

The Tax Dos and Donts of SBCs



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A Small Business Corporation (or SBC) may qualify for favourable tax treatment if it meets certain requirements in the Income Tax Act (ITA). The benefits, requirements, and common pitfalls are summarised below.

Benefits

Companies (including close corporations) are generally subject to a flat rate income tax of 28%. SBCs are subject to more favourable tax rates on taxable income up to R550 000. The SBC tax rates for financial years ending between 1 April 2018 and 31 March 2019 are:

- 0% of taxable income up to R78 150.
- 7% of taxable income above R78 150.
- R20 080 21% of taxable income above R365 000.
- R58 930 28% of taxable income above R550 000.

SBCs also qualify for an accelerated depreciation allowance on plant and machinery (or movable assets). Movables owned and acquired by an SBC for a cost qualify for this allowance. The cost is determined as the lesser of the actual cost to the SBC or the amount that would have represented an arms length cost. Assets that were acquired by a SBC for no consideration will not qualify. Such assets may qualify for the general wear and tear allowance, based on the amount by which, in the Commissioners view, the value of the assets has been diminished during the year of assessment.

An SBC may elect to claim the following deductions in respect of movable assets brought into use for the first time by the SBC:

- Assets used directly in a process of manufacture or similar process: 100% of the cost in the year of assessment in which the asset is first brought into use.
- Other qualifying assets: 50% of the cost in the year of assessment in which the asset is first brought into use, 30% in the first succeeding year, and 20% in the second succeeding year.

SBCs can elect to claim the general wear and tear allowance or the special allowance. The latter is usually more favourable from a timing perspective, especially for assets used directly in a process of manufacture.

Requirements

To qualify for the special tax treatment, the SBC must meet six requirements, namely:

1. Corporate entity: Only close corporations, co-operatives, private companies and personal liability companies currently qualify for the SBC regime.
2. Natural shareholders: Shareholders of the SBC must be natural persons throughout the year of assessment.
3. R20 million gross income: The SBCs gross income for the year of assessment may not exceed R20 million.
4. Shareholders not to hold shares in other entities: Shareholders or members of an SBC may not hold a share or interest in the equity of another company, close corporation or co-operative, other than listed companies; collective investment schemes; body corporates, share block companies and certain associations; less than 5% of the interest in certain co-operatives; friendly societies; less than 5% of the interest in certain co-operative banks; venture capital

companies; companies, close corporations or co-operatives which have never carried on any trade and never owned any assets with a total market value exceeding R5 000; and companies, close corporations or co-operatives which have taken certain steps to liquidate, wind up or deregister, which steps have not been withdrawn or invalidated.

5. Investment income and income from rendering of a personal service 20% rule: Not more than 20% of the total receipts and accruals of the SBC may collectively consist of investment income and income from the rendering of a personal service. Investment income includes dividends, foreign dividends, royalties, rental in respect of immovable property, annuities or income of a similar nature, interest and proceeds from investment or trading in financial instruments, marketable securities or immovable property. Personal service includes services performed in a wide array of fields if the service is performed personally by any person who holds an interest in the SBC or by a connected person in relation to a person who holds an interest in the SBC. Services will not be regarded as personal services if the SBC throughout the year of assessment employs three or more full-time employees who are on a full-time basis engaged in the business of the SBC of rendering the service (other than shareholders or members of the SBC, or connected persons in relation to them).
6. Exclusion of personal service providers: The SBC may not be a personal service provider. A company is a personal service provider if a connected person in relation to the company renders services on behalf of the company and the person would otherwise have been regarded as an employee of the company's client; or the client exercises control or supervision over the manner in which the duties are performed in cases where the duties must be performed mainly at the premises of the client; or more than 80% of the company's income from services for the

year of assessment consists of or is likely to consist of amounts received directly or indirectly from any one client or an associated institution in relation to a client. A company will not be regarded as a personal service provider if it (throughout the year of assessment) employs three or more full-time employees who are engaged in the business of the company of rendering the service on a full-time basis (other than shareholders of the company or connected persons in relation to them).

Pitfalls

Companies held by trusts do not qualify as SBCs, even if all the beneficiaries of the trust are natural persons. The natural persons must hold the shares in the SBC directly.

SBCs should inform their shareholders or members of the prohibition on the holding of shares or interests in the equity of other companies, close corporations, or co-operatives, and the exceptions to this rule. A single shareholder holding prohibited shares in another company may result in the SBC as a whole being disqualified from the regime. Shareholders may unknowingly contravene this rule if they hold shares in dormant or semi-dormant companies. Even if an entity never carried on a trade, it will only be an allowable exception if it never owned any assets with a total market value exceeding R5 000. Entities that previously carried on a trade (no matter how long ago) will only qualify as an allowable exception if formal steps have been taken to liquidate, wind up, or deregister.

To ensure compliance with the 20% rule, receipts and accruals should be classified appropriately. Only amounts that properly constitute consulting fees should be labelled as such. Owner operated companies that mainly provide services will usually fall foul of the 20% rule in relation to income from rendering a personal service. These companies may also constitute

personal service providers. To overcome both of these difficulties, a company can appoint three or more full-time employees who are not shareholders or connected persons in relation to the shareholders. Companies will also fall foul of the 20% rule if they derive excessive income from the rental of immovable property (or other investment income). One would therefore not expect SBCs to own substantial immovable property other than immovable property occupied by itself.

When a company's gross income exceeds the R20 million threshold it will, from the commencement of that year of assessment, be taxed at the flat corporate income tax rate of 28%. The SBC regime is worthwhile to benefit from until this threshold is reached.