

# **THE IMPACT OF THE INTRODUCTION OF DIVIDENDS TAX IN SOUTH AFRICA ON FOREIGN AND LOCAL INVESTORS**

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## **ABSTRACT**

# **THE IMPACT OF THE INTRODUCTION OF DIVIDENDS TAX IN SOUTH AFRICA ON FOREIGN AND LOCAL INVESTORS**

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The system used for the taxing of dividends in South Africa (SA) has been subject to constant reform over the past two decades. The stated objective for each reformation process has remained constant since 1986, which is to align SA with international tax norms and to encourage investment into the SA economy.

In the 2007 budget, the Minister of Finance announced that the new dividends tax legislation would replace the Secondary Tax on Companies (STC) legislation. STC was considered to be a complex tax system, which was only used by SA and a handful of other countries. Therefore it was difficult for foreign investors to understand the technical aspects of STC. These complexities deterred foreign investors from investing in South Africa.

Dividends tax, on the other hand, is a withholding tax which is levied at a shareholder level. It is easily understood and internationally recognised.

The South African Government indicated that the objective for the introduction and implementation of dividends tax in SA was to make SA a more attractive investment

destination by aligning the South African system used for the taxing of dividends with internationally recognised systems.

The purpose of this study is to determine whether or not there are any tax incentives or benefits included in the dividends tax legislation which will encourage foreign investors to consider SA as a potential investment destination.

The study is based on an extensive literature review, the exploration of STC and dividends tax legislation and also incorporate the views of previous academic research performed on this subject.

This study has established that foreign investors will benefit from the implementation of dividends tax in SA. The benefits for foreign investors are not necessarily embedded in the dividends tax legislation, but there are still benefits that can be enjoyed from applying this type of system for the taxing of dividends declared and distributed.

The objective for the implementation of dividends tax was to align SA with international tax norms and to encourage investment in SA.

This study has revealed that the introduction of dividends tax has achieved this objective. It further established that the legislation is not particularly partial towards one type of shareholder or investor but rather that dividends tax strives to increase investment opportunities in order to stimulate growth in SA.



## **OPSOMMING**

# **DIE IMPAK VAN DIE IMPLEMENTERING VAN DIVIDENDE BELASTING IN SUID-AFRIKA OP OORSESE EN SUID-AFRIKAANSE BELEGGERS**

deur

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Die Suid-Afrikaanse dividend belastingstelsel word vir die afgelope twee dekades aan konstante verandering blootgestel. Die rede vir die verandering het onveranderd gebly sedert 1986, naamlik om Suid-Afrika (SA) inlyn te stel met internasionaal-aanvaarde belasting praktyke en om sodoende investering in SA te bevorder.

Gedurende die 2007 Begroting het die Minister van Finansies aangekondig dat dividend belasting Sekondere Belasting op Maatskappye (SBM) sal vervang. SBM was beskou as `n ingewikkelde vorm van belasting wat net deur SA en `n handjie vol ander lande toegepas word. Gevolglik was dit moeilik vir internasionale beleggers om die belastingstelsel te verstaan en dit het hulle verhinder om fondse in SA te belê.

Die hoofdoel van hierdie studie is om te bepaal of daar enige belastingvoordele in die dividend belasting wetgewing ingesluit is wat as motiveerder sal optree vir internasionale beleggers om SA as `n beleggingsmoontlikheid te oorweeg.

Dividend belasting is makliker verstaanbaar en word internasionaal erken. Dit is `n belasting wat gehef word op die ontvanger van die dividend eerder as op die maatskappy wat dit verklaar.

Die owerheid het aangedui dat die rede vir die bekendstelling van dividend belasting in SA is om SA se dividend belastingstelsel meer ooreenstemmed met internasionaal erkende stelsels te maak en sodoende SA meer aantreklik te maak as `n internasionale beleggingsbestemming.

Hierdie studie is gegrond op `n uitgebreide oorsig van die literatuur in hierdie verband. Dit sluit ook `n oorsig van die SBM wetgewing asook die dividend belasting wetgewing in. Vorige akademiese navorsingsverslae in die veld word ook bespreek.

Hierdie studie het bewys dat dividend belasting wel voordele vir oorsese beleggers inhou. Hierdie voordele is nie noodwendig in die wetgewing ingesluit nie maar word ewaar uit die toepassing van hierdie tipe stelsel vir die belasting van dividend verklaar.

Die hoofdoel vir die bekendstelling van dividend belasting was om SA in lyn te stel met internasionale belastingnorms en om sodoende investering in SA te bevorder.

Die studie het getoon dat die bekendstelling van dividend belasting in SA sal bydrae om hierdie doel te behaal. Dit het bewys dat die wetgewing onpartydig is teenoor alle aandeelhouders en beleggers, en beleggingsgroei in SA nastreef.

# THE IMPACT OF THE INTRODCUTION OF DIVIDENDS TAX IN SOUTH AFRICA ON FOREIGN AND LOCAL INVESTORS

## CHAPTER 1

### INTRODUCTION

#### 1.1 BACKGROUND

Before the introduction of Secondary Tax on Companies (STC) in 1993, SA was considered to be the land of milk and honey as far as dividend income was concerned. The reason for this is due to the fact that from 1990 until 1993 dividend income was not taxable in the hands of the company shareholder. As a result shareholders received dividend income without being liable for taxes on this income.

In the 1993 budget it was announced that STC was to be introduced as a tax levied on dividends declared and distributed by companies at a rate of 15%. According to the Race Relations Survey (1994:425), the objective for the introduction and implementation of dividends tax in SA was to encourage companies to reinvest the company profits, which would have been available for distribution to the company shareholders, rather than to distribute these profits to these shareholders.

In 2005 the Katz Commission was mandated to evaluate the South African tax system, including STC. According to the Katz Commission (2005:2) Government aimed to achieve its main goal for the introduction of STC in SA, which was to create a strong and sustainable economic environment which promotes economic growth.

The STC system was considered to be complex, outdated and not in line with international tax norms. Furthermore Government's main objective for the introduction of STC which was to encourage re-investment in SA, was not achieved by applying the STC system.

A study by Davidson (1996) and a study by De Wet and Ras (2008) also show that Government's objectives for the introduction of STC, as mentioned above, were not

achieved under the STC regime. The outcome of these studies will be discussed in Chapter Two of this study.

According to Van Dyk (2012:1) potential foreign investors' found the SA tax system to be complex. One of the reasons for this view was due to the fact that foreign investors are not familiar with the technical aspects of STC. These complexities made it difficult for foreign investors to consider SA as a potential investment country.

Therefore the announcement in the 2007 budget that STC would replace dividends tax was no surprise.

According to South African Revenue Services, (SARS) (2013:1), the main objective for the introduction and implementation of dividends tax in SA is to align SA with international tax norms and to make SA a more attractive international investment destination.

The one corresponding objective throughout all the tax reforms of the dividend taxing system is to align SA with internationally accepted tax practices and to encourage investment opportunities in SA.

To encourage investment in SA, the country has to be viewed as an attractive investment destination by both foreign and local investors.

## **1.2 PROBLEM STATEMENT**

As mentioned above, one of the objectives for the introduction of dividends tax is to encourage foreign investors to invest in SA. The objective for the introduction of STC in 1993 was also to encourage re-investment in SA. To accomplish economic growth SA is largely dependent on both foreign and local investments. The question is therefore; is there any tax incentive in the dividends tax legislation which provides benefits to foreign investors and thereby encourages investment in SA?

### **1.3 PURPOSE STATEMENT**

The purpose of this study is to determine whether or not there are any tax incentives or tax benefits provided in the new dividends tax legislation to encourage foreign investors to invest in SA.

### **1.4 RESEARCH OBJECTIVES**

This study is guided by the following research objectives:

- To explore the new dividends tax legislation;
- To determine to what extent this legislation is beneficial to foreign investors by applying a simple case study;
- To determine to what extent the benefits received by foreign investors will outweigh the benefits received by local investors.

### **1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY**

A report by Grant Thornton (2013:02) indicated that SA is among the highest ranked emerging markets on the African continent. The 2012 results indicated that out of all the African countries, SA is the only country to be ranked in the top 15 emerging economies in the world. SA is the only African country to be ranked in the top 15 emerging economies worldwide.

Due to the importance of foreign and local investments and the fact that these investments largely attribute to the economic growth of the country, it is important from a practical point of view to perform this research. This study will assist to determine the impact of the introduction of dividends tax on foreign investors and local investors.

Dividends tax is a new tax which was only recently introduced in SA. From an academic point of view, this study will make a valuable contribution to determine whether or not the objectives for the introduction of dividends tax can be achieved.

## 1.6 DELIMITATIONS AND ASSUMPTIONS

### 1.6.1 DELIMITATIONS

This study has several delimitations with regard to the context and theoretical perspectives of the study, namely:

- it is limited to the taxation of South African investors and foreign investors in SA;
- it compares taxation of dividends received by foreign investors from a SA source to that received by South African investors from a SA source;
- the literature review primarily focuses on literature on income tax, STC and dividends tax consequences for South African investors and for foreign investors.
- the legislation discussed in this research proposal for SA is limited to the Income Tax Act (58/1962) and the Value-Added Tax Act (89/1991).

### 1.6.2 ASSUMPTIONS

This study is based on the STC legislation available immediately prior to the introduction of dividends tax and based on the new dividends tax legislation introduced on 20 December 2011.

## 1.7 DEFINITION OF KEY TERMS

This study includes a number of key concepts. These key terms have been defined below:

**Beneficial owner:** refers to the person who is entitled to the benefit of the dividend attached to a share (Section 64D of the Act).

**Contributed tax capital:** refers to the sum of the following:

- the share capital of the company; and
- the share premium of the company immediately before 1 January 2011, reduced by any capital distributions made to shareholders on or after 1 January 2011 (Section 1 of the Act).

**Direct foreign investment (FDI):** refers to an investment made by a company that is based in one country, into a company that is based in another country. Foreign direct investment differs considerably from indirect investments such as portfolio flows. Entities making direct investments typically have a significant degree of influence and control over the company into which the investment is made. The Organisation for Economic Co-operation and Development (OECD) defines an acceptable threshold for a foreign direct investment relationship as 10% (Investopedia, 2013).

**Dividend:** in terms of the new dividends tax legislation refers to any amount transferred by a South African resident company for the benefit or on behalf of any shareholder of such a company by way of a distribution or as consideration for the acquisition of any share, excluding a reduction in the contributed tax capital of the company or a distribution which constitutes shares in the company; or constitutes an acquisition by the company of its own shares by way of a general repurchase of securities (Section 1 of the Act).

**Dividends tax:** is a tax which is imposed on the shareholders of a company at a rate of 15% upon the receipt of a dividend. Dividends tax can be categorised as a withholding tax. It is a tax that is withheld and paid to SARS by the company declaring and distributing the dividend or by a regulated intermediary, and not the person liable for the tax, i.e. the beneficial owner of the dividend (SARS, 2013:1).

**Regulated intermediary:** refers to any approved nominee, any central securities depository participant or a portfolio of a collective investment scheme in securities; or a transfer secretary (Section 64D of the Act).

**Resident (other than a natural person):** refers to any person, who is not a natural person, who is formed, incorporated or established in the Republic of SA or a person whose effective management is conducted in SA (section 1 of the Income Tax Act No.58 of 1962).

The table below contains a list of the abbreviations used in this study:

**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
BRICS	Brazil, Russia, India, China, South Africa
CTC	Contributed tax capital
DTA	Double taxation agreement
FDI	Foreign direct investment
OECD	The Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SA	South Africa
STC	Secondary tax on companies
The Act	The Income Tax Act No. 58 of 1962

## **1.8 RESEARCH DESIGN**

The study will be performed by using a non-empirical research design.

The non-empirical part of the study consists of two parts namely, a critical review of available literature and the application of a simple case study.

Firstly, a critical review is performed on the literature currently available in respect of STC and dividends tax. The researcher, due to the nature of the thesis, undertakes no primary research. The researcher engages mainly in secondary research, namely to analyse the opinions of appropriate academic writers and by exploring the relevant tax legislation. This research design has been selected as it is the most suitable as a critical review will be employed to formulate and describe the main objectives for the replacement of STC with dividends tax and the impact on the economic growth in SA (Mouton, 2001:180). The critical review also determines whether or not the objectives as set out by SARS for the introduction and implementation of dividends tax in SA have been achieved.



Secondly, the researcher will perform a case study using a sample of foreign and local investors to compare the taxation of dividends under the STC legislation to that under the dividends tax legislation.

## 1.9 CHAPTERS OUTLINE

This research study has five main chapters outlined as follows:

**Chapter One – Introduction:** This chapter provides background to the study, the problem statement, purpose statement, research objectives, the importance of the study, delimitations and assumptions, definitions of key concepts and the outline of the chapters.

**Chapter Two – Literature review:** This chapter provides the theory underlying the research. This includes the writings and opinions of appropriate writers.

**Chapter Three – Critical evaluation of tax legislation:** This chapter provides a critical evaluation of the STC legislation and dividends tax legislation including a comparison between STC and dividends tax.

**Chapter Four – Case study:** This chapter provides a case study which illustrate the taxing of dividend income in the hands of shareholders, by applying both STC and dividends tax.

**Chapter Five – Conclusion:** This chapter provides a summary of the research study, findings and the proposal for further study on the subject.

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

This study focuses on researching the taxation of dividends declared and distributed by SA resident companies to both foreign and local investors and the impact of dividends tax on investors.

The taxing of dividend income in SA has been an evolving process with one common goal which is to align SA with international tax norms and in doing so to encourage investment in SA.

This chapter commences with a literature review regarding the taxing of dividends declared and distributed and the impact of the taxing of dividend income for both foreign and local shareholders. The literature review also encompasses previous research studies conducted in the field and will expand on the research conducted by Molebalwa (2012) to determine the impact of the introduction of dividends tax in SA on both foreign and local investors.

#### **2.2 THE HISTORY OF TAXING DIVIDENDS IN SA**

##### **2.2.1 Criteria for a good tax system**

Adam Smith, author of “The Wealth of nations” and Professor of Moral Philosophy at the Glasgow University designed certain canons of taxation. These canons can be used as yardsticks to measure a taxing system in order to determine if the taxing system qualifies as a good tax system. The main canons are set out below:

- Equity – equity refers to the fair and equal treatment of all tax payers;

- Certainty – the tax system should contain elements of certainty, tax payers should not experience any doubt regarding the tax rates, the amounts payable and when payment is due;
- Convenience – the tax system should be designed in such a way that it is convenient to both the tax payer and the tax administrator. The tax should be demanded when the tax payer is in the best position to pay the tax;
- Economy of collection – taxes should not be expensive to collect and it should not discourage business decisions.

A good tax system will be impartial to all tax payers. It is a system which conveys certainty as to what is to be paid and when the payment is due. It further provides convenience as payments should be due when tax payers will be able to make payments. It should include an element of flexibility and be easily understood with minimal administrative burdens for both tax payers and tax administrators while having no impact on the economic decisions of tax payers.

It should balance the desired amount of and economic efficiency with objectives such as fairness, simplicity and transparency.

In order to determine whether or not the system used for taxing dividend income in SA meets the requirements for a good taxing system we need to review the history of the taxing of dividends in SA and evaluate whether or not any of the taxing systems implemented in SA meets the above-mentioned set of criteria.

### **2.2.2 Taxing of dividends prior to STC**

SA has experienced constant tax reforms over the past two decades. The taxing of dividend income in SA is an issue which has received attention over the years.

The Margo Commission conducted an investigation in 1986 into the South African method used for the taxing of dividends. This investigation was performed as a result of a number of SA's leading trade partners who changed from the classical system of taxing dividends to the imputation system of taxing dividends. The Commission reviewed various

international systems for taxing dividends in order to suggest certain practical alternatives for the taxing of dividends in SA. Internationally it was considered to be ideal to have a uniform system for the taxing of dividends (Margo, 1986:194).

The desire to align the system implemented in SA for the taxing of dividends with internationally accepted tax norms already existed in 1986 and the same desire still exists today.

In the early nineties SA was accepted in to the global economy. This occurred as a result of certain political changes in SA. For the first time in years foreign countries suddenly started to consider investing in SA. However, according to the Katz Commission (1994:213,221-222) SA's high tax burden deterred foreign investors from investing capital in SA.

Government realised that certain tax reforms were required to persuade foreign investors to consider SA as a potential investment destination.

### **2.2.3 Taxing of dividends in SA under the STC regime**

In 1993 the Minister of Finance, Derek Keys, announced the implementation of a dual corporate taxation system which marked the introduction of STC in SA. According to Van Blerck (1993:50) the dual corporate system allows for a reduction in the corporate tax rate to an internationally acceptable rate while stimulating dividend retention and re-investment.

STC is a secondary tax as it is payable over and above the normal corporate tax (primary tax) imposed on companies.

Under the STC regime the liability for STC falls on the company who declares and distributes the dividend rather than on the shareholder receiving the dividend, although the tax is indirectly borne by the shareholder who will receive lower dividend income. STC has an impact on the accounting profits of the South African company, who distributes the dividend, as the tax charge must be deducted from company profits.

At the time of inception of STC, the company tax rate, 48% at the time, was regarded as being too high and as a result STC was introduced at a rate of 15% and the company tax was reduced from 48% to 40%. The STC rate was later increased from 15% to 25% with effect from 22 June 1994 and the company tax rate was further reduced from 40% to 35%.

The STC rate for dividends declared and distributed on or after 14 March 1996 was reduced to 12.5%. It remained at that rate until 1 October 2007 when it was further reduced to 10, which it remained at until the replacement of STC by dividends tax in 2012.

STC has always been a controversial subject and where it was seen as a solution to SA's problems by certain individuals, it was considered to be a burden by others. According to Honiball, (in Hazelhurst, 2006:66) STC is almost unique to SA. The only other countries which have a similar tax system to STC are India and Estonia. Honiball argued that it was an ingenious device which was introduced when SA's economy was in stasis. By introducing STC, the Government tried to encourage dividend retention and in doing so increase re-investment in SA.

According to Van Blerck (quoted by Hazelhurst, 2006:66) Government experienced a pressing need to reduce SA's corporate tax rate as SA was out of line with most developing economies. A lower tax rate on undistributed profits and a higher tax rate on distributed profits would provide relief and re-investment in SA would be rewarded.

Although STC was seen as ingenious by certain individuals, it was not considered to be a blessing in the eyes of others.

Laubscher (in Hazelhurst, 2006:66) differed from Van Blerck's view when it came to STC. His argument was that by discouraging companies from paying dividends, STC effectively undermines the efficacy of the financial system to allocate available funds optimally. Laubscher (quoted by Hazehurst, 2006:66) indicated that companies that experienced strong growth would continue to pay dividends and STC would simply encourage stagnating companies to hoard cash that could otherwise flow to growing companies.

This view is further highlighted by Davidson (1996:12) where he indicated that the Government was concerned at the low and declining levels of gross domestic fixed investment. They introduced STC with the hope that it would encourage firms to retain earnings and then invest those retained earnings which would reverse the decline in gross domestic fixed investment.

However, this was not experienced under the STC regime. Davidson (2006:17) further indicated that firms continued to pay dividends in an STC environment. The reason for this may well be that the benefits of declaring a dividend outweigh the costs incurred to pay dividends taxes. Therefore even though the view was that STC would act as a strong incentive to retain profits, companies continued to pay dividends to their shareholders.

Another benefit of STC argued by Poterba and Summers (1985) was that firms could voluntarily reduce their corporate tax rate by not declaring dividends. The more a company exploits reinvestment opportunities, the lower their corporate tax rate would be.

The view that companies who refrain from declaring and distributing dividends have a lower corporate tax rate may act as an investment motivator if the corporate income tax rate and the STC rate are considered in isolation. However STC is a tax on company profits and has a direct impact on the corporate tax rate. When foreign investors consider investment opportunities they evaluate the foreign country as a whole, and not individual companies within the country. They would therefore not consider the SA tax rates in isolation but in unison which would result in the view that under the STC regime the effective corporate tax rate is higher.

Government endeavours to implement a tax system which would give SA a competitive edge in the international community and therefore in 2005 the Katz Commission was mandated to evaluate the STC system and to consider other possibilities for the taxing of dividends in SA.

## 2.3 INTERNATIONAL ARENA

### 2.3.1 Taxing of dividends in the international arena

In order to align the taxing of dividends in SA with internationally accepted tax norms, it is also necessary to understand how dividends are taxed in the international arena.

There are various methods for the taxing of dividends. It is very important to ensure that economic double taxation is avoided when taxing dividends, by only taxing corporate profits once. If this is not accomplished it becomes unattractive to carry on a trade through a company and the country would become unattractive as a foreign investment destination.

When the Katz Commission evaluated the abolishment of STC in SA, the Commission also evaluated the efficacy of the methods for taxing dividends in a South African context (SARS, 2010:1).

The three most popular, internationally recognised, methods for the taxing of dividends declared and distributed by a company to its shareholders are discussed below (SARS, 2010:1):

- **The classical system** - when applying the classical system a company pays tax on the company profits and the shareholders of the company will pay the tax on the dividend received by them. This method's main disadvantage is that it causes economic double taxation as both the company and the shareholder pay tax on the same profits.

The application of the classical system for the taxing of dividends received will not encourage investment opportunities as it leads to economic double taxation which will be seen as a disadvantage.

- **The imputation system** – when applying the imputation system the company will pay tax on the company profits and the company will withhold an additional tax amount from any amounts declared and distributed as a dividend. The dividend is

subject to tax in the hands of the shareholder by grossing up the net dividend and a rebate is given for the underlying withholding tax and or corporate tax.

Prior to 1941 South African companies were liable for the taxes on company profits and the company shareholders were liable for the tax on any dividends received. Companies would therefore not declare dividends to their shareholders, in order to avoid super tax for their shareholders. A new system was introduced in 1941 under which company profits were apportioned to each shareholder, but this system caused certain difficulties such as cash flow difficulties for the minority shareholders whose tax liability exceeded the dividend income received. As a counter action to this problem a levy was introduced on the company, which acted as an advance payment, however this caused additional problems such as lost levy certificates and eventually in 1952 the apportionment levy was abolished.

Australia has applied the imputation system from 1987. Canada and New Zealand also apply the imputation system. Recently countries have moved away from the full imputation system due to administration and other problems experienced.

- **The corporate level system** - this system is also known as the dividend exclusion system. Under this system tax is only imposed at a corporate level. STC falls within the corporate level system.

The disadvantage of the corporate level system lies in the increased corporate tax rate as the additional tax levied on the dividend declared is considered to be a corporate tax. The higher tax rates can be an investment deterrent.

### 2.3.2 Foreign investment considerations

According to Jooste (2011:32) foreign investors consider various elements when they search the globe for attractive investment destinations. These considerations include political stability, a stable legislative framework, exchange controls and corporate tax rates. A country with low corporate tax rates and minimal to no exchange controls would be seen an attractive investment destination.



SA has relaxed some of its exchange controls but its complex and uncertain tax laws have pushed foreign investors to go elsewhere (Jooste, 2011:32).

Foreign investors are choosing countries such as Mauritius as an investment destination instead of SA. Mauritius has a simpler tax structure than SA; the country has a stable political environment and no exchange controls. Countries such as Botswana, Kenya, Dubai and the Seychelles are also becoming popular investment alternatives for foreign investors. SA's corporate tax rates are not as competitive as the corporate tax rates of these countries (Jooste, 2011:32).

A low corporate tax rate is only one of the considerations when foreign investors evaluate a country as a potential investment destination, but it still contributes towards the attractiveness of a country as a potential investment destination.

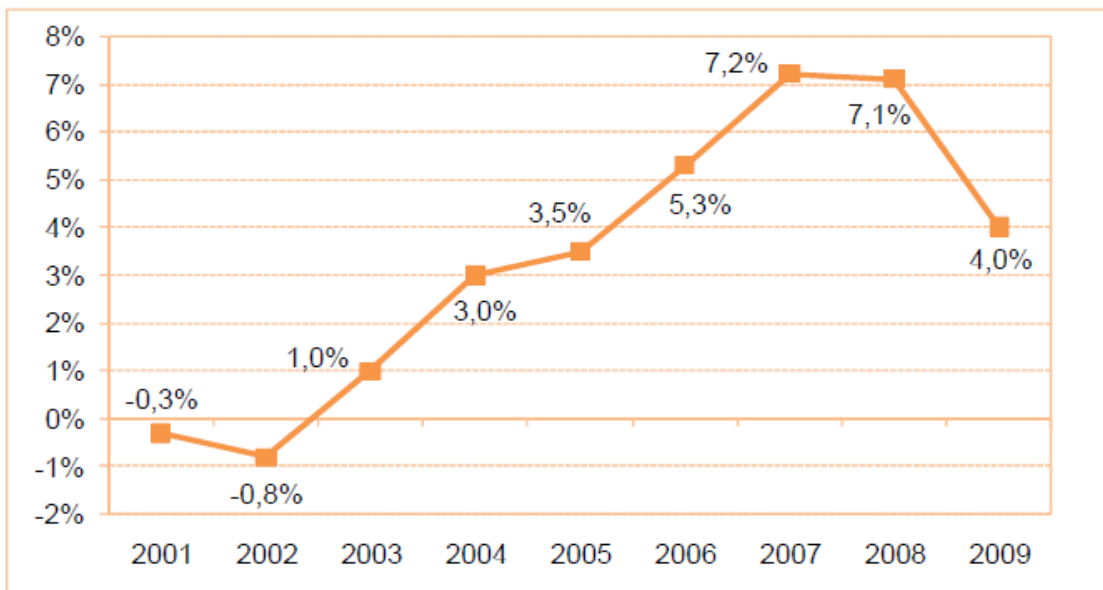
Potential foreign investors are deterred by a complex tax system and high tax rates. STC can act as such a deterrent; it is in many cases technically quite complex albeit administratively simple. STC is an ill-understood tax internationally whereas a withholding tax levied at a shareholder level is more acceptable and better understood in the international arena.

### **2.3.3 SA and foreign direct investment (FDI)**

The corporate tax rate of a country has an impact on the FDI in that country. STC was considered to be a corporate tax and contributed to higher corporate tax rates in SA.

The figure below indicates that foreign investment in SA has increased from 1% in 2002 to 7% in 2008, before declining in 2009 to 4%. The figure illustrates the impact on FDI in SA while the STC regime was still enforced.

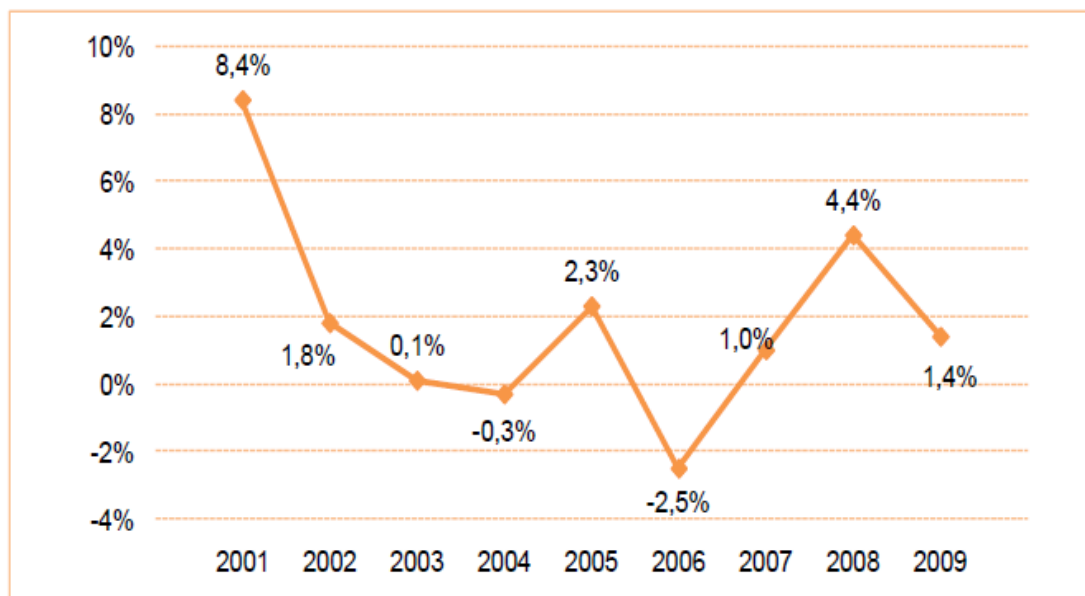
**Figure 1: Foreign direct investment as a percentage of GDP**



Source: Quarterly Bulletin, South African Reserve Bank; Gross Domestic Product, Statistics South Africa

However, if we focus on net foreign direct investment (FDI) as a percentage of GDP, as shown in the figure below it provides a completely different view and clearly illustrates the strong influence of short term investment in overall investment flows. Looking specifically at FDI, foreign investment has in fact declined substantially from 8% in 2001 to just below 2% in 2009.

**Figure 2: Net Foreign Investment as a percentage of GDP**



Source: SARB (KBP5683J, KBP6006J), DNA Economics

The World Bank Ease of Doing Business Survey (2010) provides a relatively fair review of the regulatory environment in almost all the countries in the world. The survey provides a good indicator of the ability of different countries to compete for foreign investment.

In 2010 SA was ranked 34<sup>th</sup> out of 183 economies. SA performed reasonably well in the survey but certain reforms are necessary to indicate that SA is a serious competitor where direct foreign investment is concerned.

The South African Savings Institute, (SASI) (2007), suggested that the absence of profitable investment opportunities within SA, due to high cost of capital, labour market flexibility and high corporate tax rates, deters the corporate sector from saving for future investments.

As the STC rate is part of the corporate income tax rate, it is one of the contributing factors to the increased corporate tax rate in SA and therefore one of the deterrents for increased FDI in SA.

The impact of the introduction of dividends tax in SA on the net FDI as a percentage of GDP can only be determined over the lapse of time.

SA forms part of BRICS (Brazil, Russia, China, India and South Africa) which is the acronym for an association of five major emerging national economies. The BRICS countries are all developing countries with fast-growing economies. SA is the newest member of the association and only became a member in 2010.

India is the only other member of BRICS who uses the STC system for the taxing of dividends. It is believed that by implementing dividends tax in SA, the country will be in-line with the other BRICS countries which will improve SA's chances to be viewed as a potential investment destination.

## 2.4 REPLACEMENT OF STC WITH DIVIDENDS TAX

### 2.4.1 Motives for the replacement of STC

There is a fine line between stimulating growth through the retention of profits and the loss in tax revenue that results from fewer dividends being distributed (SARS, 2007:4).

As indicated earlier a good tax system will balance the desired amount of revenue and economic efficiency with objects such as equity, simplicity and transparency.

A study conducted by Skuy (2005:42) on the desirability and efficacy of STC in SA found that the existence of STC discourages investors from investing in SA. He further found that it also discourages certain entrepreneurs from starting businesses at all. His study proves that STC is not viewed in a positive light by international investors and that it is not understood by them. STC causes the South African tax rate to be higher than the global average and it's unlikely to boost foreign direct investment in SA.

The dividend policy of a country has an impact on the share value of a company. Therefore any effect of STC on the dividend policy, which creates a high retention policy of the company, will result in a negative impact on the share value of the company (Skuy, 2005:35).

Furthermore, as the liability for STC falls upon the company declaring the dividend, rather than the shareholder receiving the dividend, any dividends declared to foreign shareholders will be subject to STC.

The taxation of dividends paid to shareholders at a distributing company-level also means that double taxation agreement (DTA) limits on dividend rates has no effect (Department of National Treasury 2008:4).

Davidson (1996:22) indicated that despite the strong incentive to retain profits in terms of STC, South African firms continued to pay dividends in the first year of operation of the

STC system. It was further concluded that as an incentive to retain earnings for investment, STC has failed.

STC is not an internationally recognised tax system and it failed in its objective to encourage investment in SA and after years of controversy National Treasury finally came to the realisation that certain tax reforms were required to achieve these objectives.

#### **2.4.2 Views on the replacement of STC by dividends tax**

In February 2007, the Minister of Finance announced that STC will be reformed (Department of National Treasury, 2008:4).

The over-arching purpose of the proposed change in the taxing of dividends is to align the system of taxing distributions by companies with international practice. This is due to the fact that the STC regime, which forms part of the South African tax system, is not common to the majority of other countries (Dachs: 2010).

As previously indicated STC was unique to SA and a couple of other countries. It was not in line with internationally accepted tax norms and it acted as a deterrent for investment rather than a motivating factor.

According to the SARS (2013:1) there are two main objectives for the introduction of dividends tax namely:

- A) To align SA with the international norm where the beneficial owner of the dividend, not the distributing company, is liable for the tax levied on the distribution;
- B) To make SA a more attractive international investment destination by eliminating the perception of a higher corporate tax rate (STC was an additional corporate tax accounted for in the Income statement of the distributing company).

By replacing STC with dividends tax Government endeavours to accomplish the same objectives which it has been trying to achieve since 1986. The objectives for the introduction of dividends tax are the same as the objectives for all dividends tax reforms since 1986. Yet, none of the SA tax reforms implemented to date have been able to

successfully achieve these objectives. The question for consideration is whether or not the introduction of dividends tax legislation will be a good tax reform and will be able to achieve these goals.

Dividends tax is a tax which is imposed on the beneficial owner of the dividend rather than on the company declaring and distributing the dividend. The beneficial owner is the shareholder who receives the benefit from the dividend.

Before its implementation dividends tax was to be introduced at a rate of 10%, however, in the 2012 budget speech it was announced that dividends tax will be introduced at a higher rate of 15%.

Mazansky (2009) stated that with the replacement of STC by dividends tax SA has fallen in line with international tax trends and this move is likely to make SA a more attractive foreign investment destination. Mazansky (2009) indicated that the implementation of dividends tax may simplify tax for foreign investors and therefore attract foreign investors, but for local companies it introduces numerous complexities.

SA can lay claim to being among the best in the world in the area of corporate tax efficiencies (Stafford, 2010:38). However, attracting foreign investors has always been a challenge for SA. One of the reasons for this is due to the fact that SA's corporate tax rate has always been considered as high when comparing SA with other countries such as Mauritius. STC was incorrectly considered as an additional corporate tax by foreigners and this contributed to the perception of a high corporate tax rate. Another contributing factor is that there was no DTA relief under the STC system.

Multinational companies stand to benefit from the introduction of dividends tax STC. There may even be sufficient incentive to cause a delay in dividend declarations until such a time as the new legislation comes into force (Brislon: 2009). The application of an appropriate DTA to reduce the dividends tax rate may be one of the incentives to cause delays in dividend declarations.

According to Brislon (2009) the introduction of dividends tax in SA can be seen as both a blessing and a curse. STC was little understood in the international community as it is not applied in many international countries. It raises question marks in foreign jurisdictions and does not always allow companies to qualify for credit in the parent company's home jurisdiction. Dividends tax, on the other hand, is aligned with international norms; it will more likely encourage the free flow of funds. SA may experience a surge in dividend distributions once the dividends tax comes into force, this will be as a result of the lower rates and the greater certainty relating to credits. Conversely, a system aligned with international norms is likely to attract capital inflows (Brislon: 2009).

### **2.4.3 Impact of dividends tax on foreign investors**

National Treasury became aware that tax reforms are necessary to align SA with countries such as Mauritius and in order to embark on the new “Gateway into Africa” initiative SA needs to be an attractive destination for foreign companies wanting to do business in SA (Stafford, 2010:38).

According to Stafford (2010:38) the move from STC to dividends tax, may result in a loss of tax revenue for SARS. Dividends paid to foreign companies with a 20 or more shareholding in a SA resident company will be affected as a reduced rate in terms of an appropriate DTA can be applied. In certain cases the rate can be reduced to as little as 5%. SARS realised that the reduced income is a tradeoff that must be accepted if SA wants to conform to international norms.

Dividends tax is a tax levied on a shareholders level, and therefore it will not increase the effective corporate tax rate. It is a withholding tax which is internationally accepted and understood. It is therefore easier for foreign investors to consider SA as a potential investment destination as they have a better understanding of the withholding tax system. In certain cases the application of DTAs can reduce the dividends tax rate. This also plays an important role into attracting foreign investors.

#### 2.4.4 Reduced dividends tax rates for foreign investors

Most DTAs between SA and other countries include an article dealing with the withholding tax on dividends. Most of these articles within the DTAs on the withholding tax on dividends provides for the reduction of the SA dividends tax rate on foreign shareholders. The provision of course depends on the country by country DTA with SA.

However, STC was not a withholding tax and therefore fell outside of the scope of the articles in the DTA. In *Volkswagen South Africa (Pty) Ltd v C: SARS 70 SATC 195*, it was held that STC was not a tax on dividends as contemplated in the DTA and therefore fell outside of the ambit of the DTA between SA and Germany (SARS, 2010:5).

The Volkswagen case illustrates that STC forms part of corporate tax which results in higher effective corporate tax rate. This factor contributes to the unpopular view of STC among foreign investors.

Although talk of the reformation of STC started in 2007 it only became effective on 20 December 2011 and implementation took place from 1 April 2012. One of the reasons for the delay in the introduction of the new dividends tax was due to the fact that SA had to enter into re-negotiation with foreign countries regarding any DTAs between SA and other countries. The article contained in each DTA dealing with dividends had to be amended to reflect that SA has changed to a dividend withholding tax regime. The percentage withholding tax rate for each country included in the DTA also had to be negotiated and all the DTAs had to be amended to reflect the new withholding rates.

The implementation of dividends tax gives SA a competitive edge in the international community. Mazansky (in Visser, 2012:2) indicated that under the STC regime the effective combined rate of corporate income tax was 34.5%, while with dividends tax it is 38.8%. However, this can be significantly reduced by routing investments through a country with which SA has an appropriate double taxation agreement in place, where the withholding tax will be limited to 5%. This reduced the effective tax rate to 31.6%.



The application of appropriate DTAs to reduce the dividends tax rate will act as an incentive for foreign investors to invest in SA.

According to Lund (2012:24) the dividends tax system offers certainty and relief for certain shareholders, including foreigners. For example if a SA company declares a dividend to a shareholder who is a tax resident in the UK, the shareholder can obtain relief in terms of the DTA between the UK and SA and the dividends tax rate can be reduced to as little as 5%.

Lai King (2008:11) felt that overall the replacement of STC by dividends tax is welcomed in SA. The reason for this is that it is better understood by the international community, it lowers the cost of equity financing and it avoids double taxation where dividends are paid to non-resident shareholders.

#### **2.4.5 Impact of dividends tax on local investors**

Dividends tax may be the answer to SA's problems to attract foreign investors but what incentive does it hold for local investors?

According to Lund (2012:24) local companies and financial institutions buying shares on clients' behalf will not only bear the brunt of a regime that guarantees mountains of more paperwork and systems to manage the dividends taxing process and directors will be held personally liable for any taxes that are not paid on time.

Dividends tax is technically quite simple in comparison with STC, but from an administrative perspective it is more complex. The administrative burden will fall upon the declaring company and in many cases the regulated intermediaries as well as the tax administrator. The comprehensive administrative requirements may increase the public and private tax collection costs, which is not an indicator of administrative efficiency.

## 2.5 CONCLUSION

National Treasury and SARS were aware that in order to accomplish the objective to make SA a more attractive investment destination for foreign investors certain tax reforms were required. SA had to align their tax system with international norms and tax incentives are needed to draw the attention of foreign investors away from investing countries such as Mauritius and to focus their attention on SA. Government believes that the tax reform to achieve this is the replacement of STC with dividends tax.

The next chapter explore the STC and dividends tax legislation and the impact of dividends tax on different classes of shareholders. It also contains a case study to determine whether or not there are any incentives embedded in the dividends tax legislation to encourage foreign and local investment in SA.

## CHAPTER 3

### A CRITICAL ANALYSIS OF TAX LEGISLATION

#### 3.1 EXPLORATION OF STC LEGISLATION

##### 3.1.1 General overview of STC legislation

Section 64B and section 64C of the Act contains the provisions for STC. Section 64B of the Act governs the levying and recovery of STC while section 64C deals with the prevention of avoidance of section 64B. This research has not examined section 64C of the Act since it is considered to be outside of the scope of this research as section 64B deals with deemed dividends.

STC is a tax imposed on dividends declared and distributed by SA companies in terms of Section 64(B) of the Act. The dividend referred to under this section of the Act is defined in section 1 of the Act as discussed under point 4.2.1 of this chapter.

In terms of the Act there are two kinds of dividend declarations:

- dividends declared and distributed by a company to its shareholders;
- cash or assets distributed to shareholders which qualify as a dividend in terms of the dividend definition contained in section 1 of the Act.

A company will be liable for STC upon the declaration or deemed declaration of a dividend to the shareholders of that company. In the case of a distribution made out of untainted share capital or out of the share premium of the company, the distribution will fall outside of the scope of the dividend definition contained in section 1 of the Act, and therefore it will not be subject to STC. Untainted share capital in simple terms means that there are no capitalised capital or revenue profits contained in the share capital and share premium of the company, the share capital and share premium consist of pure share capital or share premium.

Section 64B(5) of the Act contains certain exemptions from STC on dividends declared such as:

- dividends declared by a company that qualifies for an exemption from normal tax in terms of section 1p of the Act, for example any Government or any provincial administrations, municipalities and public benefit organisations (section 64B(5)(a) of the Act);
- any dividends declared and distributed by a fixed property company as contemplated in section 11(s) which may be allowed as a deduction under section 11(s) (section 64B(5)(b) of the Act);
- any liquidation dividend or a dividend declared as part of the winding-up, deregistration or final termination process of a company that represents a capital distribution or a distribution of profits which were derived during any year of assessment up to 31 March 1993(section 64B(5)(c) of the Act);
- any dividend declared by a company referred to in subsection (12)(e) which signifies a distribution of any amount received by way of the disposal of any gold mining assets (section 64B(5)(e) of the Act);
- any dividends declared by a controlled group company to any other companies within the same group of companies, as long as the company elects the section 64B(5)(f) exemption;
- The *in specie* transfer of a primary residence from a close corporation to the members of the close corporation or in the case of a company to the shareholders of the company in terms of par 51 of the Eighth Schedule is exempt from STC (section 64B(5)(k) of the Act);
- the declaration of a dividend by a company or close corporation which falls within the scope of a micro business (in terms of the 6th Schedule to the Act) is not subject to STC to the extent that it does not exceed R 200 000 during the micro business's year of assessment.

Section 64B(7) of the Act deals with the date of payment of STC. The payment of the STC must be made by the company that declared the dividend. Payment must be made before

the last day of the month following the month in which the dividend declared accrues to the shareholders.

### 3.1.2 Definition of a dividend in terms of STC legislation

Section 1 of the Act comprehensively defines the term 'dividend' as follows:

A dividend refers to any amount distributed by a company (other than section 10(1)(d) institutions) to its shareholders. This definition of a dividend applies to dividend declarations within a specific dividend cycle. It applies to dividends declared after 1 January 2009 but before 1 April 2012. Companies can either make distributions *in specie* or cash distributions to their shareholders.

Certain distributions are specifically included in the definition while others are specifically excluded from the definition.

Distributions specifically included in the definition of a dividend are:

- dividends declared out of profits while awaiting the winding up, deregistration or liquidation of a company (Par (a) of old dividend definition in section 1 of the Act);
- any distributions made by a company that is not in the process of being liquidated, being wound up or deregistered, specifically including any distributions of capitalisation shares, bonus debentures and securities (Par (b) of the old dividend definition in section 1 of the Act);
- any reduction in profits where one company holds shares in a company that is its shareholder and the company cancels the shares held by the company (Par (cB) of the old dividend definition in section 1 of the Act);

Distributions specifically excluded from the definition of a dividend are:

- the nominal value of any capitalisation shares where the shares were paid up by using the share premium account (Par (e) of the old dividend definition in section 1 of the Act);
- distributions which lead to a reduction in the share capital or the share premium of the company (Par (f) of the old dividend definition in section 1 of the Act);

- any distributions by a company to its shareholders where the distributing company and the shareholder form part of the same group of companies (where one company directly or indirectly holds 70% of the shares in the other company) as defined in terms of section 41 of the Act (Par (g) of the old dividend definition in section 1 of the Act);
- the nominal value of capitalisation shares that form part of the equity share capital of the company (Par (h) of the old dividend definition in section 1 of the Act);
- any amounts distributed by a co-operative by way of a bonus to the extent that such an amount is deductible from the income of such co-operative under the provisions of s27 (Par (i) of the old dividend definition in section 1 of the Act);
- any amount distributed by way of the redemption of a participatory interest in a portfolio of a collective investment scheme in securities (Par (j) of the old dividend definition in section 1 of the Act);

In terms of the STC legislation, a dividend has to be declared, or deemed to be declared for a STC liability to arise. Therefore a company becomes liable for STC upon the declaration of a dividend to the company shareholders. The STC liability is calculated on the net dividend and arises on the dividend declaration date rather than on the dividend payment date. It is therefore crucial to determine when a dividend is considered to be declared.

Section 64B(1) of the Act defines the term declared as follows:

‘declared’, in relation to any dividend (including dividends *in specie*), encompass the approval of the distribution of a dividend by the directors of the company to the shareholders of the company.

In simple terms a dividend is considered to be declared when the directors of the company or persons with the same authority approve the decision to distribute a dividend to the company shareholders. This will be noted in the minutes of the directors or annual general meeting.

A dividend cycle, in terms of section 64B(1)(a) is, the period commencing on the later of:

- 1 September 1993;

- the day following the dividend declaration date of the last dividend cycle prior to 17 March 1993;
- the date of incorporation or establishment of the company;
- the date upon which the company becomes a SA resident;

and ending on the date on which the first dividend accrues to the shareholder or the date on which the amount is deemed to have been distributed as contemplated in section 64C(2). In relation to any subsequent dividends declared the period commences immediately after the previous dividend cycle and ending on the date on which such dividend accrues to a shareholder or on which the amount is deemed to have been distributed in terms of section 64C(2).

In short a dividend cycle is a period within which the net dividend declared is determined by subtracting dividends received from the dividends declared. The dividend cycle starts the day after the end of the previous cycle, which is the day after the declaration of the previous dividend and ends on the date upon which the new dividend is declared to the shareholders of the company.

When calculating the net amount of a dividend declared in order to calculate the STC liability, dividends, which have accrued to the company in the dividend cycle, are subtracted from the dividends received by the company (for example if a company declares a dividend of R 100 and received a dividend of R 40, the net dividend will amount to R 60). It is therefore important to identify the starting date and completion date of any particular dividend cycle as this is crucial to determine the net dividend which is used to calculate the STC liability.

## **3.2 EXPLORATION OF DIVIDENDS TAX LEGISLATION**

### **3.2.1 Introduction to dividends tax legislation**

The dividends tax provisions are contained in section 64D to section 64N of the Act.

The new Dividends Tax sections in the Act can be summarized as follows:

- Section 64D – Dividends Tax Definitions
- Section 64E – Levy of Dividends Tax
- Section 64F – Exemptions
- Section 64G – Withholding tax
- Section 64H – Shares held by regulated intermediaries
- Section 64I – Insurers
- Section 64J – Secondary Tax on Companies Credits
- Section 64K – Payment and recovery of tax
- Sections 64L and 64M – Refund of Dividends Tax
- Section 64N – Rebate in respect of foreign taxes on dividends

These sections will now be explored in detail below but first it is important to consider the definition of a dividend as the definition under dividends tax differs considerably from the definition under the STC legislation. The two definitions are discussed in detail under point 4.2 of this chapter.

In summary a dividend under the new dividends tax legislation refers to any amount transferred or applied by a SA resident company for the benefit of the company shareholders. It does not include any amount so transferred out of the contributed tax capital (CTC) of the company or constitutes shares in the company or a constitutes an acquisition of the company's own shares by way of a general repurchase of securities.

### **3.2.2 Definition of a dividend under the new dividends tax legislation**

Section 1 of the Act defines a dividend declared on or after 1 April 2012 under the new dividends tax legislation as any amounts transferred by a SA resident company for the benefit or on behalf of any person in respect of any shares in that company. The amount can be transferred or applied by way of a distribution or as consideration for the acquisition of any share in that company. It excludes any amounts transferred or applied out of the contributed tax capital (CTC) of the company or any amount which constitutes shares in



the company or constitute an acquisition by the company of its own shares by way of a general repurchase of securities.

This definition of a dividend specifically excludes:

- amounts transferred which result in a reduction in the company's contributed tax capital (Par (i) of the dividend definition in section 1 of the Act);
- any amounts transferred or applied which constitute as shares in the company and will not be a dividend (Par (ii) of the dividend definition in section 1 of the Act);
- any amounts transferred or applied which constitute the acquisition of its own shares by a listed company, the amount is not a dividend (Par (iii) of the dividend definition in section 1 of the Act);

Under the new dividends tax rules the dividends which accrued to a company are no longer deducted from the dividends declared to determine the tax payable.

In short, a dividend is the return on an investment. It is the portion of corporate profits paid out to shareholders and it is allocated as a fixed amount per share.

### 3.2.3 New definitions included in the legislation (Section 64D)

The following terms are defined as follow in section 64D of the Act:

**'beneficial owner'** refers to the person who is entitled to the ultimate benefit of the dividend attaching to a share;

**'dividend'** means any dividend as defined in section 1 that is paid by a SA resident company or paid by a company that is not a resident if the share in respect of which that foreign dividend is paid is a listed share, and to the extent that the foreign dividend does not consist of a distribution of an asset *in specie*;

**'dividend cycle'** refers to a dividend cycle as defined in section 64B;

**'effective date'** means the date on which this legislation becomes operational;

**'regulated intermediary'** refers to any: —

(a) central securities depository participant in terms of section 34 of the Securities Services Act, 2004 (Act No. 36 of 2004);

- (b) any authorised user as defined in section 1 of the Securities Services Act, 2004;
- (c) any approved nominee as contemplated in section 36(2) of the Securities Services Act, 2004;
- (d) nominees who holds investments on behalf of clients as contemplated in section 9.1 of Chapter 1 and section 8 of Chapter Two of the Codes of Conduct for Administrative and Discretionary Financial Service Providers, 2003 (Board Notice 79 of 2003) published in *Government Gazette* No. 25299 of 8 August 2003;
- (e) portfolio of a collective investment scheme in securities; or
- (f) a transfer secretary, other than a natural person, who has been approved by the Commissioner.

**'STC credit'** means an amount determined in terms of section 64J(2).

An understanding of the definition of a dividend as well as the terms defined in section 64(D) is crucial as they play an important role in the understanding of the dividends tax legislation.

### **3.2.4 Levy of dividends tax (Section 64E and section 64EA)**

Section 64E of the Act is the provision which deals with the levy of dividends tax and it also addresses the payment date of the dividend. Section 64E of the Act states the following:

- (1) Subject to par 3 of the Tenth Schedules there must be levied for the benefit of the National Revenue Fund a dividends tax, calculated at the current rate of 15% of the amount of any dividend declared and paid by a company to its shareholders.
- (2) For the purposes of this Part, a dividend, excluding dividends *in specie*, is considered to be paid on the earlier date of the payment of the dividend or the date upon which it becomes payable.
- (3) Any distributions of an asset *in specie*, the amount of that dividend, for the purposes of subsection is deemed to be, in the case of a listed financial instrument, the price quoted on the exchange on the business day before the declaration date or in the case of an asset other than contemplated in par (a), it will be equal to the market value of the asset on the declaration date.

As indicated in section 64E(1) dividends tax is levied at 15% of any dividend declared and paid by a SA company. Dividends tax differs from STC in various ways. One of these differences as indicated in section 64E(2) is the fact that dividends tax is triggered on payment date and the dividend is considered to accrue to the beneficial owner upon the date of payment, whereas STC was triggered upon the dividend declaration date and upon this date the dividend was considered as accrued to the shareholder.

The dividend date is very important as this determines when dividends tax has to be deducted and paid over to SARS.

Section 64EA of the Act provides the provisions to determine who is liable for dividends tax. In terms of this section and subject to section 64J any beneficial owner of a dividend, excluding assets *in specie*, or company that is a resident that declares and pays dividends to the extent that it constitutes an asset *in specie* will be liable for dividends tax in respect of that dividend.

Another variance from STC is the fact that dividends tax is levied on the beneficial owner of the dividend rather than the company declaring the dividend.

### **3.2.5 Dividends tax exemptions (Section 64F)**

A section 64F exemption will apply if the beneficial owner of the dividend is one of the following:

- SA resident company;
- the Government;
- public benefit organisations;
- environmental rehabilitation trusts in terms of section 37A;
- pension funds, provident funds or similar funds;
- medical schemes;
- micro-business shareholders.

The biggest variance from STC which can be determined from section 64F is that all dividends declared between SA resident companies are exempt from dividends tax. Under STC legislation only intragroup dividends were exempt.

### **3.2.6 Withholding of dividends tax by companies (Section 64G)**

Section 64G of the Act deals with the responsibility of companies declaring and distributing dividends to withhold dividends tax. Section 64G states the following:

(1) Subject to subsections (2) and (3), a company who declares and pays a dividend to its shareholders must withhold an amount of dividends tax as contemplated in section 64E, which is currently at a rate of 15%.

(2) A company must not withhold any dividends tax from the payment of a dividend contemplated in subsection if:

(a) the beneficial owner has by a date determined by the company; or if the company did not determine such a date, by the dividend payment date, submitted a declaration by the beneficial owner that the dividend is exempt from the dividends tax in terms of section 64F; and submitted a written undertaking in such form as may be prescribed by the Commissioner to forthwith inform the company in writing should the circumstances regarding the exemption change or should the beneficial owner cease to be the beneficial owner;

(b) the beneficial owner and the company paying the dividend forms part of the same group of companies, in terms of section 41; or

(c) the dividend payment is made to a regulated intermediary.

(3) A company must withhold dividends tax from the dividend payment contemplated in subsection (1) at a reduced rate if the person to whom the payment is made has:

(a) by a date determined by the company; or

(b) if the company did not determine such a date, by the dividend payment date, submitted to the company:

(i) a declaration by the beneficial owner that the dividend is subject to a reduced rate as a result of the application of an appropriate DTA; and

(ii) a written undertaking to forthwith inform the company in writing should the beneficial owner cease to be the beneficial owner.

It is the primary obligation of the company declaring the dividend to withhold dividends tax (section 64G(1) of the Act). In the case where a dividend is declared to a regulated intermediary the obligation to withhold dividends tax shifts from the company to the regulated intermediary.

A question for consideration is the withholding rate. As indicated above the company has to withhold dividends tax at 15%, however, where dividends are declared to shareholders who are foreigners we need to consider the application of a DTA between SA and the resident country of the foreign shareholder to determine whether or not a reduced rate may apply. This is a significant variance from STC. The dividends tax legislation itself does not cater for reduced rates, but it opens up a window to the application of DTA's which results in lower dividends tax rates. This can contribute towards making SA a better investment destination.

### **3.2.7 Withholding of dividends tax by regulated intermediaries (Section 64H)**

A regulated intermediary is defined in section 64D of the Act. In short this is considered to be an intermediary. It is a person who pays a dividend that was declared by another person after the dividend was declared and paid by the company. For instance, where an investment agent makes investments on behalf of an individual, the investment agent will be a regulated intermediary.

Section 64H of the Act deals with the responsibility of regulated intermediaries to withhold dividends tax. Section 64H states the following:

- (1) Subject to subsections (2) and (3), a regulated intermediary that pays a dividend that was declared by any other person must withhold dividends tax from that payment at a rate as contemplated in section 64E, currently at 15%.
- (2) A regulated intermediary must not withhold any dividends tax from the payment of a dividend contemplated in subsection (1) if:
  - (a) the beneficial owner has;
    - (i) by a date determined by the regulated intermediary; or
    - (ii) if the regulated intermediary did not determine such a date, by the dividend payment date, submitted to the regulated intermediary:

- (aa) a declaration by the beneficial owner that the dividend is exempt from the dividends tax in terms of section 64F; and
  - (bb) a written undertaking to forthwith inform the regulated intermediary in writing should the beneficial owner cease to be the beneficial owner; or
  - (b) the payment is made to another regulated intermediary.
- (3) A regulated intermediary must withhold dividends tax from the payment of a dividend contemplated in subsection (1) at a reduced rate if the beneficial owner has:
- (a) by a date determined by the regulated intermediary; or
  - (b) if the regulated intermediary did not determine such a date, by the dividend payment date, submitted to the regulated intermediary:
    - (i) a declaration by the beneficial owner that the dividend is subject to a reduced rate as a result of the application of an appropriate DTA; and
    - (ii) a written undertaking to forthwith inform the regulated intermediary in writing should the beneficial owner cease to be the beneficial owner.

In the case where a dividend is paid to a regulated intermediary, the obligation to withhold dividends tax shifts from the company paying the dividend to the regulated intermediary.

### **3.2.8 Payment and recovery of tax (Section 64K)**

Section 64K of the Act provides for the provisions which deal with the payment and recovery of dividends tax. The section states:

- (1) The beneficial owner is liable for the dividends tax. The dividends tax payment is due before the last day of the month following the month during which the dividend was paid to the shareholders, unless the tax has been paid by any other person.
- (4) Where the dividends tax was withheld at a reduced rate in terms of section 64G(3) or 64H(3), the person must submit a declaration to the Commissioner on behalf of the beneficial owner indicating why a reduced rate was applied.

The beneficial owner, in other words the shareholder is liable for the payment of dividends tax. The beneficial owner will only be relieved of this liability if another party, for instance the company declaring and distributing the dividend, pays the liability on behalf of the beneficial owner.

### 3.3 MAIN DIFFERENCE BETWEEN STC AND DIVIDENDS TAX

In simple terms, dividends tax is a tax imposed on shareholders at a rate of 15% on the receipt of a dividend, whereas STC is a tax imposed on companies (at a rate of 10%) on the declaration of dividends. The Dividends Tax is a withholding tax as it should be withheld and paid to SARS by the company paying the dividend or by a regulated intermediary (i.e. a withholding agent interposed between the company paying the dividend and the beneficial owner), and not the person liable for the tax (i.e. the beneficial owner of the dividend) (SARS 2012:1).

Dividends tax legislation is simplistic compared to STC legislation.

The table below highlights the differences between STC and dividends tax:

**Table 2: Main differences between STC and Dividends tax**

	<b>SECONDARY TAX ON COMPANIES(STC)</b>	<b>DIVIDENDS TAX</b>
Underlying theory	Movement of an amount representing a profit/reserve to a shareholder outside company / group should attract tax	Payments/distributions (less CTC) made to the beneficial owners should attract dividends tax  (Deemed dividends are the exception)
Trigger	<ul style="list-style-type: none"> <li>• Upon the declaration of a dividend; or</li> <li>• Upon the deemed declaration of a dividend</li> </ul>	<ul style="list-style-type: none"> <li>• Listed shares: upon the actual payment of the dividend;</li> <li>• Unlisted shares: upon the actual payment date or the date when the dividend becomes due and payable (whichever is first);</li> <li>• Dividends <i>in specie</i>: upon the actual payment date or the date when the dividend becomes due and payable (whichever is first);</li> <li>• Debt owing to company during year (low / no interest): last day of the year of assessment.</li> </ul>
Liability for tax	<ul style="list-style-type: none"> <li>• The declaring company is liable for the STC</li> </ul>	<ul style="list-style-type: none"> <li>• Beneficial owner: Normal/cash</li> <li>• Company: In specie dividends (including deemed debt dividends)</li> </ul>
Counter parties	Company vs. Shareholder	Company vs. Beneficial owner
Withholding/ Payment to SARS	The declaring company will pay the STC over to SARS.	<ul style="list-style-type: none"> <li>• The company will act a withholding agent, or</li> <li>• The regulated intermediary will act as withholding agent.</li> </ul>

Source: SARS 2012

### 3.4 CONCLUSION

From the exploration of the STC legislation it is clear that STC is quite complex and therefore it prohibited foreign investors from investing in SA. They found it difficult to understand the STC system. It is a tax imposed on companies and therefore increases the effective tax rate. Higher tax rates act as a deterrent when foreign investors consider investment opportunities.

Another negative element of STC is that there is no DTA relief under the STC system as it is not seen as a withholding tax and therefore will not qualify for the relief in terms of DTA's.

On the other hand, dividends tax legislation is quite simple and therefore better understood by foreign investors. It is also in line with international tax norms.

However, the administrative burden under dividends tax legislation is quite cumbersome.

Dividends tax is not considered to be a corporate tax as it is a tax levied on the beneficial owner (shareholder) of the dividend rather than on the company declaring the dividend. As dividends tax is not considered to be a corporate tax it will not increase the effective tax rate which will reflect SA in a better light with foreign investors.



## **CHAPTER 4**

### **CASE STUDY**

#### **4.1 INTRODUCTION**

We need to understand the impact of dividends tax on all forms of investors in SA and to determine whether or not the dividends tax legislation contains any tax incentives or benefits for these investors. In order to do this we need to compare the impact of dividends tax for different classes of shareholders with the effect of STC.

#### **4.2 SHAREHOLDERS INCLUDED IN THE CASE STUDY**

As indicated in Chapter Three both STC legislation and dividends tax legislation provides for certain exemptions from paying tax on dividends.

For the purpose of this study the following shareholders will be included case study:

- A South African Company (resident company) – Resident (Pty) Ltd
- A Foreign Company (Non- resident company) where no DTA applies - UK Plc
- A Foreign Company (Non- resident company) where a DTA applies – Kenya LLC
- A South African Natural Person (Resident) – Mr Van der Merwe

#### **4.3 FACTS:**

ZA (Pty) Ltd, a South African resident company declares a dividend of R 1,000,000 from their after tax profits to its four shareholders. Each shareholder holds a 25% shareholding in ZA (Pty) Ltd. ZA (Pty) Ltd has not received any dividends during the year. The net dividend declared and distributed/ paid will amount to R 1,000,000.

## 4.4 RESULTS:

The STC liability falls upon the declaring company. The dividend declared and distributed will be subject to STC at a rate of 10%, the STC rate prior to the introduction of dividends tax.

As mentioned earlier dividends tax is imposed on the shareholder rather than on the declaring company. The dividends tax rate used is 15%.

The result for each shareholder included in the study is set out below:

### 4.4.1 Resident (Pty) Ltd

- **The impact of STC on Resident (Pty) Ltd**

Resident (Pty) Ltd is a company incorporated in SA. The company owns a 25% shareholding in ZA (Pty) Ltd.

Section 64B(5)(f) of the Act provides for an exemption on dividends declared by a controlled group company to other companies in the group who elects not to pay STC. However, to qualify for this exemption group structure needs to exist. In terms of section 1 of the Act group structure exist when a shareholding of 70% or more is held by the holding company. The group exemption in terms of section 64(B)(5)(F) of the Act will not apply as the shareholding is lower than the prescribed 70% for group company structure.

ZA (Pty) Ltd will be liable for a STC liability of R 65,455. Resident (Pty) Ltd will receive a dividend of R 163,636.

The table below sets out the STC effect on the dividend declared to Resident (Pty) Ltd:

**Table 3: Effect of STC on a SA resident company**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Less: STC at 10% (R 720,000 x 10/110)	(R65,455)
Dividend distributed to all shareholders	R654,545
Shareholding of 25%	X 25%
Dividend distributed to Resident (Pty) Ltd	R163,636

- **The impact of dividends tax on Resident (Pty) Ltd**

Section 64F of the dividends tax legislation provides for an exemption of all dividends declared and distributed to SA resident companies, therefore the dividend declared to Resident (Pty) Ltd will not be subject to dividends tax as both the declaring company and the receiving company are South African resident companies.

Therefore Resident (Pty) Ltd will receive a dividend of R 180,000.

The table below sets out the effect of dividends tax on Resident (Pty) Ltd:

**Table 4: Effect of dividends tax on a SA resident company shareholder**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Shareholding of 25%	X 25%
Dividend distributed to Resident (Pty) Ltd	R 180,000
Less: Dividends tax at 0% (S64F exemption: SA companies)	R 0
Dividend received by Resident (Pty) Ltd	R 180,000

When comparing the impact of STC versus dividends tax on a South African company, it is evident that dividends tax is more beneficial than STC. This is due to the new exemption provisions under dividends tax which provides for relief from tax for all dividends declared between South African resident companies.

#### 4.4.2 UK Plc

- **The impact of STC on UK Plc**

UK Plc is a foreign company incorporated in the United Kingdom (UK). UK Plc has a 25% shareholding in ZA (Pty) Ltd.

The table below sets out the STC effect on the dividend declared to UK Plc:

**Table 5: Effect of STC on a foreign shareholder where a valid DTA applies**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Less: STC at 10% (R 720,000 x 10/110)	(R65,455)
Dividend distributed to all shareholders	R654,545
Shareholding of 25%	X 25%
Dividend distributed to UK Plc	R163,636

- **The impact of dividends tax on UK Plc**

SA has an appropriate DTA with the UK in place which reduces the dividends tax rate to 5%. A minimum holding of 10% of capital by a beneficial owner, which is a company, will apply.

UK Plc holds 25% of the capital in ZA (Pty) Ltd and therefore qualifies for the reduced rate in terms of the DTA. Therefore UK Plc will receive a dividend of R 171,000

The table below sets out the impact of dividends tax on UK Plc:

**Table 6: Effect of dividends tax on a foreign shareholder where a valid DTA applies**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Shareholding of 25%	X 25%
Dividend distributed to UK Plc	R180,000
Less: Dividends tax in terms of DTA at 5% (R 180,000 x 5%)	(R 9,000)
Dividend received by UK Plc	R 171,000

When comparing the effect of STC versus dividends tax on a foreign shareholder company where a valid DTA applies between SA and the foreign country, it is evident that dividends tax is more beneficial than STC as the dividends tax rate can be reduced in terms of the DTA which will result in a 5% higher dividend will be received by UK Plc.

One can also add, as seen in the example above, that if UK Plc's share investment was less than 25% ZA (Pty) Ltd, it could not qualify for the relief under the SA and UK DTA. Therefore, one can affirm the SA Government's argument that the objective of the introduction of the new dividends tax is to increase foreign investment in SA.

#### 4.4.3 Kenya LLC

- **The impact of STC on Kenya LLC**

Kenya LLC is a foreign company incorporated in Kenya. Kenya LLC has a 25% shareholding in ZA (Pty) Ltd.

The table below sets out the STC effect on the dividend declared to Kenya LLC:

**Table 7: Effect of STC on a foreign shareholder where no DTA applies**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Less: STC at 10% (R 720,000 x 10/110)	(R65,455)
Dividend distributed to all shareholders	R654,545
Shareholding of 25%	X 25%
Dividend distributed to Kenya LLC	R163,636

- **The impact of dividends tax on Kenya LLC**

Kenya does not currently have an appropriate DTA with SA in place. The dividend declared to Kenya LLC will be subject to dividends tax at a rate of 15%.

The table below sets out the effect of dividends tax on Kenya LLC:

**Table 8: Effect of dividends tax on a foreign shareholder where no DTA applies**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Shareholding of 25%	X 25%
Dividend distributed to Kenya LLC	R180,000
Less: Dividends tax at 15% (R 180,000 x 15%)	(R 27,000)
Dividend received by Kenya LLC	R 153,000

For a foreign shareholder where no DTA applies the effect of STC is more beneficial than dividends. SA has DTA agreements with most other countries and where no valid DTA exists it is likely that SA is negotiating the implementation of a DTA with such countries.

#### 4.4.4 Mr Van der Merwe

- **The impact of STC on Mr Van der Merwe**

Mr Van der Merwe is a natural person who is a resident in SA. He has a 25% shareholding in ZA (Pty) Ltd. ZA (Pty) Ltd will be liable for a STC liability of R 65,455 and Mr Van der Merwe will receive a dividend of R 163,636.

The table below sets out the STC effect on the dividend declared to Mr Van der Merwe:

**Table 9: Effect of STC on a natural person shareholder**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Less: STC at 10% (R 720,000 x 10/110)	(R65,455)
Dividend distributed to all shareholders	R654,545
Shareholding of 25%	X 25%
Dividend distributed to Mr van der Merwe	R163,636

- **Impact of dividends tax on Mr Van der Merwe**

In terms of the new dividends tax legislation which is a tax on the beneficial owner of the dividend, Mr Van der Merwe will be liable for dividends tax at 15% of the dividend declared by ZA (Pty) Ltd.

Mr Van der Merwe will receive a dividend of R 153,000. The implementation of dividends tax legislation results in a 6% lower return on investment for Mr Van der Merwe.

The table below sets out the effect of dividends tax on Mr Van der Merwe:

**Table 10: Effect of dividends tax on a natural person shareholder**

Description	Amount
Revenue profits	R 1,000,000
Less: Tax at 28% (R 1,000,000 x 28%)	(R 280,000)
After tax profits available for distribution	R 720,000
Shareholding of 25%	X 25%
Dividend distributed to Mr Van der Merwe	R180,000
Less: Dividends tax at 15% (R 180,000 x 15%)	(R 27,000)
Dividend received by Mr Van der Merwe	R 153,000

Local investors will bear the brunt of higher taxes in terms of the new dividends tax legislation. They do not qualify for any exemptions or reduced rates and will be subject to the tax at 15%.

#### 4.5 CONCLUSION

The impact of the case study can be summarised in the table below:

**Table 11: Summary of the impact of STC and dividends tax at the current tax rates**

Shareholder	Dividend received after taking STC into account	Dividend received after taking dividends tax into account	Difference in dividend received under dividends tax
Resident (Pty) Ltd	R 163,636	R 180,000	R 16,364
UK Plc	R 163,636	R 171,000	R 7,364
Kenya LLC	R 163,636	R 153,000	(R 10,636)
Mr Van der Merwe	R 163,636	R 153,000	(R 10,636)

The case study shows that there are incentives for both local and foreign investors embedded in the dividends tax legislation. SA companies will qualify for an exemption and foreign companies from a country where there is a valid DTA with SA will also benefit from the legislation as the DTA will reduce the dividends tax rate.



The case study indicates that a natural person SA resident shareholder and a foreign shareholder from countries where there is no DTA between the foreign country and SA will be worse off due to the implementation of dividends tax.

However one of the reasons for the difference in the dividend paid as indicated in this case study is due to the difference in the rate applied. The table below sets out the effect if we compare the impact on the shareholders where a STC rate of 10 % is compared to a dividends tax rate levied at 10%.

**Table 12: Summary of the case study**

<b>Shareholder</b>	<b>Dividend received after taking STC into account</b>	<b>Dividend received after taking dividends tax into account</b>	<b>Difference in dividend received under dividends tax</b>
Resident (Pty) Ltd	R 163,636	R 180,000	R 16,636
UK Plc	R 163,636	R 171,000	R 7,364
Kenya LLC	R 163,636	R 162,000	(R 1,636)
Mr Van der Merwe	R 163,636	R 162,000	(R 1,636)

It is evident from this comparison that the perceived negative impact on local investors and foreign investors where no DTA applies is much smaller than initially indicated.

When comparing the impact of STC versus dividends tax at a rate of 10% it showed that a foreign shareholder would benefit the most from the application of dividends tax. This is due to the application of appropriate DTA's, which will result in a reduced rate for the foreign shareholder.

The impact of a natural person shareholder, which is said to bear the brunt of dividends tax, showed a 1% reduction in the dividend paid when applying a 10% STC rate versus a 10% dividends tax rate and a 6% reduction when applying a 15% dividends tax rate.

## **CHAPTER 5**

### **CONCLUSION**

#### **5.1 INTRODUCTION**

The overall objective of this study was to explore the new dividends tax legislation in order to determine the impact of the new dividends tax legislation on foreign and local investors. Furthermore, the objective was to determine whether or not there are any tax incentives or tax benefits embedded in the legislation which will encourage investment in SA. Firstly, Chapter Two included the review of literature of previous studies done on this topic. Chapter Three covered the exploration of STC and dividends tax legislation. Chapter Four provided a comparison between the effect of STC and dividends tax on different classes of shareholders in the form of a case study. Chapter Five discusses the results from the case study.

This chapter summarises the findings based on the literature review as well as the results from the case study. It also includes a conclusion regarding the three research objectives set out in Chapter One, the possible areas for improvement to legislation and potential areas for future research are discussed.

#### **5.2 CONCLUSION REGARDING RESEARCH OBJECTIVES**

Since 1986 SA has experienced a number of tax reform processes, especially where the taxing of dividends is concerned. The main objective for these tax reforms has remained constant over the past two decades, namely to align SA with the international norm for the taxing of dividends and to make SA a more attractive international investment destination.

For years foreign investors have perceived SA to have high corporate tax rates. This was due to the inclusion of the STC rate as a corporate tax rate. The replacement of STC with dividends tax converted this view. Dividends tax is not a corporate tax and therefore

investors will not include the dividends tax rate when evaluating the corporate tax rate of a potential investment country.

Dividends tax is a withholding tax and this system of taxing dividends is internationally recognised.

The exploration of both STC and dividends tax legislation in Chapter Three indicates that dividends tax legislation is not as complex as STC and therefore easily understood by both local and foreign investors.

### **5.3 AREAS FOR POSSIBLE FUTURE RESEARCH**

Future empirical research is crucial to further assess the impact of dividends tax on investment in SA. These studies can assess whether or not the introduction of dividends tax in SA has achieved the objective for its introduction by creating a boost in foreign direct investment and leading to economic growth in SA.

### **5.4 CONCLUSION**

The literature review has indicated that foreign investors will benefit from the implementation of dividends tax in SA. The benefits for foreign investors are not necessarily embedded in the dividends tax legislation, but there are still benefits and incentives that can be enjoyed from applying this type of system for the taxing of dividends declared and distributed. The benefits for foreign investors include a better understanding of the taxing system as it is internationally recognised. Another benefit is the elimination of double taxation. Yet another incentive for foreign investors is the lower corporate SA tax rate as dividends tax is not seen as a corporate tax but rather as a tax levied on a shareholder level.

Dividends tax was implemented to align SA with international tax norms and to encourage investment in SA. Dividends tax legislation is simpler than STC legislation and therefore easier to understand. It is also internationally recognised and allows for the application of DTA's and as a result it acts as an incentive for foreign investors to invest in SA.

The case study has revealed that financial impact on local shareholders is minimal when the STC and dividends tax rates are aligned at 10%. The administrative burden may be more comprehensive, but this will be a burden for both local and foreign investors. The administrative aspects of dividends tax has not been addressed in this study.

The introduction and implementation of dividends tax in SA can assist SA to attract foreign investors as there are incentives and or tax benefits which may apply to certain foreign investors, i.e. DTA's. However, this does not apply to all foreign investors. The case study has indicated that local investors may suffer a small financial loss as a result of the implementation of dividends tax, however if we consider how small the impact is it should not deter local investors from investing in SA.

This study has revealed that dividends tax is not particularly partial towards one type of shareholder or investor but rather that dividends tax strives to increase investment opportunities in order to stimulate growth in SA.

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