THE TAXATION OF DIVIDENDS
IN SOUTH AFRICA

by

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Inleiding

Die doel van hierdie studie is om te bepaal wat die aangewese vorm van maatskappy- en derhalwe dividendbelasting is vir Suid-Afrika onder die huidige omstandighede.

Sedert Suid-Afrika, as gevolg van die politieke hervorming in die land, weer aanvaar is tot die internasionale handelsgemeenskap, het die land ook die belangstelling van buitelandse beleggers gewek. Om die doelwitte van die Heropbou-en-Ontwikkelingsprogram vir die Nuwe Suid-Afrika te bereik, is buitelandse investering in die land van uiterste belang.

Daar bestaan egter sekere faktore wat buitelanders inhibeer om in Suid-Afrika te belê of wat maak dat hulle eerder verkies om te investeer in ander lande wat met Suid-Afrika kompeteer vir buitelandse kapitaal. Een van hierdie inhiberende faktore is die hoë effektiewe maatskappybelasting betaalbaar deur maatskappye. In Suid-Afrika bestaan dit uit die nominale belastingkoers van toepassing op maatskappye plus die Sekondêre Belasting op Maatskappye wat gehef word op alle uitgekeerde winste m.a.w. dividende. Voordat die verskillende stelsels van dividendbelasting ondersoek word, is dit belangrik om presies te bepaal wat die term 'dividend' omvat.

Dividende

Die definisie van 'n 'dividend' word vervat in die Inkomstebelastingwet. Hierdie is een van die mees komplekse definisies in die Wet en is van uiterste belang vir hierdie studie aangesien enige dividendbelasting gehef word op die uitkering van 'n dividend.

Die inleiding tot die definisie beperk 'n dividend tot 'bedrae uitgekeer' deur 'n 'maatskappy' aan sy 'aandeelhouers'. Die definisie gaan verder en sluit sekere bedrae spesifiek in by 'bedrae uitgekeer', maar bevat ook sekere uitsluitings daartoe. Vervolgens word die belasting van dividende in Suid-Afrika ondersoek.

Die belasting van dividende in Suid-Afrika

Uit die geskiedenis van maatskappy- en dividendbelasting in Suid-Afrika blyk dit dat Suid-Afrika, voor 1990, 'n klassieke stelsel van dividendbelasting gehad het. Maatskappywinste is teen 50% belas, onuitgekeerde winste is swaarder belas en dividende is in die hande van die individue belas. So 'n stelsel van dubbelbelasting het aanleiding gegee tot ekonomiese verwringings. Met die afskaffing van dividendbelasting het die regering gepoog om die ekonomiese verwringings reg te stel, om die belastingstelsel te vereenvoudig en om ekonomiese groei aan te moedig.

In 1993 het 'n nuwe vorm van dividendbelasting die lig gesien, naamlik die Sekondêre Belasting op Maatskappye (SBM). Hierdie belasting word gehef op die uitkering van dividende. Die doel met SBM was om die interne investering van winste deur maatskappye aan te moedig en om sodoende ekonomiese groei te stimuleer. 'n Verdere voordeel was die verlaging in die nominale maatskappybelastingkoers tot 'n internasionaal meer aanvaarbare vlak.

SBM het 'n versterking in die balansstate van maatskappye tot gevolg en die fiskus het 'n nuwe bron van inkomste om aan te wend in die Heropbou- en ontwikkelingsprogram. SBM het egter ook nadelige gevolge waarvan die belangrikste die invloed van SBM op buitelandse investering in Suid-Afrika is. Gekombineer met die nominale maatskappybelasting, is die effektiewe belastingkoers steeds baie hoog; SBM is 'n vreemde vorm van dividendbelasting wat nie erken word in meeste dubbelbelastingooreenkomste nie en SBM het ekonomiese verwringings tot gevolg.

Die regering het die negatiewe invloed van SBM raakgesien en gereageer daarop deur belangrike veranderinge in die belastingstelsel aan te bring in die 1996 begrotingsrede. Hierdie veranderinge sluit in die verlaging van die SBM-koers vanaf 25% tot 12.5%, die afskaffing van die belasting op buitelandse aandeelhouers, die instelling van 'n belasting op Suid-Afrikaanse takke van buitelandse maatskappye en die belasting van rente ontvang deur buitelandse maatskappye. Verder erken die Verenigde Koningkryk SBM nou vir die doeleindes van belastingkrediete, en reëls ten opsigte van die kapitaalstruktuur van maatskappye is onlangs ingestel.

Hierdie veranderinge het die huidige SBM-stelsel drasties verbeter en maak dit 'n aanvaarbare opsie op die korttermyn. Dit is egter nodig om die ander aanvaarbare metodes van dividendbelasting wat internasionaal gebruik word te ondersoek om sodoende tot 'n gevolgtrekking te kan kom ten opsigte van die mees aanvaarbare vorm van dividendbelasting vir Suid-Afrika.

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Internasionale metodes vir die belasting van dividende

Daar bestaan twee tradisionele stelsels van dividendbelasting, nl. die klassieke stelsel en die geïntegreerde stelsel. Onder die klassieke stelsel word beide die maatskappy en die aandeelhouer gesien as afsonderlike entiteite wat afsonderlik belas word. Hierdie siening gee aanleiding tot die dubbele belasting van dividende wat op sy beurt lei tot ekonomiese verwringings.

'n Ten volle geïntegreerde stelsel beskou die maatskappy en sy aandeelhouer as een belastingentiteit. Alle winste - uitgekeer of onuitgekeer - word dus eenmaal belas teen die belastingkoers van toepassing op die individu. Sodoende word dubbele belasting van dividende ten volle uitgeskakel. Die ten volle geïntegreerde stelsel is egter onprakties en geen land het dit nog gewaag om so 'n stelsel te implementeer nie. Meeste lande het gedeeltelik geïntegreerde dividendbelasting stelsels wat 'n mate van verligting van die dubbele belasting van dividende verskaf.

Gedeeltelik geïntegreerde stelsels bestaan uit stelsels wat verligting van dubbele belasting verskaf op aandeelhouervlak en die wat verligting verskaf op maatskappyvlak. Die metodes waar dividendverligting op aandeelhouervlak verskaf word, word meestal gebruik. Die belangrikste metode van dividendverligting op aandeelhouervlak is die imputasiestelsel. Volgens hierdie metode verkry die aandeelhouer 'n krediet vir die belasting alreeds betaal deur die maatskappy.

Die internasionale neigings in dividendbelasting toon 'n defnitiewe neiging weg van klassieke stelsels van dividendbelasting. Meeste lande verskaf dividendverligting op aandeelhouervlak en die meerderheid lidlande van die Organisasie vir Ekonomiese Samewerking en Ontwikkeling gebruik imputasiestelsels of skedulêre metodes van dividendbelasting en slegs die hoogs ontwikkelde lande maak gebruik van imputasiestelsels.

Die imputasiestelsel is baie aanloklik omdat dit konseptueel suiwer is, dit skakel die ekonomiese verwringings veroorsaak deur die klassieke stelsel uit en is 'n internasionaal erkende en aanvaarde stelsel. Gesien teen die Suid-Afrikaanse agtergrond, blyk dit egter nie die ideale metode van dividendbelasting vir ons land te wees nie. Die instelling van so 'n stelsel van dividendbelasting sal 'n bykomende administratiewe lading vir die Suid-Afrikaanse Inkomste Diens, wat reeds 'n administrasieprobleem het, tot gevolg hê.

'n Eenvoudiger vorm van dividendbelasting wat dividendverligting verskaf op aandeelhouervlak, soos die skedulêre hantering van dividende, blyk 'n beter alternatief te wees. So 'n stelsel kan aangepas word om die spesifieke omstandighede of behoeftes eie aan 'n land soos Suid-Afrika in ag te neem. Dit kan byvoorbeeld dividendverligting verskaf deurdat dividende teen 'n laer vaste koers belas word wat op maatskappyvlak ingevorder word. So 'n stelsel verskil nie baie van die huidige stelsel nie, is maklik om te administreer, dit beskerm die regering se inkomste en word internasionaal erken.

Gevolgtrekkings

SBM het sy doel gedien in Suid-Afrika, maar dit is tyd vir hervorming. Hoewel die onlangse veranderinge aan die land se belastingstelsel sekere van die probleme wat deur SBM veroorsaak word, behoort te verminder, is dit my mening dat 'n stelsel van dividendbelasting wat internasionaal erken word, aanvaar behoort te word.

Dit is belangrik om die internasionale metodes van dividendbelasting te ondersoek, maar daaruit is dit ewe duidelik dat elke land sy eie unieke metode van dividendbelasting het, aangepas vir die land se unieke behoeftes. Gesien teen die huidige Suid-Afrikaanse milieu blyk 'n skedulêre vorm van dividendbelasting die aangewese alternatief te wees.

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LIST OF ABBREVIATIONS

Companies Act............Act 61 of 1973

DTA..........................Double Taxation Agreement

EC............................European Community

Income Tax Act............Act 58 of 1962

NRST.........................Non-resident Shareholders Tax

OECD........................Organisation for Economic Co-operation and Development

STC...........................Secondary Tax on Companies

UPT...........................Undistributed Profits Tax

CHAPTER 1

INTRODUCTION

1.1 Subject of this dissertation

1.2 Background and motivation for this dissertation

1.3 Scope of this dissertation

1.1 Subject of this dissertation

South Africa's re-entry into the international business arena is both exciting and challenging. It poses the opportunity for South Africa to become part of the global economy. There is world-wide interest in South Africa for potential investment, but certain reforms are required to bring our taxation policies closer to those practised or recognised internationally. South Africa's method of taxing dividend distributions is one of the areas inhibiting foreign investment and where reform therefore is required. The taxation of dividend distributions will be the subject of this dissertation.

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1.2 Background and motivation for this dissertation

As a developing country that has recently, since the abolition of apartheid, again become acceptable to foreigners for investment, consideration should be given to the attractiveness of this country to foreign capital.

Corporate structures are the preferred business entities that foreigners invest in. Any potential investment is evaluated with regard to the return that can be obtained. The distribution of corporate profits by way of a dividend is the usual manner by which investors obtain a cash return on their investment.

The legislation regarding the taxation of corporate profits and dividends in a country is thus of great importance when foreign investors evaluate the potential of an investment.

Currently in SA, all corporate profits are taxed at 35% and on all distributed profits - dividends - 12,5% Secondary Tax on Companies (STC) is levied. If all profits were to be distributed the effective tax rate is 42,2% which is higher than that of other countries competing for foreign investment (Katz, 1994:221). Furthermore ST.C is not internationally recognised as a tax on dividends or as an additional corporate tax. It is not embodied in double taxation treaties and in most cases no foreign tax credit is

received by shareholders for STC paid. In short - the costs of international unfamiliarity with STC may outweigh the domestic advantages thereof.

In an interview with Deloitte & Touche International Tax partner, Anne Bennet these problems that multi-national companies such as RTZ-CRA have with STC and the need for reform, was expressed. The concerns regarding STC were also stressed in the Interim Report of the Katz Commission(1994: 168-178, 213-234).

It is clear that STC's shortfalls can seriously hamper SA's attractiveness to foreign investors. The alternative methods of taxing dividends, that are accepted and known internationally, should therefore be examined and the most acceptable alternative should be adopted.

1.3 Scope of this dissertation

The scope of this dissertation is outlined below:

Chapter 1:

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This chapter describes the subject of this dissertation. It also sketches the background and motivation that led to the choice of the subject. The scope of the study which consists of three parts is also outlined.

PART I:

The current STC legislation is confined to amounts distributed as a dividend or deemed to be a dividend. Any dividend tax proposed to replace STC will also be triggered by dividend distribution. The meaning of the term dividend is therefore of great importance. PART I of this dissertation attempts to explain what is meant by a dividend distribution in the South African Tax legislation.

Chapter 2:

The ordinary meaning of dividend is considered in this chapter and the general preamble to the dividend definition in the Income Tax Act is analysed. The general preamble contains the following three important concepts which will be explained:

- 'Amount distributed'
- By a 'company'
- To its 'shareholders'

Chapter 3:

In chapter 3 the specific inclusions to 'amounts distributed' as contained in paragraph (a) and (b) of the dividend definition in the Act will be studied, namely:

- Liquidation dividends
- Going-concern dividends

Chapter 4:

This chapter deals with rest of the specific inclusions contained in paragraph (c) and (d) of the dividend definition. Both paragraphs deal with the situation where cash or value of assets is given to shareholders as a dividend:

- Paragraph (c) under a redemption of share capital; and
- Paragraph (d) under the reconstruction of a company.

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Chapter 5:

Chapter 5, concluding PART I of the dissertation, analyses the specific exclusions, focusing on paragraphs (e), (f) and (h) that deal with:

- Capitalisation issues utilising the share premium,
- Reduction of the share premium and
- Capitalisation issues.

PART II:

The taxation of corporate profits and dividends in South Africa (past and present) will be explained and STC will be evaluated in PART II.

Chapter 6:

The tax on dividends and corporate profits in South Africa prior to the introduction of STC under the dual corporate tax system is explained and evaluated in this chapter.

Chapter 7:

Chapter 7 takes a closer look at STC. It outlines the dual corporate tax system and explores the philosophy and objectives behind STC.

Chapter 8:

STC impacted on economic decisions both domestically and internationally. Chapter 8 evaluates the domestic impact of STC by looking at the benefits and negative effects resulting from this tax.

Chapter 9:

STC had a critical impact on foreign investment in South Africa. In this chapter the reasons for this impact and consequences thereof is studied.

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Chapter 10:

The negative impact that STC had, especially on foreign investment, was not ignored and Chapter 10 is a study of the changes to the tax system that were recently introduced in order to correct some of the wrongs that STC has done.

PART III:

In PART III the alternative systems of taxing corporate profits and dividends - from the traditional classical system to the various systems of integration - will be explained and evaluated with reference to specific countries where these systems are in practice. This is a subject that has received considerable international attention in the past three decades since 1966 when France adopted a system of integration of personal and corporate income taxes, followed in the seventies by the United Kingdom, Germany, Italy and in the eighties by Australia and New Zealand to name just a few. Certain countries like the USA have spent a considerable amount of time researching integration, but are currently still using the classical system. International

trends regarding the taxation of corporate profits and dividends will also be reviewed in the search of a more acceptable alternative to STC.

Chapter 11:

In this chapter the traditional systems of dividend taxation is explained and evaluated. These vary from the classical system where the company and shareholders are seen as separate entities, to the system of full integration where the conduit principle applies fully and only the shareholder is ultimately taxed on corporate source income.

Chapter 12:

The imputation system, a variant of the system of integration, has been adopted by many of the leading countries and the introduction of this system in South Africa is thought to be the ideal. For that reason the imputation systems is studied and evaluated in detail in Chapter 12.

Chapter 13

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In our attempt to find the most appropriate system of dividend taxation for South Africa, the international trends in dividend taxation is studied in this chapter.

PART IV:

In this part a conclusion is reached on the most appropriate tax system for South Africa.

Chapter 14:

In the last chapter of the dissertation, the knowledge gained in the previous chapters is applied to and evaluated against the particular circumstances that prevail in South Africa and finally, a conclusion is reached on the most appropriate form that South Africa's dividend tax reform should take.

PART I - DIVIDENDS

CHAPTER 2: THE MEANING OF DIVIDEND AND THE GENERAL PREAMBLE TO THE DIVIDEND DEFINITION

CHAPTER 3: SPECIFIC INCLUSIONS TO THE DIVIDEND DEFINITION - paragraph (a) and (b)

CHAPTER 4: SPECIFIC INCLUSIONS TO THE DIVIDEND DEFINITION - paragraph (c) and (d)

CHAPTER 5: SPECIFIC EXCLUSIONS TO THE DIVIDEND DEFINTION

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CHAPTER 2

THE MEANING OF DIVIDEND AND THE GENERAL PREAMBLE TO THE DIVIDEND DEFINITION

2.1 Introduction
2.2 Ordinary meaning of dividend
2.3 The general preamble to the dividend definition
2.4 Conclusions

2.1 Introduction

The meaning of the term 'dividend' will be analysed in this section. It is an important starting point for is dissertation for the following reasons:

- The current STC legislation is confined to amounts distributed as a dividend or deemed a dividend; and
- Any proposed replacement of STC will also be triggered by the distribution of a dividend.

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Firstly, the ordinary meaning of 'dividend' will be discussed. Thereafter the dividend definition as contained in section 1 of the Income Tax Act definition will be discussed as follows:

- The general preamble to the dividend definition - chapter 2
- Specific inclusions to the dividend definition - chapter 3
  (paragraph (a) and (b))
- Specific inclusions to the dividend definition - chapter 4
  (paragraph (c) and (d))
- Specific exclusions to the dividend definition - chapter 5
- The provisos to the dividend definition will be discussed where applicable.

2.2 Ordinary meaning of dividend

The ordinary meaning of 'dividend' received attention in several English court cases. In Henry v Great Northern Railway Co (1857, 27 LJ Ch1(CA)), Lord Cranworth L.C. said:

> "...The word 'dividend', if we look to its derivation, means obviously the fund to be divided, not the share of any particular partner or person in that fund, and strict language would require us to speak, not of the dividend which each shareholder is entitled to receive but of his aliquot portion of the dividend..."

Regardless of the above the word 'dividend' is commonly used to refer to a shareholder's individual portion of the 'fund to be divided'. In Staples v Eastman Photographic materials Co (1896, 2 Ch 303 (CA)), Kay L.J. commented as follows on the meaning of 'dividend':

> "...I suppose it is taken from dividendum, the thing to be divided; but it is used in ordinary commercial language as the share of the thing to be divided - that share which is coming to each person who is entitled to share in that division...."

The meaning of 'dividend' is however specifically defined in section 1 of the South African Income Tax Act of 1962. It is a very complex definition and in CIR v Legal and General Assurance Society Limited (1963, 3 SATC 876 (A)), Steyn C.J. expressed himself as follows about the 'dividend' definition:

> "...The definition is quite clearly a radical departure from the ordinary meaning of the term defined. The ordinary connotation of a dividend is replaced by an entirely artificial and much more comprehensive concept..."

The dividend definition in its complexity, is difficult to understand. The way in which the legislation is written further complicates it. The main body of the definition contains 122 words and the only punctuation marks used are three commas (Coetzee, 1996:17). An attempt will be made to analyse the definition into all its different aspects and to present it in a way that is more understandable than the definition as it is contained in the Income Tax Act.

Firstly, the general preamble to the dividend definition will be analysed.

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2.3 The general preamble to the dividend definition

The Income Tax Act starts the dividend definition with a preamble:

> "...'Dividend' means any amount distributed by a company .... to its shareholders..."

The following key components of the general preamble will be analysed below:

- Amount distributed
- Company
- Shareholder

2.3.1 *Amount distributed*

Amounts distributed by a company refer to amounts which can legally be distributed in terms of company law. The company must also comply with the legal rules regarding the distribution of profits laid down in its articles of association.

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In CIR v Legal and General Assurance Society (1963(3) SA 876 (AD), 25 SATC 303), Steyn, C.J. pointed out:

> "...In my view, effect can be given to this apparent intention of legislature by ascribing to 'distribute', in the relevant context, the wider meaning of apportion, appropriate, allocate or apply towards..."

It therefore follows that 'amounts distributed' has the wider meaning of apportion, appropriate, allocate or apply towards.

A dividend distribution can be payment in cash, it can be an issue of shares or securities or an asset can be distributed as a dividend.

'Amount distributed' can be summarised as the appropriation, apportionment, allocation or application of cash, share issues, securities or assets. The 'company' as the next component of the general preamble is discussed below.

2.3.2 Company

The general preamble to the dividend definition limits the meaning of dividend to amounts distributed by a 'company'.

'Company' is defined in section 1 of the Income Tax Act and mainly includes any association, corporation or company (including close corporations) incorporated in terms of any law of the Republic or any other country provided that the body corporate has some connection with the Republic. This can be a direct connection where it 'carries on business or has an office or place of business in the Republic or derives income from any source within or deemed to be within the Republic' or it can be indirect 'in which any person ordinarily resident or carrying on business in the Republic is interested as shareholder or member' or the body corporate holds shares in a Republic company or in a foreign company which is connected with the Republic.

In short, 'company' as defined means an association, corporation, company or close corporation incorporated in terms of law. To be a dividend, a distribution made by a company must be made to its shareholder. 'Shareholder' is also defined in the Income Tax Act. This definition is analysed in 2.3.3.

2.3.3 Shareholder

Amounts distributed by a company must be to its 'shareholder' to be a dividend.
Section 1 of the Income Tax Act defines 'shareholder' as:

> "in relation to any company ... means the registered shareholder in respect of any share, except that where some person other than the registered shareholder is entitled, whether by virtue of any provision in the memorandum or articles of association of the company or under terms of any agreement or contract, or otherwise, to all or part of the benefit of the rights of participation in the profits or income attaching to the share so registered, such other person shall, to the extent that he is entitled to such benefit, also be deemed to be a shareholder;... or in relation to any close corporation, means a member of such corporation..."

From the above it can be seen that the definition is very specific and only in the case where a person other than the registered shareholder is entitled to

the benefits attaching to a share can there be more than one shareholder in respect of the same shares.

In the case of S.I.R v Smant (35 SATC 1) the taxpayer sold his shareholding, but the company was unwilling to register the shareholding in the name of the purchaser. The Commissioner sought to tax the original owner on payments made in respect of the shareholding. The Court held that the purchaser had become the 'beneficial owner' and that the payments were not income in the hands of the original owner who was still the registered shareholder.

The above case illustrates the possibility of more than one person being the 'shareholder' in respect of the same shares. The taxpayer being the registered shareholder, but the purchaser being entitled to the benefits attached to the share by virtue of an agreement. The possibility of more than one 'shareholder' as defined was also dealt with in Bell's Trust v C.I.R. (15 SATC 255) where Centlivres, J.A. pointed out:

> "...I am of the opinion, that under the definition of 'shareholder', the registered shareholder is always a shareholder within the meaning of that definition and that some one else who is entitled to all or part of the benefit of the rights of participation in profits or income attaching to the shares may also be a shareholder. From this it follows that in the present case both the Trust, which is the registered shareholder, and the major children are shareholders within the meaning of that definition. The major children are such because they are entitled to part of the benefit of rights of participation in the profits or income attaching to 94 000 shares registered in the name of the Trust..."

The entitlement to the benefits by a person other than the registered shareholder must be an enforceable right which can be upheld in a court of law e.g. in the above case the trust deed gave the major children the right to participate in distributed profits only.

For the purpose of the dividend definition, the shareholder may be two parties - the registered shareholder or a person with an enforceable right to the benefits, such as the right of participation in the profits or income, attaching to a share.

2.4 Conclusions

The ordinary meaning of dividend as determined by common law pertains to an entitled person's share of the of a fund to be divided.

Dividend is defined in the Income Tax Act starting with the general preamble of amounts distributed by a company to its shareholders. Amounts distributed relate to cash, assets, shares or securities allocated, apportioned or applied. Company is defined as any association, close corporation or company incorporated in terms of law. Shareholder is defined as meaning the registered shareholder, except in the case where another person is entitled to the benefits attaching to the share, then such a person also falls within the definition of a shareholder.

After the general preamble, the definition goes on to include and exclude certain distributions as a dividend. In chapter 3 and 4 the specific inclusions will be discussed and in chapter 5, the specific exclusions to 'amounts distributed'.

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CHAPTER 3

SPECIFIC INCLUSIONS TO THE DIVIDEND DEFINITION - paragraph (a) and (b)

3.1 Introduction
3.2 Liquidation dividends
3.3 Going concern dividends
3.4 Conclusions

3.1 Introduction

The general preamble to the dividend definition was analysed in Chapter 2. Specific inclusions to 'amounts distributed' as per the general preamble are contained in paragraph (a) - (d) of the 'dividend' definition in the Income Tax Act.

Briefly the specific inclusions deal with:

- Liquidation dividends - contained in paragraph (a) of the dividend definition.
- Going-concern dividends or dividends paid in the course of normal operations - contained in paragraph (b) of the dividend definition.
- Reductions and redemptions of share capital - contained in paragraph (c) of the dividend definition.
- Reconstructions - contained in paragraph (d) of the dividend definition.

In this chapter paragraph (a) and (b) of the dividend definition will be discussed. Paragraph (c) and (d) of the dividend definition will be discussed in chapter 4.

The specific inclusion to the dividend definition contained in paragraph (a) deals with amounts distributed as part of a process of liquidation i.e. liquidation dividends.

3.2 Liquidation dividends

The first of the special inclusions deals with liquidation dividends. Paragraph (a) in the dividend definition contained in the Income Tax Act reads as follows:

> "... in relation to a company that is being wound up or liquidated, any profits distributed, whether in cash or otherwise, other than those of a capital nature, earned before or during the winding-up or liquidation ..."

The important terms are underlined in the above paragraph and will be further analysed below:

- Winding-up or liquidation
- Profits
- Profits of a capital nature
- In cash or otherwise

3.2.1 Winding-up or Liquidation

The first important concept contained in paragraph (a) of the dividend definition is that of winding-up or liquidation.

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This is an important concept because capital profits and unearned/unrealised profits distributed during a process of liquidation or winding-up is excluded from the definition of a dividend in terms of paragraph (a) of the definition contained in the Income Tax Act.

If, however, the distribution is not part of a winding-up or liquidation process, then capital and unearned profits are included in the dividend definition under paragraph (b) of the definition contained in the Income Tax Act.

It is therefore of great importance to know whether a process is one of liquidation or winding-up or not, since the latter may create tax problems to the detriment of the shareholders.

The process of 'winding-up' or 'liquidation' is not defined in the Income Tax Act nor in the Companies Act. In Corporate Law, (Cilliers,1992:490) the following definition is provided:

> "...The process of dealing with or administering the company's affairs prior to its dissolution by ascertaining and realising its assets and applying them firstly in the payment of creditors of the company

according to their order of preference and then by distributing the residue (if any) among the shareholders of the company in accordance with their rights, is known as the winding-up or liquidation of the company..."

It continues by defining deregistration:

"...Neither winding up nor dissolution should be confused with deregistration, which is an act which does not affect the existence of the company, but only deprives the company of its legal personality, so that it can continue to exist as an association whose members are personally liable for its debts..."

Deregistration is not regarded as liquidation by the Commissioner. Such amounts will not fall into paragraph (a), but into paragraph (b) of the dividend definition contained in the Income Tax Act and the words of Melamet J, at ITC 1306 (42 SATC 139), are fitting:

"I am of the opinion, therefore, that it is not possible to equate dissolution or winding-up of a company with deregistration."

What is important is that capital profits and unrealised profits distributed during a process of liquidation are not included in the definition of a dividend as contained in the Income Tax Act.

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3.2.2 Profits

Before a dividend can be distributed there must be profits in a company, earned or unearned i.e. dividends can only be paid out of profits. The concept of 'profit' is contained in both paragraph (a) and (b) of the dividend definition.

The Income Tax Act does not define 'profit' available for distribution and the Companies Act has also been silent on the subject. The rules to ascertain divisible profits have all been formulated by judicial decision therefore 'profit' is essentially a legal concept. If no guidance could be found in South African common law our courts drew on the experience of the English law.

The common law rules that will be discussed are as follows:
(Cilliers et al,1992: 347-352)

- Dividends may not be paid out of contributed share capital.

- The company's financial statements as a whole must be taken into account in determining whether profits are divisible.

- Dividends may be distributed out of revenue profits without first providing for losses or depreciation of fixed assets; losses and depreciation of 'circulating or floating assets' must, however, be taken into account.

- Losses incurred in previous years may be disregarded in the computation of divisible profit.

- Realised profit on the sale of fixed assets is available for distribution by way of a dividend.

- Unrealised profits/appreciation may also be available for dividends in appropriate circumstances.

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3.2.2.1 Dividends may not be paid out of contributed share capital

The rule that dividends may not be paid out of contributed share capital is there to prevent the wrongful application of share capital. Cotton, L.J. said at Guiness v Land Corporation of Ireland (1882, 22 ChD 349 (CA)):

> "...capital cannot be derived from the objects of the society. It is of course liable to be spent or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which creditors have a right to look as that out of which they are to be paid..."

Lindley, L.J. confirmed and added to the above statement in Verner v General and Commercial Investment Trust (1894, 2 Ch 239,266):

> "...It has already been said that dividends presuppose profits of some sort, and this is unquestionably true. But the word profits is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits..."

3.2.2.2 The company's financial statements as a whole must be taken into account in determining whether profits are divisible

This implies that not only profits, but also the company's solvency must be taken into account. If a dividend is distributed and the liabilities of the company exceeded its assets such a dividend may be impeached upon the winding-up of a company on the grounds that it constitutes a disposition not for value.

3.2.2.3 Dividends may be distributed out of revenue profits without first providing for losses or depreciation of fixed assets; losses and depreciation of 'circulating or floating assets' must, however, be taken into account

This rule follows from a number of cases, the first being Lee v Neuchatel Asphalte Company (1889, 41 ChD 1 (CA)), where it was held that a company working a wasting fixed asset need not provide for the replacement of capital before a dividend may be paid.

3.2.2.4 Losses incurred in previous years may be disregarded in the computation of divisible profit

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It was finally decided in the Ammonia Soda Co v Chamberlain (1918, 1 Ch 266) that divisible profits made in a financial year can be distributed as a dividend without first making good the accumulated losses from previous years.

3.2.2.5 Realised profit on the sale of fixed assets is available for distribution by way of a dividend

This follows from Lubbock v British Bank of South America (1892, 2 Ch 198), however from Foster v New Trinidad Lake Asphalt Co (1901, 1 Ch 208) follows that any loss made on other fixed assets or trading activities during the financial year, must be set off against the profit to determine the divisible profit. The articles of a company may also contain restriction in respect of the distribution of realised profits on fixed assets.

3.2.2.6 Unrealised profits/appreciation may also be available for dividends in appropriate circumstances

In the Scottish case Westburn Sugar Refineries Ltd v Inland Revenue Commissioners (1960 SLT 297), it was ruled that such a distribution would be illegal. Thereafter in Dimbula Valley (Ceylon) Tea Co Ltd v Laurie, (1961, 1 All ER 769 (Ch)) it was held that reserves resulting from the revaluation of fixed assets may be distributed as a dividend if certain conditions are met.

Although neither the Income Tax Act, nor the Companies Act define profits, we have the common law rules available the help us determine when profits are divisible.

In the next paragraph the profit concept is extended to 'capital profits'.

3.2.3 *Capital profits*

Capital profits distributed as a liquidation dividend are not dividends as per the definition.

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The issues, whether an amount received is of a capital or revenue nature and whether expenditure is of a capital nature or not, has been dealt with extensively in the court. The principles resulting from the numerous capital versus revenue tax cases are also applied to determine the capital or revenue nature of profits earned prior to liquidation.

For income tax purposes we keep track of 'income' of a capital nature, but the term used in the dividend definition is 'profits' of a capital nature. In practice it is very difficult to keep track of 'profits' of a capital nature because this concept differs from that of 'income' of a capital nature.

Profits earned during liquidation are specifically covered by paragraph (a) of the dividend definition contained in the Income Tax Act. Such profits are normally regarded as being of a capital nature and support is found in the following two cases:

> "...Eamings by a limited company after the commencement of its liquidation are capital and not income..." (Bishop v Smyrna and Cassaba Railway Co. (1895, 2 Ch. 596))

> "...The assets have ceased to be profits or income and have become capital..."(Dominion Tar and Chemical Co. (1929, 2 Ch. 387))

Accordingly the profits, being of a capital nature would not be a dividend in terms of paragraph (a) of the dividend definition contained in the Income Tax Act.

The next concept - 'in cash or otherwise' - will be analysed below. It is found in both paragraph (a) and (b) of the dividend definition.

3.2.4 In cash or otherwise

The distribution of profits can be 'in cash or otherwise' according to paragraph (a) and (b) of the dividend definition contained in the Income Tax Act.

The expression 'in cash or otherwise' is very wide. In order to determine the limits the court decided in CIR v Butcher Bros. (Pty) Limited (1945, AD, 13 SATC 21) that an 'amount received in cash or otherwise' means that there must be an 'ascertainable money value'. Furthermore the onus was placed upon the Commissioner to prove that there is an 'ascertainable money value'. Thus, for an amount distributed to be a dividend the onus is on the Commissioner to prove that there was a distribution of profits that has an 'ascertainable money value'.

Paragraph 3.1 analysed the important terms in paragraph (a) of the dividend definition contained in the Income Tax Act. This paragraph explicitly states that profits other than unearned and capital profits distributed in cash or otherwise as part of the process of liquidation falls within the definition of a dividend.

Paragraph 3.2 will continue to analyse paragraph (b) of the dividend definition in the Income Tax Act. This paragraph deals with dividends paid in the course of normal operations, in short - going concern dividends.

3.3 Going concern dividends

Where paragraph (a) of the dividend definition contained in the Income Tax Act dealt with liquidation dividends, paragraph (b) of the dividend definition concerns dividends

distributed in the normal course of operations and reads as follows in the Income Tax Act:

> "...in relation to a company that is not being wound up or liquidated, any profits distributed, whether in cash or otherwise, and whether of a capital nature or not, including an amount equal to the nominal value, at the time of issue thereof, of any capitalisation shares awarded to shareholders and the nominal value of bonus debentures or securities awarded to shareholders..."

This paragraph includes as a dividend all amounts distributed by a company which is a going concern or in the normal course of its operations. This differs from distributions in the course of liquidation as discussed in paragraph 3.1 in that both capital and revenue profits are treated as a dividend. Furthermore the Revenue Department interprets the lack of reference to realised or 'earned' profits in paragraph (b) of the dividend definition contained in the Income Tax Act as meaning that both realised and unrealised profits are included.

The term 'winding up or liquidation' was already analysed in paragraph 3.1 above and paragraph (b) of the dividend definition contained in the Income Tax Act merely deals with the opposite. 'In cash or otherwise' has the same meaning in both paragraph (a) and (b) of the dividend definition contained in the Income Tax Act. The terms 'profits' was discussed extensively in paragraph 3.1 above, unrealised profits is however looked at in more detail below. Capitalisation shares and bonus debentures or securities awarded by a going concern to shareholders are also discussed below.

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3.3.1 Unrealised profits

Profits, whether realised or unrealised are included in a dividend distribution in the normal course of operations.

If an asset is given to shareholders as a dividend, the market value of the asset and not the cost, is treated as a dividend per section 22(8) of the Income Tax Act. Where an asset is sold to the shareholder at cost, the difference between cost and market value (i.e. the unrealised portion) will be treated as a dividend. The capital or revenue nature of the asset is irrelevant, because paragraph (b) of the dividend definition includes both capital and revenue profits.

The interpretation of the Revenue Department that unrealised profits should be included as a 'dividend' as mentioned above has been challenged in The Income Tax Reporter (1970: 236-241), on the basis that the qualification as to 'earned profits' in paragraph (a) of the dividend definition contained in the

Income Tax Act relates to the time when the profits were earned and not to the fact that they must be earned profits. It follows that in paragraph (b) there was no need to qualify the word 'profits' on a time basis and therefore there was no need for the word earned.

A further argument is that where legislature intended to distinguish paragraph (a) from paragraph (b) for example, in respect of capital profits, it did so in precise terms and the distinction is clear. If legislature had intended to include unearned profits in paragraph (b) of the dividend definition it would have done so in the same precise terms.

The distribution of unrealised profits is thus, arguably treated as a dividend if distributed in the normal course of operations. It does seem improper to treat an amount which under company law would not be a regarded as being paid out of divisible profit as a dividend.

Paragraph (b) of the dividend definition contained in the Income Tax Act also includes capitalisation issues as a dividend distribution, but this inclusion is subject to an exclusion under paragraph (h) of the dividend definition.

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3.3.2 *Capitalisation issues*

Capitalisation issues are included in the dividend definition in terms of paragraph (b), but capitalisation issues of equity shares made after 1/7/1975 are again excluded per paragraph (h) of the specific exclusions to the dividend definition contained in the Income Tax Act. Thus, only capitalisation issues of non equity capitalisation shares are included as a dividend in terms of the dividend definition in the Income Tax Act. An example of the latter would be the issue of preference shares as a capitalisation issue.

The terms 'capitalisation shares' and 'equity share capital' are defined in section 1 of the Income Tax Act. 'Equity share capital' will be analysed in Chapter 5 where the issue of capitalisation shares excluded from 'amounts distributed' is discussed in more detail.

'Capitalisation shares according to section 1 of the Income Tax Act are:

> "...are shares issued by a company, whether by way of a bonus award or otherwise, in such manner that the company's reserves (including any share premium account) or unappropriated profits are in whole or in part applied to paying up those shares..."

The following summarises the situation concerning capitalisation shares issued:

- Paragraph (b) of the dividend definition contained in the Income Tax Act includes in 'amount distributed' the nominal value of all capitalisation shares issued, but;
- Paragraph (e) of the dividend definition excludes from 'amount distributed' the extent to which the share premium account was applied in paying-up the capitalisation shares (both equity and non equity shares), and;
- Paragraph (h) of the dividend definition excludes from 'amount distributed' the nominal value of capitalisation shares awarded as part of the equity share capital;
- The second proviso to the dividend definition applies where capitalisation shares have been excluded from 'amount distributed' as a result of paragraph (h) then the profits or reserves so applied will be deemed to be profits available for distribution and they will retain their nature as capital or revenue profits.

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Lastly, paragraph (b) of the dividend definition includes bonus shares or securities awarded in 'amounts distributed'.

3.3.3 *Bonus debentures or securities*

The nominal value of bonus debentures or securities awarded to shareholders are included in amounts distributed per the dividend definition contained in the Income Tax Act. The Act defines bonus share or securities in section 1 as meaning:

> "...debentures or securities issued by a company, whether by way of a bonus award or otherwise, in such a manner that the company's reserves or unappropriated profits are in whole or in part applied in paying up such debentures or securities..."

Unlike capitalisation shares the share premium cannot be utilised in issuing bonus debentures or securities. This can clearly be seen from the exclusion thereof in the above definition. Reserves or unappropriated profits have to be applied to pay up the bonus debentures.

Thus, where a company's reserves are in whole or in part applied to pay up bonus shares or securities, the nominal value of such shares or securities is included as a dividend according to paragraph (b) of the dividend definition in the Income Tax Act.

3.4 Conclusions

The dividend definition in the Income Tax Act specifically includes certain amounts in 'amounts distributed' per paragraph (a) to (d) of the definition.

Paragraph (a) of the dividend definition includes as a dividend any amount distributed as part of a process of liquidation. Capital profits and unrealised profits distributed as part of a liquidation process are specifically excluded in paragraph (a) and such distributions do not constitute a dividend.

Paragraph (b) of the dividend definition includes any amount distributed in the normal course of business as a dividend, irrespective of its capital or revenue nature and irrespective whether the profit so distributed is earned or unearned. Capitalisation issues of non equity shares and bonus issues of shares or securities are also included in paragraph (b) of the dividend definition.

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Paragraph (c) and paragraph (d) of the dividend definition contained in the Income Tax Act, deal with amounts distributed in cases where there is a reduction or redemption of share capital or where a company is reconstructed. Both these paragraphs will be discussed in chapter 4.

CHAPTER 4

SPECIFIC INCLUSIONS TO THE DIVIDEND DEFINITION - paragraph (c) and (d)

4.1 Introduction
4.2 Partial reduction or redemption of share capital
4.3 Reconstruction of a company
4.4 The second proviso to the dividend definition
4.5 The third proviso to the dividend definition
4.6 Conclusions

4.1 Introduction

Paragraphs (a) to (d) of the dividend definition in the Income Tax Act all deal with specific inclusions to the dividend definition. Paragraphs (a) and (b) were discussed in chapter 3 and include in the dividend definition certain amounts distributed in the course of liquidation and amounts distributed in the normal course of business.

In this chapter paragraphs (c) and (d) of the dividend definition in the Income Tax Act will be analysed. These paragraphs deal with the situation where cash or value of assets are given to shareholders as part of a reduction or redemption of share capital or under the reconstruction of a company.

4.2 Partial reduction or redemption of share capital

Paragraph (c) of the dividend definition in the Income Tax Act includes in amounts distributed as a dividend,

> "... in the event of a partial reduction or redemption of the capital of a company, so much of the sum of any cash and the value of any asset given to the shareholder as exceeds the cash equivalent of the amount by which the nominal value of the shares of that shareholder is reduced..."

The Companies Act contains strict regulations regarding the reduction of share capital to protect the rights of creditors. It allows for a reduction with or without court approval only if certain conditions are met.

The partial reduction of issued share capital would only be a dividend to the extent that the cash and the value of the assets distributed exceed the nominal value which has been reduced. Effectively, by considering the market value of the assets distributed, unrealised profits are included in paragraph (c) of the dividend definition.

Similarly a redemption of preference share capital would not be included as a dividend provided that the nominal value of such shares are not less than the sum of the cash and/or assets given to the shareholders.

Section 98 of the Companies Act allows the issue of redeemable preference shares. Redemption is allowed at a given time or at the option of the company. Ordinary or preference shares are convertible into redeemable preference shares if the necessary requirements of the Companies Act have been complied with.

According to paragraph (c) of the dividend definition in the Income Tax Act the amount by which the cash or the value of any assets given to shareholders under a redemption of capital exceed the nominal value of the shares reduced constitutes a dividend.

Paragraph (d) of the dividend definition considers the dividend inclusions under the reconstruction of a company.

4.3 Reconstruction of a company

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Paragraph (d) of the dividend definition in the Income Tax Act includes in amounts distributed as a dividend,

> "... in the event of the reconstruction of a company, so much of the sum of any cash and the value of any asset given to a shareholder as exceeds the nominal value of the shares held by him before the reconstruction..."

Although the term 'reconstruction' is used in both the Income Tax Act and the Companies Act, it is not defined in either. In Wilde v South African Supply & Cold Storage Co, (1904, 2 Ch 268), it was said that reconstruction envisages a situation where one company transfers its undertaking, in substance, to a new company, which has substantially the same business as the original company.

This definition is in line with the one that is provided in Corporate Law (Cilliers, 1992: 469) :

> "A reconstruction involves the transfer of the whole or a part of the undertaking of a company ('transferor company'), which is subsequently dissolved, to another company ('transferee company'), which is controlled by the shareholders of the transferor company. The effect of a reconstruction is that substantially the same business is carried on by the transferee company

> which has substantially the same shareholders as the transferor company had."

The meaning of 'reconstruction' is important because in the event of a reconstruction, unrealised and capital profits are included as a dividend per paragraph (d) of the dividend definition in the Income Tax Act.

According to Meyerowitz (1993: 469), if a liquidation takes place during the course of a reconstruction paragraph (d) of the dividend definition would apply. This has severe consequences because paragraph (a) of the dividend definition would have excluded any unrealised and capital profits from being dividends.

The Companies Act sets out the procedures that can be followed in case of restructuring a company.

It follows from paragraph (d) of the dividend definition that if cash or the value of assets are given to shareholders in the event of the reconstruction of a company, the amount by which the value of the cash or assets given exceed the nominal value of the shares originally held by the shareholder, will constitute a dividend.

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The second and third provisos are applicable to paragraphs (c) and (d) of the dividend definition and will be discussed below.

4.4 The second proviso to the dividend definition

The second proviso states that where a company has lost some of its paid up share capital and has formally (in terms of the Companies Act) reduced its share capital to take account for the losses, such a company may reduce the capitalised profits with the realised losses. A classification indicating the capital or revenue nature of the losses should be made and the losses should be set off against the appropriate category of capitalised profits. Any excess loss should be set off against the other category only if the original category of capitalised profits is exhausted.

The second proviso states further that in case of a reduction or redemption of capital or the reconstruction of a company, capitalised revenue profits are considered to have been distributed first, thereafter the capitalised capital profits. It goes on to say that capitalised capital profits will not be deemed a dividend, whereas capitalised revenue profits will be deemed to be a dividend.

4.5 The third proviso to the dividend definition

The phrase the "value of any asset given to a shareholder" is used in both paragraphs (c) and (d) of the dividend definition. The third proviso defines it by deeming an asset to have been given to a shareholder if "any asset or any interest, benefit or advantage measurable in terms of money is given or transferred to such shareholder or if the shareholder is relieved of any obligation measurable in terms of money".

4.6 Conclusions

In chapters 3 and 4, all the specific inclusions to the dividend definition in the Income Tax Act have been analysed.

Paragraphs (a) and (b) of the dividend definition include certain amounts distributed in the course of liquidation and amounts distributed in the normal course of business as a dividend.

Paragraphs (c) of the dividend definition includes the amount by which the cash or the value of any assets given to shareholders under a redemption of capital exceed the nominal value of the shares reduced as a dividend.

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According to paragraph (d), if cash or the value of assets are given to shareholders in the event of the reconstruction of a company, the amount by which the value of the cash or assets given exceed the nominal value of the shares originally held by the shareholder, will constitute a dividend.

Paragraphs (e) to (i) of the dividend definition in the Income Tax Act contain the exclusions to amounts distributed as a dividend. These will be analysed in chapter 5.

CHAPTER 5

SPECIFIC EXCLUSIONS TO THE DIVIDEND DEFINITION

5.1 Introduction

5.2 Capitalisation issues utilising the share premium

5.3 Reduction of the share premium

5.4 Capitalisation issues

5.5 Conclusions

5.1 Introduction

The four specific inclusions in the dividend definition of the Income Tax Act were considered in chapters 3 and 4 of this dissertation.

In this chapter the specific exclusions as contained in paragraphs (e),(f) and (h) of the dividend definition will be discussed. Paragraphs (g) and (i) of the dividend definition apply to situations prior to 1975 and will not be discussed.

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The exclusions to the dividend definition in paragraphs (e), (f) and (h) deal with the following issues:

- Paragraph (e): Capitalisation issues utilising the share premium
- Paragraph (f): Reduction of the share premium
- Paragraph (h): Capitalisation issues

5.2 Capitalisation issues utilising the share premium

Paragraph (e) specifically excludes from the dividend definition,

> "... the nominal value of any capitalisation shares awarded to a shareholder to the extent to which such shares have been paid up by means of the application of the whole or any portion of the share premium account of a company..."

Section 76 of the Companies Act allows the share premium account to be applied in certain instances. One of these instances are where the share premium is applied to award capitalisation shares. The Companies Act procedures in respect of the reduction of share capital must be adhered to when capitalisation issues utilising the share premium are made.

Although paragraph (b) includes capitalisation issues out of any funds in the dividend definition, a capitalisation issue where the share premium is applied is specifically excluded from the dividend definition in terms of paragraph (e).

Paragraph (e) to the dividend definition was introduced into legislation as a result of a the case of Dibowitz v CIR (1952 AD, 18 SATC 11). In the case capitalisation shares were awarded to the shareholder. The shares issued were partly funded by applying the share premium account. The court found that the words in paragraph (b) "including an amount equal to the nominal value of any capitalisation shares awarded to any shareholder" meant that all capitalisation shares constituted a dividend and that the manner in which they were funded was irrelevant. Paragraph (e) was drafted to exclude the application of the share premium for capitalisation issues from the dividend definition.

5.3 Reduction of the share premium

Paragraph (f) to the dividend definition goes on to exclude,

> "... subject to the provisions of the second proviso to this definition, any cash and the value of any asset given to a shareholder to the extent to which the cash and the value of the asset represents a reduction of the share premium account of a company..."

This paragraph has the effect of treating the share premium account in the same way as share capital. This is consistent with company law principles. The reduction of share capital is implicitly excluded from the dividend definition because commom law principles prevent the distribution of dividends from contributed share capital in order to prohibit the wrongful application of contributed share capital. This was also discussed in chapter 3.

If an amount or assets not exceeding the nominal value of the share premium are given to the shareholder the amount so distributed does not constitute a dividend. If, however the value of the assets given exceed the reduction in the share premium account the excess will be treated as a dividend. This treatment is similar to the way in which paragraph (c) of the dividend definition treats share capital. It is the opinion of Huxham and Haupt (1995: 277) that even in the absence of the paragraph (f) exclusion to the dividend definition, a reduction of the share premium account would not constitute a dividend because it does not represent a distribution of profits by the company to its shareholders.

The fourth proviso was introduced to address the situation where companies transferred amounts from the share premium account to reserves. This was possible because any share premium which arose before 1 January 1953 could be freely distributed. The proviso merely states that an amount transferred from share premium to reserves shall retain its original character as a share premium for the purposes of the dividend definition.

Similar to share capital, the reduction of the share premium does not constitute a dividend.

5.4 Capitalisation issues

Paragraph (h) of the dividend definition excludes from amounts distributed,

> "... the nominal value of any capitalisation shares awarded to shareholders as part of the equity share capital of a company, if -
> (i) such shares are or were awarded on or before 30 June 1975 and during the period of ten years ending the day before the date of such award the company has not made any partial reduction of its paid-up share capital involving a distribution to shareholders of cash or other assets; or
> (ii) such shares are awarded on or after 1 July 1975..."

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This means that, although all capitalisation issues are included in amounts distributed as a dividend in terms of paragraph (b) of the dividend definition, capitalisation issues of equity shares made from 1 July 1975 onwards are excluded from the dividend definition. In the case of capitalisation issues made prior to 1 July 1995, the exclusion only applies if the company did not have a reduction in share capital in the ten years prior to that date.

Paragraph (h) of the dividend definition deals specifically with capitalisation shares awarded that are part of the equity share capital of the company. Equity share capital is defined in section1 of the Income Tax Act:

> "...'equity share capital' means, in relation to any company, its issued share capital excluding any part thereof which, neither as respects dividends not as respects capital, carries any right to participate beyond a specified amount in a distribution..."

The above definition is the same as the definition of equity share capital contained in the Companies Act. Shares carrying a right to share in capital or profit beyond a specified amount would constitute equity share capital. To be excluded from equity

share capital, shares must carry a right to a fixed dividend and must carry a right to a specified amount on repayment of capital.

The first proviso to the dividend definition had the effect that capitalisation issues made by private companies prior to 1 January 1974 were not subject to the paragraph (h) exclusion.

The second proviso to the dividend definition applies to capitalisation issues that did not constitute a dividend or to transfers to the share premium account. The profits or reserves applied in the capitalisation issues or in the transfer to the share premium account shall be deemed to be profits available for distribution and will be classified into capitalised revenue profits or capitalised capital profits for tax purposes. This classification is necessary because upon the winding up or liquidation of a company the distribution of capitalised capital profits will not be deemed to be a 'dividend' in terms of paragraph (a) of the dividend definition in the Income Tax Act.

Capitalisation issues in general are included in the dividend definition in terms of paragraph (b), but paragraph (h) of the dividend definition then specifically excludes capitalisation issues of equity shares made after 1 July 1975 from being dividends.

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5.5 Conclusions

To summarise, the general preamble to the dividend definition deals with 'amounts distributed' by a 'company' to its 'shareholders'.

'Amounts distributed' include the following distributions as a dividend:

- Realised revenue profits distributed on liquidation or winding-up,
- Realised and unrealised, capital and revenue profits distributed in the normal course of operations,
- The excess, including the unrealised portion, over the nominal value of the shares of any cash or assets given to shareholders in case of a reduction or redemption of share capital or the reconstruction of a company.

Excluded from 'amounts distributed' as a dividend are capitalisation issues made by applying the share premium account, any reduction of the share premium account and capitalisation issues of equity shares made after 1 July 1975.

'Dividend' as defined in the Income Tax Act has been analysed in PART I of this dissertation, PART II will study and evaluate the South African situation (past and present) of taxing dividends.

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PART II - THE SOUTH AFRICAN SITUATION

CHAPTER 6: TAX ON DIVIDENDS AND CORPORATE PROFITS PRIOR TO STC

CHAPTER 7: STC - THE CURRENT SYSTEM OF DIVIDEND TAXATION IN SOUTH AFRICA

CHAPTER 8: AN EVALUATION OF THE DOMESTIC IMPACT OF STC

CHAPTER 9: FOREIGN INVESTMENT AND STC

CHAPTER10: RECENT SIGNIFICANT CHANGES TO THE SYSTEM OF TAXING DIVIDENDS AND CORPORATE PROFITS IN SOUTH AFRICA

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CHAPTER 6

TAX ON DIVIDENDS AND CORPORATE PROFITS PRIOR TO STC

6.1 Introduction

6.2 The situation up to 1 March 1990

6.3 The situation after 1 March 1990 prior to the introduction of STC in 1993

6.4 Conclusions

6.1 Introduction

The reform of the South African taxation of corporate profits and dividends is an issue that has received attention for the past decade. The Margo Commission first investigated the situation and published their findings in 1986 and in 1994 and 1995 the Katz Commission evaluated the current SA situation of dividend taxation.

In 1986 the Margo Commission investigated the method of taxing dividends that existed at that stage. It went further to look at international systems of taxing dividends and to suggest certain practical alternatives of dividend tax for the South African situation. This was done in reaction to a number of South Africa's leading trade partners that had changed from classical systems of taxing dividends to imputation systems. Internationally it would be ideal to have a uniform system for taxing dividends (Margo, 1986: 194).

Katz looked at the same issue from a slightly different perspective. South Africa's political changes in the early nineties resulted in its acceptance into the global economy. This made South Africa a country that foreign investors were suddenly considering for potential investment. Katz found that the high tax burden inhibited foreign investors to invest capital in South Africa (Katz, 1994: 213,221-222). Our increased international trade also meant that the system of taxing corporate profits and dividends had to be changed to make it more acceptable internationally.

Chapter 6 will look at the South African system of taxing dividends prior to the introduction of the Secondary Tax on Companies ("STC"). In chapter 7 and 8, STC, the current system of taxing dividends will be evaluated. Chapter 9 will look at the impact that STC has had on foreign investment and chapter 10 will deal with important changes to our tax system effected recently.

6.2 The situation up to 1 March 1990

6.2.1 Basic outline of the tax system prior to 1990

Prior to 1990 the corporate tax rate was fixed at 50% (from 1985). For taxation purposes companies were classified into South African and other companies. South African companies were split into public and private companies and closed corporations for the purposes of calculating the Undistributed Profits Tax ("UPT").

UPT was levied at 33.3% of a company's undistributed profits. This was done to encourage the distribution of profits to shareholders. The tax was levied on the amount with which the distributable profits of a company exceeded the dividends paid out. Fifty percent of trading profit (excluding dividend income), and 50% of net dividend income in the case of public companies was allowed as a deduction from the leviable amount.

As a result of the deduction of 50% and the company tax rate of 50% of trading profits no UPT was payable even if no dividend was paid. In the case of a private company a UPT liability resulted if less than 100% of net dividend income was distributed.

Companies where 50% or more of the equity share capital was effectively held by foreign shareholders and closed corporations were exempted from UPT.

Dividends received by a company were exempt from tax in the hands of the company. Dividends paid to non South African companies and individuals were subject to a 15% withholding tax.

Individuals were subject to the normal income tax on dividend income, deductions were however allowed ranging from 100% of the dividend income where taxable income prior to the deduction did not exceed R2 600 to 33,3% where such taxable income exceeded R4 600.

South African companies were thus exempt from tax on dividends, however if a company did not distribute dividend income within a certain period, the company was subject to 33.3% of UPT. The purpose of the UPT was to induce the flow of dividends through the corporate structure to the individual shareholder where it was taxed in their hands (in most cases one third of

dividends were exempt from tax in the hands of the shareholder) (Margo, 1986: 192-194).

6.2.2 *Problems with the tax system prior to 1990*

The Margo Commission (1986:198, 205), identified the problems that this method of taxing dividends gave rise to; the first being a distortion of the return on debt and equity funding. This situation occurred because interest was deductible from taxable income and therefore it was only taxed in the hands of the investor, whereas dividends were not deductible from taxable income. Dividends were therefore subject to 50% corporate tax and usually two thirds of dividends were again subject to the individual shareholder's tax rate resulting in an effective tax on profits of 66% at the top individual marginal rate. If not distributed UPT of 33.3% was payable. Any investor rather invested in debt than in equity instruments.

The second problem created was a distortion in the selection of the form of business organisation. As mentioned above the effective tax on corporate profits - that is the company tax rate plus the impact of dividend taxation - was around 66%. This made the corporate structure a relatively unattractive form of doing business as the effective rate was considerably higher than the top individual marginal rate at which a sole trader was taxed.

Furthermore UPT had the weakness that it could only be levied on undistributed dividend income and nothing prohibited companies to pass on profits in the form of dividends from one company to the next. There was no time limit for the dividends to reach the final shareholder and no UPT was payable because dividends were distributed.

It was in reaction to these problems and after recommendations by the Margo Commission that the South African authorities abolished dividend taxes in March 1990.

6.3 The situation after 1 March 1990 prior to the introduction of STC in 1993

The March 1990 budget initiated a program of tax reforms. It included the bold step to abolish taxes on dividends in the hands of private investors and close corporations. South Africa was virtually the only country in the world that provided such a tax dispensation.

6.3.1 Implications of the abolition of dividend taxes

Economically the abolition of dividend taxes would have major implications. According to Economic Focus (April, 1990:1-6), the elimination of economic double taxation of profits would boost overall personal savings in the country. It presented a new dispensation for private investors and would have ramifications for the share market by making it more dividend orientated. Higher dividend payments could serve to lower cost of equity capital and increase the mobility of such capital to stimulate new investments which would in turn create new jobs and enhance the economic growth rate.

Other benefits would also result namely that it would contribute towards neutrality of tax in the selection of the form of business organisation and lead to neutrality between debt and equity funding in the tax system.

This tax treatment of dividends would simplify the tax system because it rendered UPT redundant. The purpose of this tax was to induce the distribution of profits so that they could be taxed in the hands of the individual shareholder. It would also ease the administrative burden that Inland Revenue faced in processing tax returns because the tax was now only collected upfront at company level and the company had the final tax liability.

In short - the exemption of dividends from tax would help to usher in a far more simple tax system and would encourage economic growth.

6.4 Conclusions

Up to March 1990 South Africa had a tax system whereby undistributed profits in the hands of the company were taxed at a higher rate than distributed profits. This system served to promote dividend distributions so that dividends could be taxed in the hands of the individual shareholder.

In March 1990, UPT was abolished and a system was adopted whereby dividends were completely exempt from tax in the hands of shareholders.

South Africa again introduced a dividend related tax, namely the Secondary Tax on Companies ("STC") in 1993. The tax system under STC and the objectives thereof will be discussed in Chapter 7.

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CHAPTER 7

STC - THE CURRENT SYSTEM OF DIVIDEND TAXATION IN SOUTH AFRICA

7.1 Introduction
7.2 Outline of the dual tax system under STC
7.3 Meaning of dividend for STC purposes
7.4 The philosophy and objectives of STC
7.5 Conclusions

7.1 Introduction

In March 1993 former Minister Keys introduced a dual system of corporate taxation in South Africa. It was here that STC - a tax on dividends declared by a company - first saw the light. As a macro-economical and fiscal device it allowed for a reduction in the company tax rate to an internationally more acceptable rate without losing revenue. At the same time it stimulated dividend retention and re-investment. (Van Blerck, 1993: 50). In March 1996 with the lowering of the STC rate, South Africa came closer to the international norm for corporate tax rates of between 40% and 45%.

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7.2 Outline of the dual tax system under STC

The dual corporate tax system comprises a lowered income tax rate at 35% (40% up to 21 June 1994) of taxable income and in addition to the prevailing corporate tax rate, a secondary tax on companies, currently levied at 12.5% (15% to 21 June 1994; 25% to 13 March 1996). It essentially applies to all dividends declared on or after 17 March 1993. It is a tax imposed on the company declaring the dividend and not on the shareholder.

The corporate tax rate and STC effectively constitute a combined tax rate of 42.2% (prior to 13 March 1996, 48%) if we assume that a company distributes all of its taxable income in a combination of dividends and STC.

A company may elect to pass or reduce its dividend in order not to become liable to pay STC or to reduce such liability - it is therefore not a precondition of the dual system that a company must distribute a dividend. This will have the effect that the combined tax rate will be below 42.2% with a minimum of 35% .

If a company has no taxable income (e.g. due to tax allowances), but declares a dividend, STC at 12.5% will still be payable on the distribution.

While STC is a dividend related tax, as said above, it is a tax on the company, calculated on dividends declared. The shareholder receives the full dividend, without any deduction and he does not bear any responsibility in the event of non-payment of STC by the company.

The classification of STC is difficult. Whether it is a tax on income or a tax on dividends is not certain and has caused a dilemma especially in the international arena (refer Chapter 9). Although the intention for it is to be a tax on distributed income, STC is seen by many as a reimplementation of the dividend taxation that existed prior to 1990.

STC in most cases does not differentiate between capital and revenue profits (distributions upon liquidation being an exception) and in effect taxes capital gains (Connell, 1994:1).

7.3 Meaning of dividend for STC purposes

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STC is in a sense a conditional minimum tax on companies triggered by a dividend declaration (Refer PART I for a detailed discussion of the definition of a 'dividend').

Section 64B(5) of the Income Tax Act contains certain provisions exempting or deeming certain amounts as dividends. These were not discussed in PART I as they are STC specific and were introduced into legislation with the introduction of STC and will be discussed briefly below.

Section 64B(5) exempts from STC all dividends declared by companies to which section 10 of the Income Tax Act applies, dividends declared by property unit trusts and dividends distributed in the course of liquidation or winding up of a company out of profits earned prior to 31 March 1993.

In terms of the 'dividend' definition unrealised and capital profits distributed in the course of liquidation do not constitute a dividend and is thus exempt from STC. As from 19 July 1995 this exemption from STC was extended to the following three situations, namely where:

- Dividends are distributed in anticipation of liquidation;

- Dividends are distributed in the course of or in anticipation of the deregistration of a company, and
- Dividends are distributed out of capital profits.

As only the STC exemption, and not the 'dividend' definition, was amended the position now appears to be:

- Where a company distributes its reserves in the course of liquidation, only realised revenue profits derived during the years ending after 31 March 1993, will attract STC.

- Where a company distributes its reserves in anticipation of liquidation, or in the course of or anticipation of deregistration, all unrealised revenue profits and realised revenue profits derived during the years ending after 31 March 1993, will attract STC (Deloitte & Touche Tax News, 1995: 16).

Section 64C(3) contains provisions designed to prevent companies from avoiding an STC liability by providing shareholders (or their relatives or a trust of which the shareholder or relative is a beneficiary) with benefits otherwise than through a normal dividend distribution. Section 64C(4) deals with instances where the deeming provisions of S64C(3) do not apply.

7.4 The philosophy or objectives of STC

STC's introduction coincided with the country's re-emergence into the international business arena. The confidence foreign investors would have to invest capital in South Africa largely depended on the level of domestic investment. The result was the introduction of STC as a fiscal incentive to encourage domestic investment.

STC was thus introduced in 1993 in an attempt to encourage economic growth and fiscal discipline. The two main objectives behind STC, namely as an incentive to encourage corporate reinvestment and to signal a lower nominal corporate tax rate to foreign investors will be examined below.

7.4.1 Incentive to encourage corporate reinvestment

Finance Minister Derek Keys said in his March 1993 budget speech:

> "The dual rate tax should prove an incentive for the new and fast growing company: the more a company exploits investment opportunities and finances itself, the lower will its tax rate be. Such investment is not only important from a job creation perspective, but can serve to stimulate domestic demand."

According to MC van Blerck (1993: 38), the new dual tax system was designed to encourage corporate reinvestment by taxing distributed profits at higher effective rates while lowering the tax rate on undistributed profits to an internationally acceptable level. This would serve as an incentive for shareholders to approve productive reinvestment. Companies would look harder for investment opportunities. Given that the decade leading up to the introduction of STC was characterised by low fixed investment this was seen as a positive step.

A number of economists have argued in favour of this correlation between policies promoting retention and stimulation of economic growth and demand (Connell, 1994: 5).

The effect of taxing dividends is to increase their relative cost. By increasing the cost of profit distributions, STC acts as a fiscal incentive aimed at retention of profits and investment (Sent, 1995: 8).

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It was furthermore argued that STC favoured companies with investment opportunities yielding returns in excess of the cost of capital and fast growing companies.

7.4.2 Lower nominal corporate tax rate

With the introduction of STC the corporate tax rate was reduced from 48% to 40%. At that point in time this reduction brought the basic corporate tax rate closer to the international norm of between 40% and 45%. The loss of revenue resulting from the lower tax rate was compensated for to a certain extent by the STC that was collected. Together with STC, tax rates effectively ranged from 40% to 47.83% at the time STC was introduced. Compensation could also be found in the fact that any loss of corporate tax revenue would also be directed towards the goal of economic growth.

Since STC's introduction the nominal corporate tax rates saw another drop from 40% to 35% in June 1994. This brought it more along the lines of the

nominal corporate tax rates of countries with which South Africa competes for foreign capital.

7.5 Conclusions

STC was introduced in 1993 as an additional or 'secondary' company tax on dividends.

The meaning of 'dividend' was extended and measures were introduced into the Income Tax Act to cater specifically for STC.

The most important objectives with the introduction of STC were to encourage corporate reinvestment and to lower the nominal corporate tax rate.

Since its introduction in 1993, STC has had a great impact on the economy. The domestic impact of STC will be considered in chapter 8.

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CHAPTER 8

AN EVALUATION OF THE DOMESTIC IMPACT OF STC

8.1 Introduction
8.2 The benefits of STC
8.3 Negative effects of STC
8.4 Conclusions

8.1 Introduction

STC has been widely criticised since its introduction. The most important point of criticism relate to its effects on foreign investment. This issue deserves a more in-depth examination and will be dealt with in Chapter 9 as this will form the basis of PART III where internationally acceptable alternatives to STC will be set out.

The domestic impact of STC - the benefits that were derived from it, but also its negative aspects, will be briefly outlined in this chapter.

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8.2 The benefits of STC

The First Interim Report of the Katz Commission (1994:175) highlighted some of the benefits of STC. These and others are discussed below:

- STC means considerable revenue to the fiscus. If abolished revenue of approximately R1.16 billion would be lost and there would be considerable pressure to increase the corporate tax rate. It is comparatively easy to administer by virtue of the fact that it is collected "closer to source".

- It allowed a lowering in the basic corporate tax rate to 35% which is internationally competitive. If it were not for STC a dramatic reduction in the company tax rate would have been impossible. This was possible because the loss of revenue from corporate tax was made up by revenue raised as a result of STC.

- By encouraging reinvestment of profits the balance sheets of South African companies were strengthened. Evidence of the financial impact of STC on

the market was clearly indicated by an increase in the value of companies with growth prospects due to the new incentive for internal growth.

- As a result of STC companies made capitalisation issues instead of paying out cash dividends. This also brought about a strengthening in the companies' balance sheets.

- By increased investment in fixed plant, growth takes place in the economy. This growth broadens the corporate and individual tax base.

- It serves as a minimum tax whereby companies with low effective tax rates are taxed at the prevailing STC rates on distributed profits due to the fact that STC is calculated independently from normal company tax.

- Small and medium enterprises which are incorporated can enjoy the benefit of the lower rate of 35%. These companies usually plow back profits and no STC would thus be payable.

8.3 Negative effects of STC

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STC's negative effects, other than those relating to foreign investment, are as follows:

- STC has had a notable effect on dividend distribution policies of companies since the rate was raised to 25%. Scrip dividends or capitalisation issues were widely used in stead of cash dividends as scrip dividends do not fall within the dividend definition (refer PART I) and are therefore not subject to STC (Katz, 1995: 90).

- STC encouraged retention, but instead of funding internal growth it encouraged take-overs, the argument being that growing companies do not need encouragement to retain funds they are compelled to do so for commercial survival (Asher, 1994:9).

- It has been contended that STC is a retroactive tax in that companies who chose to issue preference shares to raise capital face adverse consequences (Katz, 1994:177).

- STC effectively subjects companies to a degree of capital gains tax to the extent that capital gains are distributed (Connell, 1994:1).

- Whether STC is a tax on dividends or income is a widely debated issue. As mentioned above it is also a capital gains tax to a certain degree. It is clearly not a pure tax, but a hybrid of taxes in one and therefore lacks theoretical integrity (Sent, 1995:9).

8.4 Conclusions

Since its introduction, STC brought certain benefits to the South African economy, the most notable being revenue to the fiscus, despite the lowering of the nominal company tax rate and the strengthening of balance sheets of companies, because of the reinvestment of profits.

Domestically STC also had negative effects. Most notably dividend distribution policies were distorted especially at the rate of 25% and take-overs were encouraged. The negative effects were not limited to domestic disadvantages; it greatly impacted on foreign investment in this country. In chapter 9 the negative effects of STC on foreign investment will be discussed.

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CHAPTER 9

FOREIGN INVESTMENT AND STC

9.1 Introduction
9.2 Taxation and foreign investment
9.3 Effective tax rate
9.4 Debt vs equity considerations
9.5 Business form - branches vs corporate structures
9.6 Conclusions

9.1 Introduction

STC has had a critical impact on foreign investment. Speaking at the annual conference of the Institute of Life and Pension Advisors, former Finance Minister Chris Liebenberg described the effects of STC on foreign investors as "horrific" (Cameron, 1995:1).

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New York-based stockbroking firm, Lynch Jones & Ryan, following an analysis of South Africa's investment taxes on foreigners concluded that it is not politics, but taxes that have kept investors away from the JSE (Spira, 1995:14). They found that

> "...the South African taxes are serious impediments to a country that is trying to fund its development with foreign capital..."

9.2 Taxation and foreign investment

Foreign direct investment is perceived to bring economic growth to a country. It may also have additional benefits for the host country such as increased employment opportunities, creation of new industries, transfer of technology, training of local workforce and managers, access to new markets and improved balance of payments. By taxing the profits of the foreign investor, the wages of its employees and the goods it produces it also contributes to increased government revenue (Easson, 1992:400). These benefits will in turn aid in achieving the objectives of the Reconstruction and Development Program.

Business opportunities, economic and political stability are generally seen as the most important factors that foreign investors take into account when they make investment decisions. The world-wide relaxation of exchange controls and

consequently the increased international mobility of capital has however made taxation a very significant investment consideration (Easson, 1992:394).

A further conclusion by Easson is that once an investor has decided to invest abroad, taxation plays an important role in the determination of the location of such investment. Unfavourable tax legislation in a country will thus inhibit foreign investors from investing in that country.

9.3 Effective tax rate

The cost of capital plays an important if not a determining role in the investment decision. The effective tax rate is a component of the cost of capital, therefore it can be said that the effective tax rate will have a significant influence on the decision to invest in a foreign country. The lower the effective tax rate, the lower the cost of capital and the more the likelihood of foreign direct investment. The effective tax rate is a function of the nominal corporate tax rate, the tax on dividends (STC) and the international recognition it attracts in the form of foreign tax credits and double taxation agreements. Each of these components will be discussed below.

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9.3.1 The nominal corporate tax rate

The primary tax upon income from foreign investment is the corporate income tax.

According to SACOB (1995:17), in its submission to the Katz Commission, the higher the nominal corporate tax rate is in a potential investment country, the greater its importance as a factor influencing investment decisions. The introduction of STC allowed for a lowering in the nominal tax rate to 35% (refer Chapter 7). The nominal tax rate is now in line with that of most of South Africa's trading partners and the countries it competes with for foreign investment. However, foreign investors often tend to have high dividend distribution policies in order to repatriate their profits and the dividend taxes are of particular importance to them in calculating the effective tax rate.

9.3.2 The taxation on dividends - STC and NRST

Despite the lowered nominal corporate tax rate, foreign investment also attracts a second liability arising with the distribution of dividends. In South

Africa this dividend tax takes on the form of the Secondary Tax on Companies ("STC") and the Non-resident Shareholders Tax ("NRST").

- The Secondary Tax on Companies

Whether it is in fact a tax on dividends or income will be discussed later in this chapter. However, irrespective of the exact classification of STC, it is part of the effective tax rate that is imposed on foreign investors. STC was first introduced at 15%, was later raised to 25% and just recently in the face of immense pressure from various sectors of business community it was lowered to 12.5%.

STC raises the effective tax rate, and the impact thereof at the various rates it is illustrated in Tables 9.1 and 9.2 below.

TABLE 9.1
SOUTH AFRICA'S EFFECTIVE TAX RATE:

	STC - 25% (1994/1995)	**STC - 25% (no NRST)** (1995/1996)	**STC -12.5%** (1996/1997)
Nominal tax rate	35%	35%	35%
STC on 100% dividends	13%	13%	7.2%
NRST @ 15% :	7.8%	-	-
TOTAL	55.8%	48%	42.2%

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TABLE 9.2

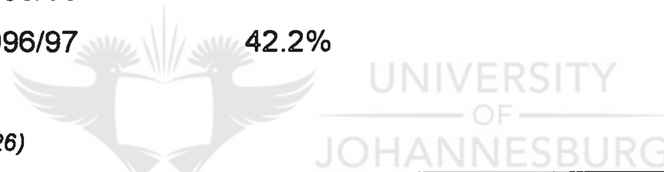
COMPANY TAX RATES :

SA AND COUNTRIES COMPETING FOR FOREIGN INVESTMENT:

(company rates are those for foreign shareholders i.e. include withholding taxes on dividends if applicable)

Country	Year	Rate
Chile		35%
Hungary		48.8%
Indonesia		44%
Malaysia		30%
Singapore		27%
Zimbabwe		50%
South Africa	-1994/95	55.8%
	-1995/96	48%
	-1996/97	42.2%

(Source: Anon, 1995:26)



When the effective tax rate per TABLE 9.1 is compared to that of the countries that South Africa compete with for foreign investment in TABLE 9.2, the effect that STC and NRST had on the effective tax rate can clearly be seen. With the effective rate at its peak of 55.8%, and even at 48% after the abolition of NRST, South Africa's tax burden was a certain turn- off to potential investors.

Nominal corporate tax rates in capital exporting countries tend to average around 39%. As a developing country South Africa is a capital importer. The average nominal tax rate for capital importers is around 33%. Even when it is compared to capital export countries such as those in TABLE 9.3, South Africa's nominal tax rate plus STC was until recently comparatively high at 48% (Anon,1995:24-26).

TABLE 9.3

COMPANY TAX RATES :
SA AND MAJOR TRADING PARTNERS:
(nominal tax rates - 1993)

Country	Rate
Belgium	40.2%
France	33.3%
Germany	41.9%
Japan	46.6%
Netherlands	35%
Switzerland	30%
Taiwan	25%
United Kingdom	33%
United States of America	41.5%
South Africa -1993/94	47.8% *
- 1994/95	48% *
- 1996/97	42.2% *

* nominal rate + STC

(Source: Anon, 1995:26)

- Non-resident Shareholders Tax

The NRST is a withholding tax on dividends . It was imposed at 15% and was recently abolished in another attempt to make South Africa more investor friendly (Refer Chapter 10).

NRST differed from STC in the fact that it was recognised by the international community. As a withholding tax on dividends it was embodied in double taxation agreements.

9.3.3 *International recognition*

STC is an unusual dividend tax innovation that is not familiar to foreign investors. It is clearly intended that the tax be imposed on the company, but it is calculated with reference to the dividends declared by such company. There exists therefore an uncertainty as to whether it is a tax on income or a tax on dividend distribution. This has caused confusion and some foreign tax authorities do not provide relief in the form of tax credits for STC paid, because the tax is also not "substantially similar" to any of the taxes covered in double taxation agreements ("DTA").

- Foreign tax credits in terms of DTA's

  Certain foreign laws provide relief in the form of a tax credit to a taxpaying company in respect of the profits that have already been taxed in the source country. This is the case if STC is seen as an income tax i.e. not a tax on dividends, but on the company with dividend declaration merely triggering the corporate tax which is determined with reference to the amount of the dividend. Since STC is often seen as a tax on dividends, no tax credit would be available in many cases. The shareholder would then have to rely on competent authority procedures as in article 25 of the model DTA to obtain relief - a process that can be very tedious (Wunsh, 1995:17).

  Inland Revenue have however expressed their commitment to take the view that STC is an income tax in their negotiations with treaty countries to try to ensure that tax credits will be granted for STC paid. This will not only affect new treaties, but some of the older agreements with countries such as the USA and the Netherlands that do not allow a tax credit for STC will have to be re-negotiated (Sharpe,1995:1).

- Withholding tax on dividends

  If STC is in substance a tax on dividends it implies that withholding taxes on dividends would apply as was the case with NRST. In turn the treaty restrictions would also apply. According to the DTA's with most developed countries, the source country may only withhold tax, in most cases of 5%, if the shareholder receiving the dividend is the

beneficial owner of at least 25% of the company paying the dividend. In all other cases a rate of 15% would apply (Van Blerck,1993:50).

If this argument is accepted, the South African tax authorities would not be able to impose STC on dividends remitted to foreign countries and only a withholding tax normally of 5% could be levied.

9.4 Debt vs equity considerations

Companies are normally financed by a combination of debt and equity capital. An imbalance of this combination called 'thin capitalisation', occurs when its equity capital is small in comparison with its debt capital.

In South Africa investors are treated differently for tax purposes. Interest payments to a non-resident were free of tax and interest is deductible in calculating normal tax payable. However, dividends payments made out of after tax income, attracted STC and NRST (up to October 1995). Tax legislation thus favoured debt financing and consequently thin capitalisation was used as a way to avoid paying tax.

The high tax burden on equity investment discouraged such investment and led to undercapitalised investments.

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9.5 Business form: branches vs corporate structures

STC is levied on companies in respect of dividends declared from South African sourced profits. Technically STC and NRST were payable on branch profits repatriated to an offshore head office.

It was not feasible to enforce these taxes. According to the Interim report of the Katz Commission (1994:177) the reasons are as follows:

- Inland Revenue is not normally notified of a dividend declaration by the offshore company;
- It is difficult to determine the part of the dividend that has its source in South Africa

Non-resident companies were therefore prejudiced to trade in South Africa via a branch structure.

9.6 Conclusions

Although taxation is not the most important consideration in investment decisions by foreign investors, it is a very significant consideration. South Africa's comparatively high effective tax rate is a disincentive for foreign investors. Uncertainties as to nature of STC also cause difficulties in terms of international recognition of the tax. As a result of the tax treatment, foreign investors prefer to provide debt instead of equity financing and they prefer to invest in branches rather than in corporate structures.

The critical impact that the high rate of STC had on foreign investment necessitated imminent changes to the tax system. The government acted thereupon and introduced drastic interim measures to attempt to correct the wrongs created by STC. Chapter 10 will elaborate on these recent changes.

CHAPTER 10

RECENT SIGNIFICANT CHANGES TO THE SYSTEM OF TAXING DIVIDENDS AND CORPORATE PROFITS IN SOUTH AFRICA

10.1 Introduction
10.2 Implications of the reduction in the STC rate
10.3 Abolition of NRST
10.4 Introduction of the branch profits tax
10.5 International recognition
10.6 Thin capitalisation rules
10.7 Taxation of interest received by a foreign company
10.8 Conclusions

10.1 Introduction

Certain proposals made by the Katz Commission resulted recently in important changes to STC and other taxes impacting on foreign investment. These were announced by former Finance Minister Chris Liebenberg in his March 13, 1996 budget speech. The most notable of the proposals was the retention of STC for the time being, but at a reduced rate of 12.5% where it was previously 25%. The Commission was not in favour of the abolition of STC for the reason that it would create pressure for an increase in the nominal corporate tax rate. In addition to that a tax was imposed on branch profits at 40% and the exemption provided to non-residents on interest received was removed. Also in reaction to the Katz proposals NRST was abolished and 'thin capitalisation' rules were introduced. The focus of these changes were to try and correct some of the wrongs that STC has done by inhibiting foreign investors to invest in South Africa (Refer Chapter 9 where this issue is discussed in detail).

10.2 Implications of the reduction in the STC rate

The reduction in the STC rate now brings the combined effective tax rate of a company that distributes all of its after tax earnings down from 48% to 42.2% (35% normal tax plus 7.2%). This has the effect that not only the normal company tax rate, but also the combined tax rate is within the internationally accepted norm. (Refer Table 9.1 and 9.2 in Chapter 9). It is also hoped that the lowered rate will minimise some of the distortions created by STC.

In 1995/1996 revenue collections from STC are expected to be around R1.16 billion, which is well below the amount of R1.44 billion that was initially budgeted for. This is because many companies have opted to issue capitalisation shares as opposed to paying cash dividends (Deloitte & Touche Tax News,1996: 4,9).

Despite the lowering of the STC rate, it is interesting that Revenue expects to collect about the same amount in STC in the 1996/1997 year as in the previous year. The revised estimate for revenue collection from STC for the 1995/1996 tax year was R1.16 billion and the budgeted collection for 1996/1997 is R1 billion. It is thus expected that companies will release and increased volume of cash dividends which have been held back. Both delayed dividend declarations and capitalisation issues will have led to some pressure for cash dividends while the STC rate was at 25% (Deloitte & Touche Tax News,1996: 4,9; Katz, 1995:91).

The lowered combined rate also has the effect of making the corporate structure the more attractive form of business organisation, since the effective corporate tax is now lower than the top marginal individual tax rate.

10.3 Abolition of NRST

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The best way to provide immediate relief to non-resident or foreign investors was to abolish the 15% withholding tax on dividends distributed to non-resident shareholders or companies.

This move gives SA quasi tax haven status in that its withholding tax for payments to non-residents is one of the most favourable amongst major trading nations (Deloitte & Touche Tax News, 1995:17).

This move would result in a substantial loss of revenue to the fiscus. NRST alone collected revenue of roughly R400 million a year. However, in the light of "the country now openly competing in the international investment markets, in a world which is decidedly more competitive", the Katz Commission (1994:225) was persuaded that NRST could no longer be justified as a measure to raise revenue and this recommendation was implemented as from 1 October 1995 when NRST was scrapped.

SACOB (1995:36), in its submission to the Katz Commission, argued that in view of the possible scrapping of STC in the foreseeable future, the wisdom of the

abolishment of NRST was questionable. They believe that if STC is scrapped a reintroduction of NRST would be desirable.

10.4 Introduction of the branch profits tax

Where foreign companies eamed South African source income, income tax at 35% was payable and STC was imposed on dividends declared by such foreign companies, to the extent that the dividend is paid out of profits generated from a South African source.

Due to the difficulty in enforcing the collection of STC from such foreign companies, STC on dividends declared by them has been abolished as from 1 April 1996. The removal of STC on foreign companies coincides with the introduction of the branch profits tax.

In view of the removal of STC on foreign companies operating branches in the Republic, income tax of 40% will be imposed on the South African sourced income derived by branches (Deloitte & Touche Tax News, 1996:7,9).

10.5 International recognition

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Intensive lobbying recently bore fruit when the UK Inland Revenue ruled that SA Companies' UK shareholders may apply for tax relief from STC paid. Tax relief has always been available in respect of income tax that was paid on South African sourced profits distributed as a dividend. Further consideration was now given as to nature of STC and the conclusion reached was that STC qualifies for tax relief. The ruling will be backdated to March 1993 when STC was first introduced. This will eliminate the double taxation of dividends that had shadowed UK parent companies since STC's introduction (Sharpe, S 1995:1; Deloitte & Touche Tax News, 1995:6-7).

Although Inland Revenue has indicated that it believes that through continued efforts, treaties with all major trading partners will resolve this matter, two recently ratified double tax agreements with France and Romania do not provide relief from STC and unilateral relief will have to be sought in the countries' domestic legislation. These two treaties are the first negotiated and formally ratified treaties in the "New South Africa" and can therefore be seen as indicative of the terms that will be contained in other treaties that are being negotiated (Deloitte & Touche Tax News, 1996:15-16).

10.6 Thin capitalisation rules

According to Alan Rosenzweig (1995:17), SA's fiscal lawmakers have taken a bold step toward First World taxing standards by introducing 'thin capitalisation' rules.

In terms of the new legislation if, in the opinion of the Commissioner, a company is inadequately capitalised, the excess interest deduction will be disallowed; it will be characterised as a dividend and consequently STC will be payable.

Apparently the guidelines used in the USA for a 3:1 debt to equity ratio will be followed by the authorities, but since hard and fast rules cannot be formulated a discretionary element is necessary. This will in turn result in uncertainty and will be negatively perceived by foreign investors.

The rules would have to address extremely complicated financing techniques and would have to specify whether the test is to be applied at the start-up of a company or thereafter and how changes in the debt/equity ratios over a period of time would be treated. Furthermore the piecemeal introduction of the legislation also holds the danger of deterring foreign investors.

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10.7 Taxation of interest received by a foreign company

Section 10(1)(hA) provided that interest received by a foreign company in South Africa was exempt from tax. This had a twofold consequence:

- Foreign companies e.g. banks operating branches locally thus enjoyed a competitive advantage over SA banks and it resulted in a substantial unintended loss of revenue to the fiscus.

- The high tax burden on equity investment versus the total exemption from tax on debt investment favoured debt investment.

With effect from 1 April 1996 this exemption was withdrawn in an attempt to rectify the above distortions it created. This should however not be seen in isolation; coupled with the reduction in the STC rate it is a major step towards debt/equity neutrality (Deloitte & Touche Tax News,1996: 7).

10.8 Conclusions

Prior to 1990, the 50% nominal corporate tax rate coupled with the tax on undistributed profits and the taxation of dividends in the hands of the individual shareholder, resulted in the double taxation of corporate profits. This system created distorted debt/equity ratio's in companies and favoured the sole trader or partnership as a form of business. With the abolition of the dividend taxes in 1990 these problems were recognised, the tax system was simplified and economic growth was encouraged.

South Africa then again introduced a dividend related tax in the form of a secondary tax on corporate profits, triggered by dividends distributed by the company. The intention with STC was to act as an incentive to encourage corporate reinvestment and in turn to stimulate economic growth. STC also allowed for a lowering in the nominal corporate tax rate to an internationally acceptable level. Along with STC came other benefits such as the strengthening of corporate balance sheets and revenue to the fiscus to be applied for reconstruction and development in the country. However, the negative effects of STC overshadowed the good. Foreign investment was the area critically affected by the high effective tax rate and the international business community's unfamiliarity with STC. Furthermore STC created distortions by favouring debt investment to equity investment and branch operations to foreign subsidiaries.

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The negative impact of STC on foreign investment was recognised and the following significant changes were recently announced:

- The STC rate was halved to 12.5%;
- NRST was abolished;
- A branch profits tax was introduced;
- The UK grants a tax credit for STC;
- 'Thin capitalisation' rules were introduced and
- Interest received by a foreign company will be taxed.

Evidently these changes have revamped the current SA system of taxation to make the STC system with its original limitations and distortions an acceptable alternative for the time being. Whether the anticipated effects of these changes on foreign investment will realise can, however, only be evaluated once the new system has been in operation for a period of time.

While the 1996 budget retained STC in its changed form for the time being, it acknowledged in principle a progression towards some form of imputation system. PART III of the dissertation will explore the various forms of dividend taxation with a particular emphasis on imputation systems.

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PART III - THE INTERNATIONAL SITUATION

CHAPTER 11: THE SYSTEMS OF TAXING DIVIDENDS - CLASSICAL AND INTEGRATION

CHAPTER 12: A CLOSER LOOK AT THE IMPUTATION SYSTEM

CHAPTER 13: INTERNATIONAL TRENDS IN DIVIDEND TAXATION

CHAPTER 11

THE SYSTEMS OF TAXING DIVIDENDS - CLASSICAL AND INTEGRATION

11.1 Introduction
11.2 The classical system
11.3 The system of integration
11.4 Conclusions

11.1 Introduction

The South African situation of taxing corporate profits and dividends was studied in PART II of this dissertation with a specific emphasis on the evaluation of STC. The possible abolition of STC will imply a natural progression to a dividend tax, for that reason the methods of dividend taxation and in particular the imputation system will be analysed in PART III of this dissertation.

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But, what exactly is meant by an imputation system? In answering this question we will first examine the basic systems of dividend taxation - classical and integration.

These two poles in company tax philosophy will be described in this chapter. At one extreme, the classical system views the company as an entity distinct from its shareholders and at the other extreme the system of integration simply sees the company as an extension of its shareholders. Both systems will be illustrated below.

11.2 The classical system

The classical system regards a company as an entity entirely separate from its shareholders. Both the company and the shareholder are taxed on the same source of income. In computing taxable income, classical systems do not allow a deduction for dividends distributed to shareholders No relief is given to the shareholder to take into account the tax already paid by the company on profits earned and dividends are again taxed in full in the hands of the shareholder at the rate applicable to the individual shareholder - ranging from the lowest to the highest marginal rate of a progressive income tax. This results in the double taxation of dividends.

Example 11.1, below, illustrates how the income is taxed twice and calculates the overtaxation of profits as a percentage of the individual's tax rate (later referred to as classical overtaxation). For illustration purposes the calculation is done for individual tax rates of 50% and 30%.

Example 11.1

Classical system

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Dividend income (1-3)	R180	R180
	6	Income tax (4x5)	R54	R90
C	Combined tax burden			
	7	Total tax (3+6)	R174	R210
	8	Effective tax rate (7/1)	58%	70%
	9	Classical overtaxation [(8-4)/4]	93%	40%

(Source: Cnossen 1993:6)

Two major countries that use the classical system are the United States of America and the Netherlands. Prior to 1990, a modified classical system was used in South Africa (refer Chapter 6).

11.2.1 Economic effects of the classical system

- The classical system has some undesirable economic effects. According to Cnossen (1993:7), supporting the traditional view, dividends are a positive signal to shareholders and companies will therefore want to equalise the tax advantages of profit retention and the non-fiscal disadvantages of reducing dividends. New investments will in part be financed by issuing new shares, because dividends cannot be lowered without a cost. The double taxation of dividends thus discourages new investment and distorts the dividend-payout

decision. This in turn leads to a concentration in market power. As opposed to established companies with large retained profits and easy access to debt financing, the double tax is most detrimental to small, growing companies, because these companies do not have a high credit-worthiness and cannot attract debt finance easily.

- A distortion between debt and equity finance is created, because interest payments are deductible for tax purposes, but dividend distributions are not. This increases the gearing and thus the riskiness of a business as well as the probability of bankruptcy (Sunley, 1979:293).

- Another criticism of the classical system as it was used in South Africa prior to 1990, was that it resulted in high effective tax rates on individuals' investment income. Consumption rather than savings was encouraged. This had an adverse effect on domestic savings and in turn on economic growth (Sent, 1995:30).

As a result of the distortions created by the classical system the idea of integrating the company and shareholder taxes was born. Advocates of integration stress that it improves the efficiency of capital markets and increases national income by eliminating the above-mentioned distortions (Sunley, 1979:292).

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11.3 The system of integration

A system of integration as opposed to the separate entity approach followed in the classical system implies that the company is seen as an extension of the shareholder and that it is merely a conduit through which corporate income flows to the shareholder.

Many approaches to integration have been devised and debated, such as simply eliminating corporate income tax or excluding dividends from taxable income, etc., but these miss the real target of integration and will politically be unacceptable. The only alternatives considered likely are 'full integration' and 'partial integration' (Mc Lure,1977:172).

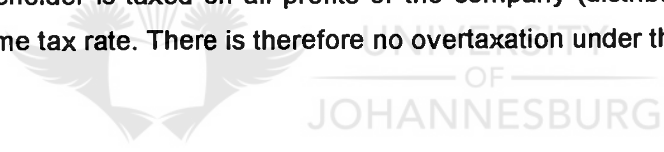
Under the system of integration it is therefore important to discern between 'full integration' and 'partial integration'. Both these variants will be explained below.

11.3.1 Full integration

Under a system of full integration it is irrelevant whether a company distributes profits. Retained and distributed profits are allocated to the shareholder in proportion to each shareholder's holding in the company and are fully taxed. This is known as the partnership method of taxation. The tax paid at corporate level can be seen as a prepayment of income tax. In this way it eliminates the double taxation of dividends.

Full integration has been proposed by the Royal (Carter) Commission in Canada, the US Treasury Blueprints and the Campbell Committee in Australia; however, it has never left the drawing board, being regarded as impractical to implement. The most notable problems mentioned were the administrative difficulty and the fact that shareholders might have to pay income tax although no cash had in fact been received. Full integration is said to be the perfect solution in an imperfect world (Cnossen, 1993:7).

Example 11.2 below illustrates the conduit effect of full integration. The shareholder is taxed on all profits of the company (distributed or not) at his income tax rate. There is therefore no overtaxation under this system.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Example 11.2

Full integration

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company withholding tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Attributed profits (1)	R300	R300
	6	Income tax (4x5)	R90	R150
	7	Company withholding tax (3)	R120	R120
	8	Net income tax (6-7)	-R30	R30
C	Combined tax burden			
	9	Total tax (6 or 3+8)	R90	R150
	10	Effective tax rate (9/1)	30%	50%
	11	Overtaxation [(9-4)/4]	0%	0%
	12	Classical overtaxation	93%	40%
	13	Tax relief [(12-11)/12]	100%	100%

(Source: Cnossen 1993:7)

Full integration is seen as impractical, but partial integration seem to be an attractive alternative and is implemented in many countries in various forms.

11.3.2 Partial integration

In the past three decades, many major countries have decided to implement some form of the partial integration system. Partial integration as opposed to full integration provides integration for dividends, but not for retained earnings. It therefore eliminates the major impracticalities of full integration.

Under partial integration dividend relief can be given at company level or at shareholder level. Under each two methods of dividend relief are discussed:

- **Dividend relief at company level**

Dividend-deduction method

This method allows dividends as a deduction when computing the company's taxable income; it is also known as the 'dividend-deduction system'. Example 11.3 will illustrate this system:

Example 11. 3

Dividend-deduction system

A	Corporate Level			
	1	Profit before tax	R300	
	2	Dividend deduction	R150	
	3	Profit after deduction (2-1)	R150	
	4	Company tax rate	40%	
	5	Company tax (3x4)	R60	
B	Shareholder level			
	6	Income tax rate	30%	50%
	7	Dividend income (1-5)	R240	R240
	8	Income tax (6x7)	R72	R120
C	Combined tax burden			
	9	Total tax (5+8)	R132	R180
	10	Effective tax rate (9/1)	44%	60%
	11	Overtaxation [(10-6)/6]	47%	20%
	12	Classical overtaxation	93%	40%
	13	Tax relief [(12-11)/12]	50%	50%

(Source: Cnossen 1993:8)

The dividend-deduction system is found in Greece, Iceland and Sweden. Finland and Norway used to have dividend-deduction systems before they changed to the imputation system.

Most governments that provide dividend relief do not use the dividend-deduction method at company level unless they specifically want to stimulate domestic investment, because non-resident shareholders automatically benefit. Governments usually want to be in a position where they can control whether those shareholders should benefit (McLure, 1972:172).

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If dividends are deductible in full the corporation tax becomes a form of undistributed profits tax. The full distribution of profits is encouraged. In practice a limitation is placed on the dividend deduction, limiting it to a 'normal' dividend. This again causes conceptual difficulties in trying to establish what a normal dividend is.

An important advantage of the dividend-deduction system is that it treats dividends in the same way as interest, thereby eliminating the distortions in debt/equity ratios created by unequal treatment of interest and dividends. There is an argument against this form of relief though, which states that dividends as a matter of law should be treated differently from interest, hence the deductibility of interest does not support the deductibility of dividends (Lamont, 1985:7).

Split-rate method

Instead of the dividend-deduction method dividend relief can be achieved by taxing the distributed profits at a different rate to undistributed profits.

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Example 11.4 illustrates a split-rate system where distributed profits are taxed at a lower rate than retained profits (e.g.20% vs 40%). The effect of the lower tax on distributed profits is a 50% tax relief from double taxation, compared to the classical system that provides no such relief.

Example 11.4

Split-rate system

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	20%	
	3	Company tax (1x2)	R60	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Dividend income (1-3)	R240	R240
	6	Income tax (4x5)	R72	R120
C	Combined tax burden			
	7	Total tax (3+6)	R132	R180
	8	Effective tax rate (7/1)	44%	60%
	9	Overtaxation [(8-4)/4]	47%	20%
	10	Classical overtaxation	93%	40%
	11	Tax relief [(10-9)/10]	50%	50%

(Source: Cnossen 1993:9)

Split rate systems are found in numerous variations. In some cases distributed profits are taxed at a lower rate than retained earnings and in other cases distributed profits are taxed at rates higher than retained earnings, depending on whether a government wants to stimulate retentions or the distribution of profits. This form of corporate tax is similar to the system under STC that is currently being used in South Africa and that is outlined in Chapter 7. This system of is not unknown in the tax world, but is not widely used either. Countries like Germany and France have combined split-rate imputation systems and Japan, Austria and Portugal abandoned the split-rate method for a schedular method (SACOB,1995:45). Such 'mixed' systems emphasise integration at shareholder level as its primary method of providing dividend relief, with the relief provided at corporate level being merely supplementary (Lamont,1985:9).

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☐ **Dividend relief at shareholder level**

The imputation system

The 'imputation system' or 'shareholder credit system' provides relief at shareholder level by allowing a credit for part or all of the corporate taxes paid by the company on distributed profits.

Example 11.5 illustrates the workings of a full imputation system. In the hands of the shareholder, credit is received for the company tax already paid. This is achieved by grossing up dividends and then imputing the tax that has already been paid at company level.

Example 11.5

Full imputation system

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Net dividend (1-3)	R180	R180
	6	Imputed company tax (3)	R120	R120
	7	Dividend income (5+6)	R300	R300
	8	Income tax (4x7)	R90	R150
	9	Tax credit (6)	R120	R120
	10	Net income tax (8-9)	-R30	R30
C	Combined tax burden			
	11	Total tax (3+10)	R90	R150
	12	Effective tax rate (11/1)	30%	50%
	13	Overtaxation [(12-4)/4]	0%	0%
	14	Classical overtaxation	93%	40%
	15	Tax relief [(14-13)/14]	100%	100%

(Source: SACOB, 1995:46)

The imputation system is the most important form of dividend relief. The 1996 Budget, supporting the findings of the Katz Commission, acknowledged that this is also the system that South Africa is moving towards. The imputation system will therefore be analysed in more detail in Chapter 12.

11.4 Conclusions

This chapter explained the workings of the traditional systems of taxing corporate profits and dividends, the classical system and the system of integration (full and partial).

The classical system taxes both the company and the shareholder as separate entities, resulting in the double taxation of dividends. Double taxation creates severe economic distortions and most major countries have moved away from the classical system towards systems of integration.

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Full integration regards the corporation as an extension of its shareholders and taxes retained and distributed earnings at the shareholder's tax rate, thus eliminating the double taxation of dividends. Due to its impracticalities no country has ever implemented this system, but most countries have adopted systems of partial integration where some measure of dividend relief is provided.

Under a system of partial integration, dividend relief is given either at company level or at shareholder level. The methods of providing relief at company level are criticised and countries clearly favour the methods where dividend relief is provided at shareholder level. The most important form of dividend relief at shareholder level is the imputation system.

Chapter 12 will hence examine the imputation system in order to evaluate it as a suitable replacement for STC.

CHAPTER 12

A CLOSER LOOK AT THE IMPUTATION SYSTEM

12.1 Introduction

12.2 The imputation system

12.3 The schedular treatment of dividends

12.4 Conclusions

12.1 Introduction

In the traditional systems of taxing corporate profits and dividends a definite bias in favour of the systems of integration has emerged among developed countries. South Africa, in its bid to become an acceptable trading partner of these countries, now also has to consider the benefits or not of conforming with our major trade partners and reforming our tax system to a system of partial integration where dividend relief is provided at shareholder level. The imputation system will be discussed in this chapter and the schedular treatment of dividends as a possible simplified solution will also be considered. The imputation system has been described briefly in Chapter 11, and this description will now be elaborated on.

12.2 The imputation system

In an imputation system a credit is granted to the shareholder for taxes paid on a company's income, effectively eliminating double taxation and reducing the tax burden on distributed corporate profits. It is, however, improper to refer to this system as 'the' imputation system since as many hybrids of this system exist as there are countries using it. It is impossible to go into the detail of all these systems, but all have the same basic concepts underlying their specific systems. The basic workings of an imputation system will be explained in simplified examples. The objectives countries had for implementing imputation systems will be explored and the resulting consequences will be examined. Lastly, arguments for and against the implementation will be considered.

12.2.1 *Workings of an imputation system*

The imputation method involves the following steps:

- At company level, a tax on corporate profits, without distinguishing between retained or distributed profits, is levied.

- At shareholder level, the shareholder includes dividend receipts in his taxable income.

- The shareholder takes a credit for some portion of the dividend receipts included in his taxable income against the tax due on his taxable income.

In the interest of simplicity and for administrative convenience, the amount that is credited is usually a fixed percentage of the shareholder's dividend receipt and is not a percentage of the tax paid by the company on its profits. The concept underlying the system, however, still remains unchanged i.e. that a portion of the tax paid by the company should be treated as though it had been paid by the company, but on behalf of the shareholder. The effect is that the creditable portion of company tax is treated as if it were withheld from the dividend payment on behalf of the shareholder.

Grossing-up is the practice of increasing the actual dividend receipt when computing the shareholder's income by the amount of the credit. A credit for dividends received without gross-up or refund is called the schedular method of treating dividends. This method, often seen as a simplified version of imputation and a possible alternative, will be studied in detail in paragraph 12.3.

Example 11.5 illustrated the workings of a full imputation system. Example 12.1 will now illustrate the workings of a partial imputation system. Dividends are grossed up at one third of the amount of the dividend.

Example 12.1

Partial imputation system

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Net dividend (1-3)	R180	R180
	6	Imputed company tax (one third of 5)	R60	R60
	7	Dividend income (5+6)	R240	R240
	8	Income tax (4x7)	R72	R120
	9	Tax credit (6)	R60	R60
	10	Net income tax (8-9)	R12	R60
C	Combined tax burden			
	11	Total tax (3+10)	R132	R180
	12	Effective tax rate (11/1)	44%	60%
	13	Overtaxation [(12-4)/4]	47%	20%
	14	Classical overtaxation	93%	40%
	15	Tax relief [(14-13)/14]	50%	50%

(Source: SACOB, 1995:46)

12.2.2 Objectives and consequences of an imputation system

The adoption of some form of imputation system by a number of countries over the past few decades, has undoubtedly been the most important and also the most interesting development in the area of corporate taxation. It is therefore fitting to investigate the objectives which countries had in changing to an imputation system (International Fiscal Association,1983:9-11). These will be discussed below:

- It was hoped that the implementation of an imputation system where dividend distributions would be treated more favourably than under the classical system would increase

investment in the shares of companies, especially by small investors.

- Adding to the above it was hoped that by making shares of companies a more attractive investment alternative, it would have a positive impact on stock markets.

- It was hoped that the imputation system would lead to less reliance on internal financing and that companies would distribute more of their profits. This would again create a more competitive market for the reinvestment of funds.

- The double taxation of dividends led to companies relying excessively on debt financing, debt financing being the more attractive alternative because interest, unlike dividends, is not subject to double taxation. Debt to equity ratios would be improved under an imputation system.

- Double taxation forced taxpayers into forms of business organisation that were inappropriate and that were undertaken with the purpose of obtaining tax benefits. Under the imputation system the treatment of dividends would not favour one form of business organisation over another.

- Income that would otherwise not have been reported by shareholders would be reported under an imputation system, because tax credits can be obtained. In this way an imputation system would have an anti-avoidance quality.

At a Seminar of the International Fiscal Association (1983:9-11) held in Montreal in 1982, the consequences of the implementation of imputation systems as experienced by eight countries of the Organisation for Economic Co-operation and Development (OECD) were discussed. Summarised, the consequences in relation to the above-mentioned objectives were as follows:

- With regard to the economic objectives of increased equity financing of companies and improved stock market performance the introduction of imputation systems did not have a dramatic effect. In some situations the reasons were

clear, such as where other governmental policies prevented an increased return on equity. In other cases inflation, recession, currency fluctuations, etc. were given as reasons why the desired effect on the stock market did not realise.

- Imputation systems have definitely had an effect on the dividend distribution policies of companies. Companies took into account the imputation credit that was available to shareholders when determining dividend distribution.

- The choice of form of business organisation was affected in the countries where this was a goal.

Having looked at the objectives that the countries where imputation systems were implemented had at the outset and evaluating these against the consequences actually derived, it is clear that it is incredibly difficult to isolate the effect of an imputation system on the economy, especially where other governmental or economic factors are also active. Any country wishing to implement an imputation system must consider all its facets and weigh up the positive aspects against the negative ones.

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12.2.3 Arguments for and against the implementation of an imputation system

Although many major developed countries have adopted imputation systems in favour of variants of the classical system, some major countries such as the USA and the Netherlands researched the imputation system extensively, but still prefer to stay with classical systems. South Africa is currently on the brink of such a decision and it is therefore worth examining the wealth of arguments for and against imputation systems that we have available.

- **Arguments for imputation**

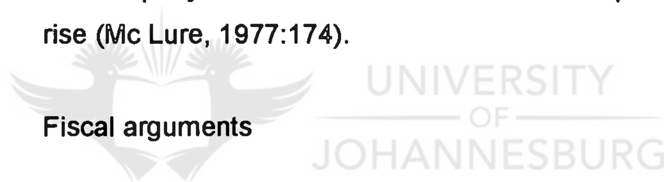
Conceptual arguments

- The imputation system recognises the fact that individuals ultimately carry the tax burden.

- The company is merely treated as the generator of earnings for the individual shareholder. The company tax can be seen in the light of a provisional tax.
- If the system is applied purely it allows for corporate earnings to be taxed at progressive personal tax rates instead of at a flat rate company tax. Thus, by attaching tax consequences to the individual, the system is seen as more equitable.
- Economic double taxation - the major criticism against the classical system - is eliminated (Katz,1995:84).

Arguments on economic grounds

- The imputation system is perceived to enhance neutrality of debt vs. equity funding.
- Profit distributions are promoted and as a result the stock markets are developed (SACOB,1995:48; Mc Lure,1977:174).
- The reduced combined tax burden increases the attractiveness of the company as form of investment and share prices are expected to rise (Mc Lure, 1977:174).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Fiscal arguments

- Imputation tax systems have a withholding quality. The tax is withheld at company level. This treatment serves as an anti-avoidance measure because the tax withheld qualifies for a credit at the personal income tax level (SACOB,1995:46).

Arguments based on international considerations

- The imputation system is the accepted system in the European Community (EC). It is the system that the EC promotes among its member countries as the most appropriate form of corporate tax. The most important EC member states (together accounting for 80% of the EC's Gross Domestic Product), namely France, Germany, Italy and the United Kingdom, employ this system. Since 1993, Finland, Norway, Australia and New Zealand have also adopted imputation systems (Norregaard, 1993:9).

□ **Arguments against imputation**

Conceptual arguments

- Unless a full imputation system is implemented, many of the arguments for imputation are no longer valid. A simplified imputation system would thus dilute the basic objectives of imputation.
- There is no consensus on what would be the best method to achieve integration (Norregaard,1992:225). This is abundantly evident from the many variants of the system in use.
- To achieve neutrality in taxation retained earnings, dividends and interest should be taxed at the same rate, implying that the top marginal rate must be the same as the company tax rate. Very few countries actually achieve neutrality (SACOB,1995:48).
- By not extending dividend relief to non-resident shareholders or to resident shareholders who invest abroad, imputation systems have an element of discrimination and non-neutrality. In this regard the reader is also referred to arguments on foreign considerations put forth below (Lamont, 1985:17).
- In cases where the nominal tax rate differs from actual or effective tax rate and the tax credit is based on the nominal tax rate, shareholders will get credit for tax never paid by the company. There are measures to correct the situation, but they will only further complicate the system (McLure, 1977:175).

Arguments on economic grounds

- First of all it is impossible to quantify the significance of the economic distortions created by the classical system, making it even more difficult to quantify the benefits to be derived from changing to an imputation system (Norregaard, 1992:225).
- Growing companies who have previously comfortably raised funds internally under systems that discriminated against dividend distributions are now faced with pressure to pay dividends. These companies will therefore be forced to place less reliance of internal funds (McLure, 1977:175).
- The cost of capital of companies that rely heavily on debt financing and who will continue to do so under and imputation system, will be increased (McLure, 1977:175).

Fiscal arguments

- An imputation system is costly in revenue terms (Norregaard, 1992:225). This cost arises from the increased administrative burden and the resulting increased compliance cost. This cost can impact greatly on either the company or the revenue authorities, depending on the choice of system (Katz,1995:85).
- Although administrative reforms are envisaged, the skills required to deal with an imputation system will at present severely strain Revenue's already limited resources.
- The legislation underlying an imputation system is undoubtedly very complex and the introduction of such a system will require a high degree of sophistication which small companies, for example, will not have at their disposal without incurring considerable cost (Katz,1995:85). Where, a compensatory tax is provided for, as is the case in most countries applying imputation, additional specific rules are required. This further increases the system's complexity (SACOB,1995:49).
- Only if the average individual rate is higher than the company tax rate will the system lead to the collection of additional tax. In South Africa this is unlikely due to the high concentration of shareholding in funds. Any attempted correction of this by granting only partial input credit or by levying equalisation taxes, will go against the basic philosophy of imputation (Katz,1995:85).

Arguments based on international considerations

- An imputation system invariably complicates a country's tax structure, but if international factors are introduced the complexities multiply (Lamont, 1985:16).
- There is conflict between measures to relieve international double taxation and the introduction of an imputation system to relieve domestic double taxation. Most countries provide that a tax credit is available to a shareholder only where an equivalent amount of domestic tax has been paid. If the company tax was paid in a foreign tax jurisdiction, no tax credit is extended to the shareholder. In this way imputation systems do not achieve capital export neutrality. In the South African situation this is not seen as an immediate drawback since South Africa is a net capital importer, but with the gradual relaxation of exchange controls and the weakening of the

Rand, increased outward investment is foreseen. In order to correct this situation a compensatory tax ('equalisation tax') will have to be levied by the capital exporting country (SACOB,1995:48).

- In respect of inward investment on the other hand, imputation systems give the tax credit at shareholder level. Dividend relief is thereby not automatically extended to non-resident shareholders (McLure,1977:176).
- To correct these problems created by imputation systems at the international level, extensive tax treaties must be negotiated or re-negotiated with foreign governments.

Political arguments

- Shareholders are usually in the upper-income tax brackets and imputation give them tax relief. The population at large sees this as tax benefits that are for the enjoyment of the rich and it results in political dissatisfaction (Lamont, 1985:14).
- Income from dividends is usually seen as a source of income of the wealthy and a tax refund (where the shareholder's tax rate is lower than the company tax rate e.g. elderly people who invest in shares) could be regarded as inequitable (SACOB,1995:48).

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Before an evaluation of the imputation system and its place or not in the South African environment is done, it is necessary to consider a simplified version of the imputation system, better known as the schedular treatment of dividends.

12.3 The schedular method of treating dividends

Other than variants of the imputation system, SACOB (1995:45) considers a schedular method of treating dividends as a possible alternative for STC. A number of OECD countries use schedular methods of treating dividends.

According to the schedular system, corporate income is taxed at the company tax rate. Dividends are relieved at the shareholder level by allowing shareholders a tax credit against their income tax without regard to the corporate tax already paid, by providing for a separate lower flat-rate tax or by exempting dividends in the hands of the shareholder. Examples 12.2,12.3 and 12.4 below illustrate each of these methods.

- **Schedular method - tax credit without regard to corporate tax**

In Example 12.2 a tax credit of 20% is given irrespective of the company tax that has already been paid. Canada and Spain uses this method by permitting shareholders a tax credit, specified as some fraction of dividends received, against their income tax. It differs from the imputation system in that the tax credit is available regardless of whether or not the corporation tax has been levied. No provision is made for grossing-up before the income tax rate is applied, nor is any refund given if the tax credit exceeds the liability.

Example 12.2

Schedular method: tax credit of 20%

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Net dividend (1-3)	R180	R180
	6	Dividend income	R180	R180
	7	Income tax (4x6)	R54	R90
	8	Tax credit (20% of 6)	R36	R36
	9	Net income tax (7-8)	R18	R54
C	Combined tax burden			
	10	Total tax (3+9)	R138	R174
	11	Effective tax rate (10/1)	46%	58%
	12	Overtaxation [(11-4)/4]	53%	16%
	13	Classical overtaxation	93%	40%
	14	Tax relief [(13-12)/13]	43%	60%

(Source: Cnossen, 1993:12)

- **Schedular method - low flat-rate tax**

Example 12.3 goes on to illustrate the schedular method where dividends are subject to a low flat-rate tax. This method is used in Austria. In this example a 10% tax on dividends is imposed at

shareholder level, but collected as a withholding tax at company level.

Example 12.3

Schedular method: 10% final withholding tax

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Net dividend (1-3)	R180	R180
	6	Dividend income	R180	R180
	7	Withholding tax (10%x6)	R18	R18
C	Combined tax burden			
	8	Total tax (3+7)	R138	R138
	9	Effective tax rate (8/1)	46%	46%
	10	Overtaxation [(9-4)/4]	53%	-8%
	11	Classical overtaxation	93%	40%
	12	Tax relief [(11-10)/11]	43%	113%

(Source: SACOB, 1995:50)

□ **Schedular method - full exemption of dividends in the hands of shareholders**

Full exemption of dividends at shareholder level is considered to be a variant of the schedular system. It was briefly used in South Africa prior to the introduction of STC. Currently it is only used in Turkey. This method is illustrated in Example 12.4.

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Example 12.4

Schedular method - full exemption

A	Corporate Level			
	1	Profit before tax	R300	
	2	Company tax rate	40%	
	3	Company tax (1x2)	R120	
B	Shareholder level			
	4	Income tax rate	30%	50%
	5	Net dividend (1-3)	R180	R180
	6	Taxable income	R0	R0
	7	Income tax (4x6)	R0	R0
C	Combined tax burden			
	8	Total tax (3+7)	R120	R120
	9	Effective tax rate (8/1)	40%	40%
	10	Overtaxation [(9-4)/4]	33%	-20%
	11	Classical overtaxation	93%	40%
	12	Tax relief [(11-10)/11]	65%	150%

(Source: SACOB, 1995:50)

Although the schedular system used prior to STC is simple and would be easy to administer, it would be impossible for South Africa to return to the pre-STC system where dividends were fully exempted without increasing the company tax rate as a result of the revenue loss (SACOB, 1995:52). As discussed in Part II of this dissertation this would be undesirable.

□ **Evaluation of the schedular treatment of dividends**

- An objection to the schedular form of dividend relief is the fact that the benefit is distributed regressively in respect to income. As is evident from the examples above the shareholder in the higher income tax bracket receives more dividend relief than the shareholder in the lower income tax bracket. The objective of dividend relief interferes with the objective of progressivity of personal income taxes. The latter objective states that tax should be levied upon individuals according to their ability to pay tax. This

would not happen if the income tax is levied at a proportional rate as is the case in Belgium, Japan and Portugal where low-income shareholders are permitted to include the dividend in income and claim a credit for the withholding tax against the gross income tax liability (Cnossen,1993:12).

- The system only provides for partial relief from double taxation as can be seen in the examples above, but at least the complete double taxation of dividends is avoided (SACOB,1995:52).

- The choice of funding internal growth is not distorted by tax considerations as is the case with STC. The schedular treatment of dividends thus provides for a more neutral tax system (SACOB, 1995:52).

12.4 Conclusions

A closer look at the imputation system brought many insights. Although simplified examples of the workings of imputation systems were given, the implementation of this method of dividend relief is relatively complicated. For this reason no two countries use the same imputation system. Each country has modified the basic imputation system to suit its own needs and achieve its own goals.

From experience we have seen how difficult it is to measure or quantify the economic benefits of an imputation system, because there are so many variables influencing a country's economy. Where imputation systems were introduced it did have the desired effect on companies' dividend distribution policies and on the choice of business organisation.

Arguments for and against imputation systems based on conceptual, fiscal, economic, political and international considerations proved that any decision to change to an imputation system should be well thought through. This is an ambiguous system; its greatest advantages nationally may be its downfall internationally. A simplified version of the imputation system in the form of a schedular method of treating dividends should also be considered.

In Chapter 13 the international trends in dividend taxation will be examined.

CHAPTER 13

INTERNATIONAL TRENDS IN DIVIDEND TAXATION

13.1 Introduction
13.2 International trends
13.3 Conclusions

13.1 Introduction

Internationally the imputation system has become the fashionable trend in dividend taxation over the past three decades. This system and its other extreme the classical system was described and evaluated in chapter 11 along with variants of the systems that lie somewhere in between the two extreme views of conduit vs separate entity.

The imputation system warranted a closer look in chapter 12 as this system was in principle recommended to the South African authorities by the Katz Commission. The imputation system is relatively complex and therefore a simplified version thereof, namely the schedular treatment of dividends, was also briefly examined.

In the search for a suitable system of dividend taxation for South Africa, international trends must be objectively viewed and principles of the most appropriate systems must be applied to the South African environment.

13.2 International trends in dividend taxation

Cnossen (1993:4-5) shows that of the 24 OECD countries, only 4 countries use the pure classical system, taxing dividends at the corporate source and again in the hands of the individual. The other 20 countries provide some form of dividend relief. This relief is given either at corporate level - 3 countries - or more popularly at shareholder level - 17 countries. At the shareholder level, 9 OECD countries have full or partial imputation systems and 8 countries treat dividends according to the schedular method. In Table 13.1 the systems used in OECD countries are classified.

During the past decade several countries have changed to some form of imputation system or schedular system. While Australia and New Zealand abandoned the classical system for the imputation system, Norway and Finland substituted the dividend-deduction method in favour of the imputation system and Austria, Japan and Portugal moved from split-rate systems to some form of dividend relief at shareholder level. The schedular treatment of dividends appears to be popular and is increasingly used to provide dividend relief at shareholder level (Cnossen, 1993:5).

The degree of dividend relief provided at shareholder level varies widely, from 31% to 100%. In many cases some form of dividend discrimination remains and the economic distortions created by classical systems are not completely eliminated. The only countries that really achieve neutrality are New Zealand and Norway.

Another trend that follows from the above is that countries providing relief at shareholder level appear to be concerned with economic investment decisions and company distribution policies, rather than with foreign considerations such as international neutrality (Cnossen, 1993:5).

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TABLE 13.1 **Degree of Reduction of Economic Double Taxation in OECD countries**

Relationship between company tax and income tax

No integration:	**Integration of distributed profits:**				**Full integration:**
Classical system	**Corporate level**		**Shareholder level**		**Conduit system**
	Dividend deduction system:	**Split-rate system:**	**Imputation system:**	**Schedular treatment:**	
			Full imputation:	*Separate tax:*	
United States	Iceland	None	Australia	Austria	None
Luxembourg	Greece		Finland	Belgium	
Netherlands			Germany	Denmark	
Switzerland			Italy	Japan	
Belgium			New Zealand	Portugal	
			Norway	Turkey	
			Partial imputation:	*Tax credit:*	
			France	Canada	
			Ireland	Spain	
			United Kingdom		

(Source: Cnossen, 1993:4-5)

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From a study of 6 developing countries commissioned by SACOB 2 countries, Indonesia and Hungary, use classical systems. Dividend relief provided by imputation systems are used in Singapore, Malaysia and Chile, and in Zimbabwe a schedular system is employed (SACOB,1995:44).

Another survey into the taxation systems of 66 countries (Van Blerck,1995:84) indicated that the majority of countries (including South Africa) granted full relief to shareholders. In many cases, however this relief was provided at the cost of a higher corporate tax rate or a withholding tax on dividend distributions. Upon rough scrutiny of past positions the study indicated a definite trend away from the pure classical system, toward systems of partial integration. The move to the imputation system as a method of partial integration, was however restricted to a few highly developed countries.

13.3 Conclusions

From the above the following conclusions can be drawn:

- Classical systems have become increasingly unpopular.
- Some kind of dividend relief at shareholder level is provided by the majority of countries.
- The OECD countries favour imputation systems and schedular methods of taxing dividends.
- The trend towards imputation systems is gradual and is attempted only by highly developed countries.
- The schedular method of taxing dividends have become increasingly popular.

Taking the above international trends into consideration, the author will in PART IV of the dissertation focus on its application in the South African situation where the most appropriate form of dividend tax for South Africa is considered.

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PART IV

CHAPTER 14: THE MOST APPROPRIATE FORM OF DIVIDEND TAX FOR SOUTH AFRICA

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CHAPTER 14

THE MOST APPROPRIATE FORM OF DIVIDEND TAX FOR SOUTH AFRICA

14.1 Introduction
14.2 Administrative burden
14.3 Fiscal requirements
14.4 International considerations
14.5 Political and economical factors
14.6 Conclusions

14.1 Introduction

The characteristics of the alternative systems of dividend taxation and international trends in dividend taxation, as described in preceding chapters, lead to a conclusion on the most appropriate form of dividend tax for South Africa.

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The equity shortcomings and economic distortions of the classical system definitely point the way to integration, also for South Africa.

The choice of the level of integration should now be considered. Local variables such as the administrative capabilities of the tax authorities; revenue needs of the fiscus; national political and economical goals; the relative importance of non-resident shareholders, and other factors should be considered. The choice of level of integration is therefore one of tax technique rather than substantive effect (Lamont,1985:4).

An evaluation of the most appropriate form of dividend tax for South Africa will now be made. The question of the form of dividend tax and the level of integration will be answered with reference to specific characteristics of the new South Africa.

14.2 Administrative burden

Tax administration in South Africa has been widely and severely criticised. It is the main reason why much of the revenue due to the authorities is never collected which again results in upward pressure on tax rates. It also has negative implications for relations between the taxpayer and the tax authority.

14.2.1 The Income Tax Act

The present Income Tax Act is probably the main reason for South Africa's inefficient tax administration. It is criticised on the basis that with all the amendments that has been added since its introduction 33 years ago it has become too complex and cluttered with obsolete sections. The legislation that was dealt with in this dissertation, namely the dividend definition and STC, also proves the complexity of the Income Tax Act. It can only be understood by specialists and therefore creates a great deal of uncertainty. Complexity and uncertainty place a greater administrative burden on the tax authorities and the taxpayer. It also leads to inefficiencies in revenue collection (Norval,1996:3).

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Recommendations to correct the administrative burden created by a too complex Income Tax Act are twofold: firstly a broadening of the tax base by widening the tax net is suggested. For this to work, tax legislation written in simple and understandable language is a definite requirement. The second recommendation is that the South African Revenue Service must be transformed into a modern and efficient organisation.

A streamlined Income Tax Act will be a great help to both the taxpayer and the tax authorities in attaining the above recommendations, because it will be easier to understand and consequently easier to administer. Again the experience of other countries such as Australia, New Zealand and the United Kingdom who are in the process of simplifying their tax legislation, will be invaluable (Norval,1996:3).

14.2.2 The technological burden

Another reason for inefficient tax administration can be found in the area of technology. The technology in use at the South African Revenue Service is outdated. It is commonly known that we are in the 'Information Age' and a competitive advantage can only be gained by using the latest computer

technology. The competitive edge that can be gained through advanced technology is not limited to companies in the private sector; it can also utilised very effectively by the South African Revenue Service.

A key factor to successful tax reform is the ability to project what the influence of any proposed changes in the tax legislation will be on the composition of tax revenue. Only advanced computer systems have the ability to simulate the effect of suggested changes and Revenue's current system definitely lacks this expertise. (Jordaan, 1996:21)

Although it will be costly, every Rand spent to upgrade the present computer system, will lead to increased efficiency and the collection of additional revenue.

14.2.3 The administrative burden and tax reform

SACOB's (1995:17-32) international study indicated that:

> "...ineffective tax administration severely limits the scope for tax reform. Many desirable elements of other countries' tax systems can simply not be introduced into South Africa unless the tax administration is improved..."

Before South Africa can attempt to introduce an imputation system, reform in the area of tax administration, as mentioned above, is required. International trends indicated that it is mostly developed countries with sophisticated tax systems that have implemented the imputation system successfully. Any attempt to adopt an imputation system in the South African environment should only be made after a higher degree of efficiency in tax administration has been achieved. At present it would not be administratively feasible to implement an imputation system.

In my opinion the adoption of a simplified version such as a schedular system that is administratively less burdensome than the imputation system is recommended.

14.3 Fiscal requirements

The implementation of an imputation system would definitely lead to a loss of revenue to the fiscus. In 1994/1995 non-mining companies generated R12 118

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million in tax revenue. STC alone amounted to R1 440 million. This loss of revenue would create pressure to again increase the corporate tax rate. This goes against the objective of lowering the tax rate in order to make the country more competitive with regard to foreign investment.

A study by SACOB (1995:52) showed that if the STC revenue is foregone the nominal corporate rate would have to be increased by approximately 5% to make up for the lost revenue. This is clearly unacceptable and would impact heavily on South Africa's bid for foreign investment.

Once the recommendations in paragraph 14.2 in respect of tax administration have been implemented it can be expected that additional revenue will be collected. It is suggested that the fiscus currently loses R17 billion a year as a result of tax evasion and unpaid taxes. As a percentage of the taxes collected, South Africa spends less than half of what the USA and New Zealand does on tax collection. Should this amount be increased it will result in a dramatic increase in tax revenue collected (Jordaan,1996: 21-23). Only when the results of better administration have led to higher revenue collection will an imputation system be a feasible option to the fiscus.

Under the current circumstances, it is suggested that if STC is replaced by a schedular method consisting of a low flat-rate withholding tax, revenue would not necessarily be lost. Initially, the rate of the withholding tax can be calculated with reference to the revenue that must be collected. This will ensure that the amount of STC that is lost will be collected through a withholding tax .

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14.4 International considerations

One of the main objectives for the adoption of a new system of dividend taxation in South Africa relates to foreign investment. Although taxation is in most cases not the deciding factor in investment decisions, it plays an important role in determining the location of the investment.

Whatever the domestic advantages of dividend relief under systems of integration might be, in the international context its implications is a major drawback. Sato (1975:444-450), concludes that the classical system is clearly the superior system in terms of capital-export neutrality.

As mentioned before, South Africa is a net capital import country and the adoption of an imputation system will thus, for the time being, not have detrimental effects.

Meanwhile this issue has recently received attention internationally and was the subject of a seminar held during the Congress of the International Fiscal Association in 1993. Mechanisms employed by countries to avoid penalising non-resident shareholders as a result of the application of the equalisation tax and the non-recognition of the tax credits such as tax treaties was the subject of the seminar. Double taxation treaties appear to be the way to relieve the international double taxation that may be created by the adoption of some form of imputation system. The fact of the matter is that these problems are not uncommon in the international arena and would be recognised by potential trade partners.

International investors are unfamiliar with the STC system and this created unique problems for the South African authorities. In South Africa's future treaty negotiations the familiarity or not of the other party with our tax system is bound to play an important role in the success of the negotiations.

Unlike with STC, a form of partial integration that provide relief at the shareholder level will not be seen as an additional tax on the company, but as a tax on the shareholder. Potential foreign investors will not add the dividend tax rate to that of the company to get to the effective tax rate on companies as they did with STC. The corporate tax rate, currently at 35%, will then be seen as competitive, and interested foreign investors will be attracted, not deterred.

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If the authorities commit themselves to the negotiation or re-negotiation of tax treaties with investor countries, it is my opinion that the adoption of an imputation system or schedular method in favour of the STC system, will be viewed as a positive move by foreign investors.

14.5 Political and economical factors

In order to relieve the unemployment problem in South Africa and to achieve the other goals of the Reconstruction and Development Program, economic growth in the country is essential. The authorities tried to achieve this with STC by artificially promoting the retention of profits using tax as the device. At the same time STC, especially at a rate of 25%, brought about distortions in dividend distribution policies and debt/equity ratios.

It is my opinion that the goal of economic growth could be achieved naturally and more effectively. Dividend relief at shareholder level through imputation would correct distortions created by STC and also stimulate the stock market. If the stock

market in any country is alive the economy is bound to grow. Growing companies also do not need STC to force them to retain profits, they are economically compelled to do so.

14.6 Conclusions

It is useful to study international trends, but from that it can clearly be seen that each country has its own unique tax system which was designed and developed to fit the needs of that particular country.

In South Africa, STC may have served its purpose, but a change to a form of dividend taxation that is internationally more acceptable, is long overdue. Recent changes to the tax system regarding STC, have made STC an acceptable alternative for the time being, but this statement also implies that a new form of dividend tax will be adopted in the foreseeable future.

The imputation system may be very alluring: it is conceptually superior, it reduces economic distortions created by the classical system and it is internationally approved, but in my opinion it is presently not a feasible option for tax reform in South Africa. It is a sad truth that the South African Revenue Services will not presently be able to cope with the extra administrative burden that will result from the introduction of an imputation system. Once a higher degree of sophistication in the national tax system has been reached, an imputation system will be an attractive alternative and adopting such a system should definitely be reconsidered. Until such time, the benefits of completely eliminating double taxation will have to be partially foregone in favour of feasibility.

The schedular method of treating dividends provides the possibility to tailor-make a system fit for the South African environment. In my opinion, a schedular method of dividend relief for the shareholder, using a low flat-rate withholding tax collected at company level would be the most appropriate form of dividend tax in the current South African environment.

The rate of the withholding tax should be calculated with reference to the revenue needs of the fiscus, but other considerations should also be taken into account. If the rate is too high economic distortions of double taxation will be magnified. This is evident from the fact that a rate of 15%, STC did not create major distortions, but the effects of the change to 25% was disastrous. A rate of between 10% and 15% is

considered appropriate in the light of the fact that the current STC rate, on which revenue will be collected, is 12.5%.

Such a schedular system is easier to administer than an imputation system, will protect government revenue and is recognised internationally. This tax will resemble the NRST, but because it will be levied on all shareholders there will be no discrimination against foreign shareholders. It will clearly be a tax on the shareholder, not on the company. The fact that the tax is internationally recognised will also facilitate treaty negotiations.

It is my opinion that the South African authorities should modify the current system of taxing dividend distributions. The present dual tax system need only be adapted to resemble a schedular method of treating dividends as described above.

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