for the financial year commencing on 1st April 2014. UK authorities allow for a reduced rate of 20% on profits below £300 000 and a marginal relief on profits higher than £300 000 but not exceeding £1.5 million (HMRC, 2012). The marginal relief is calculated according to a standard fraction, currently 3/400 (HMRC, 2012). The marginal relief implies that the rate charged on profits between £300 000 and £1.5 million gradually increase with profits. A business with profits close to £1.5 million will therefore pay a higher rate than a business with lower profits. Table 9 illustrates the effect of marginal relief.

Table 9: SMES marginal Relief illustration applicable in UK

Financial Performance	Company A with marginal relief (amounts in £)	Company B without marginal relief (amounts in £)
Taxable profit	700 000	700 000
Corporation Tax at 23%	161 000	161 000
Less: Marginal Relief (3/400)	(6 000)	
Tax payable	156 000	161 000
Effective rate	22.28%	23.00%

If the company as illustrated in the above table had a taxable income of £1 million, the effective rate would increase to 22.62%. The study will now consider the first year allowances available for SMES.

4.5.2 First year allowances

First Year Allowances (FYA) allowed for a higher deduction in the year the investment was made. Expenditure incurred on the purchase of certain plant and machinery, qualified for an allowance of 40% in the first year (HMRC, 2006:1). This allowance was increased during 2006 to 50%. Assets such as cars are excluded from this allowance. This allowance was only applicable to small incorporated businesses. On the contrary, larger businesses enjoyed an allowance of 25% on a reducing balance method (HMRC, 2007:1).

The FYA were replaced by the Annual Investment Allowance (AIA) in the tax year 2008. The AIA entails a deduction of £50 000 in the year of acquisition. The amount available for deduction was increased in 2009 to £100 000 (HMRC, 2008:1). Interestingly, the AIA is available for any person conducting business, such as individuals, unincorporated and corporate entities and applies regardless of size. The situation is therefore that there are no longer any special reliefs for SMES with regard to capital allowances.

4.5.3 Effect of reduced tax rates and FYA

With the First Year Allowances being replaced by the Annual Investment Allowance, the only relief under the old system are the reduced tax rates in the form of marginal relief. Tax policies introduced by the UK target businesses by using size as the criteria. Research shows that this approach is ineffective as all SMES do not experience the same constraints. The relief should therefore not target the entire SME sector, but only a certain group of SMES. The AIA focuses on the investment in physical assets. Crawford (2007:443) argued that tax incentives should aim to benefit a business investing in physical assets rather than service companies .

Having said that, the tax relief should benefit a certain type of entity and not necessarily focus on the size of a business. The UK government started with tax reliefs for entities which incurred expenditure on research and development activities. The next paragraph will explain the introduction of tax reliefs for expenditure incurred on research and development activities.

4.6 RESEARCH AND DEVELOPMENT INCENTIVES

Any entity that incurred Research and Development (R&D) expenditure, may deduct these costs from its taxable income. The authorities in the UK define an allowable R&D project as: “a project that seeks to achieve and advance in overall knowledge or capability in a field of science or technology through the resolution of scientific or technological uncertainty and not simply an advance in its own state of knowledge or capability” (HMRC, 2010b).

SMES that qualify for the enhanced relief are any corporate entity with:

- “a headcount fewer than 500,
- an annual turnover of less than £100 million and,
- a balance sheet value not exceeding £86 million”.

The enhanced allowance available to SMES entails a deduction of 175% of the total R&D expenditure, while the deduction for a large entity is limited to 130% (HMRC, 2010b). The limit for tax relief for R&D expenditure in the UK, is currently at least £10 000 for a project, while the enhanced allowance for a certain project is limited to £7,5million. This deduction means that for every £1 spend; the entity can claim £1.75 (HMRC, 2010b). The following paragraph will consider the secondary literature applicable to R&D allowances.

4.6.1 Comments on the applicability of the R&D tax relief

Economists globally agree that activities relating to R&D are necessary for long term economic growth. It was argued that research and development expenditure increased by 3% as a result of tax incentives implemented by the Canadian authorities (Mansfield & Switzer in Bernstein, 1986: 445). This research did not distinguish between SMES and large entities. The researchers argued that entities in Japan with a high tax liability are more likely to invest in R&D expenses (Bhagat & Welsch, 1995:448). Although these studies were done a long time ago, based on this background, introducing R&D tax reliefs should stimulate growth in research and development activities.

The incentive to be involved in R&D activities is even higher as entities in UK have the choice to deduct expenses and reduce the tax bill or simply claim a credit (HMRC, 2010b).

The expenses are likely to have a huge impact during the first year on the cash flow. Claiming an immediate credit can help to avoid negative cash flow and its consequences and could improve the success rate of SMES. Recognising the growth potential in SMES, the UK government encourages investing in SMES through Venture Capital Company (VCC) incentives. The following paragraph will discuss these incentives.

4.7 VENTURE CAPITAL COMPANY INCENTIVES

Focussing on investments in SMES, the UK is encouraging investors through an incentive. This incentive is available for the investor in a VCC and does not consider the SME tax liability. Overli (2013:1) argued that a VCC will normally operate over a period of 10 years with investments in the first 5 years. As more funds are approaching the end of its period, and fewer deals are closed, the total investment figure is seen moving downwards.

This study has discussed the income tax reliefs aimed at the SME sector and investing in the SME sector in the UK and will now consider Value Added Tax (VAT). The research will show that the UK government has worked on VAT relief since 2002. The next section will give an overview of the current VAT packages in use by the UK.

4.8 VAT

Qualifying businesses in the UK could apply for the flat rate scheme from 2002. This scheme is designed for smaller businesses which do not use complicated accounting systems but can apply a single percentage levied on turnover. A business registered under this scheme acquiring capital assets will account for VAT under the normal system. Authorities distinguish between sectors and apply a different percentage based on the sector or business activity. Table 10 illustrates the simplicity of the flat rate scheme.

Table 10: Flat Rate VAT applicable to SMES in the UK

	Amounts in £
Turnover including standard VAT	94 000
Flat Rate at 6% (determined on business activity)	(5 640)
Expenditure, including VAT	(58 750)
Profit	29 610

As seen from Table 10, the percentage is calculated directly from the turnover. SMES can greatly benefit from this scheme as there is no need to calculate VAT on purchases and sales and also no distinguishing between zero rated and standard rated supplies. The system is very simple to administer and should reduce the compliance burden significantly (HMRC, 2010c). Apart from reducing the compliance burden, more benefits arise for the entity registered for VAT. The next paragraph will consider the effects arising from implementing the flat rate system.

4.8.1 Effect of the Flat Rate Package

SMES not registered for VAT may benefit from becoming a VAT vendor. Non-registered SMES will have to bear the VAT payable on supplies from VAT registered vendors. A direct benefit from registering for VAT purposes is that businesses conducting business with VAT registered entities will be able to claim back the VAT paid. A business not registered for VAT purposes and who is unable to pass the VAT on to the buyer of the goods, by adding it to the price of their goods, will have to carry the VAT costs. These costs may become considerable and have a negative effect on profits. Most registered entities prefer to do business with other registered entities. SMES becoming registered VAT vendors may consequently also benefit from higher sales.

With regard to the non-registered entity, it is also true that if it can sell at the same prices as their registered counterparts, they can keep that part of the price as a profit, while their registered counterpart will have to account for a VAT liability when entering into similar transactions (Seely, 2013:4).

The flat rate VAT package introduced by UK focuses on smaller entities. The aim of this scheme is to assist SMES who are using basic accounting systems. It is especially time saving as there is no need for difficult calculations. It also eliminates the burden of quarterly VAT returns. As the VAT is calculated purely on turnover, the SME can manage its cash flow more efficiently. VAT is seen as one of the largest compliance constraints and consequently can lead to considerable savings in time and compliance cost. It is important to bear in mind that this tax was introduced to reduce the burden; it is possible that a business can be liable for more VAT compared to the old system but may incur lower compliance costs (HMRC, 2010c).

4.9 CONCLUSION

The role played by SMES with regard to growth and job creation should not be underestimated. One of the targets of the UK Government's plan for growth is to implement a competitive tax system and to become the best place in Europe to grow a business (HMRC 2012). When considering the latest developments, namely the cash basis system, it is evident that the focus is on simplicity in compliance rather than cutting the tax rate burden.

This study has discussed the tax reliefs implemented by SA and the UK in the previous chapters. The objective of the research is the comparison of SA and UK legislation from a Namibian perspective. The following chapter will summarize the tax reliefs in table form and discuss the effectiveness of these policies.

CHAPTER 5

INTERNATIONAL COMPARISON

5.1 INTRODUCTION

SMES are crucial for economic growth, distributing wealth and creating jobs (Venter & de Clercq, 2007:116) (Smulders & Naidoo, 2011:1). With the growing number of SMES, policy makers are under pressure to reduce the burdens regarding both compliance cost and tax rate. Freedman (2008:26) remarked that taxation of small entities is not an easy or costless process and the focus should therefore be on important pre-determined objectives. The objectives for differentiated policies can be listed as:

- increasing competitiveness against larger entities;
- reducing compliance cost;
- promoting growth;
- creating employment;
- promoting access to international markets; and
- formalising the informal markets (Sieberhagen, 2008).

The tax legislation applicable to SMES in SA and the UK were considered in previous chapters. This study will now compare the incentives applicable to SMES in the three countries and then draw upon secondary literature on the effectiveness of relief measures based on the objectives identified above.

Table 11 clearly illustrates that no work has been done on tax reform for SMES for Namibia, while SA and the UK are actively finding solutions to promote the SME sector by introducing tax incentives. Also evident from the study is the movement towards reducing the compliance burden, rather than reduced tax rate liability.

Table 11: Comparison of tax policies applicable on SMES in SA, UK and Namibia

Tax Relief	SA (amounts in ZAR)	UK (amounts in GBP)	Namibia (amounts in N\$)
Reduced Tax Rates	Available for a registered SBC. Tax rates gradually increase with profits. Profits above R550 000 (local currency) are taxed at the normal corporation rate of 28%	Available for a registered SME. Tax rates gradually increase with profits. Profits exceeding £1.5 m (local currency) is taxed at the normal corporation rate of 23%.	Incorporated entities are taxed according to a flat rate while unincorporated entities are taxed according to a sliding scale. Companies with approved manufacturing status qualify for a lower tax rate.
Accelerated capital allowances	Accelerated Capital Allowance of 50:30:20 for assets not used in a manufacturing process. Assets used in a manufacturing process qualify for a 100% deduction in the year of acquisition.	First Year Allowances (FYA) were available until 2008 and were replaced with Annual Investment Allowance (AIA) AIA is available for all taxpayers.	Capital Allowances on all assets are based on 1/3 of the cost price. Available to any person conducting a business, whether incorporated or not.
Research and Development Incentives	A deduction of 150% of the expense incurred. No distinction is made between SMES and larger entities.	A deduction of 175% of the expense incurred compared to 130% for larger entities.	Not applicable
Turnover Tax or Cash Based System	Apply to a business with a turnover between R150 000 and R1 million. Turnover exceeding R150 000 are taxed according to a sliding scale.	Available for entities with a turnover exceeding £77 000 and lower than £150 000. Incorporation is not a requirement to qualify for registration under the cash basis system.	Not applicable
VAT	Small retailer VAT package was implemented but was withdrawn in 2010 and is now incorporated under the Turnover Tax.	Flat rate system was introduced during 2002. VAT is calculated on the turnover. Rate is determined according to the business activity.	No incentive for SMES. Current threshold is a turnover of N\$200 000 per annum.
VCC	Tax relief available for investments in a VCC	Tax relief available for investments in a VCC	Not applicable

The objective of this study is to recommend possible tax reliefs for the Namibian SMES. With the objectives for tax reform now identified, the study will focus on the effectiveness of the tax reliefs implemented.

5.2 OBJECTIVES FOR POLICY REFORM

Freedman (2009:154) remarked that differentiated policies had their positive aspects but critics are concerned that the stated objectives were not met and that some of these policies created distortions in the market. Consideration needs to be given to the stated objectives. Only if these objectives have been met, can a policy be regarded as being effective. The next section will deal with the objectives on an individual basis.

5.2.1 Increasing the competitiveness of SMES

SMES normally do not have the same access to capital markets as larger companies. It is believed to be the perception of risk that affects investment in smaller projects. It is highly unlikely that tax reform will change risk perception. The ability to obtain finance is limited and is often dependent on self-financing.

Corporate taxes increase the cost of capital and the consequent rate of return. Higher tax rates discourage investments and by cutting the tax rate, investment is encouraged. Accelerated capital allowances can be used as an effective tool to encourage investments. Nam & Radulescu (2007:102) argued that the investment decision will depend on the mix of accelerated capital allowances and a reduced tax rate.

5.2.2 Reducing compliance cost

Many SME owners choose to operate in the informal sector due to a fear of the tax processes (Chamberlain & Smith, 2006:35). Unnecessary regulatory requirements, often referred to as red tape, are a huge constraint for small businesses. Tax reforms concentrate on the reduction of tax liability and compliance cost. Considering the framework for the presumptive turnover tax system, cash basis and the flat rate VAT system, the focus was largely and specifically on the compliance cost aspect.

Those entities operating within the tax net acknowledged a positive effect on their compliance costs after the implementation of differential tax policies. (Stern & Barbour in Sieberhagen, 2008:28).

5.2.3 Promote growth

Statistics indicate that 96% of all businesses in the UK can be regarded as a micro business, with employment not more than 9 people (Business Statistics, 2013:1) This indicates that although SMES grow in number, they do not necessarily grow in size. The example of reduced tax rates as seen in Croatia shows that reduced rates can assist in growth. When Croatia's corporate tax was reduced from 35% to 20% in 2001 equity levels of SMES increased, while debt levels decreased (Klapper & Tzioumis, 2008:1).

Furthermore, growth is not the main objective of all businesses. When implementing tax policies with the aim of promoting growth, policy makers should take this into consideration, recognising that businesses may not have the intention to grow and will remain small, irrespective of any allowances or incentives (International Tax Dialogue, 2007:21).

As indicated earlier, reducing the tax burden should rather be seen as a facilitator for development, rather than the driver for development. Chamberlain & Smith (2006:47) argue that the reduction of the tax compliance burden will not necessarily result in dramatic growth, but together with improvements in the general economy it will at least assist individuals to become entrepreneurs.

5.2.4 Employment creation

Small businesses in Africa are significant in job creation with more than 50% of total employment offered by SMES (Neneh & van Zyl, 2012:119). Small businesses are started for various reasons. Only 50% of small businesses aim for growth, while the larger businesses are more geared for growth. The small business that does not want to grow, may not be very keen to take on new employees (Freedman, 2006:1). Targeting a relief at the small business, whether using turnover, number of employees or other measures, will therefore not necessarily or directly promote jobs.

5.2.5 Promote access to international markets

Although government aims to provide a conducive environment for SMES to participate in international trade, certain barriers will have to be overcome. A high percentage of SME owners do not engage in the international market, due for example to a lack of knowledge. The perception held by many SMES is that the international market is a high risk environment (Nam & Radulescu, 2007:101). Until this perception is changed, these SMES will remain tied to the local market.

5.2.6 Formalize the informal sector

SA entities who feared the authorities for past non-compliance, took the opportunity in 2006 to register after a tax amnesty was announced. A small business tax amnesty became effective from 1 August 2007 (SARS, 2006). According to this system, a SME could register as a taxpayer, without being liable for previous tax obligations. Certain requirements and limitations applied in respect of the amnesty. Businesses that were already registered could apply for a waiver of additional tax, penalties and interest. The waiver applied for a qualifying period and covered all the interest, penalties and additional taxes that were outstanding on 31 July 2006. The maximum amount that could be waived was set at R1 million.

Previous Minister of Finance Trevor Manuel announced that 299 000 businesses applied for tax amnesty, while 54 574 applied for the waiver (Sieberhagen, 2008:22). If these new registrations stay active and comply with tax regulations, it might lead to a substantial revenue increase. The amnesty resulted in a win-win situation as both taxpayers and the authorities benefitted.

5.3 CONCLUSION

Sieberhagen (2008:iv) claims that apart from objectives not being met, the objective of differentiated tax policies is to earn more revenue through taxes. Freedman (2009:154) argued that the objectives for tax reform were not met. Freedman explained that the assumption that the structure of a small business is simpler because they do not have as many people employed as a large business and that less money is involved appears to be far from the truth. A SME is a business with a different design and different needs to larger concerns. "By simply adding or removing from the existing structure, proved not to be

effective” (Freedman, 2009:154). During this study it became evident that taxing the small business is not an easy task and should be implemented by considering the way in which a business forms and develops, taking their constraints into consideration (Freedman, 2010:1). Tax policies should target a specific relief and not attempt to target SMES in general. Freedman (2010:1) further claims that relief should focus on capital investments and where market failures are identified.

The task of designing a fairer simplified tax system was underestimated in the past, and it is evident that policies aimed at the SME sector lack stability. SMES for which the relief was not intended will surely use the relief if it is beneficial to them. Freedman further argued that policy design faults that results in distortions in the market should be blamed on policy makers and not the small business owner.

There are certainly lessons that countries can learn from one another. Policy makers should refer to other countries that have implemented similar policies and should use this as a base to forecast the impact. The following chapter will conclude with recommendations for implementing tax reliefs for SMES in Namibia and identify any further research.

CHAPTER 6

CONCLUSION

6.1 INTRODUCTION

The study analysed the existing literature on tax policies aimed at the SME sector in the UK and SA. The tax policies governing SMES in SA and the UK were compared with the aim of finding the best mixture of tax reliefs for possible implementation in Namibia.

This chapter will summarise the advantages and disadvantages of the available tax policies and will lastly comment on areas where further research is needed. The following paragraph will discuss the degree to which the research objectives have been met.

6.2 ADDRESSING THE RESEARCH OBJECTIVES

The study considered existing literature regarding tax legislation for SMES in SA and the UK and identified differences and similarities of the tax legislation. The study identified efforts by Governments to

- reduce tax liability through reduced tax rates and accelerated capital allowances and
- Reduce compliance costs by introducing differentiated tax policies, which do not entail complicated calculations.

An analysis of the tax policies were done to recommend possible tax policies for the SME sector in Namibia. The following paragraph will summarise the findings.

6.3 CONCLUSION

During this study, it has been shown that the criteria used to qualify for SMES tax relief, resulted in unwanted consequences. As remarked by Freedman (2010:1) “sweets need to be handed out with care, to the people who will benefit from them, and should not contain poison”. The following paragraph will discuss the major issues regarding the criteria used to qualify for SME tax relief.

6.3.1 Criteria used to qualify for tax relief

Difficulties emerge due to the criteria being used to qualify for SMES tax relief. SA and the UK use the incorporated entity status as part of the criteria. This requirement has led to businesses selecting an inappropriate business form. An advantage however is that by incorporating, a business may improve its business methods and record keeping. Another aspect which became evident is that with lower tax rates available for SMES than for employees, people select to be self-employed rather than employed. This decision should not be taken based on tax incentives, but on wider possible commercial benefits. With lower tax rates applicable on dividends as on a salary, individuals who started a business selected the option to incorporate and declare dividends instead of a salary.

Realising that the lower tax rates led to distortions, the UK government increased tax rates on SMES to be higher than on individuals. The advantage of individuals becoming self-employed lies in the subsequent growth and employment opportunities that may arise. The following paragraph will comment on the reduction of the tax burden evident from the policies implemented in SA and the UK.

6.3.2 Reduction of tax burden

The tax policies applicable on SMES in SA and the UK were discussed during the research. Tax relief includes a reduced tax rate and a simplified way to calculate taxes. It is evident from the research that the UK gradually moved away from additional capital allowances. The emphasis when it comes to capital allowances is not on the size of the entity but rather the investment decision taken by entities. Any entity investing in non-current assets qualify for the Annual Investment Allowance (AIA). The latest movements in the UK tend to reduce the tax compliance burden and not necessarily the tax rate.

The new cash-based system focussed on the compliance burden by introducing an easy, simplified way to calculate taxes. The turnover tax system in SA can be compared with the cash-based system in the sense that the aim is to reduce compliance cost. This includes the time, effort and money spent to comply with regulations. The cash-based system and turnover tax should not be seen as a way to pay less tax as it can even result in higher taxes in some cases.

The relief available on VAT also tends to reduce the compliance burden rather than the taxes themselves. The flat rate system in the UK is a simplified tax system which does not require any specialist equipment or expertise but may again, in some cases, result in a higher tax liability. Apart from considering a reduction in compliance cost and lower tax liability, incentives through research and development were also introduced. The following paragraph will comment on R & D reliefs.

6.3.3 Research & Development Allowances

The additional Research and Development allowances available for SMES should increase activities in these areas. Considering the size of the majority of SMES, regarded as micro businesses (Business Statistics, 2013:1), it is unclear if these businesses will engage in research and development activities. A comment on Venture Capital Incentives, with a focus on the possible investor, will follow in the next paragraph.

6.3.4 Venture Capital Company

Although not aimed specifically at SMES tax liability, the incentive for investors in Venture Capital Companies (VCC) could result in investment in SMES with consequent growth and employment creation. However it seems progress in this regard has so far been limited as only three companies are registered currently in SA and even in the UK, lower investment levels have been seen in 2013.

The research further showed that no differentiated tax policies focussing on the SME sector exist in Namibia. With SMES and larger entities reporting under the same system, it is evident that the compliance cost of the SMES in relation to the larger entity is much higher. Although the Government of Namibia recognised the SME sector as the driver of the economy, no efforts had been made so far to introduce tax benefits.

Countries should learn from others when implementing tax policies. A lesson evident from the research is that tax reform should be thought through and concentrate on inherent aspects of the SME sector. SMES should be seen as different entities with different needs and not just as a smaller version of larger entities. The following paragraph proposes recommendations for possible tax reform in Namibia.

6.4 RECOMMENDATION

The research showed that SMES should be seen in a different light as larger entities. Cutting or reducing legislation may prove ineffective and may even lead to unwelcome consequences as discussed in the previous chapter.

Problems such as a lack of financial support, business support and the availability of skills have been identified. A large number of SMES are formed not by choice, but out of desperation due to the lack of job opportunities. This has resulted in a large number of micro businesses (Jauch:2010). A study by the World Bank indicated that tax regulations in Namibia have too many formalities compared to other countries (NDP4, 2013).

This research focussed on tax legislation for the SME sector with the ultimate goal of recommending possible tax reform for SMES. The recommendations are given against the background of the research findings:

- Tax relief in the start-up phase of the business such as Annual Investment Allowance (AIA) should be provided. SMES investing in capital assets should benefit through this relief.
- A turnover tax system should be implemented to ensure easier tax calculations. The compliance cost burden will be dramatically reduced.
- An increase in the VAT registration threshold is of vital importance. The registration threshold of N\$200 000 has not changed since 2000 and an increase is therefore long overdue.
- An easier compliance process is needed to motivate informal businesses to become registered entities.
- Announce a tax amnesty for small businesses to motivate informal traders to register as a formal entity.
- Offer tax education to SMES owners to assist in tax compliance.

These recommendations should have a positive effect on both the SMES and Government.

6.4.1 Effect on SMES owners

SMES owners can benefit from easier tax compliance processes and a reduced need for experts to do the tax calculations. It is not anticipated that the tax liability will reduce but the reduction in compliance cost will benefit SMES substantially. Registered SMES should benefit from improved support for business practices and record keeping, with a subsequent enhancement in funding possibilities. Once a tax amnesty is announced, informal SMES will have the opportunity to start with a clean slate without fear of prosecution in terms of the Act.

6.4.2 Effect on the Government of Namibia

A turnover tax system should also be easier to verify and would enable tax officers to spend more time on other tax matters and training. By announcing a tax amnesty it is assumed that a large number of informal businesses will register, become compliant and , over time, this will lead to a substantial increase in taxes.

During this study it became evident that much more research is needed in Namibia in the area of tax reform. The following paragraph will highlight the possible areas for future research.

6.5 FUTURE RESEARCH

According to Jauch (2010:7), little research has been done on tax reform. Research on the following matters is urgently needed:

- Defining SMES in the Namibian context.
- Training and education on income tax matters.
- Research on how to create a more conducive environment for communication between the taxpayer and authorities.
- The principles of income tax and VAT should be incorporated into the secondary school curriculum.
- Research with the aim of implementing a tax amnesty.

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