COLLEGE OF ACCOUNTING

TAXATION | INTERMEDIATE

Video Transcription: Introduction to Provisional Tax

Hi, I'm Shaun Parsons. In this video I'm going to give you an overview of provisional tax.

It is often said that income tax is an annual event. This means that income tax is determined once a year, and includes all of the tax consequences of that year. We refer to the time covered by the income tax calculation as the year of assessment. For individuals and trusts, the year of assessment always runs from 1 March to the end of February. For companies, the year of assessment will always coincide with the company's financial year.

The annual calculation of income tax means that the taxpayer is assessed by SARS, with respect to income tax, once a year. This means that it is only after the end of the year of assessment, once the taxpayer has submitted an annual tax return and received their assessment from SARS, that he or she knows exactly how much income tax they will be charged. For an individual who waits until the last minute to file their tax return, this could be many months after the end of the year of assessment.

The long delay between the events that gave rise to the taxable income and the final determination of taxable income would lead to a very inefficient system if SARS were to wait all this time before collecting any tax. For this reason, SARS collects taxes throughout the year, and when the taxpayer is finally assessed, the amounts collected in advance are compared to the final calculation of taxable income tax for the year, and the taxpayer either settles, or is refunded, the difference.

One way in which income tax is collected is through employees' tax, which is deducted from the salaries and wages of employees each time they are paid. The other way is through the payment of provisional tax. Provisional tax is due twice a year – once halfway through the year, and once at the end of the year. For individuals, this is at the end of August and the end of February. For companies, it depends on their financial year-end. For example, a company with a December year-end will pay provisional tax in June and December.

Because provisional tax is an advance payment, the taxpayer will make an estimate of what their taxable income for the year will be. Let's pause for a minute: imagine that you have limited available information, what is the best predictor of your taxable income? The simplest would be to assume that your taxable income this year will be same as last year. However, if you had a once-off event last year like a capital gain or a retirement lump sum, you would probably want to exclude that, since that is unlikely to recur this year. This simple prediction – using last year's taxable income as the estimate for this year's taxable income is referred to for provisional tax purposes as the Basic Amount.

In calculating the Basic Amount, any taxable capital gains and retirement lump sums included in last year's taxable income are removed. If last year's taxable income has not yet been finalised (or assessed), the taxpayer would use the last year that has been assessed to determine the Basic Amount.

If the past year of assessment that the taxpayer is using to determine their Basic Amount ended more than 18 months before the date on which the provisional tax return is due, the effect of inflation must be accounted for. The taxpayer is then required to apply a percentage increase in determining their Basic Amount.

The First Provisional Tax Payment

For the first provisional tax return, taxpayers must submit an estimate not less than the Basic Amount. Let's say that the taxpayer is an individual, who is submitting their first provisional tax return for the 2016 year of assessment in August 2015. Their 2015 annual tax return has not yet been submitted or assessed.

The taxpayer will use their 2014 assessment to determine their Basic Amount. Let's assume their 2014 taxable income was R750 000, and it included a taxable capital gain of R50 000. The taxpayer's Basic Amount is therefore R700 000. Because the 2014 year of assessment ended exactly 18 months before August 2015, the taxpayer does not have to apply an inflationary increase. The taxpayer will submit an estimate not less than his Basic Amount of R700 000. Let's assume he submits an estimate of R700 000. The tax per the 2016 income tax tables on R700 000 is R208 080.

The R208 080 will be reduced by the primary rebate for 2016 of R13 257 as well as any medical rebates. Let's say that our taxpayer doesn't contribute to a medical aid and hasn't incurred any medical costs, so he doesn't qualify for any medical rebates. This gives our taxpayer his estimated tax for the year, of R194 823 (R208 080 – R13 257). The first provisional tax return estimates tax for six months, so we divide the tax of R194 823 by two to get to the tax for six months, giving us R97 411,50.

If the taxpayer is an employee and has paid employees' tax, this tax amount of R97 411,50 for six months will be reduced by any employees' tax he paid during the six months. The remaining amount is the provisional tax for the first six months of the year of assessment, which must be paid to SARS by the end of August.

Now let's look at the second provisional tax return. You will see that the way the amount is estimated differs between the first and second provisional tax returns.

The Second Provisional Tax Payment

The second provisional tax return differs slightly from the first return, depending on what the taxpayer's actual taxable income for the year of assessment will be. If his actual taxable income is less than R1 million, the taxpayer cannot incur any penalty as long as his estimate for the year is not less than the Basic Amount.

If his actual taxable income will be more than R1 million, the taxpayer must submit an accurate estimate, and will incur a penalty if his estimate turns out to be less than 80% of his actual taxable income (regardless of whether his estimate is above or below the Basic Amount).

Let's assume that our taxpayer submits an estimate of R810 000. The tax per the 2016 individuals' tax tables on R810 000 is R253 154. This amount of R253 154 is reduced by the primary rebate, and we will continue to assume that our taxpayer is not eligible for any medical credit rebates. The tax on his estimate for the year is therefore R239 897. Since he already paid R97 411,50 when submitting his first provisional tax return, he owes R142 485,50 with respect to his second provisional tax return.

So, given that the provisional tax payments are based on taxpayers' own estimates, why wouldn't they submit a low estimate to reduce provisional tax payments? Let's have a look at the penalty for underestimating taxable income.

The Provisional Tax Underestimate Penalty

A taxpayer with taxable income of more than R1 million is required to estimate his taxable income in the second provisional return with a degree of accuracy. If he does not, he is subject to a penalty. The penalty is only determined once his annual tax return is submitted and his taxable income for the year has been assessed. This is the first time we know how accurate his estimate was, in comparison to his actual taxable income.

If the taxpayer has taxable income of more than R1 million, he will be penalised if the tax paid during the year is less than the tax on 80% of the actual taxable income. This means that in making his estimate for his second provisional tax return, the taxpayer is not expected to be 100% accurate.

If the tax he has paid is less than the tax on 80% of his actual taxable income, he will pay a penalty amounting to 20% of the difference between the minimum that he should have paid, i.e the tax on 80% of his taxable income, and what he actually paid.

If the taxpayer has taxable income of less than R1 million, he is protected by the Basic Amount. As long as his estimate is not less than the Basic Amount he cannot be subject to a penalty. However, there might be legitimate reasons for submitting an estimate that is less than the Basic Amount.

For instance, his business might have been less profitable this year than last year, or he might have retired during the course of this year. For this reason there is a second protection: the taxpayer will also not be subject to a penalty as long as the tax he has paid on his estimate is not less than the tax on 90% of his actual taxable income, even if 90% of his actual taxable income is lower than the Basic Amount.

Let's look at our example again. Our taxpayer has submitted an estimate of taxable income in his second provisional tax return of R810 000. He can only be subject to an underestimate penalty if R810 000 is less than both his Basic Amount and less than 90% of his actual taxable income. His actual taxable income would therefore have to be more than R900 000 (since 90% of R900 000 is R810 000).

If his taxable income is more than R1 million, he will not be protected by the Basic Amount, but he is allowed a greater margin of error in estimating his taxable income. He will only be subject to a penalty if his taxable income is more than R1 012 500 (since 80% of this is R810 000).

Let’s assume that his actual taxable income turns out to be R1.2 million. His penalty will be 20% of the difference between the tax on 80% of R1.2 million and the sum of the taxes he has paid. The tax on 80% of R1.2 million (R960 000) is R301 397, and he made provisional tax payments of R97 411,50 and R142 485,50. The difference is therefore R61 500, so he will be subject to a penalty of 20% of R61 500, which amounts to R12 300.

There is one more provisional tax payment that we should consider.

The Third Provisional Tax Payment

Provisional tax is an advance payment of income tax for the year, and we only know exactly what the tax for the year is once the taxpayer has submitted his annual tax return and has been assessed. At this point, the actual tax for the year is compared to the total provisional tax (and maybe employees’ tax) already paid by the taxpayer. The taxpayer then needs to either pay the final outstanding amount or will be refunded the difference if they paid too much.

There could be a long time between the end of the year of assessment and when the final assessment is completed, during which time either the taxpayer or SARS is owed the difference. If it takes more than 7 months to finalise the taxpayer’s affairs (or 6 months if the taxpayer’s year-end is not in February), interest will be levied from the end of the grace period (i.e. the 7 or 6 months indicated) until the date on which the taxpayer’s return is assessed. If the taxpayer is unable to submit his tax return within the grace period, and does not wish to incur an interest charge, he can make a voluntary top-up payment before the end of the grace period.

This is added to his first and second provisional tax payments when he is finally assessed, and interest would only be charged if there was still a shortfall. If he has overpaid, SARS will refund the difference together with interest calculated from the end of the grace period until the date he is assessed. For example, if our taxpayer’s actual taxable income is R850 000, his income tax for the year amounts to R256 297. He has already made provisional tax payments totalling R239 897. If he has not submitted his tax return by the end of September 2016, he will have to make a top-up payment of R16 400 by the end of September in order to avoid being charged interest.

The assessment of the taxpayer’s annual tax return happens at the end of a long process. During the year, the taxpayer makes two provisional tax payments based on the estimate of his taxable income. The first estimate must not be less than his Basic Amount, and while his second estimate does not need to be perfect, it does require a degree of accuracy to avoid a penalty.

The taxpayer can also make a top-up payment to avoid being charged interest. In the end, the actual tax in his assessment is compared to the sum of the provisional tax payments, and the taxpayer either settles what is still owed or is refunded any overpayments.

Thanks for watching.