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**An in depth analysis of the development of the taxation of co-operatives in South
Africa and whether this aligns with their economic purpose**

By

Tracy Lyn Wheeler

Student No. WHLTRA001

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Faculty of Commerce

UNIVERSITY OF CAPE TOWN

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Supervisor: Prof. Jennifer Roeleveld, Department of Finance and Tax,

University of Cape Town

DECLARATION

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ABSTRACT

To the extent that co-operatives do not qualify for specific tax relief provisions, they are taxed similar to companies. Co-operatives have the potential to alleviate poverty and make a positive contribution to the economy; however South African co-operatives do not yet make a significant impact in this regard. The South African government through the Department of Trade and Industry has highlighted the need to focus on how emerging co-operatives can be better supported. One of the contributors to the fact that co-operatives are yet to make a significant contribution to employment and economic growth is the lack of a tax regime which supports this aim.

In this study, after providing background on the co-operative movement both internationally and in the South African context and an indication of what the success of the co-operative sector could mean for South Africa from a socio-economic perspective, an analysis of the tax legislation as it relates to co-operatives is conducted. The analysis tracks the development of the legislation since the introduction of the Income Tax Act No 58 of 1962.

In light of the commitment of the South African government to promoting co-operatives in order to stimulate economic growth, perceived deficiencies in the current tax legislation are highlighted. These deficiencies are identified on the basis that co-operatives should not be placed at a disadvantage when the tax treatment of co-operatives and companies are compared, nor should they simply be taxed in the same way as companies, as co-operatives have unique characteristics which should be recognised in the tax legislation.

To provide suggestions for ways in which the current legislation could be improved, a review is conducted of the taxation of co-operatives in countries with successful co-operative sectors in both the developed and developing world. The findings of the international best practices, coupled with the problem areas identified in the current tax legislation, are combined to propose amendments to the tax regime, in order to align the income tax legislation with the economic purpose of co-operatives in South Africa.

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University of Cape Town

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LIST OF ABBREVIATIONS

| Abbreviation | Meaning |
|---------------------|-------------------------------------|
| BEE | Black Economic Empowerment |
| CGT | Capital Gains Tax |
| DTI | Department of Trade and Industry |
| EU | European Union |
| GDP | Gross Domestic Product |
| ICA | International Co-operative Alliance |
| ILO | International Labour Organisation |
| SARS | South African Revenue Service |
| STC | Secondary Tax on Companies |
| STT | Securities Transfer Tax |
| UN | United Nations |
| VAT | Value Added Tax |

CHAPTER 1

INTRODUCTION

1.1 Background

It is internationally accepted that co-operatives have the potential to alleviate poverty and make a positive contribution to the economy.¹ These member owned organisations are usually formed by people with limited resources. By aggregating the market power of people who on their own could achieve little, studies have shown that for over 150 years, co-operatives have succeeded in lifting communities and nations out of poverty, particularly in the developed world.²

The development of co-operatives has been identified by the South African government as one of the critical and viable means to alleviate poverty. The mandate for co-operative development is held by the Department of Trade and Industry (DTI). The DTI's commitment to the co-operatives sector is embodied in their policy statement on co-operatives, which reads:

“A viable, dynamic, autonomous, self-reliant and self-sustaining co-operative movement can play a major role in the economic, social and cultural development of South Africa, through effective and efficient services extended by co-operative enterprises to their members. By doing so, co-operatives contribute to the creation of jobs, income generation, resources mobilization, and broad-based economic empowerment, thereby enhancing sustainable human development in South Africa.”³

The government is committed to enhancing the co-operatives sector. To this end, the Co-operatives Act of No 14 of 2005 ('the Co-operatives Act')⁴ was enacted to provide the legislative framework for promoting and regulating co-operatives. Various programmes aimed at providing funding, training and support have also been launched to ensure that the objectives set for the co-operatives sector, are realised.⁵

¹ Johnston Birchall, *Cooperatives and the Millennium Development Goals*. (Geneva, International Labour Organisation, 2004), 2.

² *Ibid*, 11.

³ The Department of Trade and Industry. 2004. *A co-operative development policy for South Africa*. Pretoria: Government Printer, 4.

⁴ All references to 'the Co-operatives Act' in this study refer to the Co-operatives Act No 14 of 2005 (effective 2 May 2007), unless specifically indicated otherwise.

⁵ The Department of Trade and Industry. 2010. *The co-operatives handbook, 2010*. Pretoria: Government Printer, 7.

In order to launch an integrated strategy on the promotion of co-operatives in South Africa,⁶ it was necessary to develop a comprehensive picture of the status of the development of co-operatives in South Africa. To this end, the DTI conducted a baseline study of co-operatives in 2009. The study found that 84.1 percent of co-operatives employ less than 15 individuals⁷ and while the contribution of the smaller emerging co-operatives could not be quantified, the larger co-operatives contributed only 0.33 percent to South African gross domestic product (GDP).⁸ A key finding of the study was that while there is evidence internationally that co-operatives can contribute directly to the eradication of poverty, employment and the stimulation of economies, in South Africa co-operatives do not yet make a significant contribution to the economy in terms of employment creation or in terms of its contribution to GDP.⁹

Enabling tax regimes are cited as one of the reasons for the success of co-operatives internationally in the aforementioned study. In Canada, for example, the study notes that a combination of the formation of secondary co-operatives and various tax incentives has resulted in the success of co-operatives such that they currently contribute approximately 10 percent of the GDP.¹⁰ Indeed the DTI itself has highlighted that one of the contributors to the fact that co-operatives are yet to make a significant contribution to employment and economic growth, is the lack of a tax regime which supports this aim.¹¹

The question therefore arises, whether the current South African tax legislation is in line with the aim of the South African government to promote co-operatives as a measure to reduce poverty and stimulate economic growth, and if not, what changes or incentives could be recommended.

⁶The Department of Trade and Industry. "Publication of the integrated strategy on the development and promotion of co-operatives for public comments" *Government Gazette*, Notice 34 (2011) Pretoria: Government Printer - as presented to the Select Committee on Trade and International Relations on 9 February 2011.

⁷The Department of Trade and Industry. 2009. *The dti baseline study of co-operatives in South Africa*. Johannesburg: The Department of Trade and Industry and the Growth Laboratory, 63.

⁸ *Ibid*, 33.

⁹ *Ibid*, 34.

¹⁰ *Ibid*, 23.

¹¹ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 60.

1.2 Objectives and value of research

The central question in this dissertation is: does the current taxation of co-operatives support the governmental goals of encouraging the use of co-operatives to alleviate poverty and make a positive contribution to the economy?

There follows from this question, a number of sub questions:

- What are co-operatives and why do they exist?
- How has the taxation of co-operatives in South Africa developed?
- What are the problems or deficiencies with the current tax legislation?
- What can be learnt from the taxation of co-operatives in countries with successful co-operative sectors?
- What possible changes or additions to existing tax legislation could be recommended, where co-operatives are concerned?

In the current tax legislation, co-operatives are treated as companies and may access tax benefits as small businesses. However, companies and co-operatives differ in their structure. For companies, the focus is to maximise profits for shareholders, while for co-operatives, the main focus is on benefiting the members. If co-operatives are to be more effectively used as tools for social and economic upliftment, a tax regime more suited to the unique case of co-operatives, may assist in stimulating growth in this sector.

De Koker¹² outlines the handful of specific provisions which appear in the current tax legislation, Income Tax Act No 58 of 1962 ('the Income Tax Act'). Apart from this work, no other academic papers or books have been identified which cover the subject of the taxation of co-operatives in any detail. There is therefore a gap in the existing body of knowledge in this regard. This dissertation aims to contribute to the general body of tax knowledge by analysing the development of the taxation of co-operatives in South Africa since the inception of the aforementioned Income Tax Act; identifying areas in the current tax legislation where co-operatives are taxed in a way not congruent with the aim of the South African government to promote the co-operatives sector; and recommending tax measures which might provide a more enabling tax regime, in order that the fiscal goals of poverty alleviation and economic growth through the co-operatives sector, might be met.

¹² A P De Koker, *Silke on South African Income Tax* [e-book] 8, 17 Durban: LexisNexis Butterworths. Available: <http://www.mylexisnexus.co.za> [5 April 2011]. Subscription website.

1.3 Limitations

With regard to the recommendations for a more enabling tax regime with regard to South African co-operatives, the dissertation is not intended to propose express provisions to be incorporated into the tax legislation in order to better promote the co-operatives sector. The dissertation intends only to provide suggestions as to where the problem areas may be and how the current tax legislation could be improved.

The paper focuses specifically on the income tax provisions, excluding Capital Gains Tax (CGT). An analysis of the effects of other taxes on co-operatives, such as Secondary Tax on Companies (STC), Value Added Tax (VAT), Employees Tax and Securities Transfer Tax (STT), are beyond the scope of this paper. Furthermore, any tax consequences relating to the new Dividends Tax¹³ are also beyond the scope of this study. The aforementioned limitations on scope, present themselves as areas of future research.

All references to the Income Tax Act in this study refer to the Income Tax Act No 58 of 1962, unless otherwise specified. The current Income Tax Act No 58 of 1962 as referred to in this study, excludes Taxation Laws Amendment Act 24 of 2011 and Taxation Laws Second Amendment Act 25 of 2011.

1.4 Methodology

The dissertation is structured as follows:

Firstly, in Chapter 2 the question of what co-operatives are and why they exist, is explored in the global context so as to provide an understanding of what the success of the co-operatives sector could mean for South Africa from a socio-economic perspective. Then the same question is explored in the South African context. To further understand the nature of co-operatives in the South African context, the legal framework is analysed. In this regard, the Co-operatives Act No 14 of 2005 is particularly relevant and the more critical provisions of this Act are highlighted and discussed. This analysis also provides the legal policy foundation against which a review of the tax legislation as it relates to co-operatives, can be tested.

¹³ Effective date for the new Dividends Tax is 1 April 2012.

The development of the taxation of co-operatives did not occur in a vacuum. The changes in income tax legislation were reflective of changes in the South African economy and political arena. Thus a brief history of the development of co-operatives in South Africa is also outlined in Chapter 2.

In Chapter 3, the evolution of the income tax legislation as it pertains to co-operatives since the introduction of the Income Tax Act in 1962, is then set out. This is accomplished through an analysis of the income tax amendments enacted since 1962 which have impacted co-operatives. Perceived deficiencies in the tax legislation are highlighted in this chapter, in light of the socio-economic aims of the South African government. More specifically, problem areas or deficiencies are identified on the basis that co-operatives should not simply be taxed in the same way as companies, as co-operatives have unique characteristics which should be recognised and, furthermore, tax incentives should be considered to aid in the strategy of promoting the co-operative sector, to which the government is committed.

To provide some possible suggestions for ways in which the current legislation could be improved or potential tax incentives to be considered, a review is conducted in Chapter 4 of the taxation of co-operatives in countries with successful co-operative sectors in both the developed and developing world.

Finally the findings of the international best practices, coupled with the problem areas identified in the current tax legislation, are combined in Chapter 5 and are used to propose a more enabling tax regime for South Africa, which aims to align the income tax legislation with the government's goal of promoting co-operatives as a vehicle to alleviate poverty and make a positive contribution to the economy. Chapter 6 contains concluding remarks.

CHAPTER 2

WHAT ARE CO—OPERATIVES AND WHY ARE THEY FORMED?

2.1 Introduction

South Africa is faced with an alarming unemployment rate of 24.9 percent, which ranks as the 27th highest in the world.¹⁴ Furthermore, approximately half the population is below the poverty line.¹⁵ The South African government has looked to foreign developed and developing countries for solutions to its socio-economic problems and one such solution is the use of co-operatives to address poverty, unemployment and stimulate economic growth. The people of South African are diverse, but a common thread in many of the cultures is a strong sense of community.¹⁶ Therefore, the co-operative model with its focus on co-operation between people and within communities in order to aggregate the market power of people who together are able to achieve more than in isolation, would appear to be an intriguing choice for South African businesses. The co-operative model encourages community development as investment remains within the community by being circulated within the co-operative. Furthermore, there is a natural inclination for training and development to be promoted among the members.

Indeed, both political and economic stakeholders in South Africa have identified co-operatives as a viable means of alleviating poverty and unemployment and as a result, the promotion of co-operatives is regarded as critical to the development of the economy, particularly in the informal sector.¹⁷ In his midterm parliamentary address, former president Thabo Mbeki first expressed the commitment of the South African government to the development of the co-operative movement, when he said on 25 June 1999:

“The Government will also place more emphasis on the development of a co-operative movement to combine the financial, labour and other resources among the masses of the people, rebuild our

¹⁴ Central Intelligence Agency World Factbook (Last update: 15 November 2011) ‘*South Africa.*’[Online]. Available: <https://www.cia.gov/library/publications/the-world-factbook/geos/SF.html>. [26 November 2011].

¹⁵ *Ibid.*

¹⁶ Economic Commission for Africa, *Relevance of African traditional institutions of governance*, (2007). [Online]. Available: <http://www.uneca.org/gpad/publications> [26 November 2011].

¹⁷ The Department of Trade and Industry, *A co-operative development policy for South Africa*, 7.

communities and engage the people in their own development through sustainable economic activity.”¹⁸

With the larger co-operatives only contributing 0.33 percent to the GDP, the contribution of smaller co-operatives unknown and with the majority of co-operatives employing less than 15 people,¹⁹ it is clear that South African co-operatives are not making the same impact with regard to the eradication of poverty, unemployment and the stimulation of economies, when compared with their international counterparts.

However, the DTI is intent on remedying the relatively poor performance of co-operatives in South Africa. In Notice 34 of 2011 of the Government Gazette, the DTI set out a comprehensive strategy on the development and promotion of co-operatives which has among its aims, the increase of co-operative contributions to GDP and the creation of decent employment and poverty reduction through the use of these entities.

This chapter provides an overview of what co-operatives are and provides examples of the benefits and success stories of co-operatives, as identified by the South African government, in both the developed and the developing world. It also provides a history of the development of co-operatives in South Africa since co-operatives were first introduced in the late nineteenth century. The history is relevant in that the changes in income tax legislation were reflective of changes in the South African economy and political arena. Thus it is important to have an understanding of the development of co-operatives in South Africa prior to analysing the tax legislative developments.

Finally, to further understand the nature of these entities in the South African context, the chapter concludes with a discussion of the legal framework of co-operatives in South Africa. Since co-operatives are far less prevalent than other traditional business models, the legal policies which create the framework for co-operatives are not as commonly known. However, should the DTI be successful in its strategy to develop co-operatives in South Africa, knowledge of what co-operatives are from a legal perspective will become more relevant. Furthermore, an understanding of the current legal framework provides a foundation for analysing the unique provisions relating to co-operatives in tax legislation.

¹⁸ UNISA, 2011. *Thabo Mbeki African Leadership Institute: Archived speeches of former president of South Africa - Mr. Thabo Mbeki*. [Online]. Available: <http://www.unisa.ac.za/Default.asp?Cmd=ViewContent&ContentID=25143> [28 June 2011].

¹⁹ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 63.

2.2 What are co-operatives? An overview

In South Africa, co-operatives are governed by the Co-operatives Act of 2005, which defines a co-operative as:

“An autonomous association of persons united voluntarily to meet their common economic and social needs and aspirations through a jointly owned, democratically controlled enterprise organized and operated on cooperative principles.”²⁰

This definition is similar to the definition provided by the International Co-operative Alliance (ICA). The ICA is an independent, non-government association that represents co-operatives worldwide.²¹ Over one billion people in the world are affiliated to co-operatives and this is reflected in the 265 member organisations from 96 countries of which the ICA is comprised.²² The ICA states that co-operatives are based on the values of self-help, self-responsibility, democracy, equality and the seven co-operative principles which are as follows:²³

- I. Voluntary and open membership
- II. Democratic member control
- III. Member economic participation
- IV. Autonomy and independence
- V. Education, training and information
- VI. Co-operation among co-operatives
- VII. Concern for community

Essentially, co-operatives are associations of people who agree to be the owners and users of their joint enterprise, in a democratic decision-making environment. These voluntary business organisations are usually formed by people with limited resources, in order to benefit the members by providing products and services to them.

Co-operatives are created through the contribution of member capital and the profits derived from the business are shared out based on the amount of capital contributed, and are used to meet member needs. Profits generated by the business may also be used to meet

²⁰ Section 1 of the Co-operatives Act.

²¹ Since 26 April 2011, South Africa has had representation in the ICA through the South African National Apex Co-operative which was founded in October 2009 and aims to advocate for and on behalf of 23 South African member societies. Reference: SANACO, *Together we can do more*, (Last updated 2011) [Online]. Available: <http://www.sanaco.coop/> [6 February 2012].

²² International Co-operative Alliance, *Statistical information on the co-operative movement*, (Last updated 24 January 2012) [Online]. Available: <http://www.ica.coop/coop/statistics.html> [6 February 2012].

²³ International Co-operative Alliance, *Statement on the co-operative identity*, (Last updated 26 May 2007) [Online]. Available: <http://www.ica.coop/coop/principles.html> [24 February 2011].

other social or cultural needs, according to the wishes of the members.²⁴ Member needs may change over time and as a result, the size of the operating activities through which co-operatives conduct their business may vary. It is noteworthy that the scale of the co-operative is driven by member needs and not by competitive pressures on the market or agendas prescribed by government.

The principle attraction of choosing the co-operative form of business is that co-operatives aggregate the market power of people who on their own could achieve little and in so doing, provide a way out of poverty. Members benefit by paying less for inputs, marketing, distribution and selling of goods.²⁵ Co-operatives are generally formed around economic sectors or activities and enable their members to access the assets they require to earn a living. Agricultural co-operatives, for example, help farmers to access the necessary inputs for growing crops and keeping livestock. They may also assist farmers with processing and marketing the farmers' produce.²⁶ In this way, co-operatives provide services to assist members to improve their livelihoods and lift people out of poverty.²⁷

There is a difference in core philosophy which underpins the objectives of a company and the objectives of a co-operative. Companies focus on maximising shareholder wealth and profits, while co-operatives focus on maximising benefits to the members. Co-operatives are unique in that they are owned by those who use the services of the co-operative, and through using its services, value is created and surpluses are returned to the members. In short, co-operatives are user-owned (the users finance the co-operatives), user-controlled (the members elect the management, thus linking membership and management), and user-benefited (surpluses are returned to the members).²⁸

The co-operative identity is also distinct from public entities owned and controlled by the state. It should be noted that some such entities purport to be co-operatives when in reality membership is compulsory and members are assigned in order to carry out government services and policy. They are also distinct from philanthropic organisations which are

²⁴ Patrick Develtere, Ignace Pollet, and Frederick O Wanyama. "Encountering the evidence: cooperatives and poverty reduction in Africa" *Working Paper on Social and Co-operative Entrepreneurship*, 2 4 (2008) [Online]. Available from Cera at: <http://www.cooperatiefondernemen.be/> [29 February 2011] .

²⁵ Companies and Intellectual Property Registration Office, *Office of the registrar of co-operatives*, (2008) [Online]. Available: http://www.cipro.gov.za/products_services/co-ops.asp [23 February 2011].

²⁶ Birchall, 4.

²⁷ Develtere et al, 4.

²⁸ Overseas Cooperative Development Council, *Cooperatives: Pathways to Economic, Democratic and Social Development In the Global Economy*,3 (2007) [Online]. Available: <http://www.acdivoca.org/site/Lookup/> [23 April 2011].

aimed at uplifting certain groups, and which raise funds predominantly through public donations and grants.

Co-operatives offer many of the same benefits as other corporate entities, such as limited liability and an existence which is perpetual. But co-operatives also offer benefits unique to this specific business model, such as the fact that the control of the business is kept in the hands of those who use the co-operatives and therefore conflict between investor and user interest is avoided with the co-operative model. From a tax perspective, corporates generally distribute dividends from after tax corporate income, whereas co-operatives are generally afforded deductions for patronage refunds distributed to the members from pre-tax income.²⁹ The taxation of co-operatives in South Africa is covered in Chapter 3, while examples of the taxation of co-operatives internationally, are provided in Chapter 4.

2.3 The international co-operative movement

According to Develtere *et al*,³⁰ there is growing consensus among the ICA, the United Nations (UN), the International Labour Organisation (ILO), and the European Union (EU), that the co-operative model is one of the few forms of organisation that address numerous aspects of poverty. Their collective view is that co-operatives identify economic opportunities for the poor, empower them, and provide security by allowing the poor to convert individual risks into collective risks.³¹

Co-operatives currently provide employment to over 100 million people around the world, which surprisingly, is 20 percent more than multinational enterprises.³² The proportion of the co-operative membership to population is as high as one in two people in Finland and Singapore, one in three in New Zealand, Honduras, and Norway, and one in four in the USA, Malaysia and Germany.³³

In terms of percentage of a country's GDP attributable to co-operatives, the proportion is highest in Kenya at 45 percent, followed by New Zealand with 22 percent.³⁴ Interestingly, co-operatives in Quebec have a 65 percent survival rate compared to less than five percent

²⁹ Refer to the discussion of the treatment of bonus payments in points 3.3.1, 3.4.1 and 4.2.

³⁰ Delvetere et al, 1.

³¹ Ibid, 2.

³² International Co-operative Alliance, *Statistical information on the co-operative movement*, 1.

³³ Ibid, 1.

³⁴ United Nations Committee for the Promotion and Advancement of Cooperatives, *Background paper on cooperatives*, 2008 [Online]. Available: <http://www.un.org/en/events/cooperativesday/> [23 March 2011].

for corporates within the first five years, and a 46 percent survival rate compared to 20 percent for corporate entities, after 10 years.³⁵

In fact, Canada as a whole is one of the major success stories for the co-operative movement in the developed world.³⁶ The co-operative movement in Canada originated to address the needs of struggling farmers to access finance. Co-operatives were also used to market the farmers' produce. The Canadian government provided an enabling environment for the growth of co-operatives and while initially the Canadian co-operatives were reliant on government support, they have developed into self sustainable organisations. The success of the co-operative movement in Canada is largely attributable to the formation of secondary co-operatives and, importantly for the purposes of this dissertation, an enabling tax regime.³⁷ One in four Canadians is a member of a co-operative and Canadian co-operatives contribute approximately 10 percent of the GDP.³⁸

A further example of a successful co-operative movement in the developed world, is that of Italy. An enabling tax regime is also cited as one of the reasons for Italy's success. Co-operatives in Italy gained popularity in the 1970s as they were sources of steady employment and they continue to make a significant contribution to Italy's economic development.³⁹

In the developing world, the co-operative movement has also contributed to economic development and job creation. Once again, enabling tax regimes are often cited as one of the reasons for their success. In India, the co-operative movement is one of the largest in the world, with over 67 percent of households involved in co-operatives.⁴⁰ The Indian government has provided tax incentives and financing to encourage the growth of co-operatives and due to the assistance and support of non-governmental organisations in the rural areas, 99 percent of the population in rural areas are involved in co-operatives.⁴¹

In Kenya, approximately 1 in 5 people derive their livelihood directly or indirectly from co-operatives and the co-operative sector generates 45 percent of GDP and 31 percent of

³⁵ Overseas Cooperative Development Council, 6.

³⁶ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 23.

³⁷ *Ibid*, 23.

³⁸ Co-operatives Secretariat, *Government of Canada invests in co-operative development in British Columbia*, (2010) [Online]. Available: www.coop.gc.ca [15 June 2011].

³⁹ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 16.

⁴⁰ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 24.

⁴¹ *Ibid*, 24.

national savings and deposits.⁴² Further information on the enabling tax regimes in Canada, Italy, India and Kenya is provided in Chapter 4.

There are also examples of co-operative movement failures. The failures are largely as a result of governments using these entities as extensions of government policy and as a result, asserting too much control over the co-operatives. A case in point is that of the consumer co-operatives in the Soviet Union which were the primary suppliers of essential goods to the urban population and which were nationalised by Stalin.⁴³ However, when the Soviet Union collapsed many co-operatives were not able to survive the transition to open national economies. Previously these co-operatives had been subject to excessive government control and they were unable to survive when faced with the pressures of global competition.⁴⁴

2.4 The South African co-operative movement: 1892 - 2005

The South African co-operative sector was formed with the establishment of the predominantly white agricultural co-operatives, targeted at developing the white farming community. Many of these co-operatives grew into successful enterprises, which controlled agricultural production, marketing and processing in rural areas.⁴⁵

The first co-operative established in South Africa was the Pietermaritzberg Consumers' Co-operative which was registered in 1892.⁴⁶ It was registered in terms of the Companies Act No 25 of 1892 in Natal, as no Co-operatives Act on a national basis existed at the time. The non-existence of a Co-operatives Act hampered the development of co-operatives as the provisions of the Companies Act did not suit unique characteristics of co-operatives and thus to be registered under a Companies Act actually meant that, in practical terms, co-operatives could not comply with all the legal provisions.⁴⁷

The co-operative movement struggled to gain momentum in the early 20th century. When the Union of South Africa was established in 1910, specific legislation targeting co-operatives was introduced. However, the legislation was applicable only to certain

⁴² International Co-operative Alliance, *Statistical information on the co-operative movement*, 1.

⁴³ Birchall, 16.

⁴⁴ Ibid, 16.

⁴⁵ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 25.

⁴⁶ Jacobus Albertus Stephanus van Niekerk. *Co-operative Theory and Practice* (Pretoria, South African Agricultural Union, 1988), 19.

⁴⁷ Van Niekerk, 24.

provinces,⁴⁸ creating confusion and hampering the development of co-operatives. The negative effect of the First World War on agriculture along with insufficient government support and little education, resulted in few new co-operatives emerging and a number of liquidations, which occurred at great loss to the members due to the fact that the liability of the members was still unlimited.⁴⁹

The Co-operative Societies Act No 28 of 1922, repealed and consolidated all previous co-operative legislation. This Act was a positive contributor to the co-operative movement as it was the first Act to control co-operatives in all four provinces and it provided that co-operatives could be established with limited or unlimited liability. Immediately prior to the introduction of the aforementioned Act, there were only 81 co-operatives in the Union, but by 1929, this number had increased to 405.⁵⁰ Despite the crippling effect of the world depression in 1929 to 1933, particularly on agriculture, membership of co-operatives actually increased during this period as farmers sought refuge in co-operatives.⁵¹ The Co-operatives Societies Act No 29 of 1939, consolidated the 1922 Act and its subsequent amendments. As with the 1922 Act, it focused primarily on agricultural activities. One of the most important provisions of the 1939 Act was that it provided for a new type of limited liability agricultural co-operative, which had the right to deal with non members and accept persons other than farmers as members. As a result, almost all co-operatives converted to limited liability co-operatives after 1939, and a period of growth in agricultural co-operatives emerged, despite periods of drought and downward swings in the economy.⁵²

The Co-operatives Societies Act No 29 of 1939, was repealed by the Co-operatives Act No 91 of 1981, which was significant as, while the focus was still on agricultural co-operatives, a number of new provisions dealing with non agriculture co-operatives were also introduced. As a result, there was an increase in the number of financial, consumer co-operatives after the introduction of the 1981 Act.⁵³

⁴⁸ The Transvaal Act governed co-operatives in the Transvaal and the Orange Free State, but the Cape and Natal were without specific legislation.

⁴⁹ Van Niekerk, 26.

⁵⁰ Ibid, 29.

⁵¹ Ibid, 29.

⁵² Ibid, 31.

⁵³ Ibid, 31.

During the period from 1922 to 1994, 1,444 co-operatives were registered under the 1922, 1939 and 1981 Acts and 70 percent of these were agricultural co-operatives, while 20 percent were consumer co-operatives and about 10 percent were financial co-operatives.⁵⁴

The growth of the number of agricultural co-operatives in particular, should be viewed in the context of other policies implemented in support of white commercial farmers. The Land and Agricultural Bank had been created by the government in order to provide co-operatives with access to finance. This resulted in agricultural co-operatives also becoming financial intermediaries. They were used as agents to provide short and medium term credit to commercial farmers at subsidised interest rates and were also used to channel disaster finance to the farmers in the form of debt consolidation.⁵⁵ Agricultural co-operatives were also benefiting as a result of the introduction of the Marketing Act No 37 of 1937 to manage the marketing of agricultural commodities through marketing control boards, also caused agricultural co-operatives to thrive as they were usually appointed as agents to the boards, giving them regional monopoly power.⁵⁶

Another factor contributing to the growth of agricultural co-operatives in particular was the generous tax concessions for co-operatives, which will be addressed further in Chapter 3. However, the substantial costs of supporting commercial farmers brought about by the tax concessions as well as through subsidies and price support, were not sustainable and thus a series of reforms occurred in the 1980s such as the removal of subsidies and the deregulation of agricultural financing and marketing.⁵⁷ As will be discussed further in Chapter 3, many of the tax concessions were removed as a result of Income Tax Act No 129 of 1991. State control of agricultural commodities also came to an end, which meant that co-operatives lost the regional monopoly power they had enjoyed through the marketing boards. While the co-operatives could still provide short and medium term credit to farmers, this had to be on a commercial basis as the Land Bank had to compete with commercial banks.⁵⁸

⁵⁴ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 26.

⁵⁵ R P King and G F Ortmann, "Agricultural co-operatives I: History, theory and problems" *Agrekon*, 46, 1 (March 2007): 46.

⁵⁶ T Doyer, J Piesse, C Thirtle and N Vink. "The changing role of grain co-operatives in the transition to competitive markets in South Africa" *Journal of Comparative Economics*, 33 (2005): 197 – 218.

⁵⁷ R P King et al, 46.

⁵⁸ *Ibid*, 47.

When the democratically elected government came into power in 1994, the co-operative form of business was identified as a means to address poverty and unemployment. Through the lobbying of socio-economic stakeholders, the government began to focus on co-operatives as a vehicle for empowerment and self-help across all sectors of the economy.⁵⁹ Therefore the mandate for co-operatives was moved from the Department of Agriculture to the DTI.⁶⁰

Showing its commitment to the co-operative movement, South Africa was a signatory to the ILO Recommendation 193 of 2002 for the Promotion of Co-operatives and in the Growth and Development Summit Agreement of 2003 co-operatives were identified as key drivers for economic development, which prompted the DTI to introduce the Co-operative Development Programme as one of its flagship projects in 2004.⁶¹ In the same year, the first comprehensive co-operatives policy was introduced by the DTI covering co-operatives in all sectors.⁶² At this stage, there were 3,990 co-operatives registered in South Africa,⁶³ which was a substantial increase from the 1,444 co-operatives registered a decade earlier, but was still insignificant when compared with the number of the more traditional business entities registered in South African at the time.

But co-operative legislation was hampering the ability of the South African government to effectively promote co-operatives as one of the drivers of economic development. The 1922 Act, the 1939 Act and the 1981 Act all had significant shortcomings in that the underlying presumption that the government would play a paternalistic role in relation to co-operatives, and moreover the legislation did not adhere to or promote the seven co-operative principles.⁶⁴ Thus work began to develop a new Co-operatives Act to address the imbalances of the past. The new Act was to be developed based on the ICA principles as well as on the co-operative policy formulated by the DTI, which focused on emerging co-operatives.⁶⁵ On 18 August 2005, the Co-operatives Act No14 of 2005 was published in the Government Gazette.⁶⁶

⁵⁹ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 26.

⁶⁰ *Ibid*, 26

⁶¹ *Ibid*, 26

⁶² The Department of Trade and Industry, *A co-operative development policy for South Africa*.

⁶³ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 26.

⁶⁴ Refer to the discussion at point 2.2.

⁶⁵ Portfolio Committee on Trade and Industry (National Assembly), Co-operatives Bill (2005a), B B – 2005, Cape Town: Government Printer.

⁶⁶ *Ibid*.

2.5 The South African co-operative movement: 2005 - 2011

The new Co-operatives Act introduced in 2005 provides for a wide variety of primary cooperatives to be registerable, including agricultural, consumer, housing, worker, financial services, burial society, and service cooperatives. It also provides for the registration of secondary and tertiary co-operatives.

The new Co-operatives Act makes it easier than before to establish and operate a co-operative.⁶⁷ Further support for co-operatives was provided with the creation of the Co-operatives Development Unit within the DTI, to review policies and strategies, co-ordinate government institutions and donor activities, and promote the co-operative concept.⁶⁸ A Co-operatives Advisory Board, was also established to represent the interests of co-operatives and is a statutory agency that advises the Minister of Trade and Industry on co-operative related issues.⁶⁹

The DTI has clearly expressed its commitment to supporting the development of genuine co-operatives that subscribe to the ICA principles.⁷⁰ The reason for the DTI's focus on the development and promotion of co-operatives, stems from the belief that the co-operative model could address a number of socio-economic problems in South Africa, due to the advantages of this model in the South African context. These advantages are summarised below:⁷¹

- Through economies of scale, independent entrepreneurs can benefit from joint purchasing power and marketing strength through operating as a co-operative.
- Co-operatives combine the supply and demand of goods and services of its members which increases their bargaining power.
- Community development is encouraged through the use of co-operatives, as investment is circulated among the co-operatives and remains within the community and there is a natural inclination for training and education to be promoted among the members.
- The active participation of members in the management of the co-operatives is cost effective.

⁶⁷ R P King et al, 47.

⁶⁸ Ibid, 48.

⁶⁹ Portfolio Committee on Trade and Industry, 9.

⁷⁰ Ibid, 26

⁷¹ The Department of Trade and Industry. *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 11.

- Since the production process in co-operatives is often more labour intensive as opposed to capital intensive, this preserves the member's self employment.
- The interests of the members are better defended through the co-operative structure than if they were acting individually.
- Increased business stability due to the risk-sharing between members.

There has been a marked increase in the number of co-operatives registered since the new Co-operatives Act was promulgated by government as part of its strategy to promote the co-operative model. In 2004, only 3,990 co-operatives were registered in South Africa.⁷² The introduction of the new Co-operatives Act, coupled with support measures and procurement from all tiers of government saw this figure jump to 22,619 registered co-operatives by 31 March 2009. The majority of these entrants were black women-owned enterprises, with a number of youth-owned co-operatives also emerging.⁷³

The growth rate in registrations is certainly impressive, but it should be noted that the increase in co-operatives registrations does not correspond to an equally positive impact on GDP and employment, due to the fact that the survival rate of co-operatives is very poor. According to the baseline study conducted by the DTI, only 2,644 co-operatives in South Africa could be confirmed as operational.⁷⁴ Furthermore, the study indicated that the operational co-operatives only employed 2,646 employees in South Africa. However, the study was not conclusive due to the inadequacy of data as it was not possible to locate many of the co-operatives due to these co-operatives not complying with the requirement to submit annual financial statements, and due to changes in contact details which were not communicated to the registrar of co-operatives.⁷⁵ The global economic crisis in the 2008/2009 financial year, also resulted in a number of co-operative deregistrations as South Africa suffered its first recession in almost two decades.⁷⁶

Of the 22,619 co-operatives registered in South Africa as at 31 March 2009, the majority of these are registered in KwaZulu Natal (38 percent). The Eastern Cape is home to 19 percent of the co-operatives in South Africa, with Gauteng at 10 percent, Limpopo at eight

⁷² Ibid, 26.

⁷³ Ibid, 27.

⁷⁴ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 23.

⁷⁵ The Department of Trade and Industry. *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 35.

⁷⁶ Ibid, 35.

percent, Mpumalanga at seven percent, North West at six percent, and with the Western Cape and the Free State both at four percent.⁷⁷

Analysing the spread of co-operatives across sectors, reveals that the agricultural sector is dominant with 25 percent of registered co-operatives listed as agricultural co-operatives.⁷⁸ This is largely due to the fact that in rural areas, the majority of opportunities exist in the agricultural sector. However, the services sector is gaining momentum and comprises 17 percent of co-operatives, and the multipurpose sector constitutes 14 percent.⁷⁹ Due to the support of government and enterprise development agencies at lower levels, co-operatives are appearing in sectors like arts and crafts, mining, construction, and manufacturing⁸⁰ which are industries largely dependent on labour and as such, should have a positive impact on unemployment if emerging co-operatives are able to survive and thrive.

2.6 The legal framework of co-operatives in South Africa

Co-operatives are sometimes referred to as ‘associations’, ‘mutual societies’, ‘consumer stores’, ‘credit unions’ and ‘village banks’ in South Africa. Co-operatives must be legally registered in terms of the Co-operatives Act and cannot exist as informal organisations.⁸¹

The Broad Based Black Economic Empowerment Act No 53 of 2003 (‘the BBBEE Act’), the Cooperative Development Policy for South Africa⁸² and the new Co-operatives Act are the three main policy pillars upon which the South African government is building the legislative environment for the development of co-operatives. The BBBEE Act provides explicitly for co-operatives to be part of the strategy to empower black people. However, according to the Co-operative and Policy Alternative Centre (a non-governmental non-profit organisation focusing on the development of co-operatives in South Africa), the deracialising of companies and the numerous Black Economic Empowerment (BEE) charters and procurement policies, have not benefited co-operatives.⁸³ Furthermore, the racially exclusive nature of BEE is in contradiction of the international co-operative

⁷⁷ Ibid, 28.

⁷⁸ Companies and Intellectual Property Regulation Office, 1.

⁷⁹ Department of Trade and Industry. *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 28.

⁸⁰ Ibid, 28.

⁸¹ Vishwas Satgar, “The state of the South African co-operative sector” *Co-operative and Policy Alternative Centre*, 3 (2007) [Online]. Available:

<http://www.copac.org.za/files/Statepercent20ofpercent20Cooppercent20Sector.pdf> [15 June 2011].

⁸² The Department of Trade and Industry. *A co-operative development policy for South Africa*.

⁸³ Vishwas Satgar, *The state of the South African co-operative sector*, 5.

principles upon which the Co-operatives Act is founded. The first principle is that of ‘voluntary and open membership’⁸⁴ which has a positive qualification that membership cannot be restricted based on gender, social, racial, political or religious discrimination.⁸⁵ The Co-operative and Policy Alternative Centre suggest that consideration should be given to uncoupling co-operatives from the BEE approach to development.⁸⁶

The Co-operative Development Policy and the Co-operatives Act, on the other hand are both based on the ICA principles and could be considered to be a positive contribution to creating an enabling legal framework for co-operatives. Both envisage the state providing a carefully regulated environment which will create the conditions for co-operatives to emerge as autonomous, self sustaining entities, but where the state will be separate from the ownership or control of these entities.⁸⁷ The Co-operative Development Policy and the Co-operatives Act also recognise the distinct institutional identity of co-operatives, in that co-operatives are organised around the principle of human solidarity and therefore cannot be treated in the same way as businesses which focus on profit maximisation.

Within the South African legal framework, co-operatives have many unique characteristics as set out in the Co-operatives Act. These salient features of co-operatives as prescribed in the Co-operatives Act are highlighted in the remainder of this chapter.⁸⁸

2.6.1 *Types and activities*

Since the introduction of the concept of co-operatives into the South African economic landscape and legislation, there have always been three types: primary, secondary and tertiary. Primary co-operatives are defined as co-operatives with the objective of providing employment or services to its members and to facilitate community development.⁸⁹ The majority of co-operatives in South Africa are primary co-operatives (93 percent).⁹⁰

Primary co-operatives are encouraged to organise themselves into secondary co-operatives. The secondary co-operatives must provide sectoral services to its primary co-operative

⁸⁴ International Co-operative Alliance, *Statement on the co-operative identity*, 1.

⁸⁵ Vishwas Satgar, *The state of the South African co-operative sector*, 5.

⁸⁶ *Ibid*, 6.

⁸⁷ *Ibid*, 7.

⁸⁸ References to made to specific sections (or paragraphs) in the remainder of this chapter are all references to sections of the Co-operatives Act No 14 of 2005 (or the Schedules thereto), unless otherwise specified.

⁸⁹ Definition of “primary co-operative” in section 1.

⁹⁰ Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 35.

members.⁹¹ The activities of secondary co-operatives will be determined by the sector in which their primary co-operative members operate. The sectoral services could include bulk buying and marketing of the collective products of the primary co-operative members. The objectives of the secondary co-operative must be aligned to the objectives of the primary co-operatives and the activities undertaken must be for the exclusive benefit of the primary co-operatives.⁹²

The collective power of co-operatives may be further strengthened by secondary co-operatives organising themselves into tertiary co-operatives. Tertiary co-operatives are required to engage with the state and other stakeholders on behalf of its members.⁹³ The further objectives of a tertiary co-operative may include providing assistance for education and training, establishing a guarantee fund to facilitate external financing of its members, and the establishment of an audit fund to assist members to have their operations audited.⁹⁴

The activities of co-operatives could include, but are not limited to: housing, financial services, agriculture and marketing.⁹⁵ While there are no restrictions placed on South African companies with regards to the activities they should undertake, the Co-operatives Act provides special provisions applicable to certain kinds of co-operatives with regard to specific objectives and activities they must adhere to. These provisions are included in Schedule 1 to the Act and refer to housing co-operatives, worker co-operatives, financial services co-operatives and agricultural co-operatives.

2.6.1.1 Housing co-operatives

The main objective of primary housing co-operatives must be to provide housing for its members.⁹⁶ Once the members have contributed capital in order to acquire or erect housing, the members of the housing co-operative have the right to occupy housing units allocated to them for as long as they remain members of the co-operative.⁹⁷ These co-operatives are generally based on the reciprocity of labour to build the house, in exchange for ownership of the house by a member. Secondary housing co-operatives must provide

⁹¹ Definition of “secondary co-operative” in section 1.

⁹² Section 16(2)(a).

⁹³ Definition of “tertiary co-operative” in section 1.

⁹⁴ Section 16(2)(b).

⁹⁵ Section 4(2).

⁹⁶ Paragraph 3(a)(i) of Part 1 of Schedule 1.

⁹⁷ Paragraph 3(a)(ii) of Part 1 of Schedule 1.

services to primary housing co-operatives and may also undertake housing developments on behalf of primary housing co-operatives.⁹⁸

The implementation of housing co-operatives in South Africa has been driven to a large extent by non-profit entities, which route subsidies through to housing co-operatives to facilitate cheaper delivery of housing.⁹⁹

2.6.1.2 Worker co-operatives

Worker co-operatives are defined as either primary co-operatives which provide employment to the members, or secondary co-operatives which provide services to primary worker co-operatives.¹⁰⁰ They are usually initiated as an attempt to find more empowering alternatives to conventional employment and they generally operate by hiring out the labour of the members and earning commission on the placement.¹⁰¹ The constitution of worker co-operatives must provide for whether the membership is restricted to natural persons and whether the co-operative may employ persons who are not members. There is a limitation in that no more than 25 percent of the persons employed in the co-operative can be non members.¹⁰² The constitution also provides for how work is to be allocated between the members.¹⁰³ It is noteworthy that members of co-operatives are not employees as defined in terms of the Labour Relations Act No 66 of 1995 and the Basic Conditions of Employment Act No 75 of 1997. However, the worker co-operative itself is deemed to be an employer for the purposes of the Skills Development Levy, the Unemployment Insurance Fund and certain other occupational health and safety regulations.¹⁰⁴

2.6.1.3 Financial Services Co-operatives

Member-based financial institutions make up a third tier of banking in South Africa. These include *stokvels*, burial societies, savings and credit unions. While many of these organisations are not registered as co-operatives, some do in fact meet the criteria of

⁹⁸ Paragraph 3(b) of Part 1 of Schedule 1.

⁹⁹ Kate Philip, "Co-operatives in South Africa: Their role in job creation and poverty reduction" *South African Foundation Occasional Paper*, 2 (December 2003): 15.

¹⁰⁰ Definition of "worker co-operative" in Section 1.

¹⁰¹ Philip, 13.

¹⁰² Paragraph 3(1)(c) of Part 2 of Schedule 1.

¹⁰³ Paragraph 3(2)(a) of Part 2 of Schedule 1.

¹⁰⁴ Paragraph 6 of Part 2 of Schedule 1.

member ownership and control which are principles central to the co-operative form of business.¹⁰⁵ Informal *stokvel* systems are widely used in South Africa and they originated in the 1970s to enable black communities to buy goods in bulk at wholesale prices and arrange funerals.¹⁰⁶ There are at least 800 000 active *stokvels* in South Africa, with a total membership of approximately 10 million people.¹⁰⁷

Financial services co-operatives are defined as either primary co-operatives that provide financial services to members, or secondary co-operatives that provide financial services to a primary co-operative.¹⁰⁸ The types of financial services envisaged include any financial or banking service a co-operative may provide to its members, the provision of long-term and short-term insurance, medical schemes and funeral services.¹⁰⁹

A co-operative which provides banking services would, for example, receive deposits from its members and provide loans to members.¹¹⁰ By charging the members interest or administration fees, or by investing deposits and earning a return on the investment, the banking co-operative could earn a surplus. It should be noted that primary co-operatives providing banking services with more than 200 members and holding over R1 million in deposits from the members, must register as a co-operative bank in terms of the Co-operative Banks Act No 40 of 2007.¹¹¹

2.6.2 Membership

For primary co-operatives, a minimum of five members are required. Only natural persons may be members of primary co-operatives.¹¹² In contrast, South African companies have no restrictions on the entities which may be shareholders. Secondary co-operatives require a minimum of two primary co-operative members and tertiary co-operatives require a minimum of two secondary co-operative members. Each member only has one vote,¹¹³ which helps to ensure that democratic member control and decision making prevails.

¹⁰⁵ Philip, 14.

¹⁰⁶ Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 26.

¹⁰⁷ Ibid, 26.

¹⁰⁸ Definition of “financial services co-operative” in Section 1.

¹⁰⁹ Paragraph 8 of Part 3 of Schedule 1.

¹¹⁰ Paragraph 2 of Part 3 of Schedule 1.

¹¹¹ Paragraph 2A of Part 3 of Schedule 1.

¹¹² Definition of “primary co-operative” in Section 1.

¹¹³ Section 3(1)(b).

2.6.3 *Capital structure*

Member capital may be supplied through entrance fees, member loans, membership fees or subscriptions and other similar fees.¹¹⁴ The constitution of a co-operative may then provide for membership shares to be issued to the members.¹¹⁵ Where a member is required to hold shares in the co-operative, the constitution must indicate the nominal value of the shares¹¹⁶ and it must also disclose the maximum percentage of the share capital that a member may hold in the case of primary co-operatives.¹¹⁷ Share premiums are not referred to at all in the Co-operatives Act. While companies allow different classes of shares with differing voting rights, co-operative shares must all be of the same class and ranking.¹¹⁸ Members' funds may bear interest at a rate prescribed in the constitution, and the interest on these capital contributions may be distributed to the members.¹¹⁹

2.6.4 *Reserve fund and distribution of profits*

At least five per cent of the surplus earned by a co-operative each financial year, must be set aside as a reserve in a reserve fund. This amount is not divisible amongst its members¹²⁰ and must be used only as indicated in the constitution of the co-operative.¹²¹

The balance of the surplus not credited to the reserve fund, may be allocated and paid to the members as a patronage return. The allocation must be made in proportion to the value of the business conducted by a member with the co-operative during a specified period. When determining the value of the business conducted, the board of directors must take into account the services rendered by the co-operative on behalf of or to the member as well as by the member on behalf of or to the co-operative.¹²² The board must also take into account the quantity, quality and kind of products handled by the co-operative.¹²³

This patronage return is further limited to the maximum percentage of share capital that a member may hold, as provided in the constitution of the co-operative. By implication, this also means that the distribution of profits to non members is restricted. As a result, non

¹¹⁴ Section 40.

¹¹⁵ Section 41(1).

¹¹⁶ Section 15(b).

¹¹⁷ Section 15(e).

¹¹⁸ Section 41(4).

¹¹⁹ Section 43.

¹²⁰ Section 3(1)(e).

¹²¹ Section 46.

¹²² Section 44(2)(b).

¹²³ Section 44 (2)(a).

member capital is not easily attracted. South African companies on the other hand, are not restricted in this way. Company distributions of profits are subject only to authorisation through a resolution of the board, and liquidity and solvency tests.¹²⁴

2.7 Conclusion

Co-operatives are unique in that they are voluntary autonomous associations which are user-owned, user-controlled and user-benefited, and which focus on maximising the benefits to the members rather than maximising profits to the shareholders. In the global context, co-operatives have proved to be a form of business which addresses numerous aspects of poverty by empowering the poor and enabling them to convert individual risks into collective risks.

Since co-operatives were first introduced in South Africa in the late nineteenth century, they have not enjoyed the same level of success when compared with the co-operative movement internationally, which is partially attributable to a lack of clear legislation governing forms of co-operatives other than agricultural co-operatives. Agricultural co-operatives, on the other hand, enjoyed a period of growth during the apartheid era, largely due to an enabling legislative environment created by the previous government in support of white farmers.

The democratically elected government identified co-operatives as a means of addressing the socio-economic issues facing South Africa and in 2004 the DTI introduced the Co-operative Development Programme as one of its flagship projects. In order to effectively promote co-operatives as one of the drivers of economic development, the co-operative legislation had to first be updated to address a wide variety of forms of co-operatives, to make it easier to register as a co-operative, and to incorporate the ICA principles which are internationally accepted principles upon which all co-operatives should be based.

Since the introduction of the Co-operatives Act No 14 of 2005, there has been an increase in the number of co-operative registrations, but the survival rate has been poor and contributions to unemployment and GDP have been low. This chapter identified a number of disadvantages to the co-operative model which may be contributing to the low number of operating co-operatives, such as: there are restrictions on the kinds of activities that primary, secondary and tertiary co-operatives may undertake; primary co-operatives are

¹²⁴ Section 46(1) of the Companies Act No 71 of 2008 (effective 1 May 2011).

limited to natural persons as members and are limited to one vote per member; and since non members are effectively prohibited from participating in the distribution of profits, non member capital is not easily attracted.

In response to the poor survival rate and insignificant contributions to unemployment and GDP, in 2011 the DTI introduced its comprehensive strategy to promote co-operatives. As part of its strategy, the DTI suggests the revising of the tax legislation relating to co-operatives as one way in which co-operatives could effectively be promoted in the South African context. Chapter 2 critically discusses the development of the taxation of co-operatives from the inception of the Income Tax Act No in 1962 to its current form, and identifies perceived deficiencies in light of the economic goals the DTI hopes to achieve through the promotion of co-operatives in South Africa.

University of Cape Town

CHAPTER 3

THE DEVELOPMENT OF THE TAXATION OF CO-OPERATIVES AND IDENTIFICATION OF DEFICIENCIES IN THE CURRENT TAX LEGISLATION

3.1 Introduction

Since the Income Tax Act came into effect on 1 July 1962, the primary section providing tax legislation affecting co-operatives has been section 27. When it was first introduced, section 27 consisted of just three subsections. In the current tax legislation, section 27 contains subsections 27(1) – 27(9). Since its inception, the Income Tax Act has always divided co-operatives into two categories: co-operative trading societies and agricultural co-operatives.

Historically, the legislative focus was skewed in favour of agricultural co-operatives due to the pre-1994 government's support of white farmers as discussed in Chapter 2. As a result, agricultural co-operatives have enjoyed special tax concessions, particularly during the apartheid era and currently still have a preferable tax regime when compared with other types of co-operatives. Section 27 provides for special deductions and allowances for co-operatives and the majority of these are specific to agricultural co-operatives. This is in contrast to the current Co-operatives Act which provides for a wide variety of co-operatives and does not favour one type of co-operative over another. However, co-operatives are not limited only to the special allowances in section 27. The Income Tax Act views co-operatives as companies and therefore co-operatives are taxed as such. Thus in addition to the specific allowances contemplated in section 27, co-operatives may claim any of the allowances afforded to companies, provided the relevant criteria are met.

The focus of this chapter, however, is on those provisions which are specific to co-operatives. The chapter commences with an explanation of how co-operatives are defined for tax purposes. Then, the development of taxation of co-operatives from the inception of the Income Tax Act in 1962 to date, is described. Perceived deficiencies in the current legislation are highlighted in light of the fact that the DTI has identified the amendment of the Income Tax Act as a potential part of its strategy to promote the co-operative movement. The aforementioned approach is followed firstly in respect of co-operative trading societies, and then in respect of agricultural co-operatives. Finally, co-operative-specific provisions, which apply to all co-operatives, are set out. The chapter concludes

with a summary of the development of the taxation of co-operatives and a summary of the various provisions highlighted that may warrant amendment. All references to sections of legislation in this chapter refer to the current Income Tax Act, unless specifically indicated otherwise.

3.2 Co-operatives defined for tax purposes

A co-operative is defined in section 1 of the Income Tax Act as any association of persons registered in terms of section 27 of the Co-operatives Act No 91 of 1981, or section 7 of the Co-operatives Act No 14 of 2005.

Since 1 April 1977¹²⁵ all co-operatives have been taxed in the same way as companies. At first this was due to the fact that an exemption for agricultural co-operatives was removed and co-operatives fell within the general definition of a “company” in section 1 of the Income Tax Act. In order to emphasise that co-operatives should be treated in the same way as companies for income tax purposes, co-operatives were specifically included in paragraph (c) of the definition of a “company” as a result of Revenue Laws Amendment Act No 20 of 2006. The definition of a “shareholder” was also amended to specifically include a member of a co-operative.

Section 38(2)(d) provides that a co-operative should be classified as a public company. As a result, co-operatives are treated as public companies for tax purposes and are taxed as such, unless a specific section provides otherwise.

3.3 Co-operative trading societies

3.3.1 Special provisions relating to co-operative trading societies

Section 27(1) is the only subsection which has not been amended since the inception of the Income Tax Act in 1962. This subsection is applicable to co-operative trading societies as defined in the Co-operative Societies Act No 29 of 1939 and it refers to any co-operative which is a closed society. A closed co-operative society or company is defined in terms of section 97(2) of the Co-operative Societies Act No 29 of 1939 as follows:

¹²⁵ As a result of Income Tax Act No 113 of 1977.

“...any co-operative trading society with limited liability, in respect of which the [Registrar of Co-operative Societies] is satisfied that it does not deal with persons who are not members to a greater extent than, in his opinion, is in the particular circumstances of the case essential to the proper carrying out of the objects for which it has been established.”¹²⁶

This section provides that a closed society may deduct bonuses distributed to its members, subject to a limitation. The limitation is that the bonus should not exceed one tenth of the value of the business transactions between the co-operative and its members. A “bonus” is defined in section 27(9) as any amount distributed by a co-operative out of its profits or surplus in cash, by way of credit or through an award of capitalisation shares, bonus debentures or securities. The bonus must be divided among the members entitled to it in accordance with the value of the business transactions between the co-operative and the member. It must be distributed during a “specified period” which is defined in section 1 and is generally the period starting six months before the end of the fiscal year and ending six months after the end of the fiscal year. Thus co-operative trading societies have the opportunity to claim a deduction in the current year of assessment, for bonuses which may only be distributed six months after the year end.

According to section 27(8)(b) if the bonus is distributed through an award of capitalisation shares, bonus debentures or securities, the amount of the bonus is deemed to be the nominal value thereof.

3.3.2 Deficiencies in the tax legislation regarding co-operative trading societies

The term “co-operative trading society” is only used in section 27(1) of the Income Tax Act. This term is defined in terms of Co-operative Societies Act No 29 of 1939 which has since been repealed and the current Co-operatives Act No 14 of 2005 does not refer to co-operative trading societies at all, making the terminology somewhat outdated. The deduction for bonuses distributed to members is only permissible for closed societies. Thus co-operative trading societies which are not closed societies receive no special deductions for bonuses. Furthermore, the current Co-operatives Act does not refer to “closed” co-operatives and thus this terminology is another relic of the 1939 repealed Act. Further still, the limitation of the bonus deduction for co-operative trading societies differs when compared with the limitation for agricultural co-operatives. It is not clear why the difference currently exists.

¹²⁶ De Koker, 8, 28.

Another example of inconsistent terminology is the fact that the Income Tax Act refers to “bonus payments” to members which are distributed out of surplus funds. However the Co-operatives Act No 14 of 2005 defines these types of payments as “patronage returns”.

Apart from the bonus deduction, co-operative trading societies are taxed in a similar way to companies. Agricultural co-operatives receive special capital allowances which will be discussed in the next section. Co-operative trading societies on the other hand, are not afforded any specific capital allowances.

In fact, apart from section 27(5B) which applies to all co-operatives which have come into being through conversion or amalgamation, there are no other special deductions or allowances for co-operative trading societies in section 27. The rest of the section is dominated by special provisions relating to agricultural co-operatives.

Co-operatives may be better served if the tax legislation did not separate co-operatives into co-operative trading societies and agricultural co-operatives, and instead took into account the various forms of co-operatives, as provided in the section 13 to section 19 of the Co-operatives Act No 14 of 2005, and provides standardised relief to all co-operatives with specific additional allowances or incentives applicable to the specific forms of co-operatives.

3.4 Agricultural co-operatives

3.4.1 History of the taxation of agricultural co-operatives

At the inception of the Income Tax Act, section 27(2) and section 27(3) referred specifically to co-operative agricultural societies or companies as well as to farmers' special co-operative companies. Section 27(2) provided that, to the extent that receipts or accruals were derived from transactions with members, these receipts or accruals would be exempt from tax. With regard to transactions with non members, they were taxed as normal companies. Section 27(3) provided for the determination of the extent to which receipts or accruals were derived from transactions with non members. The preferential tax treatment with regard to transactions with members was an important contributing factor to the growth in the number of agricultural co-operatives in the 1960s and early 1970s.¹²⁷

¹²⁷ Van Niekerk, 36.

The thinking behind this favourable tax treatment for agricultural co-operatives was evidenced in the resolutions passed by government on 28 and 29 May 1968.¹²⁸ In terms of the resolutions, the Council stated in its memorandum, that an agricultural co-operative does not actually make a profit or incur a loss. Either it simply charges too much for goods supplied or services rendered to its members, or it pays out too much or too little when taking delivery of members' products for example, for processing or marketing. Thus in the opinion of the Council, the question of a profit or loss was only relevant to transactions with non members.

The report referred to an example of a farmer who is in fact never quoted a price for his product by his co-operative. The co-operative sells the product at a certain price and then pays the farmer the net realisation – in other words, the price for which it was sold, less the expenses of the co-operative. In the same way, the farmer does not pay a fixed price for farming requisites which he may purchase from the co-operative – he pays the price at which the article was bought by the co-operative, plus any expenses incurred by the co-operative. However, since the amount of the expenses of the co-operative are often not known at the time of the transaction with the farmer, in practice, the farmers are provisionally charged for requisites or they are provisionally paid certain amounts for their products, and then due to the amounts being fixed such that there are unlikely to be shortages which need to be collected, there is usually a surplus of income over expenditure at the end of the year.¹²⁹

This surplus represents amounts overcharged or underpayments made to members and it belongs to the members. These amounts are generally refunded to the members and are known as bonus payments. The treatment of these bonuses at the inception of the Act was that once the bonuses were paid out to the members, it was taxable in their hands. Bonus amounts retained in the co-operative were not liable to tax until the amounts were paid out to the members. At the inception of the Income Tax Act, the prevailing understanding was that agricultural co-operatives should only transact with members and thus the Council was of the opinion that there should be no factors which would indicate that the co-operative should be liable to tax.

However, as a result of a dispute between government departments, organised agriculture, trade and industry, regarding the favourable tax exemption for agricultural co-operatives,

¹²⁸ Ibid, 45.

¹²⁹ Ibid, 46.

an announcement was made on 18 August 1977 by the Minister of Finance, that the rules for the determination of taxable income for agricultural co-operatives should be the same as those governing companies. However, concessions were granted in view of the special nature of co-operatives.¹³⁰

Following the aforementioned announcement, Income Tax Act No 113 of 1977 came into operation and brought an end to the favourable tax exemption for agricultural co-operatives. Despite this, agricultural co-operatives enjoyed a new phase of favourable tax treatment; this time, through special deductions and allowances which could be claimed by agricultural co-operatives only. To effect this change, subsections 27(2) and 27(3) were amended and new subsections 27(4) – (9) were introduced in 1977. The special tax treatment was in the form of special initial and investment allowances for storage buildings and machinery. However, the government could not sustain the preferential tax treatment and thus a number of these concessions were removed through Income Tax Act No 129 of 1991. On the other hand, some of the provisions introduced in 1977 appear unchanged in the current tax legislation.

3.4.2 Deduction of bonuses to members

The new section 27(2) introduced by Income Tax Act No 113 of 1977, provided for a number of specific income tax deductions available to agricultural co-operatives. In particular, section 27(2)(a) provided for a deduction where profits were distributed by way of bonuses to members. However, the deduction was limited to the taxable income of the agricultural co-operative as calculated before taking into account various capital allowances and before setting off any balance of assessed loss brought forward from a previous year of assessment.

The only real difference between the 1977 legislation and the current legislation in relation to bonuses to members, is that the limitation to the deduction for bonuses in section 27(2)(a) has been capped further. The current limitation is that the deduction should not exceed the ratio of the aggregate value of business conducted with members to the total value of all business conducted, multiplied by the taxable income before taking the section 27(2)(a) deduction into account and before setting off any balance of assessed loss brought

¹³⁰ Ibid, 52.

forward from a previous year of assessment. This limitation is expressed by the following formula, where the bonus deduction is limited to 'y':

$$y = \frac{\text{Business conducted with members}}{\text{All business conducted}} \times \text{TI}$$

Where "TI" in the above equation is taxable income before taking the section 27(2)(a) deduction into account and before setting off the balance of assessed loss brought forward from a previous year of assessment.

The effect of the limitation is that co-operatives cannot deduct bonuses paid to members which are in excess of the proportion of business with the members as compared with the total business conducted. If the co-operative only transacts with members, then it is possible for the taxable income to be eliminated, should the bonus payments equal the taxable income.

The term "bonus" is defined in section 27(9) as a result of Income Tax Act No 113 of 1977 and it remains unchanged in the current legislation. The definition applies to all co-operatives and therefore, as described in point 3.4.1, the bonus must be paid within the specified period, which is the period commencing six months before the end of the year of assessment and ending six months after the end of the year of assessment. As is the case with co-operative trading societies, agricultural co-operatives are able to claim the deduction in the current year of assessment, for bonuses which might only be distributed six months after the year end (subject to the limitation expressed above).

Another section introduced in 1977 in relation to bonuses which is also largely unchanged in the current legislation, is section 27(8)(a), which states that any bonus to the extent that it qualifies for deduction, is to be included in the gross income of the member, and is deemed to have accrued to that member at the date of distribution of the bonus by the co-operative. Section 27(8)(b) states that bonuses distributed through an award of capitalisation shares, bonus debentures or securities should be valued in terms of the nominal value and this particular subsection seems to apply to both agricultural and non agricultural co-operatives.

3.4.3 Storage building allowance

Income Tax Act No 113 of 1977 introduced a number of special capital allowances available to agricultural co-operatives. The first of these was section 27(2)(b), which

remains largely unchanged in the current legislation. In terms of section 27(2)(b), agricultural co-operatives may claim an allowance on the cost of storage buildings erected by any agricultural co-operative. When this provision was introduced, the allowance was at a rate of two percent. As a result of Income Tax Act No 90 of 1988 a further proviso to section 27(2)(b) was introduced, providing an allowance at five percent where the erection of storage buildings commenced on or after 1 January 1989. Thus the current legislation reflects an allowance equal to two percent for storage buildings where the erection commenced prior to 1 January 1989 and a five percent allowance where the erection commenced on or after the same date. No allowance is available for buildings erected prior to 25 March 1959.

“Storage buildings” are defined in section 27(9) and refer to any building wholly or mainly used for storing agricultural or other products, or used for carrying on a primary process in respect of those products. The definition also includes structures of a permanent nature wholly or mainly used in connection with fattening livestock. For the purposes of section 27, a “primary process” is defined in section 27(9) as the first process to which the agricultural product is subjected in order to make it marketable. The definition includes any other processes that follow the first process which could be considered to be part of one process.

Section 27(2)(b) also provides for an allowance for improvements to storage buildings, and improvements (which commenced on or after 1 April 1971) to buildings that do not qualify as storage buildings, but were used as such at any point during the year of assessment. The allowance for such improvements is also two percent for those which commenced prior to 1 January 1989, and five percent for those which commenced on or after the same date. Repairs to such buildings do not qualify for this special allowance.

“Improvements” are defined in section 27(9) and refer to any extension, addition or improvement to a storage building which is carried out for the purpose of increasing the capacity of the building for storing agricultural products or carrying on a primary process as defined above, in respect of those products.

There is a proviso to section 27(2)(b) which prohibits this allowance where the agricultural co-operative has already claimed an allowance in that year under section 13(1) which relates to buildings used in a process of manufacture. There is a further proviso, which prohibits the allowance on any portion of the cost of such buildings or improvements,

which was taken into account in any current or previous year, in the calculation of a storage building initial allowance or in the calculation of section 11(g) leasehold improvements. The storage building initial allowance referred to in the proviso to section 27(2)(b) was introduced in terms of Income Tax Act No 96 of 1985, but this 17.5 percent allowance was soon removed in 1991.¹³¹

Section 27(3) further limits the storage building allowance in section 27(2)(b) and also limits any allowance claimed in terms of section 13(1). This section states that the total allowances claimed under section 27(2)(b) and section 13(1), are limited to the cost of the buildings or improvements, less any recoupments in terms of section 27(4) and less the aggregate of any storage building initial allowance or any section 11(g) leasehold improvement allowances claimed.

De Koker¹³² notes that the cost of the storage building or improvements for the purposes of the section 27(2)(b) allowance, excludes pre-production expenses. However, pre-production interest incurred on the acquisition or erection of such a storage building or improvements thereto, would qualify for deduction under section 11(bA).

3.4.4 *Storage building investment allowance (repealed)*

The second special capital allowance to be introduced through Income Tax Act No 113 of 1977 was section 27(2)(c). This section, read with section 27(6) and section 27(7) provided for a storage building investment allowance for buildings first brought into use during any year of assessment commencing on or after 1 April 1977. Improvements to such buildings also received the same allowance in the year of completion. The storage building investment allowance was calculated on the cost to the agricultural co-operative of the relevant building or improvements and the rate of the allowance was 10 percent, 15 percent or 20 percent, depending on the date of commencement of the building or improvement. No allowance was granted if the premises were not owned by the agricultural co-operative, or where the agricultural co-operative was not entitled to the occupation of the premises for 10 years or more. However, the cost to the government of supporting commercial farmers was becoming unsustainable in the 1980s. The subsidies and price support were removed

¹³¹ As a result of Income Tax Act No 129 of 1991.

¹³² De Koker, 8, 34.

and Income Tax Act No 129 of 1991, brought the repeal of the favourable section 27(2)(c) storage building investment allowance.

3.4.5 Initial and investments allowances for plant and machinery (repealed)

The third favourable capital allowance introduced by Income Tax Act No 113 of 1977 and available to agricultural co-operatives, was found in section 27(2)(d). This section provided for a special initial allowance for new or unused plant or machinery used directly for storing or packing farm products or for primary processes. The allowance was equal to 25 percent of the cost of the new or unused machinery or plant. Furthermore, section 27(2)(e) provided for a special machinery investment allowance of 30 percent of the cost of any new or unused plant or machinery used directly for storing or packing farm products or for primary processes. Both sections applied for years of assessment commencing after 1 April 1977. To combat abuse of these favourable allowances, the Income Tax Act No 96 of 1981 introduced section 27(2A), which included an arm's length requirement for the cost of plant or machinery for the purpose of the section 27(2)(d) initial allowance or the section 27(2)(e) investment allowance. However, sections 27(2)(d), 27(2)(e) and 27(2A) were repealed by Income Tax Act No 129 of 1991 to ease the burden on the government of supporting commercial farmers.

3.4.6 Other capital allowances available to agricultural co-operatives

While on the subject of capital allowances, it should be noted that section 12C, which provides for accelerated capital allowances for plant or machinery used by any taxpayer in a process of manufacture, makes specific reference to agricultural co-operatives in section 12C(1)(c). This subsection provides for an accelerated allowance (20 percent per annum) for plant or machinery brought into use for the first time by any agricultural co-operative and used directly for storing or packing agricultural or other farm products, or for subjecting those products to a "primary process"¹³³ as defined in section 27(9). An accelerated allowance (40 percent in year one, and 20 percent in each of the following three years) is available for improvements to the aforementioned plant and machinery when brought into use in a process of manufacture.

¹³³ Refer to the definition of "primary process" described in point 3.4.2.

There are many other tax allowances that relate specifically to farming and agriculture, but are not unique to co-operatives. For example, an agricultural co-operative may qualify for the accelerated allowance in section 12B on farming machinery, implements, utensils or articles used by the co-operative in carrying on farming operations, or the production of renewable energy. Co-operatives can benefit from these special allowances and incentives relating to farming, just as individuals or other entities would. However, an agricultural co-operative will only be regarded as a farmer if it carries on farming operations itself.¹³⁴

3.4.7 Loan repayments (repealed)

Another section, also later removed by Income Tax Act No 129 of 1991 in order to reduce the dependence of agricultural co-operatives on government support, was section 27(2)(f). This section provided for a deduction for loan repayments where the funds were used in order to finance the cost of erecting any storage building or the cost of improvements thereto, or to finance the acquisition of immovable plant or machinery wholly or mainly used for storing or packing farm products produced by its members or used for primary processes. The deduction offered by this section was limited to the cost of the asset less any investment allowances claimed. The deduction was also limited to the taxable income of the agricultural co-operative before various capital allowances and before taking into account any balance of assessed loss brought forward from a prior year.

3.4.8 Losses in respect of damage to products held on behalf of a marketing board

Section 27(2)(g) provided for a discretionary allowance for losses suffered by agricultural co-operatives as a result of damage to farming products held by it on behalf of a control board established in terms of the Marketing Act No 59 of 1968. However, this allowance was to be included in the income of the agricultural co-operative in the following year of assessment. This subsection has not undergone any significant changes since it was introduced in 1977, despite the fact that the Marketing Act No 59 of 1968 has since been repealed and its replacement, the Marketing of Agricultural Products Act No 47 of 1996, no longer refers to control boards.

¹³⁴ De Koker, 8, 34.

3.4.9 *Koöperatieve Wijnbouwers Vereniging*

Section 27(2)(b), section 27(2)(h) and section 27(8) all make specific reference to the *vereniging* as defined in the Wine and Spirit Control Act No 47 of 1970, which has also since been repealed, and which referred to the Koöperatieve Wijnbouwers Vereniging or KWV as it is most commonly known. These sections have all remained largely unchanged since 1977. Section 27(2)(h) offers a special allowance to the KWV for amounts transferred from its profits to a price stabilisation fund for distribution to its members within a five year period. The allowance is limited to the portion of profits derived by the *vereniging* by the exercise of its function relating to the stabilisation of prices in the wine industry.

The KWV is prohibited from claiming a deduction under section 27(2)(b) as this would result in a double deduction of profits distributed by way of bonuses. Section 27(8) also makes reference to KWV profits transferred to a price stabilisation fund for distribution to its members and provides that the persons receiving the distribution will have a gross income inclusion that is deemed to have accrued to them on the date of distribution. Section 27(2)(h) has not been amended since its introduction in 1977.

3.4.10 *Recoupments with regard to storage building allowances*

As previously noted,¹³⁵ section 27(4) relates to recoupments. This section has remained largely unchanged since its introduction in terms of Income Tax Act No 113 of 1977. This section essentially provides for an exclusion of a section 8(4)(a) recoupment¹³⁶ from the income of the agricultural co-operative, in respect of a building where a storage building allowance was claimed under section 27(2)(b). This exclusion is only available where the agricultural co-operative will use the amount recovered or recouped as a set off against the cost of a further storage building, provided that it commences with the erection of a further storage building within 12 months of the event that gave rise to the recoupment, or another period as allowed by the Commissioner.

¹³⁵ Refer to mention of section 27(4) in point 3.4.3.

¹³⁶ Section 8(4)(a) of the Income Tax Act essentially provides there must be included in a taxpayer's gross income, any amounts allowed as a deduction in any current or previous year of assessment, which have subsequently been recovered or recouped in the current year of assessment.

3.4.11 Deficiencies in the tax legislation regarding agricultural co-operatives

Apart from the bonus deduction and a few special allowances described in this chapter thus far, agricultural co-operatives are taxed in the same way as companies. While certain agricultural co-operatives may benefit from the storage building allowances provided in section 27(2)(b) or the accelerated allowances for plant and machinery as provided in section 12C(1)(c), no other forms of co-operatives are afforded capital allowances which are specific to them. As noted in point 3.3.1 co-operatives may be better served if the tax legislation did not split co-operatives between co-operative trading societies and agricultural co-operatives, but instead provided standardised relief to all co-operatives with specific additional allowances or incentives applicable to the specific forms of co-operatives. Also relevant under this heading, as previously noted in point 3.3.1 is that the limitation of the bonus deduction for co-operative trading societies differs when compared to agricultural co-operatives and the reason for this difference is unclear. Furthermore, the terminology relating to “bonus payments” should be updated to align with the Co-operatives Act No 14 of 2005 which refers to “patronage returns”.

3.5 Co-operative conversions and corporate restructuring

3.5.1 Amalgamations of co-operatives

Section 27(5), section 27(5A) and section 27(5B) refer to special dispensations for mergers between co-operatives. Section 27(5) was introduced by Income Tax Act No 113 of 1977 and is still in existence today. Section 27(5) has application where an agricultural co-operative was constituted by amalgamation before 1 April 1977, and the ownership of a storage building has passed from one of the amalgamating co-operatives into the new amalgamated co-operative. In this scenario, any section 27(2)(b) allowance for storage buildings or improvements which was available to the amalgamating co-operative, continues in the new amalgamated co-operative. Furthermore, the provisions of section 27(2)(b), section 27(3) and section 27(4) apply to the amalgamated co-operative as if the relevant amalgamating co-operative and the new amalgamated co-operative had at all relevant times been one co-operative. The only change to this section since 1977, was the removal of 27(5)(b) which provided a deduction of debts transferred by the pre-amalgamation co-operatives to the amalgamated co-operative. This change was brought about by Income Tax Act No 129 of 1991.

Section 27(5A) was introduced by Income Tax Act No 104 of 1980 and has application for agricultural co-operatives constituted by amalgamation between 1 April 1977 and 31 December 1981. This section is also still in existence today and provides that the amalgamating co-operatives and the amalgamated co-operatives are deemed to be one and the same entity both retrospectively and going forward. The benefit of this section is that it provides for the perpetuation of deductible allowances, and that assessed losses for amalgamating co-operatives may be carried forward to the amalgamated co-operative.¹³⁷

Section 27(5B) is distinctive in that it applies to any type of co-operative and is not restricted to just agricultural co-operatives as is the case with sections 27(5) and 27(5A). Section 27(5B) was introduced by Income Tax Act No 96 of 1981 and has application where any co-operative was constituted by amalgamation or conversion from a company, on or after 1 January 1982. Therefore co-operatives wishing to amalgamate today may make use of this section. Similar to section 27(5A), in this scenario, the amalgamating or converting co-operatives or companies, and the new amalgamated co-operative, are deemed to be one and the same entity both retrospectively and going forward. It is submitted that the relief provided by the words 'deemed to be one and the same co-operative' as expressed in the legislation, would extend to ensuring the continuation of capital allowances, including the special allowances for storage buildings in the case of an amalgamation of agricultural co-operatives, and would provide for the transfer of assessed losses.¹³⁸ However, this section has been made subject to any conditions imposed by the Commissioner. The Commissioner's discretionary power is subject to objection and appeal.

3.5.2 *Corporate restructuring involving co-operatives*

The Second Revenue Laws Amendment Act No 60 of 2001 introduced the corporate rules contained in Part III of Chapter 2 of the Income Tax Act. Since co-operatives fell within the section 1 definition of a company at that stage, co-operatives were able to benefit from the corporate roll over relief. Through Revenue Laws Amendment Act No 20 of 2006, co-operatives were specifically included in the definition of a "company" in paragraph (c) and therefore, co-operatives were still able to make use of the corporate rules for restructuring.

¹³⁷ De Koker, 8.36.

¹³⁸ Ibid.

However, as a result of Taxation Laws Amendment No 3 of 2008, the wording of sections 41 and 44 was altered. The amendment to section 41 removed a company as defined in paragraph (c) of section 1, from the definition of a “group of companies”. As a result, any corporate roll over provisions conditional on the entity being part of a group of companies, could no longer apply to co-operatives. Consequently, with effect from 1 October 2007, co-operatives could no longer benefit from the roll over relief provided in terms of section 45 (intra-group transactions), and section 47 (liquidation transactions). Furthermore, section 42 (asset-for-share transactions) and section 46 (unbundling transactions) cannot be utilised by co-operatives as co-operatives do not have equity shares.

The amendments to section 44 stipulated that amalgamations entered into on or after 1 January 2007, where the resultant entity is a co-operative, are precluded from applying section 44. There was also some uncertainty with regard to the amalgamations where the amalgamating entity is a co-operative and the amalgamated entity is a company. This was due to the fact that section 44(1) requires that the existence of the amalgamating company must be terminated and, read with section 44(13), the liquidation or deregistration steps as contemplated in section 41(4) must occur within 18 months of the date of the amalgamation transaction. However, section 41(4) does not specifically mention co-operatives. In response to an application by a taxpayer regarding this issue, the South African Revenue Service (SARS) issued Binding Private Ruling 054 on 21 October 2009, which stated that in the scenario described above a co-operative will be regarded as having taken the necessary steps to liquidate or deregister if a special resolution is lodged under section 180 of the Co-operatives Act.¹³⁹

3.5.3 *Conversions of co-operatives to companies*

Section 40B provides tax relief for the situation where a co-operative is converted into a company. This section was introduced in 1993¹⁴⁰ and has not undergone any significant changes since. Section 40B makes reference to the Co-operatives Act No 91 of 1981 and the Co-operatives Act No 14 of 2005, both of which provide for this type of conversion. The section provides that where a co-operative is converted into a company, the co-

¹³⁹ It is noteworthy that while beyond the scope of this study, section 41(4) has since been amended through Taxation Laws Amendment Act 24 of 2011 to specifically include co-operatives.

¹⁴⁰ In terms of Income Tax Act No 113 of 1993.

operative and the resulting company are deemed to be, and to always have been, one company.

3.5.4 Deficiencies regarding co-operative corporate restructuring and conversions

The deficiencies highlighted below, relate to corporate restructurings and conversions as described in points 3.5.1, 3.5.2 and 3.5.3 above.

Section 27(5B) refers to co-operatives which have come into existence in pursuance of a conversion or amalgamation in terms of Chapter VIII of the Co-operatives Act No 91 of 1981. This act has been repealed and replaced with the Co-operatives Act No 14 of 2005 and therefore, the legislation should be updated in this regard. While the wording of section 27(5B) seems to provide for the continuation of the deduction of capital allowances, and the transfer of assessed losses, it is unclear whether the relief would extend to, for example, Capital Gains Tax (CGT) arising on amalgamation of co-operatives or on the conversion of a company to a co-operative. Despite this, co-operatives have to rely on the section 27(5B) relief described above for amalgamations or mergers between them as co-operatives are precluded from applying the wider relief available in terms of section 44, where the resultant company is a co-operative.

In addition to the limitation regarding section 44, co-operatives are further disadvantaged in that they are currently ineligible for the roll-over relief provided in terms of section 45 (intra-group transactions), and section 47 (liquidation transactions) due to the exclusion of co-operatives from the group of companies requirement as contemplated above. Nor are co-operatives eligible for the relief provided in sections 42 (asset-for-share transactions) and section 46 (unbundling transactions) due to the equity shares requirement. In order for co-operatives to be effectively promoted, it is submitted that the tax legislation regarding corporate restructuring should be amended to remove the current disadvantages to co-operatives involved in corporate restructuring.

Regarding conversions of co-operatives to companies, section 40B stipulates that when co-operatives are converted to companies, the co-operative and the new company are deemed to be, and to always have been, one company. The Comprehensive Guide to Capital Gains Tax issued by SARS¹⁴¹ stipulates that the conversion of co-operatives to companies will

¹⁴¹ SARS, Comprehensive Guide to Capital Gains Tax, (2011) [Online]. Available: <http://www.sars.gov.za/home.asp?pid=4150&tid=65&s=pubs&show=889> [31 December 2011].

not result in capital gains or losses. However, clarification should be provided with regard to the special deductions and allowances which are available only to co-operatives and whether once the co-operative is converted into a company, it will no longer be permissible for the company to continue claiming these allowances. An example would be the storage building allowance available to agricultural co-operatives in terms of section 27(2)(b)¹⁴² which is not available to companies. Furthermore, the Income Tax Act should provide clarity regarding how the reserve fund should be treated on conversion from a co-operative to a company.

3.6 Distributions by co-operatives to members

Distributions by co-operatives to members can be divided into two categories: distributions which do not qualify for deduction in terms of section 27 and fall within the definition of a dividend as a result, and those distributions that do qualify for deduction in terms of section 27. These two scenarios are discussed below.

3.6.1 Distributions as dividends

Income Tax Act No 113 of 1977 introduced a new paragraph regarding co-operatives into the “dividend” definition in section 1 of the Income Tax Act. The new paragraph, paragraph (i), is still in existence in the current legislation. Paragraph (i) of the dividend definition, excludes amounts distributed out of co-operative profits through bonus payments, to the extent that a deduction of the bonus has been allowed in terms of section 27. If the amounts distributed to members are not deductible in terms of section 27, these payments are received as dividends by the members. The effect of paragraph (i) is to avoid a double inclusion in gross income for the members receiving the bonus payments, due to the fact that section 27(8) would also include the bonus payments in their gross income. As a result, any amount distributed by a co-operative to its members is a dividend, unless the amount was distributed by way of a bonus that was allowed as a deduction in the hands of the co-operative or was distributed out of a price stabilisation fund of the KWV.

¹⁴² Refer to the discussion in point 3.4.2.

Distributions qualifying as local dividends are exempt in the hands of the member in terms of section 10(1)(k)(i).¹⁴³

For co-operative trading societies, which are closed societies, distributions to members in excess of one tenth of the total business of the society with its members (which is the limitation provided in section 27(1)) will fall within the ambit of the dividend definition as that portion of the bonuses will not be deductible. Since there is no deduction for co-operatives which are not closed societies, all bonus distributions to members are regarded as dividends.

With regard to agricultural co-operatives, the bonus deduction allowed in terms of section 27(2)(a) is limited to the proportion of business with the members as compared with the total business conducted. Thus any excess will fall within the ambit of the dividend definition as that portion of the bonuses will not be deductible. Distributions by the KWV, other than the special deduction in section 27(2)(h) for amounts transferred from its profits to a price stabilisation fund for distribution to its members within a five year period, will also fall within the ambit of the dividend definition.

In order for the deductions in section 27(1) and section 27(2)(a) to be allowed, the distribution must meet the definition of a “bonus” in section 27(9).¹⁴⁴ If it does not meet the definition, it is not a bonus, which means it is not deductible in terms of section 27, and consequently falls within the ambit of the dividend definition in section 1. For example, if the amount is not distributed during the specified period which is generally the period starting six months before the end of the fiscal year and ending six months after the end of the fiscal year, then the distribution will not be a bonus as defined and will fall within the ambit of a dividend if it was distributed to a member. A further example of where the distribution would be a dividend is where the amount is not divided among the members in accordance with the value of the business transactions between the co-operative and the member, but another method is used. In this case, the distribution will not be a bonus as defined and will fall within the ambit of a dividend if it was distributed to a member.

De Koker¹⁴⁵ notes that since the bonus definition includes awards of capitalisation shares, and since section 27(8)(b) provides that these shares should be valued at the nominal value, an award of these shares would not be a dividend due to the fact that the dividend

¹⁴³ While it is beyond the scope of this study, it appears that this exemption will still apply after the introduction of Dividends Withholding Tax on 1 April 2012

¹⁴⁴ Refer to the definition of a “bonus” as described in point 3.3.1.

¹⁴⁵ De Koker, 17, 5.

definition in section 1 excludes the nominal value of all equity capitalisation shares. As a result, it is interesting to note that if bonuses are distributed in the form of capitalisation shares, in excess of the limitations provided in section 27(1) and section 27(2)(a), the excess will not be a dividend.

Since STC was introduced on 17 March 1993, the exclusion of bonus payments from the definition of dividends has had an additional effect of exempting such distributions from STC. In terms of paragraph (i) of the dividend definition in section 1 of the Income Tax Act, the exemption is only applicable if the bonus is deductible in terms of section 27. Co-operatives fall within the section 1 definition of a company as referred to in section 64B, thus if the bonus is not deductible in terms of the limit or capped amount for trading and agricultural co-operatives, the distributions are subject to STC at 10 percent. The treatment with regards to bonus payments in relation to dividends and STC is as it was since the introduction of STC.¹⁴⁶

3.6.2 Deductible bonus distributions

Distributions which qualify as deductible bonuses in terms of section 27(1), section 27(2)(b) and section 27(2)(h), are specifically excluded from the definition of dividends as described above. Section 27(8) stipulates how these deductible bonuses should be treated in the hands of the members entitled to receive them. However, section 27(8)(a) applies to agricultural co-operatives only.

Section 27(8) provides that where deductions for bonus distributions have been allowed in terms of section 27(2)(a), which provides for the deduction for bonuses for agricultural co-operatives, or section 27(2)(h) which is specific to the KWV, the member entitled to the bonus must include the full amount in their gross income. The inclusion date is deemed to be the date of distribution from the agricultural co-operative.

¹⁴⁶ While beyond the scope of this study, it appears that the new “dividend” definition introduced in terms of Taxation Laws Amendment Act 24 of 2011 does not specifically exclude amounts distributed out of co-operative profits through bonus payments, to the extent that a deduction of the bonus has been allowed in terms of section 27. This is an area of concern as it appears it may result in the double inclusion in gross income for the members receiving bonus payments. With effect from 1 April 2012, these dividends would be subject to Dividends Tax. Though this development is beyond the scope of this study, it is highlighted as an area for future research.

3.6.3 Deficiencies in the tax legislation regarding distributions by co-operatives to members

There are no legislative provisions for how deductible bonuses for closed co-operative trading societies, allowed in terms of section 27(1), should be treated in the hands of the members entitled to them. De Koker¹⁴⁷ notes that these distributions should be included in the gross income of the receiving member in terms of the definition of gross income in section 1, provided the distribution is not of a capital nature. He provides an example¹⁴⁸ of where the bonus represents an additional consideration for products delivered by the member to the co-operative. In this case, the bonus is of a revenue nature and should be included in the member's gross income. Further clarity should be provided in the tax legislation in this regard.

3.7 The reserve fund

3.7.1 The tax treatment of the reserve fund

As noted previously,¹⁴⁹ section 27(2)(h) provides for a deduction of the profits transferred to a price stabilisation fund for co-operatives, which it then distributes to its members within a 5 year period. This is the only section in the Income Tax Act which makes reference to a specialised fund and it only applies for the KWV.

However, when the distributions are made from any co-operative, section 27(8) provides that the persons receiving the distribution will have a gross income inclusion that is deemed to have accrued to them on the date of distribution.

3.7.2 Deficiencies in the tax legislation regarding transfers to or from the reserve fund

All co-operatives are required to set aside at least five percent of any surplus in a reserve fund, and yet the Income Tax Act does not expressly state how amounts transferred to reserve funds should be treated for tax purposes, and how amounts transferred from reserve funds to be utilised in pursuance of the objectives stipulated in the constitution, should be treated. If the case of the KWV could be used as an example of how the transfer of profits to the reserve fund could be treated, problems could conceivably arise if a deduction is

¹⁴⁷ De Koker, 17, 5.

¹⁴⁸ Ibid.

¹⁴⁹ Refer to point 3.4.9.

claimed on transfer to the reserve fund, but then the funds are applied in respect of expenditure of a capital nature. This would put the fiscus at a disadvantage. However, in the case of the KWV the use of the special fund is clearly stipulated in the legislation. Thus perhaps a similar position could be taken with regard to all other co-operatives, with a deduction being allowed when surpluses are transferred to the reserve fund, but only if the funds are to be utilised for specific purposes such as training and education, which could aid in stimulating the development of the co-operative sector in South Africa.

3.8 Co-operatives qualifying as small business corporations

Revenue Laws Amendment Act No 19 of 2001 introduced section 12E, which provided preferential tax treatment to taxpayers qualifying as small business corporations. This section originally did not cater for co-operatives as it only applied to companies and close corporations. However, as a result of Revenue Laws Amendment Act No 20 of 2006, co-operatives are now also eligible to be considered as small business corporations.

In order to meet the definition of small business corporations in section 12E(4), co-operatives need to meet the following requirements:

- The co-operative must be a co-operative as defined according to section 1 of the Companies Act No 71 of 2008 which refers to co-operatives registered in terms of the Co-operatives Act No 14 of 2005.
- All the members must be natural persons.
- The gross income for the year does not exceed R14 million.
- The members cannot hold any shares or any interest in the equity of any other company except for those companies excluded in section 12E(4)(a)(ii)(aa) to 12E(4)(a)(ii)(ii). These excluded companies include listed companies, any portfolio in a collective investment scheme and a venture capital company, amongst others.
- The receipts and accruals from investment income as defined in section 12E(4)(c) and the total receipts and accruals from rendering a personal service as defined in section 12E(4)(d) may not exceed 20 percent of the co-operatives gross income and capital gains for the year.
- The co-operative must not be a personal service provider as defined in the Fourth Schedule to the Income Tax Act.

Co-operatives that qualify as small business corporations receive preferential tax treatment, particularly with regard to capital allowances. Where plant and machinery owned by the co-operative or acquired in terms of an instalment credit agreement as defined in section 1 of the Value Added Tax Act No 89 of 1991, and used in a process of manufacture or similar process for the purpose of the co-operative's trade, the co-operative may deduct 100 percent of the cost of the asset in the year first brought into use. Section 12E(1) applies for assets brought into use on or after 1 April 2001.

Furthermore, where the co-operative acquires any asset which would qualify for a wear and tear allowance in terms of section 11(e), the co-operative may elect to claim the allowance in terms of section 11(e), or to claim an accelerated allowance of 50 percent of the cost of the asset in the year first brought into use, 30 percent in the subsequent year and 20 percent in the year thereafter. This section, section 12E(1A) applies for assets acquired on or after 1 April 2005.

Section 12E(2) prescribes how the cost of the assets are to be determined. The cost is the lesser of the cost to the co-operative and the arm's length cash cost, including costs of installation. Section 12E(3) allows for the deduction of moving costs for assets in respect of which section 12E allowances are claimable.

Co-operatives which qualify as small businesses are also taxed at a rate which can be less than the 28 percent company tax rate. There is a progressive scale which applies to small business corporations. According to this scale, the first R57,000 of taxable income is taxed at zero percent. The amount between R57,001 and R300,000 is taxed at 10 percent. Taxable income above R300,000 is taxed at 28 percent.

There are no perceived deficiencies unique to co-operatives with regard to the preferential tax position for small business corporations. However, in order to encourage the formation of co-operatives, the tax regime for small business corporations could be amended to specifically include special allowances for co-operatives.

3.9 Co-operatives qualifying for Turnover Tax

A special turnover tax regime was introduced through Part IV of Chapter 2 of the Income Tax Act and the Sixth Schedule to the Income Tax Act, through Revenue Laws Amendment Act No 60 of 2008. This regime was introduced in order to ease the

administrative burden for small businesses which may struggle to keep proper financial records. The turnover tax regime replaces income tax, capital gains tax, secondary tax on companies and VAT with a single tax. With effect from 1 March 2009, co-operatives with a qualifying turnover of R1 million or less, can choose to register as micro businesses and be taxed on this system.

Qualifying turnover is defined in paragraph 1 of the Sixth Schedule as the total amount received by a business for the year of assessment from carrying on business activities, excluding any receipts of a capital nature and any amounts exempt from normal tax in terms of sections 10(1)(y), 10(1)(zA), 10(1)(zG) and 10(1)(zH), which refer to certain government grants, rebates or subsidies.

There are a number of circumstances where the co-operative will not be able to register as a micro business. Paragraph 3 of the Sixth Schedule lists these scenarios, which include instances where any of the members are not natural persons, where more than 20 percent of the total receipts are from investment income or from the rendering of a personal service (for years of assessment commencing on or after 1 March 2011), or where the co-operative is a personal service provider, to name a few. Also, co-operatives which choose to voluntarily register for VAT, despite having a turnover of R1 million or less, are not permitted to register for the turnover tax.¹⁵⁰

Co-operatives which qualify to register as micro businesses will be taxed on a turnover basis. The taxable turnover is calculated by including all revenue receipts from carrying on business activities in South Africa, and including 50 percent of receipts of a capital nature. Taxable turnover excludes investment income in the case of a natural person, the specific government grants and subsidies which are exempt in terms of section 10 as referred to above, amounts received by the micro business which were taxed as accruals before the co-operative was registered as a micro business, and any amount refunded to the micro business in respect of goods or services supplied. The turnover tax reduces the co-operatives compliance requirements as they would not need to keep such sophisticated records of expenses or trading stock at year end.¹⁵¹

Co-operatives registered as micro businesses are not subject to normal tax. Once the taxable turnover has been determined, the progressive scale is applied to that amount. According to section 48B of the Income Tax Act, the rates of tax must be fixed annually by

¹⁵⁰ De Koker, 17, 94.

¹⁵¹ De Koker, 17, 97.

Parliament. The progressive rates of tax are indicated in Table 1 in Appendix A. There are no perceived deficiencies unique to co-operatives with regard to the preferential tax regime for businesses qualifying for turnover tax.

3.10 Conclusion

Since the enactment of the Income Tax Act on 1 July 1962 co-operative trading societies have been taxed in the same way as companies apart from the deduction for bonus payments in closed societies, the limited relief available since 1982 in section 27(5B) for amalgamations or conversions from companies where the amalgamated entities are co-operatives, as well as the somewhat perplexing relief available since 1993 in section 40B for conversions of co-operatives to companies.

Agricultural co-operatives on the other hand, were initially exempt from tax in respect of transactions with members. However, due to a dispute between government and various stakeholders, Income Tax Act No 113 of 1977 brought an end to the tax exemption and as a result, agricultural co-operatives, like co-operative trading societies, were taxed in the same way as companies with a limited deduction for bonus payments to members. However, to temper the effect of this change, special allowances ensured that agricultural co-operatives enjoyed favourable tax treatment. The substantial costs of supporting commercial farmers brought about by the tax concessions as well as through subsidies and price support, were not sustainable and consequently a series of reform resulted in the passing of Income Tax Act No 129 of 1991, in which many of the tax concessions were removed. Nonetheless, agricultural co-operatives currently still enjoy a few special deductions and allowances such as the storage building allowance, a deduction for losses in respect of damage to products held by it on behalf of a marketing board, an allowance specific to the KWV for amounts transferred to a price stabilisation fund and an exclusion of a recoupment on storage buildings where the amount recovered is used to set off the cost of a further storage building.

There are a number of provisions which apply to both co-operative trading societies and agricultural co-operatives. Since both co-operative trading societies and agricultural co-operatives are viewed as companies in the Income tax Act, they may claim any of the deductions and allowances available to companies to the extent that they meet the required criteria. For example, agricultural co-operatives which carry on farming operations as

defined may claim the special allowances granted to farmers. Furthermore, since 1977, bonus payments which are not deductible because, for example, they are in excess of the calculated limits, are distributed as dividends and, since 1993, are subject to STC for both co-operative trading societies and agricultural co-operatives. Bonus payments which fall within the specified limits for deduction are taxable in the hands of the members, however this treatment is only clearly stipulated in the case of agricultural co-operatives.

The relief in respect of amalgamations and conversions provided in section 27(5B) and section 40B referred to above, is available to all co-operatives. Since Revenue Laws Amendment Act 20 of 2006, all co-operatives have been eligible for the preferential tax treatment available in section 12E for those entities qualifying as small business corporations. Co-operatives are also able to make use of the separate tax system available to micro businesses as contained in the Sixth Schedule to the Income Tax Act.

As identified in this chapter, there are a number of provisions relating to co-operatives which seem unsatisfactory and which may warrant amendment. These are summarised as follows:

- The Income Tax Act separates co-operatives into co-operative trading societies and agricultural co-operatives, both of which are defined in terms of co-operative legislation which has since been repealed.
- The separation of co-operatives into co-operative trading societies and agricultural co-operatives does not align with the current Co-operatives Act, which provides for a wide variety of co-operatives and does not refer to co-operative trading societies at all.
- The terminology in the Income Tax Act refers to “bonus payments”, while the current Co-operatives Act describes these payments as “patronage returns”.
- Co-operative trading societies which are not closed societies, receive no special deduction for bonuses. Furthermore, such closed societies are defined in the Co-operative Societies Act No 29 of 1939 which has since been repealed and the current Co-operatives Act makes no reference to closed societies.
- The limitation of the bonus deduction for co-operative trading societies differs when compared with the limitation for agricultural co-operatives. It is not clear why the difference exists.
- While agricultural co-operatives receive specific capital allowances and deductions which are not available to companies, all other forms of co-operatives (worker co-

operatives, financial co-operatives, consumer co-operatives etc) may only claim capital allowances which are available to all companies (provided the required criteria are met). This is in contrast to the current Co-operatives Act which does not favour one type of co-operative over another.

- Since 1 October 2007, co-operatives could no longer benefit from the roll over relief provided in terms of section 45 (intra-group transactions), and section 47 (liquidation transactions), as a result of the specific exclusion of co-operatives from the definition of a “group of companies” in section 41.
- Section 42 (asset-for-share transactions) and section 46 (unbundling transactions) cannot be utilised by co-operatives as co-operatives do not have equity shares.
- Amalgamations where the amalgamated entities are co-operatives are precluded from applying section 44. There are also uncertainties in applying section 44 in amalgamations involving co-operatives where the resultant entities are companies, due to the requirement of termination and the fact that the steps for liquidation or deregistration do not specifically refer to co-operatives.¹⁵²
- Section 27(5B) which applies for amalgamations where the resultant entity is a co-operative, does not provide as much relief as section 44. An example is CGT on the disposal of assets and shares.
- Section 40B is unclear regarding whether the resulting company, in a conversion from a co-operative to a company could continue claiming allowances specific to co-operatives, such as the storage building allowances available to agricultural co-operatives. The Income Tax Act is also unclear as to how the reserve fund should be treated on conversion.
- While section 27(8)(a) stipulates how deductible bonuses should be treated by the members entitled to the bonus for agricultural co-operatives, the Income Tax Act is silent regarding the tax treatment in the same circumstances for other types of co-operatives.
- Apart from profits transferred to a price stabilisation fund for the KWV specifically, the Income Tax Act is silent regarding the tax treatment of the compulsory transfers to the reserve fund and the transfers from the reserve fund in pursuance of the objectives stipulated in the constitution.

¹⁵² However, as previously noted, this uncertainty has been removed through an amendment to section 41(4) through Taxation Laws Amendment Act 24 of 2011.

CHAPTER 4

TAX TREATMENT OF CO-OPERATIVES BEYOND SOUTH AFRICAN BORDERS

4.1 Introduction

South Africa is certainly not the first country to introduce a strategy aimed at promoting co-operatives to target the socio-economic goals of poverty alleviation and unemployment. Governments worldwide have identified that co-operatives can stimulate economies and provide opportunities for the poor, empower them and guarantee their security. This principle is not a new one; membership-based organisations like co-operatives are at least as old as the other common legal forms of business.

However, the co-operative form of business has been overshadowed by investor-owned businesses in recent history. Despite this, many countries have continued to focus on the vital part that co-operatives can play in reaching the nations' socio-economic goals. As a result of this continued focus, the United Nations estimated in 1994 that the livelihood of nearly half the world's population was made secure by the activities of co-operatives.¹⁵³

Four such countries with a highly successful co-operative sector, are Canada and Italy in the developed world, and India and Kenya in the developing world. In its comprehensive strategy on the promotion of co-operatives in South Africa, the DTI identified these four countries as examples of where the co-operative sector has grown rapidly and has contributed positively to economic development, employment creation, economic ownership by local communities and human resource development.¹⁵⁴ Through the development of the co-operative sector, Canada, Italy, India and Kenya have, to a large extent, met the socio-economic goals which South Africa hopes to achieve and as a result the DTI views the co-operative policies in these countries as examples of best practice.

Therefore, when assessing possible amendments to the current tax legislation in order to align the tax treatment of co-operatives to the socio-economic goals of the South African government, it is beneficial to include a brief study of the taxation of co-operatives in these countries which have succeeded in reaching similar socio-economic goals.

¹⁵³ International Co-operative Alliance, *Statistical information on the co-operative movement*.

¹⁵⁴ Department of Trade and Industry. *Publication of the integrated strategy on the development and promotion of co-operatives for public comment*, 16.

As co-operatives are prevalent throughout the world, there already exists a set of international guidelines for countries to follow when making or amending co-operative legislation and therefore, the chapter commences with international views on the tax-specific aspects of creating an enabling legislative environment. The chapter then sets out the tax treatment of co-operatives in Canada, Italy, India and Kenya. The tax treatment of co-operatives in each country is invariably a complex issue and therefore, just the key features of the tax policy are highlighted.

4.2 International views on co-operative tax policy

In 2005, the International Labour Organisation (ILO) published a set of guidelines aimed at providing a checklist of items to be considered for countries involved in making or amending co-operative legislation.¹⁵⁵ The Guidelines for Co-operative Legislation ('the Guidelines') built upon the framework for co-operative legislation prepared by the ILO in 2001 and which had been endorsed by the International Co-operative Alliance (ICA). The ICA initiated the Guidelines to be drafted by the ILO in order not to provide model laws, but rather to provide assistance to nations in creating co-operative legislation which adheres to the co-operative principles, but which also encourage adaptation to each country's unique context and characteristics.¹⁵⁶ When contemplating possible amendments to the current tax legislation, cognisance should be taken of international guidelines and best practice.

One of the most important co-operative principles, as determined by the ICA, is autonomy and independence.¹⁵⁷ Therefore the Guidelines warn against public funding which brings about tight control which in turn creates a vicious circle of government involvement and co-operative dependence of government support. While the Guidelines allude to scenarios where tax incentives may be required to meet fiscal needs and which do not violate the principles of autonomy, the Guidelines in general oppose the granting of tax privileges.¹⁵⁸ The foundation of these assertions is the premise that co-operative legislation should first and foremost ensure minimum government involvement and maximum deregulation, in

¹⁵⁵Henry Hagen, *Guidelines for Cooperative Legislation* (Geneva, International Labour Office, 2005).

¹⁵⁶ *Ibid*, iv.

¹⁵⁷ Refer to the full list of co-operative principles as determined by the ICA, in point 2.2.

¹⁵⁸ *Ibid*, 13.

order to transfer the seven co-operative principles into a legal framework for a business model which provides self-determined self-help.¹⁵⁹

Co-operatives should not be used as extensions of the government in order to carry out governmental policies. Instead co-operatives should receive equal treatment when compared with other corporate entities in order to avoid distortions between competitors and to avoid to creation of pseudo co-operatives.¹⁶⁰

The Guidelines go on to explain that equal treatment in the legal sense refers to treatment which is the same as other corporate entities, but differs in order to take into account the unique characteristics of co-operatives.¹⁶¹ This concept would of course also be applicable to the taxation of co-operatives. The Guidelines specifically note that the tax treatment of surplus funds and patronage funds are two examples of where the specific nature of co-operatives warrants tax treatment which differs to that of other entities. 'Patronage' funds are how a number of nations describe the patronage returns¹⁶² or bonus payments¹⁶³ which are essentially distributions of surplus funds from co-operatives to the members. Surplus funds are produced when differences arise between the estimated costs on-charged to the members, and the actual costs incurred. This is usually as a result of a small margin being included in the calculation of the costs, in order to cover related market risks, and where the risks have not materialised at year end.¹⁶⁴ In the same way, patronage refunds are essentially the price corrections or reductions with respect to the recalculation of the aforementioned costs at year end. The point made in the Guidelines is that where these surplus funds cannot be compared with normal business profits, they should not be taxed as normal business profits.¹⁶⁵ However, surplus funds arising from transactions with non members should be taxed as normal business profits.¹⁶⁶

Another feature unique to co-operatives is the obligation for a portion of surplus funds generated through transactions with members or non members, to be transferred to a reserve fund which cannot be distributed to the members and which must be used as defined by the constitution of the co-operative. The Guidelines suggest that one option would be, with specific reference to the transfer of a percentage of transactions with

¹⁵⁹ Ibid, vi.

¹⁶⁰ Ibid, 18.

¹⁶¹ Ibid, 18.

¹⁶² As defined in terms of the Co-operatives Act No 14 of 2005.

¹⁶³ As defined in terms of the Income Tax Act No 58 of 1962.

¹⁶⁴ Hagen, 48.

¹⁶⁵ Ibid, 18.

¹⁶⁶ Ibid, 49.

members to the reserve fund, to make that portion not subject to tax, even if the funds are consequently used as a credit or additional funding from that member.¹⁶⁷ The thinking behind this favourable tax treatment is that the use of reserve funds is a way to combat the inherent financial weakness in co-operatives and to provide a cushion against a lack of liquidity.¹⁶⁸

4.3 Taxation of co-operatives in developed countries: Canada

As discussed earlier in this paper,¹⁶⁹ the co-operative movement in Canada is an example of one of the major success stories in the developed world, with 40 percent of the population being members of co-operatives and with co-operatives contributing approximately 10 percent of the GDP.¹⁷⁰ Furthermore, small businesses which take the form of co-operatives have a higher survival rate in Canada than other corporate businesses in the private sector.¹⁷¹ It is noteworthy that while initially the co-operative sector in Canada was established with government support, the sector is now self reliant and autonomous. The success of the co-operative movement in Canada is largely attributed to the formation of secondary co-operatives and an enabling tax regime.¹⁷²

Co-operatives in Canada may qualify for a special reduced rate of taxation on the first 200,000 Canadian dollars ('CAD') of taxable income. Co-operatives with taxable income in excess of 200,000 CAD pay a higher rate of tax on the excess.¹⁷³ Similar to the tax legislation in South Africa, the Canadian Income Tax Act¹⁷⁴ allows for a deduction for amounts declared as patronage returns from the determination of taxable income. In Canada, these patronage returns are referred to as patronage allocations or dividends. The deduction is available where the patronage funds do not include surpluses derived from transactions with non members and where the patronage returns are paid in proportion to the value of business conducted with each of the members. Therefore, where a co-

¹⁶⁷ Ibid, 46.

¹⁶⁸ Ibid, 46.

¹⁶⁹ Refer to point 2.3.

¹⁷⁰ Co-operatives Secretariat, *Government of Canada invests in co-operative development in British Columbia*.

¹⁷¹ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 38.

¹⁷² Ibid, 23.

¹⁷³ Department of Agribusiness and Agricultural Economics, *University of Manitoba: Forming a new generation co-operative in Manitoba*, (2000), [Online]. Available: http://www.umanitoba.ca/afs/agric_economics/MRAC [15 November 2011].

¹⁷⁴ Income Tax Act, Revised Statutes of Canada. 1985 (5th supp.) c. 1, as amended. Consolidated to 20 July 1998.

operative only transacts with its members it is possible for its taxable income to be eliminated.¹⁷⁵ As is the case with the South African tax legislation, where business is conducted with non members, there is a limitation placed on the deduction for patronage allocations. The patronage allocations which are deductible in the co-operative must be included by the member in his or her individual taxable income for the year and the co-operative is required to withhold on behalf of the member, tax of 15 percent on any patronage allocations in excess of 100 CAD.¹⁷⁶

Canada has a federal system of tax as well as a provincial system. Canada's enabling tax regime is largely as a result of provincial-specific incentive schemes which have assisted in the development of the co-operative sector. For example, in 1985, Quebec introduced legislation which provided members and workers a personal income tax deduction of between 125 - 150 percent of any capital invested in the co-operative.¹⁷⁷ This encouraged additional investment of 393 million CAD by 2006.¹⁷⁸ Similarly, in Manitoba a programme has been introduced to encourage investment in community based enterprises which include qualifying co-operatives, by providing a 30 percent personal income tax credit for capital invested which can be carried forward for 10 years or carried back for three years.¹⁷⁹ This initiative has been extended until 2014.¹⁸⁰ A similar initiative to that in Quebec is planned at federal level and it is estimated that the cost of such a plan would be 17 - 20 million CAD per year and would generate approximately 120 million CAD per year of new investment across Canada.¹⁸¹

In Alberta, New Generation Co-operatives, which differ from traditional co-operatives, have been introduced in order to encourage diversification and value-added processing and marketing in agriculture.¹⁸² These special co-operatives give investors voting rights and some control over the activities of the co-operative and allow certain types of shares to be issued to members and non members in different classes and with special preferences, restrictions and limitations which may vary from class to class. New Generation Co-

¹⁷⁵ Department of Agribusiness and Agricultural Economics.

¹⁷⁶ Ibid.

¹⁷⁷ Monica Juarez Adeler, *Enabling policy environments for co-operative development: a comparative experience*, 16 (2009) [Online]. Available: usaskstudies.coop [1 December 2011].

¹⁷⁸ Canadian Co-operative Association, *2012 co-operative legacy projects*, (Last updated: 2011) [Online]. Available: http://www.coopscanada.coop/en/gov_affair/InvestStrategy [15 December 2011].

¹⁷⁹ Adeler, 17.

¹⁸⁰ Manitoba Government, *Manitoba finance: personal tax credits*, (Last updated: 2011) [Online]. Available: <http://www.gov.mb.ca/finance/pcredits.html> [23 November 2011].

¹⁸¹ Canadian Co-operative Association.

¹⁸² Corbett Smith Bresee, *New generation co-ops: Alberta's newest choice for agricultural business*, 8 (2003) [Online]. Available: [http://www1.agric.gov.ab.ca/\\$department/deptdocs.nsf/](http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/) [15 December 2011].

operatives are treated as ordinary co-operatives and still qualify for the reduced tax rate for the first 200,000 CAD of taxable income and certain manufacturing processing deductions. One disadvantage is that capital gains are subject to tax at 100 percent and do not receive the 50 percent exclusion available to corporate entities.¹⁸³

However, co-operatives in Canada have also faced some challenges regarding the tax legislation. Until 2006, large co-operatives with capital greater than 10 million CAD suffered a federal capital tax levied on shares, retained earnings and debt. However farming co-operatives were generally exempt throughout Canada and a number of provinces exempted co-operatives from the capital tax altogether until finally the tax was scrapped in 2006.¹⁸⁴

4.4 Taxation of co-operatives in developed countries: Italy

Co-operatives in Italy are a vital source of employment with 70,400 co-operatives employing nearly 1 million people.¹⁸⁵ The DTI praises the Italian co-operative movement as one of the most successful in the world, providing a good example for South Africa for best practice in this sector.¹⁸⁶

Historically, co-operatives in Italy have enjoyed a favourable tax regime, particularly between 1947 and 1962 where the profits of co-operatives derived from transactions with members were wholly exempt from tax, as was the interest on loans from members to their co-operatives (up to certain thresholds).¹⁸⁷ This is similar to the exemption from tax which agricultural co-operatives in South Africa enjoyed until 1977.¹⁸⁸ Co-operatives in Italy also received exemption from an additional tax introduced in 1953 on the profits of business entities.¹⁸⁹ A change in legislation meant that all co-operatives, apart from certain agricultural co-operatives were no longer exempt from tax between 1963 and 1974, but co-

¹⁸³ Alberta Agriculture Food and Rural Development, *Business structure options for new generation co-ops*, 2 (2003) [Online]. Available: [http://www1.agric.gov.ab.ca/\\$department/deptdocs.nsf/](http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/) [16 December 2011].

¹⁸⁴ Gary Rogers, *Who says co-operatives don't pay tax?* (2007) [Online]. Available: <http://www.coopzone.coop> [19 November 2011].

¹⁸⁵ As recorded in 2005. International Co-operative Alliance, *Statistical information on the co-operative movement*.

¹⁸⁶ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 18.

¹⁸⁷ Francesco Forte and Michela Mantovani, "Cooperatives' tax regimes, political orientation of governments and rent seeking" *Journal of Politics and Law*, 2 4 (December 2009): 49 [Online]. Available: www.ccsenet.org/journal/index.php/jpl/article/ [16 December 2011].

¹⁸⁸ Refer to point 3.4.1.

¹⁸⁹ Forte and Mantovani, 49.

operatives received favourable treatment in the form of a 75 percent reduction in the tax rate applied to the co-operatives and their members when compared with the standard rates.

Co-operatives in Italy must allocate 70 percent of surpluses to indivisible reserves and the remaining 30 percent must be allocated to distributable reserves, a portion of which can be allocated to member share capital.¹⁹⁰ In 1977, co-operatives benefited further by receiving a 100 percent deduction for transfers to the indivisible reserve fund, a measure which was implemented to encourage self capitalisation.¹⁹¹ This deduction was reduced to 70 percent in 2003 for co-operatives that conducted 50 percent or more of their business with their members and 30 percent where business transactions with members accounted for less than 50 percent of their total business.¹⁹² The deductions were further reduced to 45 percent and zero percent respectively in 2008 in order to assist the fiscus which was struggling to sustain the favourable tax exemptions.¹⁹³ According to the DTI, the tax treatment of the reserve fund is one of the support measures cited as contributing to the success of the co-operative movement in Italy.¹⁹⁴

Another factor contributing to the success of the Italian co-operative sector is that, since 1992, co-operatives have been required to contribute three percent of its profits towards national mutual funds which are established to support fledgling co-operatives and the development of the sector in general. Contributions to these funds are exempt from tax.¹⁹⁵

4.5 Taxation of co-operatives in developing countries: India

More than 239 million people are members of co-operatives in India,¹⁹⁶ with 99 percent of the population in rural areas involved in co-operatives.¹⁹⁷ When India gained independence in 1947, co-operatives were identified by the new government as important for poverty

¹⁹⁰ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 18.

¹⁹¹ Forte and Mantovani, 50.

¹⁹² Adeler, 17.

¹⁹³ Forte and Mantovani, 50.

¹⁹⁴ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 19.

¹⁹⁵ Adeler, 18.

¹⁹⁶ International Co-operative Alliance, *Statistical information on the co-operative movement*.

¹⁹⁷ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 24.

alleviation and economic growth,¹⁹⁸ which mirrors the current stance of the South African government. Historically, the profits of co-operatives and the dividends or other payments received by members were exempt from tax in India, making co-operatives an attractive form of business and encouraging the development of the co-operative sector.¹⁹⁹

However, a change in the legislation in 2006 defined co-operatives as associations of persons, subject to tax at rates specific to co-operatives.²⁰⁰ In spite of this, many co-operatives still enjoy preferential treatment such as 100 percent exemptions from income for co-operatives engaged in agriculture, banking and labour among others, as well as an exemption for interest received by co-operatives or members on loans between them and an exemption for dividends received by members.²⁰¹

4.6 Taxation of co-operatives in developing countries: Kenya

Approximately 1 in 5 Kenyans derive their livelihood directly or indirectly from co-operatives and the co-operative sector generates 45 percent of GDP and 31 percent of national savings and deposits in Kenya.²⁰² The majority of the success of the co-operative movement in Kenya is attributable to the following factors: an enabling legislative environment; an independent Ministry of Co-operatives and Marketing which is well resourced and deals specifically with co-operative issues; a strong focus on training and education; and the establishment of savings and credit co-operatives and the Co-operatives Bank of Kenya to provide co-operatives with financial support.²⁰³ The Kenyan government is very involved in the co-operative sector and have given a great deal of support to agricultural co-operatives and the savings and credit co-operatives. As a result, these types of co-operatives have enjoyed the most success in Kenya.²⁰⁴

With regard to the taxation of co-operatives, while certain co-operatives, such as the Co-operatives Bank of Kenya, are subject to tax as ordinary companies, qualifying co-

¹⁹⁸ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 20.

¹⁹⁹ Indian Co-operative, *NAFCUB: Patil makes a strong case for budgetary concessions*, (2011) [Online]. Available: <http://indiancooperative.com/tag/taxes/> [29 December 2011].

²⁰⁰ Government of India, *Taxation of other forms of business entities: taxation of cooperative societies*, (2011) [Online]. Available: http://business.gov.in/taxation/co_operative_societies.php [28 December 2011].

²⁰¹ Ibid.

²⁰² International Co-operative Alliance, *Statistical information on the co-operative movement*.

²⁰³ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 21.

²⁰⁴ Ibid, 21.

operatives, called “designated co-operatives” are taxed on their total taxable income less the aggregate of bonuses and dividends distributed to the members, where the amount deducted should not exceed the total income of the co-operative for the year.²⁰⁵ In order to qualify as a designated co-operative due regard is given to the number of members, the nature of the business and the extent to which business is conducted with non members, among other related factors.²⁰⁶ Funds not distributed to members are taxed in the co-operative at 30 percent in order to discourage the investment of member funds in non core activities.²⁰⁷ While the main reason for the success of co-operatives in Kenya is the supportive environment created by the government, the tax regime is favourable in that designated co-operatives often have a portion of non member income and yet there is no limitation in the Kenyan tax legislation on the deductible bonuses and dividends generated from transactions with non members. This is to be compared with the South African tax legislation where such a limitation exists.²⁰⁸ However, Kenyan revenue authorities may at their discretion tax co-operatives as companies should the extent to which business is conducted with non members exceed appropriate levels.

Savings and credit co-operatives are taxed slightly differently to other designated cooperatives. For this particular type of co-operative, only 50 percent of its gross interest income is included in taxable income, while 100 percent of any other income, such as rental income and taxable capital gains, is included in taxable income.²⁰⁹ Interest income from members is exempt from tax.

4.7 Conclusion

The international Guidelines on co-operative legislation suggest that in order to uphold the fourth co-operative principle of autonomy and independence, co-operatives should not be granted favourable tax privileges which could create distortions between competitors and lead to the creation of pseudo co-operatives. However, the Guidelines provide that co-operative tax legislation must account for the unique characteristics of co-operatives.

²⁰⁵ Owen Koimhuri Njenga, “Taxation of co-operatives in Kenya, leveraging the common bond: perspectives from a developing nation” *International Journal of Co-operative Management*, 4 2 (September 2009): 71 [Online]. Available: <http://www2.le.ac.uk/departments/management/documents/research/research-units/umbo/IJCM%20Vol%204%20No%202%20.pdf> [1 December 2011].

²⁰⁶ Ibid, 71.

²⁰⁷ Ibid, 71.

²⁰⁸ Refer to points 3.3.1 and 3.4.2.

²⁰⁹ Ibid, 71.

Specifically, the creation of surpluses in respect of transaction with members and the payment of those surpluses to members in the form of patronage returns, should not be taxed as these transactions essentially represent price corrections. Thus the surpluses are taxed once in the hands of the members, rather than twice as is the case with companies (once at the company tax rate and again when distributed as a dividend). Furthermore, tax free contributions to and from reserve funds created from surpluses on transactions between members are suggested as a way to combat the inherent financial weakness of co-operatives. The general principle is that co-operatives should not be taxed in respect of transactions with members, but should be taxed as companies with regard to normal business profits generated through transactions with non members.

The four countries analysed in this chapter have followed this general principle. However, co-operatives in Canada, Italy, India and Kenya, which are among the most successful in the world, have all enjoyed favourable tax privileges which go beyond this general principle. The study of the taxation of co-operatives in Canada revealed personal income tax credits or deductions for capital invested in co-operatives, as well as the introduction of the New Generation Co-operative which allows for non member investment and control and is still taxed as an ordinary co-operative. Italian co-operatives have also enjoyed tax incentives, ranging from a complete exemption from tax in respect of transactions with members, to lower tax rates for co-operatives and their members, varying deductions for amounts transferred to reserve funds, and full deductions for amounts distributed to compulsory mutual funds which are utilised to facilitate the development of the sector. Co-operatives in India enjoyed a long history of exemptions for surpluses and payments to members, and some types of co-operatives still enjoy such exemptions while others receive interest exemptions for loans to or from members. It appears that the primary reason for the success of co-operatives in Kenya is the high level of government involvement and support. While Kenyan co-operatives do not receive major tax incentives, in certain circumstances they are able to deduct bonuses and dividends which include a portion of non member generated income.

From analysing the taxation of the four countries in this chapter, a trend emerges in Canada, Italy and India in that historically generous tax incentives are introduced to aid in the development of the co-operative sector and then as the sector matures and the co-operatives become sustainable and autonomous, these incentives are moderated or removed. In developing co-operative tax policy, legislators are faced with the difficult task

of formulating a tax regime which encourages the formation of co-operatives and yet does not violate the co-operative principle of autonomy by creating too strong a dependence on tax incentives. It is submitted that by introducing temporary tax incentives or tax privileges aimed at encouraging the formation of small co-operatives, this may stimulate growth in the co-operative sector without creating too great a dependence on state support in the long term.

University of Cape Town

CHAPTER 5

PROPOSED CHANGES TO THE TAX LEGISLATION

5.1 Introduction

In this study, perceived deficiencies in the current co-operative tax legislation have been highlighted, which if left unaddressed, may continue to hamper the development of co-operatives, thus limiting the impact of these entities in addressing poverty, unemployment and stimulating economic growth. The DTI itself has highlighted that one of the contributors to the fact that these entities are yet to make a significant contribution to employment and economic growth, is the lack of a tax regime which supports this aim.²¹⁰ This leads to the following question: what changes should be made to the current tax legislation, in order to address the deficiencies highlighted in this study? Without intending to propose express provisions to be incorporated into the tax legislation, this chapter aims to address this question by providing suggestions of where the current income tax legislation could be improved.

When proposing changes to legislation, cognisance should be taken of the generally accepted principles of taxation in the South African context. There have been two commissions of inquiry into the South African tax structure, namely the Margo Commission (1984 to 1986)²¹¹ and the Katz Commission (1994 to 1999)²¹². The Margo Commission provided the following summary of the basic principles of taxation:

“The basic characteristics of an adequate tax structure (where one principle of taxation does not conflict with another) are equity, neutrality, simplicity, certainty, administrative efficiency, cost effectiveness, flexibility, stability, distributional effectiveness and a fair balance from the point of view of taxpayers between the respective burdens of direct and indirect tax.”²¹³

In addition to taking the above principles of taxation into account when considering how certain areas in the tax legislation could be improved, it should also be noted at the outset of this chapter, that the existing tax legislation relating to co-operatives in South African is

²¹⁰ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 60.

²¹¹ Margo Commission, Report of the Commission of Inquiry Into the Tax Structure of the Republic of South Africa RP34/1987 (Pretoria: Government Printer, 20 November 1987), para 1.28(a).

²¹² Katz Commission, The Ninth Interim Report of the Commission of Inquiry Into Certain Aspects of the Tax Structure of South Africa (Pretoria: Government Printer, February 1999).

²¹³ Margo Commission, para 1.28(a).

not entirely unfavourable. The tax treatment of *agricultural* co-operatives in South Africa is in line with international standards²¹⁴ in that where these particular co-operatives conclude business transactions only with members, surpluses derived from these transactions when distributed as patronage returns or bonus payments, are fully deductible in the co-operative.²¹⁵ This effectively renders the co-operative tax neutral. However, the same cannot be said of co-operative trading societies which are only afforded a deduction of up to just one tenth of the value of the business transactions between the co-operative and the members.²¹⁶

Another favourable aspect of the current tax legislation, applicable in this case both to agricultural and non agricultural co-operatives, is that where the patronage returns or bonus payments qualify for deduction, this deduction may be claimed in the current year of assessment even if the distributions are made up to six months after the year end.²¹⁷

But with only 22,619 co-operatives registered as at 31 March 2009, of which only 2,644 co-operatives could be confirmed as operational by the DTI²¹⁸, it is clear that the aforementioned tax advantages are not beneficial enough to have any noticeable effect on the development of the co-operative movement. Moreover, it is submitted that the deficiencies in the current co-operative tax legislation are hampering the development of co-operative movement and far outweigh the few tax benefits considered above.

In this chapter, suggestions for improvements to tax legislation relating to co-operatives are provided, with reference to the generally accepted principles of taxation. These suggestions are built upon the following two assertions:

1. The application of the tax legislation should not render co-operatives disadvantaged when compared with the tax treatment of companies in similar scenarios. An extension of this assertion is that the tax treatment of co-operatives should recognise that co-operatives have unique characteristics.
2. Tax incentives should be considered to aid in the strategy of promoting the co-operative sector, to which the South African government is committed.

²¹⁴ Refer to the discussion under point 4.2.

²¹⁵ Refer to the discussion under point 3.4.2.

²¹⁶ Refer to the discussion under point 3.3.1.

²¹⁷ Refer to the discussion under point 3.3.1 and point 3.4.2

²¹⁸ The Department of Trade and Industry, *The dti baseline study of co-operatives in South Africa*, 23.

Proposed changes motivated by these two assertions, are set out below. This is followed by a discussion of non tax related measures which should also be considered in addition to the creation of an enabling tax regime, in order to effectively promote co-operatives as a vehicle to address poverty, unemployment and economic growth. This discussion is set out with reference to lessons learned from the history of failures of co-operative promotion and development in South Africa, as highlighted previously in this study.²¹⁹

5.2 Proposed changes to address current deficiencies

As discussed in Chapter 4, the International Labour Organisation (ILO) recommends in their Guidelines for Co-operative Legislation ('the Guidelines'), that co-operatives should receive equal tax treatment when compared with other corporate entities in the sense that the tax treatment should be the same as other corporate entities, but should differ to take into account the unique characteristics of co-operatives.²²⁰ This recommendation could be seen as an extension of the principle of equity as highlighted in the Margo Commission.

To apply this principle more specifically in the context of co-operatives in South Africa, it is submitted that co-operatives should receive relief in respect of transactions with members, since surpluses derived from these transactions are not comparable to normal business profits. On the other hand, co-operatives should be taxed in the same way as companies with regard to normal business profits generated through transactions with non members. This simple principle is not clearly reflected in the current tax legislation.

In the current legislation, non agricultural co-operatives receive little relief in respect of surpluses distributed to members²²¹ and with regard to restructurings and conversions, all types of co-operatives are in fact at a disadvantage when compared with the tax relief available to companies.²²² Therefore, it could be said that some aspects of the current tax legislation as it relates to co-operatives, appear to be in violation of the principle of equity as identified in the Margo Commission. Therefore, the following changes are proposed, in order to ensure that co-operatives receive relief with regard to the unique nature of member transactions and are not at a disadvantage when compared with tax relief available to companies:

²¹⁹ Refer to the discussion under point 2.4 and 2.5.

²²⁰ Refer to the discussion under point 4.2.

²²¹ Refer to the discussion under point 3.3.2.

²²² Refer to the discussion under point 3.5.4.

- Section 27(1) of the Income Tax Act should be amended so that the limitation placed on the deduction for bonuses distributed to members in co-operative trading societies, is the same as the limitation provided in section 27(2)(a) for agricultural co-operatives. The effect of this amendment would be that whenever agricultural or non agricultural co-operative business is conducted with members only, surpluses distributed to the members would be deductible up to the value of taxable income before the deduction. Therefore, these surpluses would not be taxed in the co-operative. Where co-operatives conduct business both with members and non members, the deduction would be limited to the proportion of business conducted with members to all business conducted, as applied to the amount of taxable income before the deduction.
- Co-operatives should once again be included in the definition of a “group of companies” in section 41, so that they may be able to benefit from the roll over relief provided in terms of section 45 (intra-group transactions), and section 47 (liquidation transactions).
- Due to the fact that co-operatives do not have equity shares, section 42 (asset-for-share transactions) and section 46 (unbundlings) cannot be utilised by co-operatives and therefore these sections should be updated to provide for the transfer of shares in a company for shares in a co-operative, so that co-operatives may benefit from the relief provided in these sections.
- Amalgamations where the amalgamated entities are co-operatives are precluded from applying section 44 and must apply section 27(5B). However, since section 27(5B) does not provide as much relief as section 44 as it is unclear whether the relief in section 27(5B) would extend to, for example, Capital Gains Tax (CGT) on the disposals of assets and shares, either section 44 should be amended to provide for amalgamations where the resultant entity is a co-operative, or section 27(5B) should be revised to provide wider relief similar to the relief provided in section 44. For amalgamations involving co-operatives where the resultant entities are companies, section 44 may be applied. It is further proposed that section 41(4), which contemplates the steps for liquidation or deregistration as required under section 44, be updated to specifically include co-operatives in order to remove any uncertainty in that regard.²²³

²²³ It is noteworthy that, while beyond the scope of this study, section 41(4) has been amended through Taxation Laws Amendment Act 24 of 2011 to specifically include co-operatives.

- Section 40B which contemplates the conversion from a co-operative to a company, should be amended to clearly express how co-operative specific allowances, such as the storage building allowances available to agricultural co-operatives, should be treated on conversion to a company, as well as how the reserve fund should be treated on conversion.

As identified in Chapter 3, some of the terminology used in the co-operative specific sections of the Income Tax Act does not align with the terminology used in the Co-operatives Act of 2005. Furthermore, certain terms in the current tax legislation are defined with reference to co-operative legislation which has since been repealed. The principle of certainty is also identified in the Margo Commission and the uncertainty created by the outdated terminology may deter entrepreneurs from choosing the co-operative model over other business models. Therefore, the following changes are proposed with respect to terminology used in the Income Tax Act which is outdated or not in alignment with the terminology used in the current Co-operatives Act:

- The reference in section 27(1) to co-operative trading societies as defined in the Co-operative Societies Act No 29 of 1939, and the reference to in section 27(9) to agricultural co-operatives as defined in the afore-mentioned Act, should be amended as the Co-operative Societies Act No 29 of 1939 has since been repealed. Furthermore, the reference in section 27(1) to “closed societies” as defined in terms of the afore-mentioned repealed Act, should also be amended. The current Co-operatives Act makes no reference to co-operative trading societies or to closed societies, nor does it split co-operatives between agricultural and non agricultural co-operatives as the current Income Tax Act effectively does. Therefore, section 27 should be amended to align with the current Co-operatives Act which provides for a wide variety of co-operatives. Co-operatives in the Income Tax Act should be defined in terms of the Co-operatives Act No 14 of 2005.
- The references to bonus payments in section 27(1), 27(2)(a), and 27(8), as well as the definition of a “bonus” provided in section 27(9) should be amended to describe these payments as “patronage returns” as contemplated in the current Co-operatives Act.

With reference once again to the principle of certainty, the current co-operative tax legislation falls short in that the Income Tax Act is silent on some important tax matters

such as how deductible bonuses should be treated by the members entitled to the bonus for non agricultural co-operatives, as well as the tax treatment of the compulsory transfers to the reserve fund and the transfers from the reserve fund. This creates confusion and therefore, the following changes are proposed, in order to remove this uncertainty:

- Section 27(8)(a) should be amended to clarify that the amount of bonuses distributed by *any* co-operative should, to the extent that such amount qualifies for deduction in the co-operative, be included in the gross income of the member entitled thereto.
- All co-operatives are required to set aside at least five percent of any surplus in a reserve fund, and yet the Income Tax Act does not expressly state how amounts transferred to reserve funds should be treated for tax purposes, and how amounts transferred from reserve funds to be utilised in pursuance of the objectives stipulated in the constitution, should be treated. The Guidelines for Co-operative Legislation as prepared by the ILO suggest that the portion of funds transferred to the reserve fund which was derived from transactions with members, should not be subject to tax, as a way to combat the inherent financial weakness in co-operatives and to provide a cushion against a lack of liquidity.²²⁴ In Italy, co-operatives were historically afforded significant deductions for transfers to reserves funds and complete exemptions for compulsory contributions national mutual funds which were established to support fledgling co-operatives and the development of the sector in general.²²⁵ Section 27(2)(h) of the Income Tax Act provides the KWV with an allowance for transfers of profits to a price stabilization fund and the use of this price stabilisation fund is clearly stipulated.²²⁶ The afore-mentioned examples are combined to propose that a subsection be inserted into section 27, which provides for a deduction for transfers to reserve funds, where the deduction is limited to that portion of the funds which were derived from transactions with members. Furthermore, it is suggested that this deduction only be permitted if the constitution of the co-operative stipulates that the funds must be utilised for qualifying purposes such as training, education, social development, the sustainability of the co-operative itself, and the development of the co-operative sector. This deduction should be granted regardless of whether the funds are applied in respect of expenditure of a capital nature and there should be no tax effect when the funds are transferred from the reserve fund to be applied for that purpose.

²²⁴ Refer to the discussion under point 4.2.

²²⁵ Refer to the discussion under point 4.4.

²²⁶ Refer to the discussion under point 3.4.9.

5.3 Proposed changes to incentivise the formation of co-operatives

Amendments to the tax legislation to ensure that co-operatives are not disadvantaged when compared with companies, may not be enough to stimulate growth in the co-operative sector. In order to align tax legislation with the aim of the South African government to promote co-operatives as a measure to reduce poverty and stimulate economic growth, it is submitted that the introduction of tax incentives should also be considered. In Chapter 4, a trend was identified in Canada, Italy and India in that, historically, generous tax incentives were introduced to aid in the development of the co-operative sectors and then as the sectors matured and co-operatives become sustainable and autonomous, these incentives were moderated or removed.²²⁷ While the ILO alludes to scenarios where tax incentives may be required to meet fiscal needs, the Guidelines generally oppose the granting of tax privileges due to the risk that tax incentives may encourage the formation of co-operatives reliant on government support, which would be in violation of the International Co-operative Alliance (ICA) principles of autonomy and independence.²²⁸ This is relevant in the South African context in that the current Co-operatives Act is based upon the ICA principles.²²⁹ It could also be argued that the principle of neutrality as identified in the Margo Commission could be jeopardised if the tax incentives have an unduly significant influence on economic behaviour and decision-making in respect to the formation of co-operatives.

Therefore a dichotomy exists between the evidence that tax incentives have contributed to the success of co-operative sectors internationally, and the risk that tax incentives may violate the principles of autonomy and independence upon which the current Co-operatives Act is based, as well as the generally accepted tax principle of neutrality upon which the current Income Tax Act should be based.

However, the DTI aims to emulate the success of co-operatives internationally with respect to poverty alleviation, job creation and economic growth and to meet these socio-economic goals, the DTI has indicated the need for a tax regime which supports these aims. It is submitted that by introducing *temporary* tax incentives aimed at encouraging the formation of emerging co-operatives, this may stimulate growth in the co-operative sector without

²²⁷ Refer to the discussion under points 4.3, 4.4 and 4.5.

²²⁸ Refer to the discussion under point 4.2.

²²⁹ Portfolio Committee on Trade and Industry, 89.

creating too great a dependence on state support in the long term. In this regard, the following tax incentives are suggested:

- A personal income tax deduction of, for example, 150 percent of any capital invested in a co-operative. A similar initiative is planned at federal level in Canada and it is estimated that the cost of such a plan would be 17 - 20 million Canadian dollars per year and would generate approximately 120 million Canadian dollars per year of new investment across Canada. This represents, approximately, a 500% return on investment. While it would be optimistic to assume that South Africa, with its fledgling co-operative sector, would experience the same level of success, it may still be worthwhile to introduce this measure for a period of five years for example, after which the incentive could be reduced or remitted altogether.
- While the 100 percent exemptions found in India for certain types of co-operatives might not be sustainable in South Africa, a lower tax rate could be introduced for a limited period of time for co-operatives and their members, as is currently the case in Italy. Also, full exemptions for interest received by co-operatives or members on loans between them could also be considered in order to promote the development of co-operatives.
- While agricultural co-operatives receive specific capital allowances and deductions which are not available to companies, all other forms of co-operatives (worker co-operatives, financial co-operatives, consumer co-operatives etc) may only claim capital allowances which are available to all companies (provided the required criteria are met). This is in contrast to the current Co-operatives Act which does not favour one type of co-operative over another. It is proposed that special capital allowance should be considered, which would apply to all forms of co-operatives with qualifying capital expenditure.

5.4 Other measures required to create an enabling environment for co-operatives

It is submitted that the implementation of the above proposals would encourage growth in the co-operative sector by ensuring that the unique characteristics of co-operatives are recognised, that co-operatives are not disadvantaged when compared with companies, and by providing temporary tax incentives to stimulate growth without compromising the independence and autonomy of co-operatives in the long term.

However, while an enabling tax regime may contribute to the success of the co-operative movement, the improved tax regime in isolation would not be sufficient to make a significant positive impact on poverty, unemployment and economic growth in South Africa through an increase in the use of co-operatives, since many of the proposals highlighted in this chapter would only benefit co-operatives which have taxable income.

Indeed, the Income Tax Act is not the only piece of legislation which should be considered for revision; the legislative environment as a whole must be aimed at creating a framework in which co-operatives can thrive. As identified in Chapter 2, there are a number of disadvantages to the co-operative model, which may be contributing to the low number of operating co-operatives. For example, in the Co-operatives Act of 2005, there are restrictions on the kinds of activities that primary, secondary and tertiary co-operatives may undertake, primary co-operatives are limited to natural persons as members and since non members are effectively prohibited from participating in the distribution of profits, external financing is not easily attracted. It is noteworthy that the Guidelines commissioned by the ILO do not recommend limiting the activities of co-operatives.²³⁰ Nor do they recommend limiting members to just natural persons. Rather, the recommendation is that natural persons and legal persons may be members as long as the one-member-one-vote principle is adhered to, in accordance with the ICA co-operative principle of democracy.²³¹ With regard to securing external financing, the Guidelines recommend that though it may represent a slight deviation from the co-operative principles, external investment would be acceptable by means of debentures or negotiable subordinated bonds, or through allowing non members to hold transferable investment certificates which grant participation rights in the surpluses or assets on liquidation, but do not grant voting rights.²³²

Based on the history of the development of co-operatives in South Africa, if amendments are made to the Co-operatives Act in order to address perceived disadvantages highlighted in Chapter 2 and referred to above, coupled with the proposed amendments to the Income Tax Act as suggested in this chapter, it is likely that this would result in an increase in the number of registered co-operatives, but the sustainability of these new co-operatives is not guaranteed. This contention is on the basis that when the Co-operatives Act No 91 of 1981 was repealed and replaced with the Co-operatives Act No 14 of 2005, the new legislation

²³⁰ Hagen, 17.

²³¹ Ibid, 26.

²³² Ibid, 47.

represented a significant improvement, but while the number of registered co-operatives jumped from 3,990 in 2004 to 22,619 in 2009 largely as a result of the new Act, the survival rate was poor with less than three thousand co-operatives being confirmed as operational in the baseline study conducted by the DTI.²³³

Therefore, while an enabling legislative environment may encourage new co-operative registrations, there is a need to address the poor survival rate. In this regard, it is submitted that further government involvement and control in order to sustain emerging co-operatives would not be the answer. The Guidelines warn against public funding which brings about tight control which in turn creates a vicious circle of government involvement and co-operative dependence of government support²³⁴ as was the case during the *apartheid* regime where the Land and Agricultural Bank was established to provide agricultural co-operatives with access to finance, and agricultural co-operatives enjoyed regional monopoly power by acting as agents of the marketing control boards established through the Marketing Act of 1937.²³⁵ These types of support measures are costly and violate the principles of independence and autonomy.²³⁶ Rather, it is submitted that if the success of co-operatives in Kenya is used as an example,²³⁷ the answer must lie in a combination of an enabling legislative environment and a strong focus on training and education, in order to develop self-sustaining organisations.

In its strategy on the promotion and development of co-operatives, the DTI highlights a number of non financial support measures such as programmes which provide training on the principles of co-operation, co-operative management skills, technical support and mentorship, as well as programmes focussed on legislative compliance education and registration procedures training.²³⁸ Since co-operatives are not widely understood in South Africa, the effectiveness of the implementation of these non financial support measures will have a significant bearing on the success and sustainability of the co-operative movement in South Africa.

²³³ For further details, refer to the discussion under point 2.5.

²³⁴ Refer to discussion under point 4.2.

²³⁵ Refer to discussion under point 2.4.

²³⁶ International Co-operative Alliance, *Statement on the co-operative identity*.

²³⁷ Refer to discussion under point 4.6

²³⁸ The Department of Trade and Industry, *Publication of the integrated strategy on the development and promotion of co-operatives for public comments*, 55.

5.5 Conclusion

In this study, the central question of whether the current taxation of co-operatives supports the governmental goals of encouraging the use of co-operatives to alleviate poverty and make a positive contribution to the economy, is answered in the negative. Deficiencies in the tax legislation have been identified, which render co-operatives disadvantaged when compared with companies, thus discouraging the formation of co-operatives. Furthermore, co-operatives have unique characteristics which are not reflected in the tax legislation, acting as a further deterrent to the use of these entities. It is proposed that these problem areas be addressed by National Treasury²³⁹ and that tax incentives be considered to provide further support to the DTI's strategy of promoting the use of co-operatives to reach socio-economic goals. Suggestions of the types of amendments to be considered have been highlighted in this chapter and these suggestions have been made with reference to the generally accepted principles of taxation.

However, improvements to the tax legislation alone will be insufficient in isolation to stimulate significant development of the co-operative sector. The legislative environment as a whole should support this aim and therefore the revision of certain aspects of the Co-operatives Act should be considered to ensure minimum government involvement and maximum deregulation. In addition, it is crucial that a comprehensive training and education programme is effectively implemented to assist in creating a sustainable co-operative sector. It is internationally accepted that co-operatives have the potential to alleviate poverty and make a positive contribution to the economy²⁴⁰ and it is submitted that an enabling tax regime, coupled with the effective implementation of non tax related support measures, would represent a significant step forward in making South Africa another example of the way in which co-operatives can lift communities and indeed entire nations out of poverty.

²³⁹ The National Treasury is responsible for managing South Africa's national government finances and is mandated to draft income tax legislation. For further information, visit <http://www.treasury.gov.za/>.

²⁴⁰ Birchall, 2.

CHAPTER 6

CONCLUDING REMARKS

This study sought to analyse the development of the taxation of co-operatives and address the question of whether the current tax legislation supports the governmental goals of using co-operatives to make a positive contribution to the economy, thereby alleviating poverty and unemployment. In order to answer this question, a discussion of the nature of co-operatives was provided in Chapter 2, including background on the co-operative movement both internationally and within South Africa, and highlighting the unique characteristics of co-operatives which have contributed to their international success in poverty alleviation.

It was noted that while there is evidence internationally that co-operatives can contribute directly to the eradication of poverty, employment and the stimulation of economies, co-operatives in South Africa do not yet make a significant impact in this regard. To further understand the nature of co-operatives in the South African context, the more critical aspects of the legal framework were analysed, which also provided the legal policy foundation upon which a review of the development of the tax legislation, could be built. This review was set out in Chapter 3.

As noted in Chapter 3, the current tax legislation generally treats co-operatives as companies. There are deficiencies in the legislation particularly with regard to circumstances where the tax treatment of co-operatives is less favourable than the tax treatment of companies in similar scenarios, and where the unique characteristics of co-operatives are not clearly recognised in the tax legislation. In order to provide suggestions for ways in which the current legislation could be improved, a review was conducted in Chapter 4, of the taxation of co-operatives in countries with successful co-operative sectors in both the developed and developing world.

Finally the findings of the international best practices, coupled with the problem areas identified in the current tax legislation, were combined in Chapter 5 and used to propose amendments to the tax legislation in order to create a more enabling tax regime for South African co-operatives, including some temporary tax incentives that could be considered in order to align the tax treatment of co-operatives with the socio-economic goals of the South African government.

The general principle which emerges from this study is that the tax legislation should provide an enabling environment for people with similar business needs to pool their strengths and resources to provide needed products and services to themselves through the creation of *bona fide* co-operatives, while also ensuring that co-operatives are taxed as companies with regard to normal business profits generated through transactions with non members.

The United Nations has proclaimed the year 2012 the International Year of Co-operatives,²⁴¹ encouraging member states to take action to promote the growth of co-operatives as business and social enterprises that can contribute to sustainable development, eradication of poverty, and livelihoods in various economic sectors in urban and rural areas.²⁴² Therefore, in the spirit of this proclamation, it is submitted that action should be taken to address the deficiencies in the current taxation of co-operatives, which are hampering the development of the co-operative sector in South Africa.

(24,984 words, excluding footnotes)

²⁴¹ United Nations General Assembly, *Resolution adopted by the General Assembly on the report of the Third Committee (A/64/432): 64/136 Cooperatives in social development*, (11 February 2010) [Online]. Available: http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/64/136 [9 January 2012].

²⁴² *Ibid*, 2.

APPENDIX A

Table 1

| Turnover | Marginal Rate |
|---------------------|---|
| R0 – R100 000 | 0% |
| R100 001 – R300 000 | 1% of each R1 above R100 000 |
| R300 001 – R500 000 | R2 000 + 3% of the amount above R300 000 |
| R500 001 – R750 000 | R8 000 + 5% of the amount above R500 000 |
| R750 001 and above | R20 500 + 7% of the amount above R750 000 |

Note that in terms of Taxation Laws Amendment Act 24 of 2011, the new rates applicable in respect of any year of assessment ending during the period of 12 months ending on 31 March 2012, are as follows:

| Turnover | Marginal Rate |
|---------------------|---|
| R0 – R150 000 | 0% |
| R150 001 – R300 000 | 1% of each R1 above R150 000 |
| R300 001 – R500 000 | R1,500 + 2% of the amount above R300 000 |
| R500 001 – R750 000 | R5,500 + 4% of the amount above R500 000 |
| R750 001 and above | R15,500 + 6% of the amount above R750 000 |

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