

# DISSERTATION

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**Taxing of dividends – a transition from  
Secondary Tax on Companies (STC) to Dividends Tax**

**Submitted in fulfilment of the requirements for the degree of LLM  
Prepared under the supervision of Adv C Louw  
of the University of Pretoria**

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# DECLARATION

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I, Tebogo Tsoai, hereby declare that this dissertation is my own, unaided work. It is being submitted in partial fulfilment of the prerequisites for the degree of Master's in Tax Law at the University of Pretoria. It has not been submitted before for any degree or examination at any other University.

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## CHAPTER 1. INTRODUCTION

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### 1.1. Various ways of taxing dividends

Tax authorities in many parts of the world use various ways of taxing dividends. However, for the purposes of this research, the focus will be on the three main systems. These are:

#### 1.1.1 *The classical system*

Under this system, tax authorities receive a double dose of tax in that shareholders are taxed on dividends received whilst companies pay tax on their profits. The disadvantage of this system is double taxation. One school of thought is in favour of this system because of the advantages and disadvantages of a corporate personality. Its advantages include limited liability whilst its disadvantages include double taxation. This school of thought argues that this system makes the formation of vertical groups a challenge. Other challenges which came with the vertical groups were corporate governance and corporate tax avoidance<sup>1</sup>.

In some countries the classical system is modified. It is then referred to as the 'reduced rate' system. The United States of America is a typical example of this modified system. The application of this system has inter-corporate dividend concessions and a lower tax rate on dividends for shareholders<sup>2</sup>.

The Double Taxation Agreement (DTA) between South Africa and Australia which is based on the Organisation for Economic Co-operation and Development (OECD) model contains concepts and principles which are commonly found in agreements based on the OECD model. The preamble to this agreement states that it is entered

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<sup>1</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), page 1.

<sup>2</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), page 1.

into, *inter alia*, for avoidance of double taxation. Section 23B of the Income Tax Act No. 58 of 1962 provides that no amount or part of an amount may be allowed or taken into account more than once as a deduction, an allowance or otherwise a determination of a person's taxable income. South African case law supports the proposition of taxing the receipt once as either a capital receipt or a revenue receipt. In the case of *Pyott Ltd v CIR (1945 AD)* Davis AJA refused to accept the principle of an amount that was neither 'non-capital' nor 'non-income'. He described it as a 'half-way house' of which he had no knowledge of. The same argument can go that a receipt cannot be both income and capital. Pure classical system will never survive in the South African tax system.

### **1.1.2 The imputation system**

The imputation system entails a company paying tax on its profits and when the dividends are distributed to its shareholders the company has another responsibility of withholding tax on the dividends distributed to shareholders. This means that the shareholder does not receive the full amount of the dividend distributed by the company but the shareholder receives the dividend less the tax withheld by the company. The shareholder will then qualify for the rebate on the tax withheld by the company on the corporate tax already paid by the company. Tax authorities vary on the extent of the rebate the shareholder is entitled to<sup>3</sup>. Australia adopted a rebate system known as the 'franking' system. This system seeks to ease the tax burden on shareholders in that shareholders may be entitled to a tax offset for all or some of the tax the company has already paid on its income and its working brilliantly in Australia.

The more a shareholder has interest in the company, the greater the rebate on the corporate tax the shareholder will be entitled to. Shareholders with smaller interest in companies are credited with smaller withholding tax. This is because shareholders with smaller interests in companies under normal circumstances do not have access to the company information necessary to determine the applicable corporate tax. This is termed the partial imputation system. South African companies had until 1941 adopted

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<sup>3</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), Page 1.

the imputation system.

Under this system, companies paid income tax on the company profits and the shareholders paid their tax on the dividends distributed to them. To ease the tax burden on the shareholders, the companies would avoid declaring dividends. The South African Revenue Services (SARS) introduced a system where company profits were apportioned between the company and the shareholder. Minority shareholders experienced cash flow problems and their dividend income was not enough to pay off the tax liability. A solution to this challenge was the introduction of levies on the companies that acted as advance payment. Levy certificates got misplaced and to trace the shareholders became a nightmare. The system was abolished in 1952 because of its failure<sup>4</sup>.

The Australian method of taxing dividends has evolved over the years. In 1987 Australia adopted the full imputation system. South Africa has recently adopted this system by the introduction of the new Dividends Tax. The introduction of the new Dividends Tax has placed South Africa at par with most tax authorities who adopted the imputation system. The system has only come into operation on 1 April 2012 and the advantages and disadvantages it brings are not yet fully established.

### ***1.1.3 The corporate level system***

As its name suggests, tax is levied at the corporate level. The shareholders receive the dividends free of tax. STC fits into this category. STC derived its name from the fact that it is imposed after the company has paid its income tax. STC is a secondary tax in nature in that it is payable when the company distributes its profits to its shareholders after the normal tax has been paid. The normal tax which is payable by a company before the company profits are distributed is primary in nature. STC is imposed on the amount by which a dividend declared exceeds the sum of dividends received during

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<sup>4</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), page 2.



the assessment period. This period is referred as the dividend cycle<sup>5</sup>. The dividend cycle does not always coincide with the year of assessment. A dividend cycle can run from a period of six months to a few years.

## **1.2. Problem statement**

STC increased the rate of corporate tax from 28% to 38%. This was a disincentive for most foreign investors. South Africa as a developing country depends largely on foreign investment. Will the new Dividends Tax close the gap?

## **1.3. Purpose of the research**

This research will focus on the evolution of taxing of dividends. The definition of a dividend is discussed together with the changes made thereof. A comparison between the imposition of taxes at a corporate level and at a shareholder level is also discussed. STC is analysed and is compared with the proposed Dividends Tax to be implemented.

The purpose of this research will mainly focus on the comparison between STC and the proposed Dividends Tax. Although STC had some advantages (i.e. *inter alia*, it is far easier for SARS to collect STC from a smaller and more sophisticated corporate tax base than to collect income tax on dividends from many shareholders), STC become outdated and there was a need for South Africa to be in line with the rest of the world, hence the transition to Dividends Tax.

The implementation of South Africa's new Dividends Tax, which is set to replace the out-dated Secondary Tax on Companies, has not come without controversy. It has emerged that corporate taxpayers could be caught off guard when the amended tax legislation comes into being, because the Taxation Laws Amendment Bills of 2010, presented to cabinet by Finance Minister, Pravin Gordhan, has unexpectedly removed

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<sup>5</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), page 2.

the Secondary Tax on Companies (STC) liquidation exemption.

This effectively denies companies and tax advisors a fair chance to prepare for the changes. The respected South African Institute of Chartered Accountants (SAICA) is quite rattled by the change, saying that the Minister's timeline leaves taxpayers with 'a very short window of opportunity to make use of the exemption before it disappears'.<sup>6</sup>

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<sup>6</sup> New Dividends Tax ruffles feathers: Fin24: Economy.

## CHAPTER 2. ANALYSIS OF STC

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### 2.1. Background of STC in South Africa

STC was introduced into the Income Tax Act by section 31(1) of Act 113 of 1993. These provisions came into operation on 17 March 1993. Section 34 has since been repealed. At its inception, STC was introduced at 15%. The company tax rate was 48% at the time. The company tax rate of 48% was regarded as being too high taking into account that STC was 15%. The company tax rate was reduced from 48% to 40% whilst STC was increased to 15% to 25%. The rocket sky increase in STC discouraged companies from distributing dividends. This affected SARS in that the collection of STC was greatly affected. Most companies resorted to issuing capitalisation shares as opposed to cash dividends<sup>7</sup>.

The rate of STC was reduced from 25% to 12.5% and finally to 10%. There is very little difference between growth stimulation through the retention of profits and the loss in tax revenue which came as a result of fewer dividends being distributed. Issuing of capitalised shares became unpopular as time went by and companies were more prompted to issuing cash dividends. For smaller companies, STC worked wonderfully as it was an incentive to reinvest in their profits.

### 2.2. Introduction

Before STC is discussed it is prudent to define certain concepts. These concepts are at the centre of STC.

Section 64B defines these concepts as follows:

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<sup>7</sup> Comprehensive Guide to Secondary Tax on Companies (Issue 3), page 3.

Section 64B “declared”, in relation to any dividend (including a dividend in specie), means the approval of the payment or distribution thereof by the directors of the company or by some other person under authority conferred by the memorandum and articles of association of the company or, in the case of the liquidation of a company, by the liquidator thereof”.

Dividend cycle means,

“In relation to the first dividend declared by a company (other than a company which carries on long-term insurance business) on or after 17 March 1993, the period commencing on the later of-1 September 1992;

The day following the date of declaration of the last dividend (other than a dividend in specie or a dividend payable on a preference share) declared by the company prior to 17 March 1993;

The date on which that company was incorporated, formed or otherwise established; and

The date on which that company becomes a resident

And ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been declared as contemplated in section 64C(6)

(aA) in relation to the first dividend declared by a company which carries on long-term insurance business out of profits derived during any year of assessment commencing on or after 1 July 1993, the period commencing on the later of-

The later date of the date on which that company was incorporated, formed or otherwise established or 1 July 1993; and

The day following the date of declaration of the last dividend (other than a dividend in

specie or a dividend payable on a preference share) declared by the company prior to the declaration of the said first dividend,

And ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6); and

In relation to any subsequent dividend declared by that company, the period commencing immediately after the previously dividend cycle of the company and ending on the date on which such dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6)<sup>8</sup>.

In summary a dividend cycle is a period within which the net amount of a dividend declared is determined as the difference between the dividend declared and the dividend received. A dividend cycle commences the day after the previous dividend ended. A dividend cycle ends on the date on which a dividend accrues to the shareholders of the company. The date on which the directors of the company approve the payment is referred to as the date on which the company declares the dividend. Where the directors of the company approve the dividend, an interim dividend is declared. A final dividend is declared when it has been approved by the shareholders at the annual general meeting, subsequent to the directors having approved the dividend. The date of the annual general meeting determines the date final declaration of the dividend<sup>9</sup>.

When a company decides to distribute its profits to its shareholders it does so by declaring dividends to its shareholders. On declaring the dividends to its shareholders, the company becomes liable to a tax that is known as STC. STC was introduced in South Africa in 1993.

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<sup>8</sup> Income Tax Act No. 58 of 1962.

<sup>9</sup> Silke: South African Income Tax 2007, page 424.

Dividends declared on or after 17 March 1993 were affected by STC. At this time circumstances arose wherein companies credited their shareholders' loan account with dividends. An example of such a case is the case of SATC 478<sup>10</sup>. In this case, the appellant company declared two dividends to its sole shareholder; Mr A. The one dividend was declared on 2 March 1992 and the other one was declared on 5 March 1993. In both instances no payment was made in cash or by cheque and instead Mr A left the money on loan with the appellant company.

The actual crediting of Mr A's loan account was only effected on 31 July 1993. The issue before the court was whether the appellant company was liable for STC on the dividends it declared in its 1992 and 1993 years of assessments. The crisp issue for determination in the appeal was when exactly payment of the dividends had been made to the appellant. The court came to the conclusion that on a proper construction of all the facts, the nature of the transaction could only have meant that the payment of the dividend and the advancing of the loan would be regarded as taking place at the same time. In upholding the appeal, the court held that the date upon which payment was made was a question of fact.

Dividends declared by non-resident companies are not subject to STC. These companies are however still liable for normal tax on the on the South African source income.

### **2.3. Incoming dividends**

STC is levied at the prescribed rate i.e. 10% on the net amount of any dividend declared by a resident company. The net amount of any dividend is the amount by which such dividend declared by a company exceeds the sum of any dividends which have accrued to the company during the dividend cycle in relation to the first mentioned

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<sup>10</sup> (1999) 62 SATC 478 (N).

dividend<sup>11</sup>. For STC purposes, dividends consist of incoming and outgoing dividends.

Dividends and deemed dividends qualify as incoming dividends. It is a requirement of section 64B(3) that the incoming dividend must have accrued to the company during the dividend cycle.

Section 64B(3A) provides that in determining the sum of the dividends which have accrued to a company, the following will not be taken into account:

-Any dividend declared by a fixed property company or by a controlled group company;

- (a) Any dividend to the extent that the dividend is not exempt in terms of section 10;
- (b) Any dividend which accrued to a borrower;
- (c) Any foreign dividend.

Section 64B(4)(a) provides that where a company declares a dividend subject to a condition that it will be payable to a shareholder on a particular date, the dividend accrues to the shareholder on that date. Where a company distributes profits by way of cash or assets, section 64B(4)(c) provides that dividends are deemed to have been declared on the day the shareholders become entitled to the dividends.

## **2.4. Dividends declared but exemptions from STC**

Section 64B(5) exempts from STC some dividends that are declared by companies. These are:

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<sup>11</sup> Income Tax in South Africa, law and practice, fourth edition, RC Williams, page 550.

Dividends declared by companies that are exempt from STC (section 64B(5)(a));

Dividends declared by a fixed property company;

Dividends declared in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of the company;

Dividends declared by a gold mining companies;

Certain intra-group dividends;

Dividends declared by a company that carries on a long-term insurance business;

Dividends declared by a collective investment scheme.

As explained above, dividends which are declared by a property company out of profits that are of a revenue nature are exempt from STC. The shares thereof should be included in a portfolio of a collective investment scheme in property. The dividends declared out of revenue profits are deducted in terms of section 11(s). As a result of the deduction the fixed property company is not liable for income tax on revenue profits that are distributed to the collective investment scheme in property. Section 11(s) being applicable distributed to the collective investment scheme in property. Section 11(s) being applicable to deductions of a revenue nature is not applicable to dividends declared by a fixed property company out of profits of a capital nature. These dividends will be subject to STC<sup>12</sup>.

## **2.5. Payment of STC**

Section 64B(7) provides that STC shall be paid by the company that is liable for it to the Commissioner for SARS by no later than the last day of the month following the

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<sup>12</sup> Silke: South African Income Tax 2007, page 413.



month in which the relevant dividend cycle ends. This payment must be accompanied by the return (IT 56). The Act empowers the Commissioner to extend the payment period if he considers it necessary. The Commissioner may, where he is satisfied that STC has not been paid in full, estimate the unpaid amount and issue an assessment for such amount. The provisions of the Income Tax Act relating to the assessment and recovery of normal tax and additional tax shall apply *mutatis mutandis* in respect of STC. If payment is not made within the prescribed period interest is charged at the prescribed rate on the outstanding amount. The second proviso to section 79(1) provides that the Commissioner shall not raise an STC assessment for a year where three years have elapsed from the date of the income tax assessment for that year, unless he is satisfied that there has been fraud, misrepresentation or non-disclosure of material facts<sup>13</sup>.

## **2.6. Deemed Dividends**

Section 64C is an anti-avoidance provision for STC. The objective of this provision is countering the schemes where amounts are distributed by a company in a form other than the declaration of a dividend or a deemed declaration as contemplated in section 64B. The section also prevents an avoidance of STC through the payment to persons other than a shareholder, in that a company will be liable for STC where payment is made to persons connected to the shareholder.

Section 64C does not per se levy STC. It determines circumstances where deemed dividends arise. These dividends become dividends for the purposes of section 64B.

## **2.7. Deemed dividend declaration**

Section 64C(2) provides that for the purposes of section 64B, an amount shall subject to the provisions of subsection (4), be deemed to be a dividend declared by a company

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<sup>13</sup> Income Tax in South Africa, law and practice, fourth edition, RC Williams, page 556.

to a shareholder in certain circumstances<sup>14</sup>.

## **2.8. Deemed distribution**

There are a number of deeming provisions in terms of which transactions or distributions are deemed to be a dividend declared for the purposes of section 64B. These are:

- (a) Any cash or asset distributed or transferred by a company to or for the benefit of a shareholder is deemed to be a dividend declared to the shareholder;
- (b) If the shareholder is released from any obligation, measurable in money, which is owed by him to the company the amount so released is a deemed distribution;
- (c) Any debt owing by a shareholder to a third party is paid or settled by the company;
- (d) If any amount is used or applied by the company in any manner to benefit a shareholder such amount is deemed to be an amount distributed;
- (e) Any amount which represents an amount that has been adjusted or disallowed in accordance with the provisions of section 31 of the Income Tax Act;
- (f) If the company ceases to be a South African resident, all the profits and reserves that are available for distribution are deemed to be distributed and are subject to STC;
- (g) Any loan or advance granted to the shareholders or to a person connected to

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<sup>14</sup> Notes on South African Income Tax: 2007 edition, page 279.

the shareholder is a deemed dividend unless one of the exclusions applies;

(h) An amount incurred by the company in terms of an instrument in respect of which section 8F applies is a deemed dividend<sup>15</sup>.

## 2.9. Exclusions

The deemed distributions will not apply in the following situations:

Where the amount constitutes a dividend or would have constituted a dividend but for the provisions of paragraphs (e) to (i) of the dividend definition;

(b) Where the amount distributed constitutes remuneration in the hands of the shareholder or settlement of a debt owing by the company to the shareholder;

(c) So much of any amount distributed as exceeds the company's profits and reserves which are available for distribution or which are deemed to be available for distribution in terms of the dividend definition;

(d) To any loan granted in respect of which a rate of interest of not less than the official rate of interest is payable;

(e) To any loan granted to a shareholder or his connected person as an employee in compliance with the normal terms of a loan scheme generally available to employees of the company who are not shareholders;

(f) To any loan or credit granted to a shareholder;

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<sup>15</sup> Notes on South African Income Tax: 2007 edition, page 280

(g) Deleted;

(h) Deleted;

(i) To any loan or credit granted to a trust by a company to enable that trust to purchase shares in that company, or that company's controlling company, with a view to the resale of those shares to employees of the company;

(j) Deleted;

(k) To any amount contemplated in subsection (2)(a), (b), (c), (d) or (g) distributed, transferred, released, relieved, paid, settled, used, applied, granted or made available for the benefit of any shareholder or any connected person in relation to the shareholder<sup>16</sup>.

## **2.10. STC and non-residents<sup>17</sup>**

STC may in certain instances lead to economic double taxation. This means that a company and a shareholder may be taxed twice on the same amount. This is because South Africa's DTAs do not list STC as a tax on the company profits but as a tax covered by the relevant DTAs.

For example, Article 2(3)(a)(ii) of the agreement for the avoidance of double taxation with the United Kingdom lists STC as a tax covered by the treaty and the note at the end of the treaty recognises STC as a tax on the profits of South African companies. The result is that South African treaty partners would not give credit for the underlying corporate income tax (i.e. STC) to the shareholder (in his country of residence). The reason is that STC is unknown to most tax authorities. Where a tax credit is granted for

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<sup>16</sup> Notes on South African Income Tax: 2007 edition, page 280.

<sup>17</sup> Comprehensive guide to secondary tax on companies (Issue 3), page 4.

the portion of the underlying corporate income taxes the non-resident's country of residence will prevent economic double taxation.

Currently, South Africa does not impose any withholding tax on dividends. In the case of Volkswagen of South Africa (Pty) Ltd v C SARS,<sup>18</sup> a South African resident was a wholly owned subsidiary of a German holding company that sought to obtain a rate of STC of 7,5% under article 7 of the tax treaty with Germany. The court found that there are substantial differences between STC and a withholding tax, and STC was therefore not substantially similar to a withholding tax. STC is a tax on a company declaring a dividend and not a tax on the recipient shareholders. It is not a tax on dividends as contemplated in the tax treaty and accordingly fell outside the ambit of the article<sup>19</sup>.

## **2.11. Do other countries tax companies on the distribution of their profits?**

Taxes on distributed profits imposed solely at corporate level are still rare. In India the situation is that the domestic company shall be liable to pay additional income tax on any amount declared, distributed or paid by such company by way of dividend on or after 1 June 1997. The additional income tax is payable at 10%. This additional tax shall be payable even if no income tax is payable by such company on its total income. The situation in India was that up until 31 May 1997, the company was not liable to pay any income tax on the amount of dividends declared, distributed or paid by such company. However, such dividend was included in the income of the shareholders under the head "income from other sources".<sup>20</sup>

In Estonia there is no classical corporate income tax system. Estonian companies do not pay income tax on their profits but the profits are taxed on their distribution. The timing of taxation of profits is moved from the time of earning them to the time of

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<sup>18</sup> Volkswagen of South Africa (Pty) Ltd v C SARS [2008] JOL 21746 (T), 70 SATC 195.

<sup>19</sup> Comprehensive Guide to Secondary tax on companies (Issue 3) page 5

<sup>20</sup> [finance.indiamart.com/taxation/corporate\\_tax/distributedprofits.html](http://finance.indiamart.com/taxation/corporate_tax/distributedprofits.html)

distribution. The result is that undistributed profits are not taxed whether they are retained or invested<sup>21</sup>.

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<sup>21</sup> [www.uhy.com/...business.../Doing%20Business%20in%20Estonia.pd...](http://www.uhy.com/...business.../Doing%20Business%20in%20Estonia.pd...)

## CHAPTER 3. THE ADVANTAGES AND SHORTCOMINGS OF STC

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When STC was introduced the company tax rate was 48%. STC was introduced at 15%. The company tax rate was thus regarded as being too high. The company tax rate was later reduced to 40% for companies with tax years falling within the year ending on 31 March 1994. Later, the company tax rate was reduced to 35% however the STC was increased to 25%. The increase in STC rate discouraged companies from distributing dividends. The non-distribution of dividends by companies affected the collection of STC. Companies started opting to issue capitalisation shares instead of cash dividends. The rate of STC was reduced to 12.5% for dividends declared after 14 March 1996. On 1 October 2007 the rate was further reduced to 10%<sup>22</sup>.

The taxing of companies in the distribution of their profits encourages companies to reinvest their profits. It was an incentive for companies to invest their profits and to finance itself because in doing that, it paid lower tax rates. Where dividends are taxed in the hands of shareholders, the tax authorities are faced with difficulties of identifying and tracing the individual shareholders and getting their cooperation. This is because most shareholders do not declare their dividend income. As far as South African Resident companies are concerned, STC brought about a solution to the problem.

It is far easier for SARS to collect the STC from the smaller and more sophisticated corporate tax base than to collect income tax on dividends from numerous shareholders. Tax avoidance was also limited. For example, South Africa faced many dividend-stripping schemes during the period that it taxed dividends in the hands of the shareholders. Thus in the case of *CIR v Nemojim*,<sup>23</sup> the taxpayer purchased dormant companies with substantial reserves available for distribution.

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<sup>22</sup> <sup>22</sup> Comprehensive Guide to Secondary tax on companies (Issue 3) page 3.

<sup>23</sup> *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935(A).

The *modus operandi* was to cause the company to declare a dividend, distributing the total cash reserve as soon as the shares in the company had been transferred into the name of the respondent company, and then to resell the shares in the 'stripped' company, i.e. the so called 'shell'.

The dividend and the resale price of the shares constituted in each case the proceeds of the transaction as a whole. In each case the dividend constituted by far the major component of such proceeds and was a *sine qua non* to the profitability of the transaction. The receipt of the dividend was, moreover, in each case no more an adventitious event; it was something planned by the respondent company to take place immediately after transfer of the shares.

The issue before the court was whether the respondent company, taking into account the provisions of sections 10(1)(k), 11(a), 22 and 23(f) of the Income Tax Act, was entitled, in calculating its taxable income, to deduct from the income derived by it from the sale of shares the full cost of the acquisition of those shares. If it were allowed to do so, it would in effect be entitled to claim a substantial assessed loss on the overall transaction. The cost of acquisition was generally far greater than the price realised on the resale of the shares and the dividends 'stripped' from the purchased company were exempt from tax in terms of section 10(1)(k).

The court concluded that the full purchase price was not deductible since the share dealing transactions had a dual purpose; i.e. production of income and exempt income and only a proportionate amount of the expenditure was deductible and therefore a formula has to be employed. Such schemes are ineffective in the context of STC. The collection of STC was further boosted by the introduction of CGT. Capital profits derived after 1 October 2001 was subject to STC upon liquidation, winding up, deregistration or final termination of the company's corporate existence<sup>24</sup>.

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<sup>24</sup> <sup>24</sup> Comprehensive Guide to Secondary tax on companies (Issue 3) page 4.



## CHAPTER 4. REASONS FOR FACING OUT STC

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### 4.1. Introduction

South Africa has for a long time used an outdated system of taxing company distributions. STC has advantages in that it is easier to collect tax from corporate taxpayers than from numerous individual shareholders. However, its disadvantages could no longer be tolerated. South Africa, being a developing country, needs and depends greatly on foreign investment.

When corporate distributions are taxed in the hands on a corporate taxpayer, the rate of normal tax increases from 28% (lowered from 29% in 2008) with an additional 10% of STC (lowered from 12.5% in 2007) to 38%. This rate applies to companies that distribute all of their after-tax profits as dividends.<sup>25</sup> This high tax rate made South Africa unattractive as a potential investment destination to foreign investors.

Most foreign authorities tax distribution of company profits in the hands of shareholders. This is different from STC which tax the distribution of company profits in the hands of the distributing company. The difference between STC and the imputation system give rise to the following problems:

Firstly, Under the STC, when company profits are distributed to shareholders, the company becomes liable for tax. The company's profits are therefore reduced by the tax liability. In foreign jurisdictions when a company distributes its profits, it is not liable for tax but the shareholders are. This places South African company at a disadvantage as compared with companies in other foreign jurisdictions;

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<sup>25</sup> Maxwell, C. (n.d.). Low Tax Global Tax & Business Portal, South Africa: Foreign Investment-Back to South Africa Information: Business, Taxation and Investment. Foreign Investment in South Africa- An Overview. Available at [www.lowtax.net](http://www.lowtax.net).

Secondly, tax treaties between two contracting states which purport to limit the rate of tax which is imposed on dividends in the hands of the shareholders have no effect because STC is levied at the company level;

STC and how it is applied is foreign to foreign investors. Its application makes foreign investors uncertain.

As a result, the combined effects of these difficulties are an increased cost of equity financing.

## **4.2. Need for a change to the tax base**

The drive towards phasing out STC and replacing it with Dividends Tax was motivated by the following factors:

To align South Africa with the international norm where the distribution of company profits are taxed in the hands of the shareholders.

Where dividends are taxed at corporate level, subsequent to the company paying normal income tax, a perception is created that a corporate tax rate is very high. STC has thus made South Africa to be viewed as having a higher corporate tax rate and this has made South Africa appear unattractive to foreign investors.<sup>26</sup>

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<sup>26</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009, page 31-32.

## CHAPTER 5. PROPOSED CHANGES TO THE SYSTEM OF TAXING DIVIDENDS

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### 5.1. Introduction

STC had become outdated and South Africa had fallen behind with the international tax trends. In order to fall in line with the international tax trends, South Africa introduced a Dividends Tax to replace STC, a move likely to make South Africa a more attractive foreign investment destination.<sup>27</sup> With the phasing out of STC South Africa will not be viewed as having a higher tax rate. South Africa might soon attract more foreign investment.

On 21 February 2007 the Minister of Finance announced that STC would be phased out and replaced with the new Dividends Tax. The Dividends Tax will take effect on 1 April 2012. The intention is that the liability for the tax will move to the shareholder level, but the responsibility for the payment of the tax will remain at company level.

### 5.2. Implementing the process

The implementation proposed that this process will take place in two phases:<sup>28</sup>

#### 5.2.1 Phase 1

This phase entails a reduction in the rate of STC together with a broadening of the tax base for dividends. The rate of STC was reduced from 12,5 % to 10% with effect from

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<sup>27</sup> Mazansky, E. (2009). *Dividends tax means shareholders pay more tax*. [Online] Available at [www](http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page266?oid=36076&sn=).

<sup>28</sup> Grant Thornton. (2008). *Fiscal Handbook 2008/2000*. 19<sup>th</sup> Edition. [Online] Available at [http://www.gt.co.za/files/publications/fiscal\\_handbook08.pdf](http://www.gt.co.za/files/publications/fiscal_handbook08.pdf).

1 October 2007. The current exemption relating to dividends declared in anticipation of liquidation or deregistration of a company will no longer be available in respect of dividends declared on or after 1 January 2009. The dividend definition has been amended with effect from 1 October 2007 to include both realised and unrealised profits of the company, whether or not those unrealised profits have been recognised in the financial records of the company.

### **5.2.2 Phase 2**

Draft legislation has been released for commentary dealing with the new proposed 'Dividend Tax'. The highlights are:

The formal legal liability for Dividends Tax will be moved from the company paying the dividend to the shareholder receiving it. The tax cost therefore shifts off the company's income statement and becomes a cost to the shareholder;

Dividends Tax of 15% will generally be withheld by the company paying the dividend, and the net dividend will be paid to the shareholder;

Dividends Tax will not be imposed on South African resident companies, retirement funds, benefit funds, approved PBOs, any sphere of government, and exempt parastatals;

In principle, Dividends Tax will be payable when a dividend is paid to a beneficial recipient who is an individual or non-resident;

STC credits will still be available for utilization for a period of three years from the date of the introduction of Dividends Tax. The period may be extended to five years;

The liability for the payment of Dividends Tax will be determined with reference to the date of payment of the dividend, as opposed to the current STC regime which uses the date of declaration of the dividend;

Dividends Tax means shareholders pay more tax.

## CHAPTER 6. BASICS OF DIVIDENDS TAX

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### 6.1. Introduction

Dividend's Tax will apply only in respect of dividends paid by a South African resident companies and will be levied at the rate of 15%. Before its implementation, the new Dividends Tax was to be levied at the rate of 10%. The Minister of Finance has, however, in his 2012 budget speech announced that the rate of dividend's tax will be increased to 15%.

The Dividend's Tax will be imposed on the date when the dividend is paid by the company, i.e. the date on which the dividend 'accrues' to the shareholder, as opposed to the date of declaration under the STC regime. 'Accrual' will not coincide with dividend declaration. The meaning of 'accrual' was explained in the case of *Lategan v CIR*<sup>29</sup> to mean 'become entitled to. This means that the shareholder will become liable for Dividends Tax once he becomes entitled to the dividends.

The meaning of 'accrued' was extended in the case of *Mooi v SIR*<sup>30</sup> where the court held that accrual takes place only when the taxpayer becomes unconditionally entitled to the amount. An entitlement which is contingent on a future event does not result in an accrual until the event has occurred. Practically, in a listed share context, the accrual of a dividend to a shareholder will generally take place sometime after the dividend is declared.

There are special valuation rules provided for by the new Dividends Tax. These rules are in respect of *in specie* dividends. Where a company makes an *in specie* distribution, the amount of the dividend is deemed to be equal to the market value of the property distributed. The market value of the assets distributed is determined in one

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<sup>29</sup> (1926 CPD).

<sup>30</sup> (1972 AD).

of the following ways:

- (a) On the date of approval of the distribution, in the case of listed companies;
- (b) The date of distribution in the case of unlisted companies.

The status of the beneficial owner determines whether the dividend is exempt or not. The beneficial owner is the person the dividend has accrued to. The beneficial owner of a dividend will be exempt from the Dividends Tax where the beneficial owner is:

A South African Company;

The Government, a provincial administration or a municipality;

A public benefit organisation;

A trust;

An institution, board or body that conducts research, provides services to the State or the general public, or that promotes commerce, industry or agriculture as contemplated in section 10(1)(cA);

A retirement fund or a medical scheme;

A parastatal contemplated in section 10(1)(t);

A shareholder in a registered micro business;

A natural person upon receipt of an interest in a residence contemplated in paragraph 51 of the Eighth Schedule to the Income Tax.

STC had fewer categories of dividends that were exempt as compared to Dividends Tax. Under the new Dividends Tax, dividends paid to retirement funds are now exempt. This encourages retirement savings. Further, all dividends paid from one South African company to another are now exempt without regard as to whether or not those companies are within the same group of companies. The exemption of dividends paid by one company to another is an element of a conventional model of taxing dividends.

Even though shareholders are taxed at 15% upon the payment of dividends, this rate may be reduced by the TDAs South Africa has entered into with various countries. The reduction in the rate of tax occurs where the shareholder on whom the dividends have accrued to own a minimum percentage of shares in the company paying the dividends. An example of the effect of the new Dividend's Tax is where dividends are issued in between the companies within the same group of companies. No dividends tax will be payable by the shareholder company unless the dividends are finally paid to the individual.<sup>31</sup>

## **6.2. Transitional arrangements**

### ***6.2.1 Co-ordination between the STC and the Dividends Tax***

There are special rules between STC and Dividends Tax to prevent double taxation and under-taxation. Companies will be liable to STC on the dividends declared before 1 April 2012 even though they are paid after that date. The fact that these dividends are paid after 1 April 2012 will not make them subject to Dividends Tax. Further, all dividend cycles will end on 31 March 2012. The dividend cycles ending on 31 March 2012 will cut off further STC credits under the old system with the new STC credits arising only after the implementation of the Dividends Tax.<sup>32</sup>

### ***6.2.2 Use of STC credits against the Dividends Tax***

A general concern has been raised about dividends paid by companies that have STC credits that would not have been used after 1 April 2012. This concern proposes that profits previously subjected to STC are not liable to Dividends Tax when they are subsequently paid to South African resident companies. All the dividends which accrued to the company up to the last dividend cycle under the STC system and which

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<sup>31</sup> Explanatory Memorandum on The Taxation Laws Amendment Bill, 2009, page 32 and 33

<sup>32</sup> Explanatory Memorandum on The Taxation Laws Amendment Bill, 2009, page 34

exceeds the dividends declared up to 31 March 2012 consists of STC credits.

Dividends paid on or after 1 April 2012 by companies with STC credits will always reduce the balance of their STC credits. The effect is that STC credits will be exhausted first. This means that a company will not be entitled to pay a dividend which does not reduce STC credits.

It is possible to increase the STC credits of a company. This happens where the dividend is paid to the company from another resident company and the result is that STC credits of a company are transferred from one company to another. This increase of STC credits will be possible only if the company paying the dividend has provided the recipient shareholder of the dividend with prior notice of the amount by which its STC credit has been allocated to that shareholder, otherwise the STC credits are simply lost.

STC credits should be allocated to shareholders in proportion to their shareholding within the same class regardless of whether those shareholders are exempt from Dividends Tax. It is only necessary to give notification of STC credits to shareholders who are resident companies. The liability for STC will be calculated and the use of STC credits will be used in respect of dividends declared to South African resident companies.

STC credits can only be used for a period of five years from the 1<sup>st</sup> of April 2012. All STC credits remaining after five years will terminate.<sup>33</sup>

### **6.3. New definition of 'dividend'**

The new Dividends Tax brings in a new definition of dividends to the Income Tax Act. According to this new definition, any amount transferred or applied by a company to or

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<sup>33</sup> Explanatory Memorandum on The Taxation Laws Amendment Bill, 2009, page 34.



for the benefit of a shareholder by virtue of a share is a dividend.

This new definition has four exclusions. The first exclusion is that the dividends exclude amounts which reduce the contributed tax capital. The second exclusion is that dividends exclude the transfer of the company's own shares. The reason for this exclusion is that this transfer of a company's own shares does not result in the reduction of the company's share capital. The third exclusion is that where a listed company purchases its own shares on the JSE, this purchase cannot be distinguished from other purchases on the JSE market. The last exclusion is that dividends do not include redemptions of a participatory interest in a foreign collective investment scheme.

'Dividend' is defined in section 64D (as of 1 April 2012, definition of 'dividend' substituted by s. 75(1) of Act 24 of 2011) *According to this new definition, "dividend means any dividend or foreign dividend as defined in section 1 that is-*

Paid by the company that is a resident company; or

Paid by a company that is not a resident –

If the share in respect of which foreign dividends is paid is a listed share; and

To the extent that that foreign dividend does not consists of a distribution of an asset in specie".

Section 64D refers to an amount. The term 'amount' is not defined within the context of the new Dividends Tax. The term 'amount' is also not defined in section 1. The term has become the subject of interpretation before the South African courts. In the case of *Lategan v CIR*<sup>34</sup>, the court held that within the context of gross income, 'amount' means not only money but the value of every form of property, whether corporeal or incorporeal, but which has a money value. It is submitted that the same meaning should be ascribed to the word within its context in the definition of 'dividend'. This new

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<sup>34</sup> (1926 CPD)

dividend definition includes the transfer of cash as well as the transfer of property to the shareholder. An 'amount' transferred to a shareholder would include going concern distributions, liquidation distributions and amounts paid as a result of the redemption, cancellation or buy-back of issued shares.

Where the company has made an *in specie* distribution, the open market value of the asset is determined by the open market value of the asset on a specified date. Where the company making the distribution is a listed company, the amount of the dividend is determined as the market value of the asset on the date that the directors of the company approve the distribution. On the other hand, where the company making the distribution is not a listed company, the amount of the dividend is determined on the same date as in the case of a listed company, except where the distribution is:-

Subject to the condition that it be payable to a shareholder registered in the company's share register on a specified date. In this case the market value of the asset must be determined on a specified date; and

Made otherwise than by way of a formal declaration of a dividend or made by the liquidator of the company in the course of the winding up or liquidation of the company.

In these cases, the market value of the asset must be determined on the date on which the shareholder becomes entitled to the distribution. The amount of an *in specie* dividend is determined as the market value of the asset on a specified date.<sup>35</sup>

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<sup>35</sup> Silke: South African Income Tax 2010, page 529.

## CHAPTER 7. WITHHOLDING OF DIVIDENDS TAX

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### 7.1. Withholding by companies declaring dividends

The move from STC to Dividends Tax was motivated by a need to tax dividends at a shareholder level as opposed to corporate level. Under the new Dividends Tax, the liability for tax rests with the shareholder, whilst the company has a duty to withhold the Dividends Tax. This system of collecting Dividends Tax is practiced in most jurisdictions<sup>36</sup>.

In general, the company paying a dividend to a shareholder is obliged to withhold the amount of Dividend Tax on the dividend from the amount paid to the shareholder. In certain circumstances, the obligation to withhold the Dividends Tax could move to a regulated intermediary. The Dividends Tax regime requires that a person who has the responsibility to withhold the Dividends Tax, be it a company or an intermediately, must be aware of the shareholders' situation. The reason is that there may be situations where Dividends Tax may not be withheld because a treaty relief is available in respect of a non-resident shareholder or the shareholder is exempt from tax in terms of section 64F.<sup>37</sup>

Where a company declares and pays a dividend it will generally be liable to withhold Dividends Tax at a rate of 15% of the dividend paid. The amount so withheld must be paid to SARS by the last day of the month following the month in which that dividend was paid. However, the company will be absolved from the liability to withhold:

Where the company has received a declaration of exemption from the Dividends Tax in respect of the beneficial owner of a dividend; or

Where the company makes a payment to certain entities.

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<sup>36</sup> Explanatory Memorandum on The Taxation Laws Amendment Bill, 2009, page 40

<sup>37</sup> Silke: South African Income Tax 2010; Edition, page 534.

The company paying the dividend must withhold Dividends Tax at a reduced rate where the person to whom the dividend is paid has, by a date determined by a company, submitted a declaration by the beneficial owner to the company that the dividend is subject to a reduced rate as a result of the application of a double tax agreement<sup>38</sup>.

Prescribed forms in respect of a claim for exemption or a treaty reduced rate must be submitted to the company by a specified date. Where the forms are not submitted timeously, the company must proceed to withhold the tax regardless of the exemption or treaty reduction. Where Dividends Tax was withheld in circumstances where an exemption or reduced treaty rates is applicable it is not the end of the world for the shareholder because he can still at a later stage submit late declaration forms to claim a refund.<sup>39</sup>

## **7.2. Withholding by regulated intermediary**

Where a company declares and pays a dividend to a regulated intermediary, that company is automatically exempt from the liability of withholding Dividends Tax. It then becomes the responsibility of the intermediary to withhold the Dividends Tax paid by the company. This happens where a listed company declares and pays a dividend because listed shares are reflected in share registers kept by various regulated intermediaries.

The companies and the intermediaries are governed by the same rules in respect of withholding Dividends Tax. In the same way as companies, unless the intermediary receives a declaration for exemption or the reduced rate because of a treaty, he must withhold the Dividends Tax. Regulated intermediaries also receive an automatic exemption when paying dividends to another regulated intermediary.

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<sup>38</sup> Explanatory Memorandum on The Taxation Laws Amendments Bill, 2009, page 42

<sup>39</sup> Explanatory Memorandum on The Taxation Laws Amendments Bill, 2009, pages 42 and 43

The later intermediary then has the withholding obligation<sup>40</sup>.

### **7.3. Refunds of Dividends Tax withheld due to late declaration**

In circumstances where a declaration for Dividends Tax exemption or a reduced rate by reason of the application of a double taxation agreement is not received by the required date, amounts withheld in respect of that dividend may still be refundable. The amounts withheld will be refunded if the beneficial owner submits the declaration within a period of three years after the payment of the dividend. No refunds will be payable where a declaration is submitted after this date. The manner in which the refund mechanism operates depends on whether the withholding was performed by a company paying and declaring the dividend or by a regulated intermediary<sup>41</sup>.

### **7.4. Refunds in respect of dividend declared and paid by companies**

A company is responsible for paying the refund to the beneficial owner where the amounts were withheld by the company declaring and paying the dividend. The company may fund these refunds from one of two sources.

The primary source is in respect of withholding from future dividends paid by the company. This is the amount of Dividends Tax withheld from any dividend declared by the company within one year after the beneficial owner submitted the relevant declaration to the company.

The secondary source is that the company may claim a refund of the shortfall from the Commissioner where the refunds cannot be drawn from withholding from future

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<sup>40</sup> Explanatory Memorandum on The Taxation Laws Amendments Bill, 2009, page 43 to 44

<sup>41</sup> Explanatory Memorandum on The Taxation Laws Amendments Bill, 2009, page 44

dividends within one year. The company may only recover the amount from the Commissioner to the extent that the amount refundable exceeds the Dividends Tax withheld by the company within one year after the company received the declaration from the beneficial owner. The company will not be able to recover any amount from the Commissioner where the claim for refund is made after a period of four years from the date of payment of the dividend.<sup>42</sup>

## **7.5. Refunds in respect of dividends paid by regulated intermediaries**

In circumstances where the intermediary paid a dividend and withheld the Dividends Tax because the beneficial owner did not furnish the declaration form by the required date or that the dividend is subject to a reduced rate by reason of a DTA, that Dividends Tax is refundable. A condition for the refund is that the beneficial owner furnishes the declaration to the intermediary within a period of three years from the date that the dividend was paid.

The amount must be refunded by the intermediary because it was the intermediary that paid the dividend. The intermediary may obtain the amount from one source only as compared to a company that has two sources from which it can obtain the amount. The refund is paid out of the Dividends Tax withheld from any dividends paid by the intermediary subsequent to the beneficial owner submitting the declaration to the intermediary. It is not a requirement that a refund must strictly be paid out of the Dividends Tax withheld. The amount is refundable from Dividends Tax withheld by the intermediary from a dividend paid to any person. The intermediary may not recover from the Commissioner the amount of the refund.<sup>43</sup>

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<sup>42</sup> Explanatory Memorandum on The Taxation Laws Amendments Bill, 2009, page 44.

<sup>43</sup> Silke: South African Income Tax: 2010 Edition, Page 538.

## 7.6. STC Credits

STC credit of a company consists of an amount of dividends and deemed dividends which have accrued to that company during the dividend cycle ending on 31 March 2012 which exceeds the dividends declared on or before 31 March 2012 plus the dividends which have accrued to the company on or after 1 April 2012 on condition that the person that pays the dividends furnishes a written notice to the company before paying the dividend of the amount by which the dividend reduces the STC credits of the company paying the dividends.

Section 64J which deals with STC credits provides that dividends which were previously subject to STC will not be subject to Dividends Tax when they are paid to a shareholder. This will be an instance where a company has received a dividend that created an STC credit for the company and it subsequently pays that amount as a dividend to its shareholders. The objective of exempting profits from Dividends Tax which were previously subject to STC is to avoid a double taxation. The dividend is not subject to Dividends Tax to the extent that it reduces the company's STC credit.

A company does not have an option to decide whether it declares a dividend out of STC credits. STC credits must be declared first. When a company that has STC credit declares and pays a dividend, it is deemed that the company's STC credit is reduced to the extent of the dividend paid. The STC credit is allocated in proportion to the shareholder's share within the same class. This is done regardless of whether those shareholders are exempt from Dividends Tax.

The application of the STC credit under the new Dividends Tax will highly depend on the company payer providing reporting information to the payee. The company payer has a responsibility of determining the percentage of the dividend that will be exempt because of STC credits. This percentage will need to be reported and relied upon throughout the chain. Failure to transmit this report to the payee will result in the denial of STC credits for the shareholder with the STC credits of the payer still being reduced. This report must be furnished by the date of payment of the dividend. All STC credits will terminate after a period of five years.

## CHAPTER 8. DIVIDENDS TAX SUPPORTING DATA

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### 8.1. Administration

All entities involved in the dividend distribution chain will for Dividends Tax purposes be required to furnish supporting data. This will enable SARS to effectively administer Dividends Tax and ensure a complete audit trail of a dividend from the time the dividend was declared/paid up to the point where it is received by the beneficial owners. The data requirements can be summarised as follows:

The entity declaring/paying the dividend is required to submit information about the dividend declared as well as information about the entities to which the dividend was paid.

Regulated intermediaries will be required to submit information about:

The entities from which the dividend payment was received;

The entity that declared the dividend;

The entities to which the dividend was paid.

Beneficial owners who received dividends which were exempt from Dividends Tax (such as South African companies, pension funds, etc) will be required to submit information to SARS about the:

Dividend received;

Details of the entity that it was received from;

Details about the entity that declared the dividend.

SARS and all the stakeholders agreed to a phased implementation approach in respect of the data requirements. The first phase will include the enforcement of the dividend payment side whilst the receipt side will be deferred until 31 March 2013 to allow the external stakeholders to prepare their systems to cater for this requirement. On the other hand SARS system will be ready to cater for both payment and receipt sides to



allow for submission of the receipt side information from the first day.

Once the information has been received, SARS will provide a pre-populated Dividends Tax return. The return will be consolidated from the supporting data received and will be issued to the channel from where the request was made<sup>44</sup>.

## **8.2. Channels for submission**

SARS will pull off its existing electronic channels infrastructure to provide a mechanism for listed and unlisted companies to submit their Dividends Tax information to SARS.

The following channels will be available for submission:

### **8.2.1 e@syFile™**

The e@syFile™ solution will provide the ability to upload or capture the required supporting data. The data will be consolidated into the Dividends Tax which will be submitted to SARS. In addition, an e@syFile™ user can create a manual disk that can be submitted over the counter at a SARS branch.

### **8.2.2 Direct Data Flow channel (secure file transfer)/ Connect: Direct**

It is more likely that this channel will mainly be used by regulated intermediaries acting as agents to administer the distribution of the dividend on behalf of listed companies. It will allow the taxpayer to extract the relevant supporting data from their respective information systems and upload the data in a prescribed format to SARS' systems.

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<sup>44</sup> Introduction to dividends tax. Available from [www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID](http://www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID)

No manual intervention will be required from the taxpayer. SARS will consolidate the data and populate the Dividends Tax return.

The taxpayer will be able to log-in to eFiling to request and view the Dividends Tax return. Data validation will be performed to ensure correctness and completeness. The ability to rectify any omissions or errors on the detail data will be provided.

The taxpayer will be able to submit the Dividends Tax return from the eFiling platform. It will reduce the overall administrative burden of data transfer and shorten data processing cycle times. This platform will provide faster feedback on the submission and possible review of declarations to taxpayers.<sup>45</sup>

### **8.2.3 eFiling**

As an interim solution, all dividends taxpayers will be able to request, manually capture and submit a Dividends Tax return for a specific transaction period. However as a long term solution, dividends taxpayers with limited transaction data will be able to use this channel to capture the relevant dividend transactional data and submit it to SARS. Further, dividends taxpayers will be able to request, verify and submit a pre-populated Dividends Tax return to SARS<sup>46</sup>.

### **8.2.4 SARS branch**

As an interim solution, all dividends taxpayers will be able to request, manually capture and submit a Dividends Tax return for a specific transaction period. As a long term solution, dividends taxpayers with limited transactional data will be able to use this channel to capture the relevant dividend transactional data and submit it to SARS.

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<sup>45</sup> Introduction to dividends tax.  
Available from [www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID](http://www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID).

<sup>46</sup> Introduction to dividends tax.  
Available from [www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID](http://www.SARS.gov.za/Tools/Documents/DocumentDownload.asp?FileID).

Further, dividends taxpayers will be able to request, verify a pre-populated Dividends Tax return to SARS. In addition, dividend taxpayers will be able to create a Pipe Separated Values (PSV) encrypted disk from easyFile™ software and submit the encrypted disk at a SARS branch where the relevant dividends transactional data will be unloaded and the Dividends Tax will be submitted.

## CHAPTER 9. DIFFERENCES BETWEEN STC AND DIVIDENDS TAX

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### 9.1. Base and person liable

STC liability arises where a dividend is declared. The company declaring the dividend is responsible for paying the STC. STC is payable over and above the dividend distributed.

As opposed to STC, the liability for Dividends Tax arises when dividends are paid to the beneficial owner. The liability for payment of Dividends Tax rests with the beneficial owner. The company only has the responsibility to withhold the Dividends Tax or in certain instances the intermediary will be responsible for withholding the Dividend Tax.

The only exception to this rule is with regard to the dividend *in specie*. The liability for Dividends Tax for the *in specie* distribution is the company paying the dividend. Where low or no interest loans are provided by a company to a person by virtue of shares held in that company the interest benefit so provided is deemed to be a dividend and consequently subject to Dividends Tax in the form of Value Extraction Tax.

### 9.2. Rate

Dividends Tax was introduced at the rate of 10% and the rate was recently increased to 15% by the Minister of Finance in his 2012 budget speech. The 15% will thus be withheld by the company or the necessary intermediary once the dividend is paid unless one of the exemptions or a reduced rate is applicable. The current rate of STC is 10%.

### **9.3. Exemptions**

Under the STC regime, dividends declared by certain companies were exempt based on the status of the declaring company. However under the Dividends Tax, dividends paid could be exempt from Dividends Tax depending on the nature or status of the recipient. The exemptions may or may not apply in the sense that it will only apply where the beneficial owner furnishes the distributing company or the relevant intermediary with the required notifications prior to payment of the dividend. Where the beneficial owner does not timeously furnish the distributing company or the relevant intermediary with the relevant notification, the Dividends Tax will be withheld at the full rate. The beneficial owner may still claim a refund of the Dividends Tax paid should he/she furnish the required notification within a period of three years.

### **9.4. Reduced rates for foreign residents**

Where the double Taxation Agreement between South Africa and a foreign country provide for a reduced rate of Dividends Tax, foreign residents may pay a reduced rate instead of the full rate of 15% Dividends Tax. This will occur where the foreign beneficial owner to be a company and holds between 10% and 25% of the share capital of the South African company declaring the dividend. It remains the responsibility of the foreign resident to declare their status to the company declaring the dividend or the regulated intermediary. Under the STC regime, it was not possible to have a reduced rate because STC was not viewed as a tax on dividends as contemplated in the tax treaties.

### **9.5. Calculation**

STC calculation is based on the dividends declared less dividends received in any particular dividend cycle. The Dividends Tax on the other hand is calculated by number of dividends paid with no reference to any period. STC credits available to the company are available to reduce the liability for Dividends Tax. These STC credits are only available for a period of five years from the 1 April 2012. The STC credits are made up of from two possible sources i.e. any unused STC credits of the company brought

forward from the final dividend cycle under the STC regime, as well as any new pro rata portion of any STC credit received by the company under the Dividends Tax.

## **9.6. Liability for payment**

Under the STC regime, the liability for payment of tax lies with the company. Under the Dividends Tax the beneficial owner is liable for payment of Dividends Tax, though the company paying the dividend or the relevant intermediary is liable to withhold the tax. Companies paying the dividends or the relevant intermediaries who fail to adhere to their duties of withholding Dividends Tax could be held personally liable under certain circumstances. Liability for Dividends Tax rests with the company paying the dividend where a dividend *in specie* was distributed.

## **9.7. Returns**

The payment of STC and Dividends Tax alike has to be accompanied by a return in the form prescribed by the Commissioner. A return must be submitted to SARS by each party that is engaged in the dividend distribution chain and must account for the payment of dividends to the beneficial owners and in certain circumstances the pass through of dividends to regulated intermediaries for further distribution. The return summarises how the dividends were dealt with and whether any taxes were withheld.

## **9.8. Refunds under the Dividends Tax dispensation**

Under the Dividends Tax regime, refunds can only be claimed from the company or regulated intermediary which withheld the Dividends Tax. A refund can only be claimed by a beneficial owner within a period of three years from the date of payment of the dividends by submitting any outstanding documentation. A company paying the dividends or the relevant intermediary should utilise any future Dividends Tax withholdings made by them as a source for the refunds. Only in limited circumstances can a recovery be made by the withholding agent from SARS.

## **9.9. General**

Dual listed companies will be allowed a deduction on the foreign withholding taxes paid on the dividends in respect of the Dividends Tax due. Under the STC regime, such deductions were not allowed.

The administrative provisions with regard to the raising of assessments, levying of interest and the like remain the same under the new Dividends Tax as under the STC regime.

## CHAPTER 10. VALUE EXTRACTION TAX

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STC had anti-avoidance provisions under section 64C (the deemed dividend provision) that were used to prevent the avoidance of STC by distributing amounts to shareholders through guises. Under the Dividends Tax regime, the Act has introduced the Value Extraction Tax (VET) as an anti-avoidance provision to prevent companies from extracting values that seek to circumvent the Dividends Tax.

The Value Extraction Tax comes into operation on 1 April 2012. The VET was introduced as a tax levied at the rate of 10% of the value extracted from the company that is a resident of the Republic. Since the Minister of Finance, Mr. Pravin Godan has increased the Dividends Tax to 15% in his 2012 budget speech; it goes without saying that the VET will also be increased to 15%.

The VET is only levied to the extent that the value extraction is not already viewed as an actual dividend. The following may be viewed as examples of value extraction:

The company provides financial assistance to a connected person in relation to the company;

The company releases or relieved any connected person in relation to the company from any obligation measurable in money which is owed to the company;

The company pays or settles in the debt of the connected person in relation to the company which is owed to a third party; and

Any person that ceases to be a resident.

VET will only apply in all the four circumstances if the transactions took place on or after 1 April 2012. Further, VET will apply in the first three circumstances, to the extent that the transactions were not deemed to be a dividend as contemplated under section 64C. As opposed to Dividends Tax, VET is imposed on the company making the transaction and not on the beneficial owner.



The company must pay the tax to the Commissioner on the last day of the month following the month during which the value extraction is effected. Where the Commissioner is satisfied that any value extraction tax has not been paid in full, he may estimate the amount of the VET. Interest calculated at the prescribed rate is levied on the unpaid amount where a company is liable for the payment of VET and fails to pay the tax within the required period.

The amount of the value extraction is deemed to be nil to the extent that the value extraction is effected in favour of:

A company which is a resident;

The government, a provincial administration or municipality;

A public benefit organisation that is approved by the Commissioner in terms of section 30(3);

A closure rehabilitation trust as contemplated in section 37A;

An institution, board or body contemplated in section 10(1)(cA);

A fund contemplated in section 10(1)(d)(i) or (ii);

A person contemplated in section 10(1)(t)<sup>47</sup>.

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<sup>47</sup> Silke: South African Income Tax 2011 edition: page 535 to 536

## CHAPTER 11. INTERNATIONAL COMPARISONS

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### 11.1. Australia

Australia has adopted an 'imputation' system of taxing dividends. Under the 'imputation' system, the shareholders do not receive the full amount of the dividend distributed by an Australian resident company but the shareholders receive the dividend less the tax withheld by the company. In Australia, companies are subject to a flat rate of 30% on their taxable income. The tax paid by the company is allocated to shareholders by way of "franking credits" attached to the dividends the shareholders receive.<sup>48</sup>

These types of dividends distributed to shareholders from the company profits on which tax has already been paid, are known as 'franked' dividends. As shareholders are part owners of the companies in which they invest, tax paid by the company is considered to be tax paid by the shareholders themselves. Significantly, as far as the Australian Tax Office is concerned, this means that if the company has paid tax on its profits at 30% before one receives his/her dividends, then effectively one has paid tax on them at 30%. Therefore, if one receives dividends on which 30% company tax has already been paid, and one's own marginal rate of personal income tax (the highest rate of tax one pays) is also 30%, one owes no further tax on them.

If one's marginal tax rate is higher than the rate at which the dividends have been taxed, one will need to pay the taxman the difference. Conversely, if a shareholder's marginal tax rate is lower than the rate already paid on the dividends, the shareholder will receive a tax credit for the difference. Where the tax credits are great enough to reduce the shareholder's tax payable to nil, any remaining credits will be refunded. When share dividends are tax-paid in the hands of investors at the full company tax

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<sup>48</sup> New Zealand Journal of Taxation Law and Policy. (2007). Off-Market Share Buybacks: An Australian Perspective, September issue.

rate of 30%, they are known as ‘fully franked’ dividends. When they are tax-paid at a lower than 30% rate, they are known as ‘partly franked dividends’.

Some companies pay dividends out of funds on which no company tax has been paid. These are referred to as ‘unfranked dividends’. Because franked dividends have tax of up to 30%, paid on them, a fully franked dividend of 6%, is worth more than a 6% return on a term deposit. For example, a shareholder on the top marginal rate of 46.5% would need to pay only another 16.5% tax on the grossed-up value of their fully franked dividend, meaning their after-personal tax dividend return becomes 4.6%.

On the other hand, the term deposit holder, if also on the top marginal tax rate, would lose 46.5% of their 6% return to the taxman, meaning their term deposit return is reduced to a 3.2% return after tax.

When a shareholder receives his/her share dividend statements, they will state what percentage of the dividend is franked and what his/her actual franking credit (the amount of tax paid) on that dividend is. During the filing season, the taxed dividend and the franking credit are added (grossed up) into the shareholder’s total income and then the franking credit — the tax already paid by the company — is offset against the shareholder’s income to reduce the shareholder’s tax-payable.<sup>49</sup>

The basis of the system is that if a company pays or credits shareholders with dividends which have been franked, they may be entitled to a tax offset for all or some of the tax the company has paid on its income. If a taxpayer receives a franked dividend, then the franked amount of the dividend and the franking credit must be included in the calculation of taxable income. The taxpayer is then entitled to a tax offset for the amount of tax the company had paid on the dividend distributed to them in determining their final tax liability.

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<sup>49</sup> Walker, C. (2007). Reduce your tax: Dividend Imputation Explained. Money Magazine, February issue.

The franking tax offset may fully or partly cover the tax payable on the dividends.<sup>50</sup> The dividend imputation system was introduced in Australia in 1987, and stopped the double taxation of company income. Prior to its introduction, companies paid tax on their earnings, then the shareholders paid tax on the dividends at their marginal tax rate - effectively giving the government double tax on the company's earnings.<sup>51</sup>

## **11.2. The simple past: Australian Federal corporate-shareholder taxation 1915 to 1923**

Australia has not always adopted an 'imputation' system. From its inception in 1915 until 1923 the federal income tax used a dividend deduction system of corporate-shareholder taxation. Amendments introduced in 1916 limited the deduction to distributions of 'assessable income' which did not include items such as foreign source income and capital gains. Capital gains were not included in the corporate tax base but dividends funded from domestic source capital profits were assessable to shareholders at marginal rates. Capital gains and other domestic preferences were washed out on distribution.

In 1918 the dividend deduction system was replaced by a form of imputation system in relation to distribution of previous taxed income. From 1918 a rebate was allowed to both resident and non-resident shareholders for dividends funded from previously taxed corporate income. The rebate was limited to the lesser of tax at the corporate rate and tax at the shareholder's rate on income from property.

A company had an election to either pay income tax on distributions to non-residents or to withhold tax from them. A shareholder included the dividend in assessable income, but in determining tax payable, deducted the tax paid by the company.

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<sup>50</sup> New Zealand Journal of Taxation Law and Policy. (2007). Off-Market Share Buybacks: An Australian Perspective, September issue.

<sup>51</sup> Costa, N.A. Dividend Imputation in Australia.

The end result of the system was that both the resident shareholder and the non-resident shareholder were at par in respect of distributions of both current years' income and taxed income of prior years. Although the treatment of non-resident shareholders was completely non-discriminatory, the actual collection of tax from non-resident shareholder was challenging.<sup>52</sup>

### **11.3. The harrowing complexity of the present: Australian corporate-shareholder taxation in 2005-2006**

The imputation system adopted by Australia in 1987 was a shareholder credit or variable type. This was so because shareholders were given credit on the tax payable on dividends distributed by resident companies because the dividends were distributed from company profits which have already been taxed. In 2002 Australia introduced the Simplified Imputation System. This system was largely modelled from the New Zealand system. This system was somehow become more complex.

An Australian resident company is obliged to keep a record of franking accounts which track Australian corporate tax paid or payable by the company or the franked amount of dividends received from another resident company. Payments of foreign corporate tax do not enjoy franking credits.

A company may attach franking credits to any dividends that it pays. The maximum franking credit that a company can attach to a dividend equals the amount of the dividend multiplied by  $c/1-c$  where  $c$  is the current applicable corporate tax rate. The first dividend paid by a company in a franking period (one year for private companies and six months for public companies) establishes the company's benchmark franking percent for that period.

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<sup>52</sup> Taylor, C.J. (2006). An Old Tax is a Simple Tax: A Back to the Future Suggestion for the Simplification of Australian Corporate- Shareholder Taxation. *JIATA4*; Journal of the Australian Tax Teachers Association, 30.

In an effort to prevent dividend streaming within a franking period system, subject to some exceptions for public companies, it imposes a penalty tax (over franking tax) if a company attaches more franking credits to a dividend than is consistent with its benchmark percentage. Where a company attaches more franking credits to its dividends than it has or generates in its franking account before the end of the franking year, it may produce a ranking deficit at the later time.

Franking deficit tax is offset against the company's future mainstream company tax instalments and can be classified as a form of equalisation or compensatory tax. Where the franking deficit exceeds 10% of the company's total franking credits for the year, the offset against mainstream company tax is reduced by 30%. Attaching fewer franking credits to a dividend than is consistent with the company's benchmark percentage produces a debit in the company's franking account but does not pass a corresponding franking credit onto shareholders. Hence the effect is simply that underfranking produces a loss of franking credits for the company. Specific anti-streaming rules and a requirement that companies report excessive variations in their benchmark percentage are aimed at preventing dividends streaming between periods. The system also contains a general anti-avoidance rule directed at dividend streaming and rules aimed at counteracting trading in franking credits.

Receipt of a franked dividend produces a credit in the recipient company's franking account equal to the franking credits attached to the dividend. The recipient company is also allowed a gross up and creditor for any franking credit attached to the dividend. While this means that a dividend that is franked to 100% will be tax free to the recipient shareholder, it also means that a recipient shareholder will have a tax liability on any dividend received that is franked to less than 100%.

Any tax paid by the recipient shareholder on dividends franked to less than 100% will in turn generate credits in the recipient shareholder's franking account. Although excess franking credits are generally refundable under the Simplified Imputation System, this is not the case where the recipient of the dividend is a company. Excess credits are divided by the corporate rate and are carried forward by the company as a tax loss. Franking credits attached to dividends paid to resident shareholders are included in the assessable income of the shareholder.

Tax is assessed on the shareholder's grossed up income and the shareholder is allowed a tax offset equal to the amount of the attached franking credit. Excess credits are refundable to resident shareholders other than companies and some tax exempts. Excess credits on dividends received by resident companies are converted into tax losses.

The unfranked part of a dividend paid to a non-resident is subject to withholding tax. Non-residents are not entitled to a franking gross up and credit, but the franked part of a dividend paid by a resident company to a non-resident is not subject to withholding tax. Certain redistributions of foreign source income to non resident shareholders are also not subject to withholding tax. Dividends paid to non-residents that are subject to withholding tax, or would be but for certain specified exemptions, are not subject to tax on an assessment basis.

Australia currently uses a dividend imputation credit type system which since 2002 has been modelled on the New Zealand system. While the current system produces vertical equity, by permitting either full pass through or deferred recognition of tax preferences, it favours partnerships and trusts over the corporate form. It also discriminates against non-resident investors by not fully extending imputation benefits to them. Moreover, while producing capital imports neutrality at the corporate level it only produces national neutrality at the underlying resident shareholder level, as payment of foreign taxes are merely treated as pre-tax expenses for the purposes of the dividend imputation system<sup>53</sup>.

#### **11.4. A comparison between the Australian and the South African system of taxing dividends**

From 1915 to 1923 the Australian tax system used a dividend deduction system of

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<sup>53</sup> Taylor, C.J. (2006). An Old Tax is a Simple Tax: A Back to the Future Suggestion for the Simplification of Australian Corporate- Shareholder Taxation. JIATA4; Journal of the Australian Tax Teachers Association, 30.

corporate-shareholder taxation. Under this system, companies paid tax on their profits and the shareholders paid tax on the dividends distributed to them. This resulted in the company being taxed twice on its earnings. This is a typical classical system. This system of taxing dividends is not popular in most tax authorities.

South Africa unlike Australia started taxing dividends by introducing STC on 17 March 1993. Unlike the classical system which was adopted by Australia which resulted in double taxation, STC is levied at the corporate level and the shareholders receive the dividends free of tax. Even though STC does not result in double tax it has its own shortfalls in that it increases the rate of corporate tax. In South Africa, companies are currently taxed at 28% and when dividends are declared before 1 April 2012, the company will still be liable for STC at 10%, which will make the company to pay tax effectively at 38%. This high rate of corporate tax made South Africa to be unattractive to foreign investors.

The classical system as initially adopted by Australia and STC by South Africa were not in line with most foreign tax authorities and they had to be abandoned. Australia adopted the Simplified Imputation System in 1987, whilst South Africa adopted the imputation system by the introduction of the new Dividends Tax on 1 April 2012.

## **11.5. The United States of America**

### ***11.5.1 Introduction***

The USA adopted and uses the classical system. In the United States, dividend income is classified as any taxable profit distributions that are not treated as distributions of a capital nature. For most people, the dividend tax is commonly paid on distributions made from regular corporations to their shareholders. Virtually all shares traded through ones stock-broker will fall into this category. The dividends are not taxable at the corporate level, as is the position in most tax authorities.



The USA system of taxing dividends has attracted severe criticism in that it is one of the few nations that penalises investment through the double taxation of dividends<sup>54</sup>.

### ***11.5.2 Dividend tax rates by type***

When it comes to the dividend tax there are several categories into which each dividend payment may fall.

### ***11.5.3 Qualified Dividends***

For the purposes of calculating the dividend tax, ordinary dividends are for shares held more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. These are taxed at what is known as the qualified dividend tax rate, which is 5% or 15% depending upon the income tax bracket into which the investor falls.

In respect of shareholders with personal income tax brackets of 25% or higher, they will pay a 15% dividend tax on their qualified dividends. On the other hand, for investors in a lower income tax bracket, they will pay a 5% dividend tax. Qualified dividends must be paid between 1 January 2003 and 31 December 2010.

### ***11.5.4 Non-Qualified Dividends***

A non-qualified dividend is any dividend that doesn't meet the test of qualified dividends. The dividend tax on these dividends is the same as a shareholder's personal income tax bracket. If a shareholder is in the 35% tax bracket, for instance, a

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<sup>54</sup> Kennon, J. (n.d.) Investor's Guide to the dividend tax - How the dividend tax works and the dividend tax rates. Available at [www.about.com](http://www.about.com).

shareholder will pay a 35% dividend tax on non-qualified dividends<sup>55</sup>.

### ***11.5.5 Sunset of Dividend Tax Relief scheduled for 1 January 2011***

Under the current dividend tax law, so-called qualified dividends will no longer be taxed at the same rate of long-term capital gains, but will instead be taxed like the non-qualified tax dividends i.e. the same as the shareholder's tax bracket.

A corporation is separate taxable entity, taxable on its income, and shareholders are also generally taxed on dividends paid by the corporation. Shareholders have historically been taxed on dividends as ordinary income, but for the years 2003 through 2010, qualified dividend income of a non-corporate shareholder is taxed as a net capital gain at the rate of 15%.

The framework for taxation of corporate distribution is provided by section 301(c) and 301(a), which require shareholders to include dividends in their gross income and defines the term 'dividend' as a corporate distribution of property (including money) to shareholders out of the corporation's current or accumulated earnings and profits.

A non-dividend distribution is one that is paid out of the capital assets of a corporation and reduces the value of a shareholding, rather than as a dividend. Thus, where a distribution is not made from current or accumulated earnings and profits, it is treated as a return of the shareholder's capital and applied in reduction of the adjusted basis of the shares, and if the non-dividend portion of the distribution exceeds the basis of the shares, the excess is treated as gain on a sale of the shares, ordinarily taxable as capital gain.

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<sup>55</sup> Bittker, B.I., Lokken, L. (2011). Federal Taxation of Income, Estate and Gifts Current Through 2011. Part 13. Corporation and Shareholders.

So long as a corporation's original shareholders retain their share, the reason for gearing the taxability of distribution to the corporation's record of earnings and profits is clear. Until a corporation has profits, any distribution to shareholders is a return of their capital rather than income.

The equity of the system is far less clear where it is applied to shareholders who receive distributions from earnings accumulated before they acquired the shares in the company. Although such a distribution is economically a return of the shareholder's capital, it is taxed as a dividend to the extent of the corporation's earnings and profits, regardless of when accumulated.

The Supreme Court noted this 'miracle of income without gain' in its 1921 decision in *United States v. Phellis*, observing that the incoming shareholder,

*'... simply stepped into the shoes, in this as in other respects, of the shareholder whose shares he acquired, and presumably the prospect of dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon'.*

The USA system of taxing dividends is also complicated in that one must keep track of the shares held by the shareholder. According to this principle, if a shareholder has shares worth R1000, he/she cannot receive dividends which are more than the value of the shares held. The minute there is excess, the excess is deemed to be a gain for capital tax purposes.

### **11.5.6 'Dividend': A term of art**

A distribution is included in a shareholder's gross income to the extent it is a dividend as defined in section 316(a). Section 316(a)'s definition of 'dividend' does not correspond to the usage of the term under state law. A corporate distribution may be a dividend under section 316(a) even if it impairs capital or otherwise unlawful under state law.

The definition of dividend in section 316(a) is two-edged: A distribution by a corporation to its shareholders is a dividend if it is out of (1) earnings and profits accumulated after 28 February 1913 or (2) earnings and profits of the taxable year. The first part of section 316(a), providing that a distribution is a dividend if it comes from earnings and profits accumulated since 28 February 1913, looks to the financial success of the corporation over a long period.

The second part of section 316(a), defining 'dividend' to include distributions out of earnings and profits of the taxpayer. To the extent it exceeds both post-1913 accumulated earnings and profits and current earnings and profits; a distribution cannot be a dividend. A non-dividend distribution is applied against and reduces the adjusted basis of the shareholder's shares. If the distribution exceeds the adjusted basis of the shares, the excess is usually treated as gain from the sale or exchange of property and thus as a capital gain if the share is a capital asset.

The second sentence of section 316(a) lays down an irrefutable presumption that every distribution is out of earnings and profits to the extent thereof and comes from the most recently accumulated earnings and profits. This prevents earmarking a distribution to control its tax status. For example, if a corporation has either current earnings or profits or post-1913 accumulated earnings and profits, it cannot make a distribution from capital until the earnings and profits have been exhausted. Current earnings and profits are computed as of the close of the tax year, without reduction for distributions during the year. A distribution is thus a dividend, at least in part, if the corporation has earnings and profits for the tax year as a whole, even if it had none when the distribution occurred.

Similarly, a distribution that seemed to be a distribution when made, may turn out to be a return of capital because the corporation has no earnings and profits at the end of the year.

If, however, a corporation has earnings and profit deficit when shares are purchased, subsequent distributions to the shareholder may be treated as tax-free returns of capital, even if they come from income earned by the corporation after the shareholder buys the shares.

This possibility is reduced by a nimble dividend rule under which a distribution is a taxable dividend to the extent of current earnings and profits even if the current earnings are not sufficient to restore an accumulated deficit. Also, if a corporation is acquired for the primary purpose of utilising an accumulated deficit to offset subsequent earnings, tax benefits normally flowing from the deficit may be denied.

Despite these shortcomings, the existing system of relating the tax status of corporate distributions to earnings and profits is responsive to a felt need for protecting returns of capital from tax. A better response to this need could no doubt be devised. For example, all receipts from a corporation could be treated as taxable income, and a correction for any resulting over taxation could be made in computing gain or loss when shares are sold, exchanged, or becomes worthless. Alternatively, all distributions could be applied against basis until a shareholder's cost is recouped, and all subsequent distributions or receipts could be taxed as ordinary income, capital gain, or a combination thereof. Congress, however, has shown no disposition to depart from the present rules.

In prescribing the rules for taxing distributions by a corporation 'to a shareholder,' section 301 does not point a statutory finger at the proper person if there are several candidates for the honour. For example, if a shareholder transfers shares or rights to receive distributions to family members, the proper taxpayer is determined not by section 301 but by assignment of income principles or, if the transfer is accomplished by means of trust, by the statutory rules resulting to trusts.

### ***11.5.7 Earnings and profits: some reflections on the taxations of dividends***

In 1916 a distribution of money or property by a corporation was made a dividend taxable at ordinary rate to shareholders only if 'out of its earnings or profits accrued after March 1913. Since 1936, such distributions have also been taxable if 'out of the earnings or profits of the taxable year'.

### ***11.5.8 The law and the controversies***

The problem most recently litigated arises where there are earnings and profits from other transactions, but they are arithmetically insufficient to cover the present market value of the property distributed. In *Estate of Ida S. Godley* 19 T.C 1082 (1953), the Tax Court held that the distribution was a dividend only to the extent of earnings and profits available, and that the remainder of the market value of the property distributed was to be applied against shareholder's basis of his stock pursuant to section 115(d) of the 1939 Code.

The court seemed to have applied what is commonly known as the apportionment in the South African legal system. The court here apportioned the dividend income between one which was distributed from the earnings and profits of the shareholder and the remainder which was according to the court a non-dividend distribution because it was distributed out of capital assets. The interpretation of section 301(a) does not lay down the basis for apportionment. The wording of this section suggests that the calculation of all the earnings and profits are only determined at the end of the tax period. Only then can it be determined whether or not the company or the shareholder has made profits from which it can be determined if the distributions were made out of earnings and profits or out of a capital asset. The interpretation of the legislation by the court in the case of *Estate of Ida S Godley* promotes equity.

On review, in *Commissioner v. Hirshon Trust* 213 F. 2d 523 (2d.Cir.) and *Commissioner v. Godley's Estate* 213 F. 2d 529 (3d. Cir.) the Courts of Appeals for the second and third Circuits reversed the Tax Court in *Godley* and companion case, holding that since earnings and profits covered the basis of the property distribution was 'out of earnings and profits', and that such a characterisation of the distribution was not affected by the statutory requirement that the distribution be valued in the shareholder's hands at market. In coming to its conclusion, the court refused to apply apportionment. It only looked at the company's financial position at the end of the tax year to make a determination as to whether the company had earnings and profits from which it could make distributions. The court holding that at the end of the tax year the company had earnings and profits from which it could make profits it subjected the entire distributions of earnings and equity to taxation. There is clearly no equity in this

interpretation.

### ***11.5.9 The role of the concept***

In the case of *Lynch v. Hornby*, 247 U.S. 339 (1918) one of the most important cases under the 1913 statute, a dividend somewhat extraordinary in size and not covered by corporate earnings for the period since the enactment of the tax law was held fully taxable. The dividend was clearly out of surplus of assets over stated corporate capital. The taxpayer's argument was that a large part of the dividend resulted from the liquidation of property held in 1 March 1913 which had not increased substantially in value since then.

The Court noted the subsequent enactment of the earnings requirement in the 1916 statute but did not regard it as declarative of existing law. It noted that the tax in the early law on shareholders of corporation 'formed or fraudulently availed of' for the accumulation of earnings to prevent taxes on individuals, applied only to earnings after 1 March 1913<sup>56</sup> but it was answered that a distinction had been drawn for this purpose between distributed and undistributed earnings. The dividend currently distributed not in liquidation was considered *de facto* income in the period in which it was received.

Legislative history is almost nonexistent on the point, but it would appear that the out-of-earnings requirement in the 1916 statute was intended primarily to reach a result opposite to that reached by the Supreme Court in the *Hornby* case. By amendment in 1917 it was expressly provided that pre-1913 earnings could be distributed free of tax. But it is clear that this provision changed nothing.

It was ruled under the 1916 statute that a corporation could prevent tax on shareholders by simply declaring a distribution to be out of pre-1913 earnings, even though post-1913 earnings are available. There is no discussion of a distribution out of capital, it seems to be assumed that a corporate distribution is out of earnings, and that

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<sup>56</sup> Revenue Act of 1913.

the purpose of the statutory requirements is simply to make the time at which the corporation realised the earnings the controlling factor in deciding whether a distribution represents income from a period when income was not taxed.

It appears that the court erred in its judgement in the case of *Lynch v. Hornby*. The court ignored to consider an important requirement which is whether the distribution was it out of earnings and profits or whether it was out of a capital asset. The definition of a 'dividend' in section 316(a) refers to a distribution by a corporation to its shareholders if it is out of earnings and profits accumulated after 28 February 1913 or earnings and profits of the taxable year. In the case of *Lynch v. Hornby*, the distribution was out of liquidation of a property held on 1 March 1913 (i.e. after 28 February 1913). The distributions of these funds are clearly not out of earnings and profits but are capital in nature. The distribution should be tax free.

#### ***11.5.10 A comparison between the USA and the South African system of taxing dividends***

In the USA the feeling amongst writers is that the requirement that a distribution, to be taxed as ordinary income, must be out of earnings or profits has outlived its usefulness. As a device for separating income from return of capital the concept has not worked well. Its inadequacy for the task is suggested by the failure of courts and writers to be able to state convincing reasons for not taxing a distribution as a dividend in any of the controversial cases which have arisen.

The distinction between the distribution out of earnings and profits on the one hand and the capital asset on the other hand as it is applied in the USA has lost its taste as other jurisdictions of courts apply the apportionment rule and others do not apply it. There is absolutely no uniformity when it comes to apportionment in approach from the courts. The refusal to apply apportionment by some jurisdictions leads to lack of equity in some cases especially where the company did not make profits for the better part of the tax year and made marginal profits at the end of the tax year because only then it is determined that the company did make some profit and it subjects the whole distributions to shareholders to tax and that can be burdensome to shareholders.



South Africa started taxing dividends when STC was introduced in 1993. As explained in earlier chapters the term 'dividend' is comprehensively defined in section 1 of the Income Tax Act. The introductory paragraph defines a dividend as any amount distributed by a company to its shareholders. The term 'amount distributed' must refer to amounts which can legally be distributed in terms of company law. It is a well established company law principle that dividends may only be distributed out of accumulated profits and may not be distributed out of contributed share capital, share premium or the capital redemption reserve fund. This was held to be the principle in the case of *Guinness v Land Corporation of Ireland* (1882) 22 ChD 349 CA<sup>57</sup>.

The rule, although it has no express legislative authority was held to follow inevitably from the general prohibition of the return of capital to the members otherwise than on winding-up or in accordance with the statutory procedure for the authorised reduction of capital. The payment of a dividend out of capital is *ultra vires* payment. Provisions in a company's memorandum or articles for the payment of dividends out of capital and resolutions of a company which declare a dividend to be paid out of capital are invalid. Because such declarations or payments are *ultra vires*, even the concurrence of every shareholder in declaring the dividend cannot effectively sanction such a payment.

According to this principle, a company which only has share capital and no reserve cannot legally distribute a dividend to its shareholders. The importance of this distinction is that paragraph (a) of the dividend definition refers to profits distributed, other than certain profits of a capital nature by a company in liquidation or a company deregistering. The position in South Africa is clearly similar to the one on the USA. Both the USA and South Africa under the STC regime prefers to levy tax on the distributions of accumulated profits and earnings instead of capital assets.

In South Africa, under the Dividends Tax regime, a new dividend definition is added to the Income Tax Act. This definition contains four exclusions. The first exclusion states

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<sup>57</sup> Notes on South African Income Tax: 2007 edition: at page 261.

that a dividend does not include amounts resulting in a reduction of contributed tax capital. The new definition of dividend under the Dividends Tax is in line with the decision of a South Africa case of Guinness v Land Corporation and the two USA courts of appeals decisions of Commissioner v Hirsshon Trust and Commissioner v Godely'a Estate.

The distinction between a company distribution out of profits and earnings on the one hand and out of capital assets on the other hand in relation to the definition of a dividend has been accepted and applied in South Africa. The court should determine the source of the amount distributed i.e. whether it is from the profits or the capital asset. The source of the money distributed will always guide the courts as to whether the amount is taxed as a dividend or not. The case of Estate of Ida S Godley in the USA was correctly decided as it made this distinction.

## CHAPTER 12. CONCLUSION

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South Africa has for a long time used an outdated system of taxing company distributions. STC had its own advantages and disadvantages. STC was a tax imposed on the company distributing its profits. The shareholders received their dividends free of tax. It was far easier to collect STC from corporate taxpayers than from numerous shareholders.

STC came with its own disadvantages in that, under this regime, corporate tax became increasingly high. When corporate distributions are taxed in the hands of a corporate taxpayer, the rate of normal tax increased from 28% (lowered from 29% in 2008) with an additional 10% STC (lowered from 12.5% in 2007) to 38%. This rate applies to companies that distribute all of their after-tax profits as dividends. Therefore STC created an impression that South Africa's corporate tax was higher than that of other foreign countries. Double taxation is avoided by granting of a credit to companies for dividends received from South African companies that have already been subjected to STC. Consequently, STC is effectively imposed on the distributions of operating profits. Branch profits tax (for companies which are not resident in South Africa, but do business there via a resident branch or subsidiary) is 33% (reduced from 34% in 2007).<sup>58</sup> This high tax rate made South Africa unattractive as a potential investment destination to foreign investors.

South Africa being a developing country depends largely on foreign investments. The government is receptive to foreign investment and South Africa has made good progress in dismantling its old economic system which was based on import substitution, high tariff and subsidies, anti-competition measures and widespread government intervention. The government has substantially reduced its role in the economy and in the interests of promoting private sector investment competition, has reduced import taxes and subsidies to local firms, eliminated the punitive non-resident

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<sup>58</sup> Maxwell, C. (n.d.). Low Tax Global Tax & Business Portal, South Africa: Foreign Investment-Back to South Africa Information: Business, Taxation and Investment. Foreign Investment in South Africa- An Overview. Available at [www.lowtax.net](http://www.lowtax.net).

shareholder tax, removed certain limits on hard currency repatriation and reduced the second tax on corporate dividends (soon to be replaced by a new dividends tax in line with international norms).

Virtually all business activities are open to international investors, although in a few sectors ceilings have been placed on the permitted extent of foreign involvement, such as the banking industry. At present, foreign investments are treated in essentially the same way as domestic investments and receive national treatment for various investment incentives such as export initiative programmes, tax allowances and trade regulations.<sup>59</sup>

In his budget speech on 22 February 2012, the Minister of Finance, Mr Pravin Gordan, stated that,

*“The secondary tax on companies will be terminated on 31 March 2012 and a withholding tax on dividends will be implemented on 1 April 2012. This will align South Africa’s tax treatment of dividends with that in most countries”.*

Under the new Dividends Tax regime, the non-resident companies which are currently taxed at 33% on their normal tax will not be subject to a further tax upon the distribution of its profits to the shareholders. Further, investors could receive credit in their home countries for dividends tax withheld in South Africa.

Further, this form of tax was misunderstood by South Africa’s trading partners and this has led to companies distributing profits to its shareholders not benefiting from the reduced rate provided for by the DTAs. When interpreting the DTAs, foreign countries will now understand what South Africa is referring to.

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<sup>59</sup> Maxwell, C. (n.d.). Low Tax Global Tax & Business Portal, South Africa: Foreign Investment-Back to South Africa Information: Business, Taxation and Investment. Foreign Investment in South Africa- An Overview. Available at [www.lowtax.net](http://www.lowtax.net).

Moreover, under the Dividends Tax regime, shareholders will now benefit from the applicable reduced rates provided for in the DTAs.

South Africa as a country has recently adopted an imputation system by introducing the Dividends Tax. The new Dividends Tax has come with its controversies in that it removed STC liquidation exemption. This effectively denies companies and tax advisors a fair chance to prepare for the changes.

Dividends Tax is a form of imputation system in that dividends are taxed in the hands of shareholders. Dividends Tax is not, however, a complete imputation system. Inasmuch as dividends are now taxed in the hands of shareholders, the company is still liable for Dividends Tax where deemed dividend was paid. The new Dividends Tax has made this possible by the introduction of an anti-avoidance provision in the form of Value Extraction Tax. Under this rule, where a company is deemed to have declared a dividend, it will be liable for Dividends tax as opposed to the shareholder receiving the dividends.

In adopting the imputation system, Australia has introduced brilliant mechanisms which avoid double taxation. These mechanisms include the “franking” system. The “franking” system is working for Australia because in that country, as it is commonly the case everywhere else; the shareholders are part owners of the company in which they invest. Tax paid by the company is considered to be paid by the shareholders themselves. According to the revenue authorities in Australia, if the company has paid tax on its profits at a certain percentage before the dividends are distributed to shareholders, then effectively the shareholders have paid tax on that percentage.

The “franking” system has worked brilliantly in Australia, but the same system will not be effective in South Africa. The “franking” system in South Africa will have undesired consequences. The effect of the “franking” system in South Africa would be that shareholders may never be liable for Dividends Tax. for example, where a South African company has paid tax on its profits at 28% before distributing the dividends to the shareholders, the shareholder will be deemed to have paid Dividends Tax at 28%. Dividends Tax at the rate of 15% would mean that the shareholder would have overpaid the Dividends Tax by 13%.

This would mean that shareholders will always be in a refund position.

The USA system of taxing dividends is also not much of assistance to South Africa. By introducing the Dividends Tax, South Africa was walking away from a system of having a very high corporate tax which was a disincentive for foreign investors. The USA classical system of taxing dividends which result in the shareholders being taxed on the dividends received whilst companies pay tax on their profits will certainly become a setback for South Africa which has tried very hard to move away from a system that discourages foreign investment.

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