

**A CRITICAL LOOK AT THE PROPOSED LEGISLATION ON DIVIDEND TAX**

**by**

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## **SUMMARY**

### **A CRITICAL LOOK AT THE PROPOSED LEGISLATION ON DIVIDEND TAX**

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South Africa is one of the few countries that use Secondary Tax on Companies (STC) to tax dividends that are being distributed by companies to shareholders. Due to the fact that we use this complex system that the rest of the world does not understand, this has been a big issue for foreign investors. The fact that we use STC also makes our corporate tax rate seem very high for investors.

The second issue that we have is that due to the complex nature of our definition of a dividend, there are many people avoiding STC by abusing the current definition of a dividend.

In March 2007 the minister of finance announced that STC is going to be replaced by a new Tax on Dividends and that the current definition of a dividend is also going to be replaced by a new definition.

The tax rate on dividends has already been reduced to 10% from 12.5% but the rest is still a work in progress. Companies and shareholders are however expected to start getting up to date with the changes that are in the pipeline so that the final implementation takes place smoothly.

The purpose of the study is to be a guide for companies and shareholders in South Africa to help them understand the changes that are underway. It is also going to help foreign investors to see that our country is on its way to being more internationally accepted with regards to the way we tax our dividends.

A literature study is going to be used to get all the relevant information. Text books, internet articles and case law will be the main sources of information.

Key words:

*Secondary tax on companies*

*Dividends*

*Dividends Tax*

## **OPSOMMING**

### **‘n STUDIE OOR DIE VOORGESTELDE WETGEWING RAKENDE BELASTING OP DIVIDENDE**

deur Magda Marshall

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Suid-Africa is een van die enigste lande wat Sekondêre Belasting op Maatskappye (SBM) gebruik om dividende te belas wat deur maatskappye uitgekeer word aan aandeelhouders. Omdat ons SBM gebruik en die res van die wêreld dit nie verstaan nie, het dit baie oorsese beleggers afgeskrik om geld in ons land te belê. Omdat ons SBM gebruik veroorsaak dit ook dat ons korporatiewe belastingkoers baie hoog lyk wanneer dit met ander lande vergelyk word.

Die tweede probleem is dat ons ‘n baie komplekse definisie vir ‘n dividend het. Daar is baie mense wat SBM ontduik, omdat hulle die wet kan misbruik.

In Maart 2007 het die minister van finansies aangekondig dat SBM vervang gaan word met Dividende Belasting en dat die huidige definisie van ‘n dividend ook vervang gaan word met ‘n eenvoudiger definisie.

Die belasting koers is reeds verminder van 12.5% na 10% maar aan die res van die voorgestelde wetgewing word daar nog gewerk. Daar word egter van

maatskappye en aandeelhouders verwag om solank op hoogte te kom met die veranderinge sodat die implementering glad kan verloop.

Die doel van die studie is om 'n gids te wees vir maatskappye en aandeelhouders in Suid-Afrika om die nuwe wetgewing wat op pad is beter te verstaan. Dit gaan ook buitelandse beleggers help om agter te kom dat ons land nou meer internasionaal aanvaarbaar gaan wees met betrekking tot die manier waarop dividende belas word.

'n Literatuur studie gaan gedoen word om al die nodige inligting te kry. Handboeke, internet artikels en sakereg sal die hoof bronne van inligting wees.

Sleutelwoorde:

*Sekondêre Belasting op Maatskappye*

*Dividende*

*Dividende Belasting*

## TABLE OF CONTENTS

<b>CHAPTER 1 : INTRODUCTION TO THE STUDY</b> .....	<b>1</b>
1.1 BACKGROUND .....	1
1.2 NEED FOR THE STUDY .....	3
1.3 RESEARCH OBJECTIVES.....	4
1.4 IMPORTANCE OF THE QUESTIONS BEING ASKED .....	4
1.5 RESEARCH STRATEGY .....	5
1.6 CONCLUSION .....	5
<b>CHAPTER 2 : WHAT IS A DIVIDEND?</b> .....	<b>7</b>
2.1 BACKGROUND .....	7
2.2 COMPANIES AND SHAREHOLDERS .....	7
2.3 DIVIDENDS IN SPECIE .....	9
2.4 THE CURRENT DEFINITION OF A DIVIDEND.....	11
2.4.1 THE FORMAL DEFINITION OF A DIVIDEND: COMPANIES THAT ARE IN LIQUIDATION.....	14
2.4.2 THE FORMAL DEFINITION OF A DIVIDEND: COMPANIES THAT ARE NOT IN LIQUIDATION .....	15
2.4.3 THE FORMAL DEFINITION OF A DIVIDEND: INTERGROUP DISTRIBUTIONS.....	15
2.4.4 THE FORMAL DEFINITION OF A DIVIDEND: SUMMARY.....	16
2.4.5 CAPITALISATION DISTRIBUTION .....	16
2.4.6 CAPITALISATION DISTRIBUTION: SUMMARY.....	17
2.4.7 REDUCTION OF SHARE CAPITAL OR SHARE PREMIUM AND THE FIRST PROVISIO THE DEFINITION OF A DIVIDEND IN THE INCOME TAX ACT.....	18
2.4.8 REDUCTION OF SHARE CAPITAL OR SHARE PREMIUM: SUMMARY .....	21
2.4.9 DISTRIBUTION OF A COMPANY'S SHARE PREMIUM .....	21
2.5 TAXABILITY OF DIVIDENDS.....	22
2.5.1 AMOUNTS DISTRIBUTED BY A COLLECTIVE BARGAINING SCHEME IN FIXED ASSETS.....	23
2.5.2 DIVIDENDS DISTRIBUTED BY A COLLECTIVE INVESTMENT SCHEME IN SHARES.....	24
2.5.3 DIVIDENDS RECEIVED BY A SHAREHOLDER IN A SHARE BUYBACK .....	25
2.5.4 FOREIGN DIVIDENDS .....	25
2.6 CONCLUSION .....	27
<b>CHAPTER 3 : SECONDARY TAX ON COMPANIES</b> .....	<b>28</b>
3.1 BACKGROUND .....	28
3.2 NET DIVIDEND.....	29
3.3. DIVIDEND CYCLE .....	29
3.4 DECLARATION DATE.....	30



3.5 PAYABLE.....	31
3.6 EXEMPTIONS.....	32
3.7 DEEMED DIVIDENDS.....	34
3.8 REASONS FOR CHANGE .....	35
3.9 CONCLUSION .....	36
<b>CHAPTER 4 : DIVIDEND TAX .....</b>	<b>38</b>
4.1 BACKGROUND .....	38
4.2 LAUNCH OF DIVIDEND TAX.....	38
4.3 THE NEW DEFINITION OF A DIVIDEND.....	39
4.4 LAYOUT OF DIVIDEND TAX.....	40
4.5 TAX BASE .....	41
4.6 PAYABLE.....	41
4.7 DECLARATION FORMS.....	42
4.8 REFUND PROCESS.....	42
4.9 EXEMPTIONS OR DEFERRALS .....	44
4.10 WITHHOLDING TAX .....	45
4.11 STC CREDITS .....	50
4.12 VALUE EXTRACTION TAX.....	51
4.13 ISSUES REGARDING THE ADMINISTRATION .....	53
4.14 NORMAL TAX LIABILITY ON DIVIDENDS RECEIVED.....	54
4.15 OTHER PROBLEMS .....	54
4.16 CONCLUSION .....	54
<b>CHAPTER 5 : CONCLUSION .....</b>	<b>55</b>
5.1 INTRODUCTION .....	55
5.2 SUMMARY OF FINDINGS.....	55
5.3 CONCLUSION .....	56

## CHAPTER 1: INTRODUCTION TO THE STUDY

### 1.1 BACKGROUND

Currently companies in South Africa are taxed at a fixed rate of 10% on any profit that they pay out in the form of dividends. This is called Secondary Tax on Companies. (STC) According to the budget speech of March 2007 this would be replaced by a new withholding tax of 10% called Dividend Tax.

STC is a tax levied on the company's profits that are paid out to the shareholders as dividends. The company is taxed at 10% on any of these profits. Internationally South Africa, Estonia and India are the only countries that make use of STC. It was therefore no surprise that both companies and individuals wanted STC to be replaced with a tax that is recognized internationally.

The first reason for the change was that the international investors did not understand STC. The effective tax rate seemed very high because when one takes the 28% tax rate on companies and the 10% STC it comes to 34.55%. Other countries also have dividend tax, but it is paid by the shareholder and not by the company. Thus, the effective tax rate on companies is not influenced by the tax on the dividends. (Du Preez, 2007)

Secondly, STC is not recognized by countries that have double tax treaties with South Africa and it placed a limit on dividend tax at shareholder level and not at company level. (Du Preez, 2007)

Thirdly, STC could be avoided by companies because it is only applicable on dividends that are paid out of profits. The tax on dividends is going to be levied

on any distribution paid to the shareholders and not only profits that are paid out. (Du Preez, 2007)

Dividend Tax was going to be implemented in two phases in order to rectify the above mentioned problems and all the misperceptions about the South African tax system. Although companies and individuals were hoping that STC would be replaced by another form of taxation, it was still unexpected when it was announced in the 2007 budget speech. (Mc Nulty, 2007) The new proposal is a withholding tax which means that the tax liability is on the shareholder, but the company must withhold it and pay it over to the South African Revenue Service (SARS) on behalf of the shareholder.

The first phase was implemented on the 1st October 2007. In this phase the name was supposed to be changed from STC to Tax on Dividends and the rate would be lowered to 10%. Until now only the rate has been lowered. This phase did not affect the day to day running of STC and cost approximately R2bn. The second phase was going to be implemented in 2008. In this phase the liability would move from the company to the shareholder and it was supposed to change to a withholding tax. Only then would SARS start to renegotiate the double tax treaties. This has been put off until certain tax treaties have been renegotiated. (Lowtax.net, 2010)

Another major change is that in the past dividends that were declared was the net amount after STC was deducted. In the future a gross dividend will be declared and the tax will then be deducted from that amount. This will influence the way in which dividends will be shown and handled in the normal tax calculation of shareholders.

The effect this will have on ordinary shareholders is very limited, except that they are now paying 2.5% less tax than was levied on dividends being paid out to

them before. (Du Preez, 2006) There will however be a bigger impact on other types of investors and on the market as a whole which could be problematic.

An issue that needs to be looked into is the renegotiation of the tax treaties internationally. The rates that have been agreed on in most treaties vary between 5% and 10%. In some of the treaties they go as low as 0%. This is because internationally they are trying to reduce withholding tax. The South African Treasury has said that they want to put a 5% withholding tax rate under these treaties and that is safely within the international standards. This will however have to be readmitted to the international agreements.

The way in which dividends between South African companies are going to be taxed has also not been settled. There are however options that are available. The best way of doing this is to either have a credit system between companies or to grant a full tax-exemption. The easiest way to do this would be a full tax-exemption since a credit system can become very complex.

Another area of uncertainty is what is going to happen to STC credits when STC falls away in future. The one option is to make all these credits disappear when STC is abolished. This will create a form of double taxation. The second option is to set these STC credits off against the new tax on dividends. De Reus feels that the second option might be the better one because some companies have accumulated these credits over a period of time and it will be harsh to just take them away.

## **1.2 NEED FOR THE STUDY**

As seen above there are a number of problems with STC and the new Dividend Tax has been put in place to eliminate these problems. A study needs to be done to determine whether that is going to be possible with the new legislation to address these problems that were created by STC.

If it is possible that dividend tax can resolve all the problems that there are with STC it also needs to be determined whether Dividend Tax on its own will not create even more problems in our tax system.

The second problem that we need to look into is the old and the new definition of a dividend. With the old definition that we are still using at the moment it is very easy for companies to avoid STC, therefore a new definition is going to be introduced with the new Tax on Dividends that is going to be very simple and make it more difficult to avoid paying tax.

### **1.3 RESEARCH OBJECTIVES**

The aim of this study will therefore be to find clarity in whether Dividend Tax will resolve all the problems that there are with STC and that the proposed taxation is supposed to resolve.

The study is going to take a critical look at all the problems associated with STC and whether Dividend Tax can solve it. If it can solve these problems an in depth study is going to be done to determine what problems will arise through the implementation of the proposed law.

### **1.4 IMPORTANCE OF THE QUESTIONS BEING ASKED**

From the 1st October 2007 the first changes have been made to move away from STC and start the implementation of Dividend Tax for the first time in the South African tax system. Just by looking at the literature, there is great uncertainty about whether tax on dividends will eliminate all of the problems that there are with STC.

The uncertainty stretches even further when looking at all the problems that still need to be resolved with the act itself.

It will be important to analyze all the problems that there are with STC and determine whether they can be resolved by the new legislation. It will also be important to analyze the new legislation on Dividend Tax to determine whether it will be able to solve all the problems and to understand what other problems may arise.

### **1.5 RESEARCH STRATEGY**

This study will be based on all the latest and historical literature on STC that provides information on the current problems. These will also include court cases on STC. The current literature on Dividend Tax in South Africa will also be analyzed.

The current and historical literature on STC will be used to determine why the problems are there.

The current literature on Dividend Tax will be analyzed to understand whether this is the solution to all the problems that we have. The current national literature in South Africa will be analyzed to get a better understanding about which problems we are already facing with the Dividend Tax in South Africa.

### **1.6 CONCLUSION**

The aim of this study is first of all to determine exactly what all the problems are with STC and why they still exist by critically analyzing the literature around STC.

Secondly this study is aimed at determining whether Dividend Tax is going to solve all these problems and that is going to be achieved by analyzing the literature around Dividend Tax.

Thirdly the study is going to look at all the new problems that may arise from Dividend Tax and what can be done to minimize the effect of these problems.

This study will help companies and individuals get a better understanding of the changes that are lying ahead with regards to dividends being paid out. International investors who are uncertain about what all these changes will mean for their investments will also benefit from this study.

## CHAPTER 2: WHAT IS A DIVIDEND?

### 2.1 BACKGROUND

Companies distribute their profit in the form of dividends to their shareholders. A dividend can be either in the form of cash or *in specie*. At the moment Dividends Tax of 10% is being levied on the amount of the dividend.

In the 2007 budget speech the Minister of Finance stated that the definition of a dividend is going to be simplified and that STC is going to be replaced with a Dividend Tax system. The simplified definition of a dividend will be implemented on the effective date when Dividend Tax comes into use. (See chapter 4 on the new definition)

### 2.2 COMPANIES AND SHAREHOLDERS

As seen above the current definition of a dividend includes any amount that is distributed by a company to his shareholders. So to start with you have to make sure that it is actually a company that is distributing the dividend and it is actually a shareholder that is receiving it.

The definition of a company can be found in Section 1 of The Income Tax Act 58 of 1962. According to Section 1 a company includes:

- A company, association or corporation that was set up in accordance with the South African law, or any legal entity that was set up in accordance of the South African law (par (a) of the definition);
- A company that was set up in accordance with the law of any other country (par (b) of the definition);
- Co-operative (par (c) of the definition);

- An association (that is not a company or a closed corporation) that was set up in South Africa to do a specific task in favour of the public or a part of the public (par (d) of the definition);
- A portfolio in a collective investment scheme, in accordance with the Act on Collective Investment Schemes or a similar scheme outside of South Africa where members of the public can invest and where one or more of the investors contribute to have a participating interest in the portfolio of the scheme (par (e) of the definition);
- A closed corporation (par (f) of the definition)

The definition of a shareholder is also defined in Section 1 of the Income Tax Act and states that a shareholder of a South African company or any foreign company includes any registered shareholder with regards to any share. This also includes any other person that has a right to any benefit derived from a share. These benefits include profit, income or capital that is connected to the share in question. (par (a) of the definition of a shareholder)

With regards to a South African and a foreign collective investment scheme a shareholder is described as a registered owner of a part share certificate with regards to a part share. This also includes any other person who has a right to a benefit derived from the part share. These benefits include profit, income or capital that is connected to the share in question. (par (b) of the definition of a shareholder)

A shareholder of a closed corporation is defined as any member of the closed corporation. (par (c) of the definition of a shareholder) And a shareholder of a co-operation is defined as any member of the co-operation. (par (d) of the definition of a shareholder)

In the definition of a dividend there are some specific exclusions. These exclude any distributions made by the following institutions:

- Pension-, provident- or retirement annuity funds.
- Medical schemes that are registered in accordance with the Act on Medical Schemes.
- Friendly societies that are registered in accordance with the Act on Friendly societies.
- Certain other institutions if the Commissioner approved them.

### **2.3 DIVIDENDS IN SPECIE**

Not all amounts that are distributed by a company to its shareholders are in cash. An *in specie* distribution is where a company distributes an asset other than cash to its shareholders. Not only will most of these distributions result in a STC obligation, but they can also have other Income Tax implications. The normal tax implications of an *in specie* dividend depends on whether the asset is a capital asset or commercial stock.

If the *in specie* distribution is of commercial stock then Section 22(8) of the act will be applicable. This Section states that if a company distributes commercial stock, the market value of the commercial stock must be included in the company's income for the applicable year of assessment. A distribution like this can be the result of the following:

- A dividend distribution, including a liquidation dividend;
- A total or part reduction in the share capital, including the share premium;
- The release of preference shares;
- If the company starts buying back its own shares.

Even though the market value of the commercial stock that was distributed *in specie* has to be included in the income of the company, the company also gets

a deduction of the cost thereof in the same year of assessment. The cost of the commercial stock can be deducted in terms of the following Sections:

- Section 11(a), if the stock was bought in the current year of assessment or
- Section 22(2), as part of the opening stock for that year of assessment if it was bought in a previous year of assessment.

In this context, a capital asset is any asset other than commercial stock. Section 8(4)(k) provides for the recovery of deductions or reductions that was claimed against such capital asset. These deductions or reductions can be recovered when the capital asset is being distributed. The market value of the asset will be assumed to be recovered in terms of Section 8(4)(a). The result being that the difference between the market value of the asset and the tax value of the asset on the date of distribution must be included in the company's income as a recovery.

The distribution of a capital asset by a company to its shareholders is a disposal in the context of par 11(1)(e) of the 8<sup>th</sup> Schedule of the Income Tax Act. A company that distributes an asset *in specie* to its shareholders will be assumed to have disposed of the asset for a value that is equal to the assets market value. (Par 75 of the 8<sup>th</sup> Schedule) A distribution is defined in Par 74 of the 8<sup>th</sup> Schedule as any transfer of cash or assets by a company to a shareholder in terms of a share that is held by that shareholder. That is whether or not the distribution is a dividend as defined in Section 1 of the Income Tax Act.

The difference between the value that the capital asset was deemed to be disposed of and the basis cost is the capital gain or loss in terms of the 8<sup>th</sup> Schedule. The value of the deemed disposal of the asset must be reduced with the part of it that is going to be included in the companies income in terms of Par 35(3)(a) of the 8<sup>th</sup> Schedule. Any part of the cost of the asset that was allowed to

be a deducted in the calculation of the company's taxable income must be subtracted from the basis cost of the asset. (Par 20(3)(b) of the 8<sup>th</sup> Schedule)

## **2.4 THE CURRENT DEFINITION OF A DIVIDEND**

A dividend as defined in Section 1 of the Income Tax Act is an amount that is paid by a company to a shareholder. Some distributions are specifically excluded while others are specifically included in the definition. It is therefore very important to look in detail at each distribution that is made by a company to establish if that distribution results in a dividend.

Specific inclusions to the definition of a dividend:

- Profits that are distributed in the course of liquidation or deregistration of the company (Section 1(a));
- Profits that are distributed by a company that is not being liquidated or deregistered. Section 1(b) also includes amounts equal to the nominal value of capital shares, bonus obligations and effects that are distributed to the shareholders.
- Any reduction in the company's profits due to the reduction of the company's share capital, or due to the buying back of the company's shares. (Section 1(c))

Specific exclusions to the definition of a dividend:

- The nominal value of capital shares in the proportion that share premiums were used to pay for the shares. (Section 1(e))
- Distributions that are made by reducing the share capital or share premium of the company. (Section 1(f))
- An amount that is distributed to a shareholder that is in the same group of companies as the company that is distributing the amount and to the

extent that the shareholder reduces the cost of the share in the distributing company. (Section 1(g))

- The nominal value of capital shares that forms part of the equity share capital of the company. (Section 1(h))
- An amount that is distributed by a co-operation by means of a bonus. This is to the extent that the amount is allowed to be deducted from Income Tax. (Section 1(i))
- Any amount that was distributed by means of releasing participant interest in a portfolio in a collective bargaining scheme in shares. (Section 1(j))

First proviso:

- If a company capitalised profits to its share capital or share premium on or after the 1st January 1974, the profits keep their identity as either income or capital of nature. It is also deemed to be available to be distributed to the shareholders. This will be referred to as reserves. (Section 1(i))
- If a company has more than one class of shareholder, the capitalised profits that are referred to in (i) must be divided between the different classes of shareholders. (Section 1(ii))
- Where a company changes one class of share into a new class, the profit that was deemed to be available for the old class must also be deemed to be available for the new class. (Section 1(iiA))
- If a company has reserves capitalised and subsequently cancels the relevant shares without compensation, and then later pays out the share capital or share premium to the shareholders, then the capitalised reserves keep their identity and it will be a dividend. (Section 1(iiB))
- Where a company decreases their share capital or buys back some of the share capital, then the part of the assets or cash that is being distributed to the shareholders that forms part of the share capital or share premium will be seen as a dividend to the extent that the company has capital reserves that was available for distribution. (Section 1(iii))

- If the company reduced its share capital or share premium, or buys back shares from a certain class of shareholders, it is assumed that the company distributed profits to the shareholders. This is to the extent that the share capital and the share premium which was reduced, is more than the share capital and share premium that was contributed by that class of shareholders. (Section 1(iiiA))
- Where a company that previously capitalised profits now loses some of its share capital or share premium because of losses actually made by the company, then the losses must be deducted from capitalised reserves that was deemed to be available for distribution. If the loss is of a capital nature it must be deducted from reserves of a capital nature as far as possible. If the loss is of an income nature it must be deducted from reserves of an income nature as far as possible. (Section 1(iv))
- If a company is liquidated, any realised capital- and income losses must be deducted from the capitalised profits of a capital and income nature. If the company distributes an asset *in specie* during the liquidation, then the capitalised profits must be reduced by the net unrealised loss. (Section 1(v))

Second proviso:

- If a company transfers an amount from their share premium to any other reserve, then the amount will retain its identity as share premium.

Third proviso:

- For the purpose of the definition of a dividend, the word 'profits' includes realised and unrealised profits. This is irrespective of whether or not the company acknowledges these profits for accounting purposes.

#### **2.4.1 THE FORMAL DEFINITION OF A DIVIDEND: COMPANIES THAT ARE IN LIQUIDATION**

The part of an amount that is distributed to a company's shareholders during liquidation (and deregistration) that represents a dividend is defined in paragraph (a) of the definition of a dividend.

This paragraph states that any profit that is distributed to shareholders in the course of the liquidation or deregistration of a company will be seen as a dividend. As per a proviso to the paragraph any amount distributed by the liquidator will be deemed to be distributed by the company itself. This ensures that companies stay liable for STC during liquidation.

Unrealised profits can be defined as the difference between the market value of an asset and the value of the asset as stated in the accounts. Where a company distributes an asset *in specie* the distribution represents an amount of realised profit and an amount of unrealised profit. According to the third proviso the definition of 'profit' includes realised profits and unrealised profits. Therefore the whole amount of profit will be included as a dividend.

Whether a liquidation distribution is a distribution of the company's share capital (or share premium) or of profits is based on the facts. SARS will deem every liquidation distribution as partly share capital (or share premium) and partly profit. If a company keeps trading during the liquidation, and makes either a profit or a loss, they will permanently have a fluctuating balance of unrealised profits. Every time a liquidation distribution is made, the balance of the company's unrealised profits will have to be calculated in order for the dividend to be a 'dividend' as per the definition in paragraph (a).

#### **2.4.2 THE FORMAL DEFINITION OF A DIVIDEND: COMPANIES THAT ARE NOT IN LIQUIDATION**

To the extent that a company that is not being liquidated or deregistered (a running company) distributes profits to its shareholders, this distribution will be seen as a dividend as per paragraph (b) of the definition. As above, realised and unrealised profits are included when referring to 'profits'.

#### **2.4.3 THE FORMAL DEFINITION OF A DIVIDEND: INTERGROUP DISTRIBUTIONS**

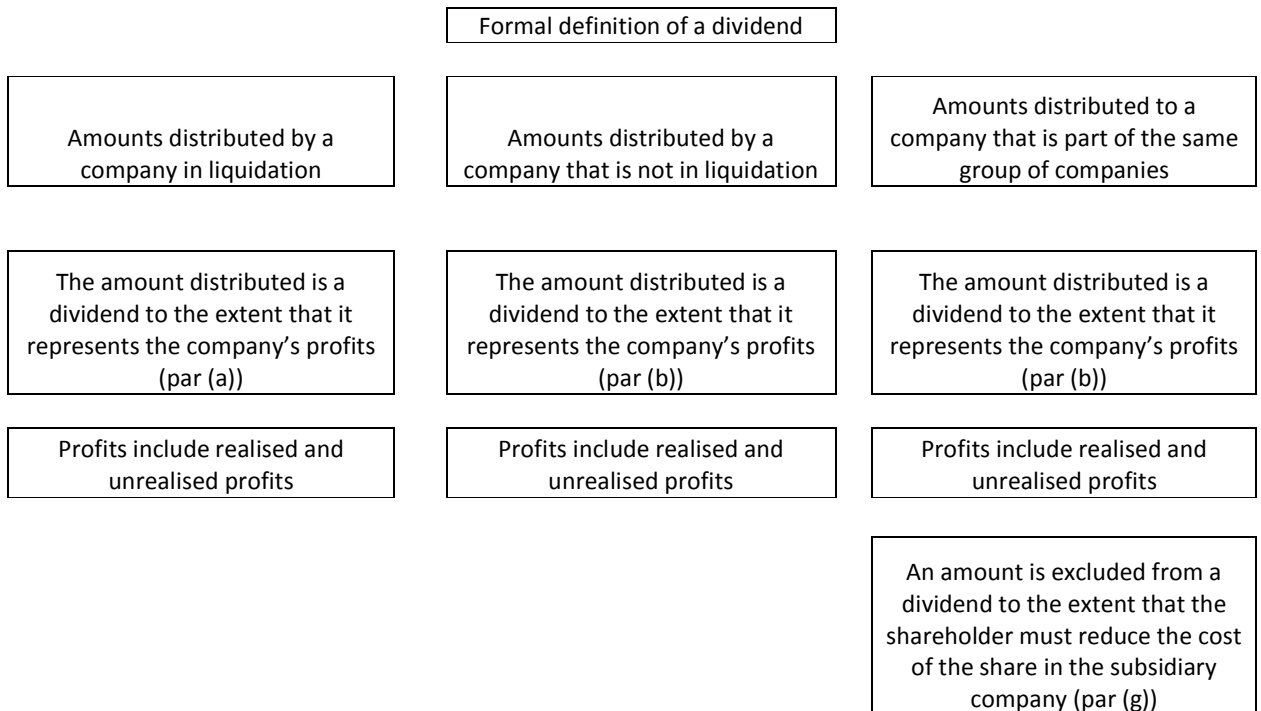
If a company distributes an amount to its shareholder, but the shareholder is in the same group of companies as the company that is distributing the amount, and the shareholder reduces the cost of the share in the company that distributed the amount, then the distribution is not a dividend to the extent that the cost of the share was reduced. (Paragraph (g) of the definition of a dividend)

The Explanatory Memorandum on the Revenue Laws Amendment Bill provides that dividends that are received from pre-acquisition profits will not be seen as income, but a reduction in the cost of the share in the subsidiary. A distribution that is excluded from the definition of a dividend qualifies as a capital distribution as per paragraph 74 of the Eighth Schedule of the Income Tax Act. If the shareholder reduces the cost of his investment in the shares of his subsidiary company, then the distribution is not seen as a dividend, but as a capital distribution.

It seems that the purpose of paragraph (g) is to deal with pre-acquisition profits.

## 2.4.4 THE FORMAL DEFINITION OF A DIVIDEND: SUMMARY

Figure 1: Summary of the formal definition of a dividend:



Source: p470, Chapter 17, Silke 2009

## 2.4.5 CAPITALISATION DISTRIBUTION

Paragraph (b) of the definition of a dividend states that an amount equal to the nominal value of any capitalisation shares that a company allocates to its shareholders as well as the nominal value of any bonus obligations or effects that is allocated to shareholders will be a dividend.

Capitalisation shares and bonus obligations or effects is defined in Section 1 as shares, obligations or bonus effects distributed by the company in such a way that the company's reserves, any share premium or undivided profits is partly or wholly used. The nominal value of the capitalisation shares and bonus

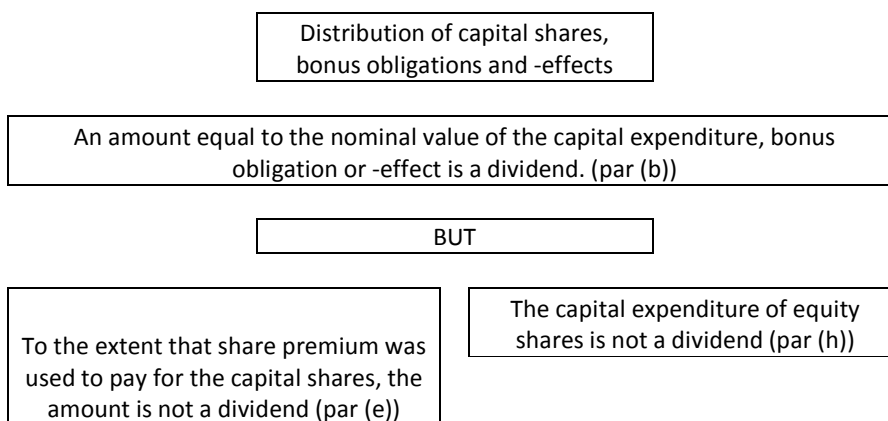
obligations or bonus effects is defined in Section 1 as the amount that was used from the company's reserves, share premium and undivided profits.

Paragraph (e) of the definition of a dividend excludes the nominal value of capitalization shares awarded to the extent that the capitalisation shares were paid for by the application of the company's share premium.

Paragraph (h) of the definition of a dividend further excludes the value of capital shares if the nominal value of the shares that were allocated to the shareholders forms part of the company's equity share capital. Equity shares are defined in Section 1 as issued share capital of a company that gives the right to participate above a fixed amount with regards to the distribution of dividends or capital.

#### 2.4.6 CAPITALISATION DISTRIBUTION: SUMMARY

Figure 2: Capitalisation distribution: Summary:



Source: p472, Chapter 17, Silke 2009

#### **2.4.7 REDUCTION OF SHARE CAPITAL OR SHARE PREMIUM AND THE FIRST PROVISIO TO THE DEFINITION OF A DIVIDEND IN THE INCOME TAX ACT**

A company's share capital or share premium will reduce when the company:

- Reduces the value of its issued shares, or
- Buys back a portion of its issued shares as per Section 85 of The Companies Act, or
- Cancels some of its issued shares, or
- Relieves some of its issued shares, or
- Gets liquidated, or
- Receives some of its own shares due to a distribution by another company, or
- Transfers it from its share premium to its reserves.

Paragraph (f) of the definition of dividend as defined in the Income Tax Act excludes any distribution to the extent that it reduces the company's share capital or share premium.

According to paragraph (c) of the definition of a dividend, the reduction in a company's profits as a result of the reduction of a company's capital or as a result of cancelling or buying back its shares, is a dividend.

A company can capitalise profits by moving the profits to its share capital or share premium. An example of this is if profits are used to pay for capital shares. As seen in the first proviso, if a company moves profits to its share capital or share premium (after the 1st January 1974), it is still deemed to be available for distribution. There is often referred to a company's capitalised profits that are deemed to be available for distribution, as tainted share capital.

Where a company reduces its share capital or share premium (or buys back or cancels issued shares) after the capitalisation of its profits, the reduction is deemed to be a distribution of capitalised profits. This distribution will be treated as a dividend.

Companies can also, subject to their statutes, freely allocate share capital and share premium to specific distributions, even though the share capital and the share premium originates from a different source. Paragraph (iiiA) of the first proviso limits the amount of share capital and share premium that is allocated to a specific class of shareholders.

When a company's share capital is reduced or the company buys back or cancels certain shares from a specific class of shareholders, then paragraph (iiiA) of the first proviso states that the reduction is deemed to be a distribution to that class of shareholders.

If a company used profits to pay for share capital or share premium, the company is now losing that payment due to losses and has to reduce its share capital to balance the loss, then paragraph (iv) of the first proviso kicks in. Any capitalised profits that are deemed to be available for distribution will be reduced to the extent that the loss has been balanced out.

If during liquidation the company loses some of its share capital or share premium due to losses that was actually incurred, then the loss to capitalised profits that was deemed to be available for distribution must be reduced according to paragraph (v) of the first proviso.

If the company has different classes of share capital and certain shareholders had the right to share in the profits of a capital nature and others in the profits of an income nature, then capital losses must be deducted from capitalised profits of a capital nature and any excess can then be deducted from capitalised profits

of an income nature. The same rule is in place for income losses. If the capitalised profits from an income nature are overshoot by the income losses, then the excess can be deducted from capitalised profits of a capital nature. (Paragraph (v) of the first proviso)

Paragraph (v) further states that if a company is being liquidated and an asset is distributed *in specie* to its shareholders, then the capitalised profits of an income nature has to be reduced by any unrealised losses.

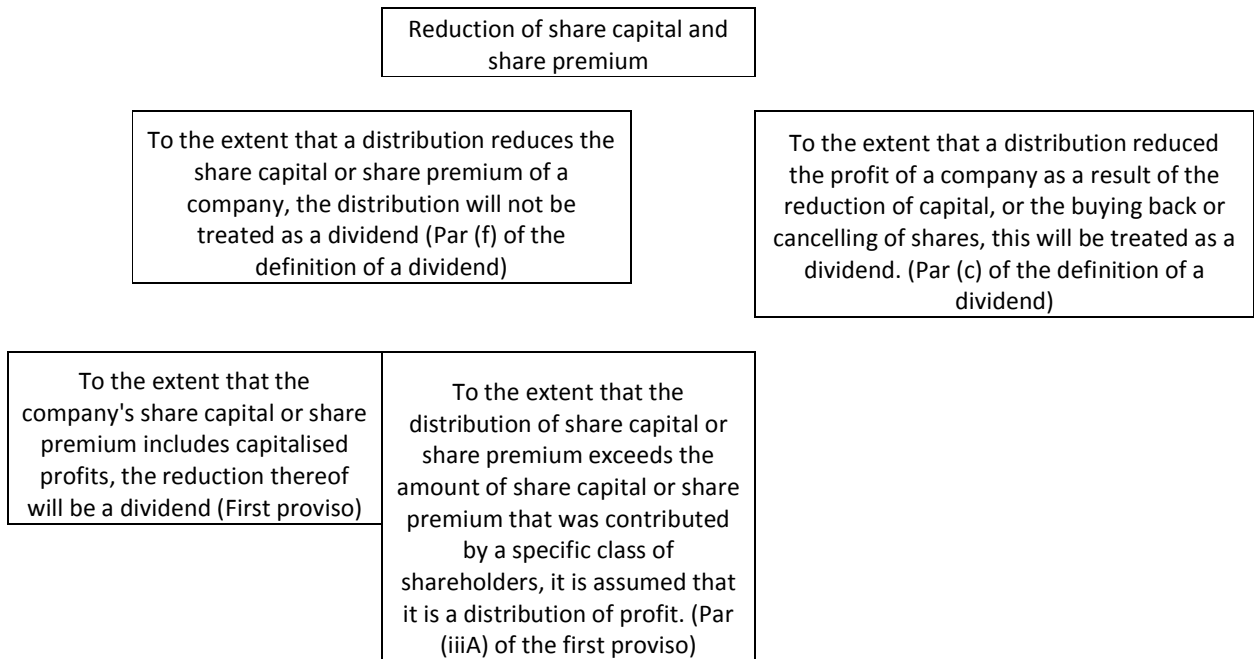
Section 89 of The Companies Act 61 of 1973 states that a subsidiary company can get shares in its holding company, but it is limited to 10% of the total issued amount of shares of the holding company. If the subsidiary company that got shares in the holding company distributes these shares back to the holding company as a dividend *in specie*, then the holding company must acknowledge these shares at market value.

Since a holding company cannot hold its own shares, the shares that it received from the subsidiary company has to be cancelled. If it was equity shares that was received, then it must be deducted from the company's equity. Paragraph (c) of the definition of a dividend provides that it can be assumed that a dividend was declared to the extent that there was a deduction against the company's equity and it reduced its income.

In the case where a company cancels its issued shares that were held by a different company, the other company's income will reduce due to the cancellation. This reduction in income will be treated as a dividend according to paragraph (cB) of the definition of a dividend.

## 2.4.8 REDUCTION OF SHARE CAPITAL OR SHARE PREMIUM: SUMMARY

Figure 3: Reduction of share capital or share premium: Summary:



Source: p484, Chapter 17, Silke 2009

## 2.4.9 DISTRIBUTION OF A COMPANY'S SHARE PREMIUM

Section 76 of The Companies Act makes it possible for companies to transfer money from their share premium account to reserves in some limited cases. The second proviso will however be in play in these cases.

An 'amount distributed' in the definition of a dividend specifically excludes the following:

- The nominal value of capitalised shares to the extent that the share premium was used to pay for the shares. (Paragraph (e) of the definition of a dividend)

- Any cash and the value of any asset that was distributed to the shareholder to the extent that the cash or the value of the asset causes a reduction of the share premium account of the company. This will however have to be applied, keeping in mind the first proviso.

## **2.5 TAXABILITY OF DIVIDENDS**

Dividends have different tax implications for the company that declares the dividend and the shareholder that receives the dividend. The company that declares the dividend will most probably be subject to STC and the shareholder who receives the dividend will most probably be subject to Income Tax.

Paragraph (k) of the definition of gross income in Section 1 of The Income Tax Act includes any amount that is received by or accrued to a taxpayer, even in the form of a dividend. With regards to a South African resident that includes foreign and local dividends. With regards to non South African residents it includes dividends that are paid from a South African source.

Most dividends are exempt from Income Tax as seen in Section 10(1)(k). These however are not exempt:

- Amounts distributed by a collective bargaining scheme in fixed assets,
- Dividends distributed by a collective bargaining scheme in shares,
- Dividends received by a share dealer through a dividend-buyback, or
- Certain foreign dividends.

### **2.5.1 AMOUNTS DISTRIBUTED BY A COLLECTIVE BARGAINING SCHEME IN FIXED ASSETS**

Dividends that are paid by a 'fixed asset company' for shares that are included in a portfolio in a collective bargaining scheme in assets, out of profits from an income nature, will not be exempt from Income Tax.

Dividends that are paid by a 'fixed asset company' for shares that are included in a portfolio in a collective bargaining scheme in assets, out of profits from a capital nature, will be exempt from Income Tax according to Section 11(s) of The Income Tax Act.

The company is not liable for tax on profits from an income nature that is distributed to shareholders and therefore the shareholder has to pay tax on the transaction. These dividends are called 'income-dividends'.

A fixed asset company is defined in Section 47 of The act on the Control of Collective Investment Schemes 45 of 2002 as a company whose shares are included in a portfolio in a collective bargaining scheme in assets and whose primary business is the acquisition of fixed assets. Dividends paid by a fixed asset company out of profits of a capital nature that is received by a non RSA citizen shareholder will also be covered by Section 11(1)(k)(i) and therefore be tax free.

The entity that receives the taxable dividend income, the portfolio in a collective bargaining scheme in fixed assets, is not seen as a company for Income Tax purposes but as a trust. All amounts received by a collective bargaining scheme keep its identity in the hands of the shareholders to whom it was distributed to. If, for example, the income out of a taxable dividend or interest is distributed to the shareholders, then they will be liable for the tax of the income that they received. Even though these amounts are not exempt in Section 10(1)(k), Section 10(1)(i)(xv) is the basic exemption Section for interest and dividends (that are not

otherwise exempt) and also income from dividends and interest that is distributed by a collective bargaining schemes in fixed assets if they are natural persons. Section 10(1)(i)(xv) can therefore be used to in this case.

### **2.5.2 DIVIDENDS DISTRIBUTED BY A COLLECTIVE INVESTMENT SCHEME IN SHARES**

A portfolio in a collective investment scheme in shares, is a company, according to paragraph (e)(i) of the definition of a company. Any income made by a collective investment scheme that is distributed to the shareholders is exempt from Income Tax in the hands of the company as per Section 10(1)(iA). The same distribution will therefore be taxed in the hands of the shareholder.

Dividends that are declared by a collective investment scheme out of amounts that were received through the scheme in the form of Section 11(s) dividends is taxed in the hands of the shareholders. Section 11(s) is only applicable where the fixed asset company's shares include shares in a portfolio of a collective investment scheme in shares. So a collective investment scheme in shares can only receive a Section 11(s) dividend if it is the registered holder of participating interest in a collective investment scheme in fixed assets.

If a collective investment scheme in shares receives dividends from a local company, the dividend will not be taxed in the hands of the collective investment scheme. If that dividend is later paid out by the collective investment scheme to its shareholders, then the shareholders will also be exempt from paying tax on it.

In the case where an investment scheme in shares receives foreign dividends from a foreign company the dividends will be exempt from Income Tax if it gets distributed to the shareholders or is going to be distributed to the shareholders. (Section 19(1)(iA)) The dividend in question will be deemed to be received by the shareholder directly from the foreign company that declared it in the first place.

Therefore a Section 11(s) dividend, a taxable foreign dividend and the part of it that is interest, that is distributed to the shareholders of a collective investment scheme in shares, is not exempt in terms of Section 10(1)(k). The Section 10(1)(i)(xv) exemption for interest and dividends, that is not elsewhere exempt, is also applicable on taxable dividends that are distributed by a collective investment scheme in shares if the shareholder is a natural person.

### **2.5.3 DIVIDENDS RECEIVED BY A SHAREHOLDER IN A SHARE BUYBACK**

In a case where a person holds shares in a company as trading stock and the company buys back a part of its share capital in terms of Section 85 of the Companies Act, then the dividend that is included in the selling price is not exempt. (Section 10(1)(k)(i)(cc))

The dividend that is included in the price is determined by paragraph (c) of the definition of a dividend. (Refer to 2.4.7 for details)

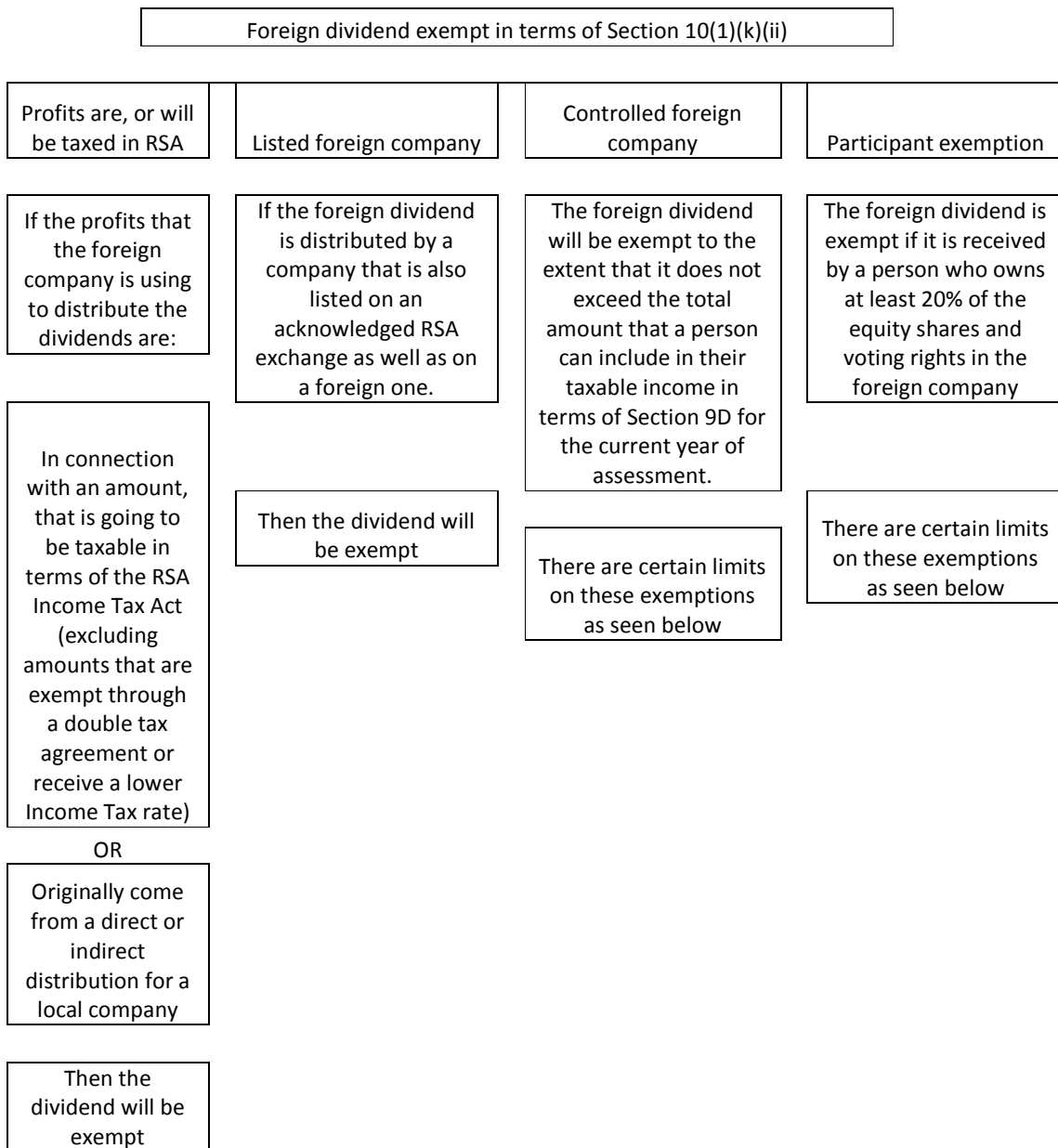
### **2.5.4 FOREIGN DIVIDENDS**

Similar to local dividends, foreign dividends are included in paragraph (k) of the definition of gross income and must therefore be included in it. Section 10(1)(k)(ii) creates an exemption from normal Income Tax in certain cases for foreign dividends.

A foreign dividend is any dividend, as seen in Section 1 in the definition of a dividend, received from a foreign company. A foreign company is any company, as defined in Section 1 that is not a RSA resident. (Section 9D(1))

The following diagram can be used to determine if a foreign dividend can be exempt in terms of Section 10(1)(k)(ii).

Figure 4: Exemption of a foreign dividend:



Source: p488, Chapter 17, Silke 2009

## 2.6 CONCLUSION

Looking at the above definition of a dividend it is very complex and there are many loopholes in it for people who want to avoid paying STC (Secondary Tax on Companies). Therefore a new definition for the word dividend is going to be introduced with the new dividends tax in order to make it simple and to keep people from avoiding the tax.

## CHAPTER 3: SECONDARY TAX ON COMPANIES

### 3.1 BACKGROUND

STC is a tax on dividends declared by companies that are resident in RSA. It was incorporated in the RSA in 1993 and went hand in hand with a lowering of the corporate tax percentage. (SARS Online)

From	Until	Rate
17 March 1993	21 June 1994	15%
22 June 1994	13 March 1996	25%
14 March 1996	30 September 2007	12.5%
1 October 2007	To date	10%

Because STC is a tax on the company and not on the shareholder, the company will have to take STC into account when declaring a dividend.

The reason STC was introduced was to encourage companies to rather reinvest their profit than to pay it out to shareholders. Sections 64B and 64C together with the definition of “dividend” in section 1 of the Income Tax Act, governs STC. (Ernst & Young, SAICA online, 1994)

Section 64B deals with the STC rate, which is payable and when it is payable while Section 64C contains all the anti avoidance clauses.

### **3.2 NET DIVIDEND**

According to Section 64B(2) STC is payable on the net dividend amount. This can be calculated by taking the amount of the dividend declared and subtracting the amount of dividends received or accrued during the same dividend cycle as per Section 64(B)(3). (Ernst & Young, SAICA online, 1994; SARS online)

If the amount of dividends received is more than the amount of dividends paid out in a dividend cycle, the excess amount will accrue in the next dividend cycle.

Certain dividends received cannot be deducted to calculate the net dividend. These are normally dividends that are exempt from STC. All of these are contained in Section 64B(3A):

- Section 11(s) dividends declared by a fixed property company
- Dividends received from a company that is in the same group of companies and the company that declared the dividend chose not to pay STC as per Section 64B(5)(f).
- Section 10(1)(k)(i)(bb) dividends
- Dividends from a share loan scheme.
- Foreign dividends that did not have their origin in RSA.

### **3.3. DIVIDEND CYCLE**

The definition of a dividend cycle is contained in Section 62B(1) of the Income Tax Act. A dividend cycle goes together with a dividend that was declared. That means that for every dividend that is declared, there has to be a dividend cycle.

The reason why the dividend cycle is important is that the dividend cycle is used to calculate the net dividend. To calculate the net dividend you need to take the dividends declared and subtract the amount of dividends received or accrued

during the same dividend cycle. Therefore it is crucial to know what the start and end date of every dividend cycle is.

A company's first dividend cycle always begins on the latter of:

- 1st September 1992
- Date that the company was incorporated
- Date that the company became a resident
- Date that a dividend was declared if it was between 1st September 1993 and the 17th March 1993

Any dividend cycle after that will start immediately after the previous cycle ended. (Ernst & Young, SAICA online, 1994) A dividend cycle ends on the date that the dividend accrues or is deemed to accrue to the shareholder.

- First day of the cycle = the day after the last day of the previous cycle
- Last day of the cycle = the day that the dividend accrues to the shareholder

It is therefore clear that the dividend cycle does not run with the financial year of the company. Because if there were two dividends declared in one financial year, then there are two dividend cycles in that financial year. (Haxham & Haupt, 2006)

### **3.4 DECLARATION DATE**

As per SARS online, the declaration date of a dividend, whether in cash or otherwise, is the date of payment by a company or close corporation or the date of the prior approval of the declaration by the directors or members.

Because deemed dividends are not a result of a formal declaration or of a prior approval by the directors Section 64 B(4)(c) was written into the Income Tax Act. Section 64 B(4)(c) covers the following situations:

- where any cash or otherwise is transferred or paid over
- by a company
- to its shareholders
- in any other way than a formal declaration
- or due to liquidation
- and the amount in cash or otherwise is due to be a dividend

In these cases the dividend is deemed to be declared on the date that the shareholders receives or accrues the amount. (Haxham & Haupt, 2006)

### **3.5 PAYABLE**

As per SARS, STC is a tax on dividends declared by companies that are resident in RSA. STC is the onus of the company or the closed corporation and not the person who receives the dividend. (SARS Online)

Sub-section 7 of the Income Tax Act deals with the payment of STC. For any dividend received after the 30th June 1993 the STC must be paid over at the end of the month after the month that the relevant dividend cycle ended. Together with the payment, an IB56 has to be completed and handed in as per the Commissioner. The Commissioner can extend the payment period if he thinks it might be necessary. (Haxham & Haupt, 2006)

The IT56 form has to be submitted to the commissioner even if the company chose to be exempt from STC because it was paid to a holding company in terms of Section 64B(5)(f).

Section 64B(8) states that the Commissioner is allowed to estimate an entity's STC liability and give an assessment to the company if he is convinced that STC which should have been paid, was not. The second anti avoidance clause is in Section 79(1). This limits the Commissioner to not assess you for more than three years before the current year, except if he is convinced that there is fraud or important facts that have been left out.

If payment is made late, there is additional tax and interest that can be levied by SARS. Additional tax of up to 200% of the STC payable can be levied and interest can be added at the prescribed rate. (The Income Tax Act, 58 of 1962)

### **3.6 EXEMPTIONS**

In section 64B(5) there are certain exemptions to STC (The Income Tax Act, 58 of 1962; Ernst & Young, SAICA online, 1994):

- Any dividend declared by a company whose receipts and accruals are exempt from tax under one of the provisions of Section 10
- Any dividend declared by property unit trusts as per Section 11(s)
- Any dividend declared by other unit trusts to the extent that they consist of interest or distributions in turn derived from a property unit trust
- Any dividend distributed, in the course of liquidation or winding up of a company, out of profits derived in a tax year which ended no later than 31 March 1993

There is however an anti avoidance clause to liquidation dividends. If a dividend was paid out while the company was awaiting liquidation or deregistration and within 6 months after the dividend was paid out, no steps (as per Section 41(4)) were taken, or the steps that were taken were reversed, to liquidate or deregister the company, then STC will be charged on the dividends and it will be claimed

from the shareholders proportionate to the amounts they received. (Haxham & Haupt, 2006)

The steps that have been put in place in Section 41(4) are as follows:

- If the declaration was done while awaiting liquidation:
  - The company or close corporation must hand in a decision to authorise the voluntary liquidation (as per Section 200 of the Companies Act 61 of 1973 or Section 67(2) of the Act on Close Corporations 69 of 1984) and,
  - The company or close corporation must dispose of all their assets and losses (except assets that they will need to cover outstanding moneys to SARS, any foreign government or admin costs that arise from the liquidation process) except if the Commissioner gave them extension and,
  - The company or the close corporation must also hand in a portfolio, as discussed below, to SARS.
- If the declaration was done awaiting deregistration:
  - The company or close corporation must hand in a written declaration that is signed by all the directors (or members of the close corporation) that confirms that the company or close corporation has stopped trading and has no assets or losses left.
  - The declaration must be handed in at the Registrar of Companies as per Section 73(5) of the Companies Act; the Registrar of Close Corporations in terms of Section 26(2) of the Act on Close Corporations; or the equivalent Authority if the company is in another country.
  - The company or the close corporation must also hand in a portfolio, as discussed below, to SARS.
- In both cases (liquidation and deregistration)

- Additional to the above the company or close corporation must hand in a copy of the decision or a written declaration to the Commissioner of SARS.
- All the information must be handed in before the end of six months, or steps need to have been taken to submit it.

Companies that earn profits inside the RSA and outside the RSA only have to pay STC on the portion of the dividend that is from the RSA profits. For all dividends STC is charged on the portion of the total profits that was earned in the preceding tax year and that was from a RSA source. Any dividend that was received, must be excluded from the calculation. In the case where the profits do not properly represent the source of the profits that were used to pay out the dividend, an entity can apply to the Commissioner to use another reasonable method to calculate which part is from RSA profits. (Ernst & Young, SAICA online, 1994)

### **3.7 DEEMED DIVIDENDS**

In section 64C(3) all the anti avoidance provisions can be found. These anti avoidance provisions provide shareholders with benefits other than through a normal dividend distribution. (Ernst & Young, SAICA online, 1994)

In section 64C(3) there are certain deemed dividends (The Income Tax Act, 58 of 1962; Ernst & Young, SAICA online, 1994):

- Cash or assets distributed for the benefit of a recipient
- If a recipient is released from monetary obligations to a company
- The company settles debt owed by a recipient to a third party
- Any amount that is used by a company in any other manner for the benefit of a recipient

In section 64C(4) there are amounts that are not deemed to be dividends (The Income Tax Act, 58 of 1962; Ernst & Young, SAICA online, 1994):

- Where the distribution consists of capitalization shares paid up out of revenue or capital reserves or represents a reduction of share premium. The reason being that a normal dividend arises in this case so the deeming provision becomes irrelevant.
- Where the amount is remuneration in the hands of the recipient or if the amount is for repayment of debt owed by the company to the recipient.
- To the extent that the amount deemed to be distributed exceeds the total of the company's reserves available for distribution.
- Where the amount is a loan that bears a market related interest rate.
- Where a loan to a recipient who is an employee of the company under the usual terms of a loan scheme generally available to employees who are not shareholders.
- Where a loan or credit is granted to a shareholder and it is repaid before the end of the company's next year of assessment.
- Where a loan is made by one company to another for use by the latter in the RSA and the one company is a wholly owned subsidiary of the other or both companies are owned by exactly the same person or persons.
- Where the amount derived from the capital profits of a company which commences liquidation or winding up proceeding within 6 months after the distribution or such further reasonable period as the Commissioner may allow.

### **3.8 REASONS FOR CHANGE**

One of the main reasons for the change as per L du Preez is that the RSA's corporate tax rate seemed very high when compared to other countries. The reason for that was because the 10% for STC was added to the 28% tax rate,

making our corporate tax rate seem very high. Other countries also have tax on dividends, but the onus is on the shareholders therefore it does not affect the corporate tax rate.

STC was seen as an abnormal feature that confused our foreign investors due to the fact that so few countries ever used it. (Cobbet & Wingate-Pearse, 2007)

According to SARS, international investors are more familiar with a Dividend Tax at shareholder level. Double tax treaties can often limit the amount of Dividend Tax that is imposed at the shareholder level, but not at the company level. (du Preez, 2007)

At the moment STC is only paid on company profits that are distributed to shareholders. Companies can therefore avoid STC by paying their dividend out of funds that are not regarded as profits. Dividend Tax on the other hand, is imposed on any distribution to the shareholder, regardless of whether the money is paid from profits. (Du Preez, 2007)

Former finance minister, Trevor Manuel, said in a 2008 media statement on revised taxation of distributed profits (Conversion of the secondary tax on companies (“STC”) to a shareholder Dividends Tax) that STC raises the cost of equity financing to the detriment of economic growth. He also said that the phasing out of STC will help lower the cost of doing business in the RSA. STC also has a significant influence on RSA companies accounting income statements. This is because the company that is paying out the dividends has to subtract the tax charge from its profits. (SARS, 2008)

### **3.9 CONCLUSION**

After making a study of the legislation on STC, it is clear that this form of taxation can prohibit foreign investors from investing in our country. They do not

understand this form of taxation because we are one of only a few countries in the world that uses it and also because it makes our corporate tax rate appear to be very high, is clearly a problem for overseas investors in our country. In order to make it more appealing to them to invest in our country, we are going to have to get in line with the way in which the rest of the world is handling tax on dividends.

## **CHAPTER 4: DIVIDEND TAX**

### **4.1 BACKGROUND**

The new Dividend Tax will be following the system of taxing distributed profits. Shareholders will therefore be subject to this new tax. The rate of Dividend Tax will be 10% as is STC at the moment. Dividend Tax will be a separate withholding tax and will not form part of the shareholders income. The new tax will apply to distributions during the life of a company as well as when the company is in liquidation.

The reason why the Dividend Tax rules are being introduced to us in such a timely fashion is because of the complexity of the change from STC to Dividend Tax. The new rules are law to the extent that the new sections have been promulgated but they will only be effective in the medium term. (Lai King, 2009)

The amendments that was made in 2009 and promulgated only recently contain the latest amendments to the dividend tax rules and there has been a lot of movement from the rules that were previously published. (Lai King, 2009)

So far dividend tax is a work in progress and by 2011 there will have been further changes. The reasons why it is being implemented in this fashion will be discussed in further detail below. (Lai King, 2009)

### **4.2 LAUNCH OF DIVIDEND TAX**

An extended launching period is vital for different reasons. In depth consultation is necessary for such a big change in our tax system. This has to be done to

identify all the practical problems that may arise from the change, especially those during the transition period. (Lai King, 2009)

Even though the final implementation date of Dividend Tax seems far away now, people should try to understand the new tax before it is fully implemented due to the fact that there are many complex changes that are very important. (Lai King, 2009)

### **4.3 THE NEW DEFINITION OF A DIVIDEND**

Dividend Tax is going to be levied on any dividend that is paid by a company that is a RSA resident. From the effective date of Dividend Tax the new definition of a dividend will also become effective. This new definition states that any amount that is paid by a company to a shareholder, because he/she has a share in the company, will be treated as a dividend. (Silke, 2009)

The word “amount” is nowhere defined in the act. There is however some case law which states that in the context of gross income, an amount does not only include amounts in cash, but also includes the value of any form of an asset that has a value in money whether it is tangible or intangible. (Lategan v CIR 1926 CPD 203 (2 SATC 16); CIR v Butcher Bross (Pty) Ltd 1945 AD 301 (13 SATC 21)) It is expected that the same will be the case when it comes to the definition of a dividend. A dividend will therefore not only include amounts in cash that is paid to the shareholders, but also every form of an asset. The value of the transfer of assets will be the amount that the asset would have been sold for in an arm’s length transaction. (Lace Proprietary Mines Ltd v CIR 1938 AD 267 (9 SATC 349))

There are however two exclusions to the definition of a dividend:

- Any amount that reduces the contributed tax capital as per par (a)

- The definition of a dividend specifically excludes any amount that reduces the contributed tax capital. The purpose of this exclusion is to avoid that an amount which was paid by the shareholder to the company's share capital gets treated as a dividend when it gets paid back to the shareholder. Any amount that is paid by the shareholder towards the company's share capital is seen as a contribution to the tax capital and is therefore not treated as a dividend when the company pays it back to the shareholder.
- Any shares in the company that is declaring the dividend as per par (b)
  - The definition of a dividend specifically excludes any amount that represents shares in the distributing company. The reason for this exclusion is that this does not represent an outflow of value from the company. The companies underlying value of all the assets stays exactly the same even though additional shares were distributed.

#### **4.4 LAYOUT OF DIVIDEND TAX**

The first important change between STC and Dividend Tax is that Dividend tax is a withholding tax while STC was a tax payable by companies when they declared dividends. What Dividend Tax will in effect do, is lower the maximum effective tax rate for companies to 28%. This will lead to higher after tax reserves that can be paid out as dividends which will in turn be taxed in the hands of the shareholders at 10%. (Lai King, 2009)

As with any new law, Dividend Tax will also have a major effect on other areas of the Income Tax Act. One example is all the new definitions, like the new and simplified definition of a dividend. (Lai King, 2009)

#### **4.5 TAX BASE**

Dividend Tax is levied on any dividend that is paid by a company (as per the definition in Section 1 of the Income Tax Act) that is a RSA resident according to Section 64E(1). The date that Dividend Tax has to be levied is the day on which the dividend gets paid to the shareholders. In terms of Section 64E(2) the date that a dividend accrues to a shareholder in terms of Dividend Tax is deemed to be the day that the dividend was paid to the shareholder. This date can differ from the date that it was actually declared.

#### **4.6 PAYABLE**

As per Section 64K(1) the beneficial owner is responsible to pay the Dividends Tax. The beneficial owner is however exempt from this responsibility if it was paid by someone else, like the company that paid out the share or the intermediary.

For the new Dividend Tax law, the company declaring the dividend or the intermediary will have to withhold the tax upon the dividend. The tax that was withheld then needs to be paid over to SARS by the company that paid out the dividends or the intermediary. As seen in Section 64K(2)(a) this payment has to be made on or before the end of the month following the month in which the dividend was declared. (SARS, 2008)

In a case where the company or the intermediary that was bound to withhold the tax on dividends did not do so, or they deducted it and never paid it over to SARS, then the company or the intermediary will be liable for the payment. (Section 64K(3)) The company or intermediary will only be exempt from this if someone else, like the beneficial owner, paid the Dividend Tax over to SARS. (Silke, 2009)

With STC the tax was levied on the net dividend of the company for the applicable dividend cycle. With Dividend Tax the tax is levied on all the dividends that are paid to the shareholder. This amount must however be reduced with the refund amount as per Section 64L.

If the Commissioner is satisfied that any Dividend Tax was not paid in full he has the authority to estimate the unpaid amount and create an assessment for the person owing the tax. (Section 64K(4)) The person can be either the beneficial owner or the company that paid the dividend or the intermediary. Since it is a withholding tax the company and the intermediary will probably be turned to first. (Silke, 2009)

If any amount of Dividend Tax is paid late, interest at the prescribed rate will be levied on the amount as per Section 64K(5). The terms of the act with respect to additional tax and administrative fines for late payment will also be applicable for late payment of Dividend Tax. (Section 64K(6))

#### **4.7 DECLARATION FORMS**

If there is an exemption or a Double Tax Agreement, declaration forms have to be submitted by certain dates. If the forms are not submitted on these dates, Dividend Tax will automatically be withheld. The owners will then have to follow a drawn out refund process to reverse the Dividend Tax. (Lai King, 2009)

#### **4.8 REFUND PROCESS**

Section 64L contains all the specific rules of the refund process. This comes into effect if too much Dividend Tax was deducted by either the company or the intermediary. This normally happens when the beneficial owner of the share did not let them know in time, or with a proper declaration that he or she is exempt

from Dividend Tax, or that Dividend Tax must be deducted at a reduced rate in terms of a double tax agreement. The refund can either be made by the company or by the intermediary or by SARS. (Silke, 2009)

If an exemption declaration (or a declaration of a lower rate of Dividend Tax) was not submitted in time by the beneficial owner, but it was submitted within one year after the dividend was paid out, then the company or intermediary that withheld the Dividend Tax must repay it to the beneficial owner. This refund payment must however only be made if the company or intermediary has a further withholding obligation in terms of Dividend Tax for the beneficial owner within one year of the initial dividend payment. The amount refunded to the beneficial owner then reduces the amount that has to be paid to SARS. (Section 64L(1),(2) and Section 64K(2)(b))

If the excess amount that was withheld has not been repaid within thirteen months after it was withheld, because no other dividends have been paid from which it could be deducted, then the beneficial owner can receive the refund from SARS as per Section 64L(3). (Silke, 2009)

There is however a limit of three years after which you cannot claim the refund back. The three years start from the day that the initial dividend was paid out. (Section 64L(4))

It is therefore clear that companies and intermediaries should rather try to avoid going down this route as it is going to be a time consuming exercise, especially if it could have been avoided by just submitting the declaration forms on time. (Lai King, 2009)

#### 4.9 EXEMPTIONS OR DEFERRALS

Shareholders who are not corporate and who are not resident will be subject to Dividend Tax of 10% on the full amount of the dividend that was declared to them. There will however be limited exemptions and deferrals, as per Section 64F, that will be applied as set out below. The net effect of these will amount to a loss of R6 billion in the first year that it is going to be applied. (SARS, 2008)

- Distributions to exempt entities – If a dividend is distributed to a company that is fully exempt from Income Tax, then the company will also be exempt from Dividend Tax. These are for example pension funds and the Government. Companies that are partially subject to Income Tax will benefit only if they are fully exempt in respect of investment income. For that reason public benefit organisations will be exempt but not recreational clubs because they are only exempt from tax on investment income up to a monetary limit.
- Treaty Relief – If there is a tax treaty between the RSA and a non-residents country of residence, then the Dividend Tax can be limited to the rate in the treaty. Depending on the proposed renegotiation of treaty rate, a 5% limit may apply.
- Intra-company dividends – As a rule, any underlying company profits should only be subject to one level of tax when distributed. This is very important especially if the profit passes through more than one company level. STC achieved this in two ways. First, by taxing the first company that declares the underlying profits and exempting subsequent dividends associated with these profits via the STC credit system. Second, by allowing companies to choose not to apply STC in certain intra group distributions. In a classical system, tax only applies on the last company level. This is done by exempting all inter-company dividends between resident companies with Dividend Tax only applying when the dividend is

declared to a person other than a company or to a non resident. Dividend Tax will be following the classical system.

As seen above, both sets of rules provide relief but in different ways. The new system has an administrative advantage over STC because they do not have to keep track of STC credits. Taxpayers also benefit because of the substantial deferral. An anti avoidance measure will be built in to ensure that the deferral is not excessive. This measure will be applied for closely-held passive holding companies used to accumulate passive dividend income. (SARS, 2008)

#### **4.10 WITHHOLDING TAX**

A company that pays out a dividend is as a general rule obliged to deduct the amount of Dividend Tax that is payable on the dividend before paying it over to the shareholder. In some cases the obligation moves over to an intermediary to deduct the tax on the dividend. Whether it is the company or the intermediary's obligation depends on the tax situation of the shareholder.

The primary obligation lies with the company that is paying out the dividend to deduct the withholding tax before paying the amount over to the shareholder. Since Dividend Tax is only payable if the company that is declaring the dividend is a RSA company, this will only be applicable to RSA companies. The obligation will only move over to an intermediary if there is a withholding tax exemption for the company that is paying over the dividend. (Section 64G(2)(a))

Whether there is a withholding tax exemption for the company depends on if the share that the dividend is being paid for is a certificate share or a non certificate share. A non certificate share is a share that cannot be proven by a certificate or a written instrument, for example a share that is proven in an electronic format. A certificate share is any other type of share, for example a share that has a paper certificate. (Section 64D)

The rules for withholding tax on non certificate shares are less strict for the company that is paying the dividend than when it is a certificate share. The reason for this is because the information of the shareholder is easily known to an intermediary in a non certificate share environment. In these circumstances the obligation normally moves over to the intermediary.

Withholding tax exemption or tax relief exists for the company paying the dividend in the following circumstances: (Silke, 2009)

- If the share that the dividend is being paid for is a certificate share and
  - The beneficial owner (the person that has the right to any dividend from the share as per Section 64D) of the dividend has given a written declaration to the company stating that he or she is exempt from Dividend Tax, then the company must not withhold Dividend Tax. The beneficial owner of the dividend must also hand in a written declaration stating that he or she will let the company know immediately if he or she stops being the beneficial owner. (Section 64G(2)(a)(i))
  - The beneficial owner of the dividend forms part of the same group of companies as the company that is paying out the dividend. Then the company paying the dividend does not have to withhold the tax (Section 64G(2)(a)(ii))
- If the share that the dividend is being paid for is a non certificate share then the company does not have to withhold tax from the dividend. In this case the obligation moves over to the intermediary to withhold the tax. (Section 64G(2)(b))
- If the beneficial owner of the dividend submits a declaration to the company stating that the dividend must be taxed at a reduced rate in terms of a double tax agreement, then the company must only withhold tax at that reduced rate. The beneficial owner of the dividend must also

hand in a written declaration stating that he or she will let the company know immediately if he or she stops being the beneficial owner. (Section 64G(3))

An obligation can also exist for an intermediary to withhold the tax on dividends. An intermediary is a person that pays out dividends that was declared by another person, after it was received from the company that declared the dividend. There are two different types of intermediaries, i.e. a regulated intermediary and an unregulated intermediary.

A regulated intermediary handles non certificate shares and includes the following (Section 64D): (Silke, 2009)

- A central security depository participant as per Section 34 of the Securities Services Act 36 of 2004. A central security depository participant is a person who keeps shares safe and manages the interest of the shares.
- A delegate user as per the definition in the Securities Services Act 36 of 2004. A delegated user is a person who is allowed by the stock market to perform certain services in relation to shares. An example of this is a stockbroker.
- A collective investment scheme as per the Act on the Control of Collective Investment Schemes 45 of 2002. This is a scheme where members of the public are invited to invest money or other assets in a portfolio.
- An insurer as per Section 29A. This is a long term insurer as per Section 1 of the Long term Insurance Act 52 of 1998.
- An approved nominee as per Section 36(2) of the Securities Services Act 36 of 2004. This is an approved person who was nominated by other people to be the registered shareholder on behalf of them. Normally this is not the beneficial owner of the dividend, but a person that only holds the shares for the benefit of other shareholders.

An unregulated intermediary is a registered shareholder in relation to a share, but the shareholder does not receive the dividends of the share. (Section 64D) This person is not the beneficial owner of the dividend but probably the only person who knows who the beneficial owner is.

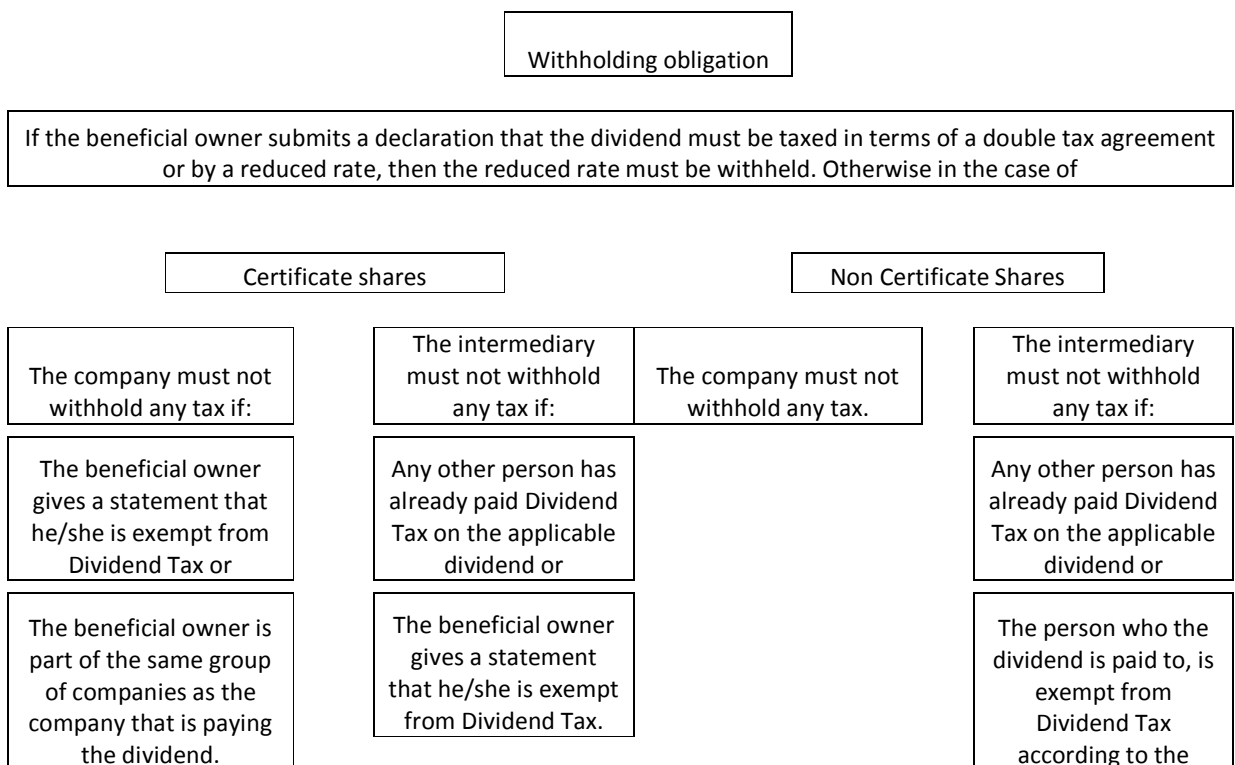
The general rule for intermediaries is that if there is one, the intermediary must withhold the Dividend Tax and not the company that is paying the dividends. (Section 64H(1)) The intermediary is only relieved of this duty if there is an exemption available or a double tax agreement that gives relief.

Withholding exemption or relief is available to an intermediary paying a dividend in the following circumstances: (Silke, 2009)

- If anybody else already paid the Dividend Tax the intermediary must not withhold it as well. (Section 64H(2)(a)) This will be the case if the company that declared the dividend already withheld the tax on it.
- If the shares that the dividend was paid for was certificate shares and the beneficial owner of the dividend gave a written declaration to the intermediary stating that he or she is exempt from Dividend Tax. In a case like this the intermediary must not deduct Dividend Tax before paying out the dividend. The beneficial owner of the dividend must also hand in a written declaration stating that he or she will let the intermediary know immediately if he or she stops being the beneficial owner. (Section 64H(2)(b))
- If the share that the dividend was paid for is a non certificate share and
  - The person to whom the dividend is paid is exempt from Dividend Tax according to the intermediaries register, then no tax needs to be withheld. (Section 64H(2)(c)(i)(aa))
  - The person who the dividend is paid to, is a regulated intermediary. Then the intermediary that is paying the dividend does not have to withhold Dividend Tax. (Section 64H(2)(c)(i)(bb))

- If the beneficial owner of the dividend gave a written declaration to the intermediary stating that he or she is exempt from dividends tax. In this case the intermediary must not deduct Dividend Tax before paying out the dividend. The beneficial owner of the dividend must also hand in a written declaration stating that he or she will let the intermediary know immediately if he or she stops being the beneficial owner. (Section 64H(2)(c)(ii))
- If the beneficial owner of the dividend submits a declaration to the intermediary stating that the dividend must be taxed at a reduced rate in terms of a double tax agreement, then the intermediary must only withhold tax at that reduced rate. The beneficial owner of the dividend must also hand in a written declaration stating that he or she will let the intermediary know immediately if he or she stops being the beneficial owner. (Section 64H(3))

Figure 2: Summary of withholding tax on dividends:



intermediaries  
records or

The person who the  
dividend is paid to is  
a regulated  
intermediary or

The beneficial owner  
gives a statement  
that he/she is exempt  
from Dividend Tax.

Source: p533, Chapter 18, Silke 2009

#### 4.11 STC CREDITS

The STC system allowed the accumulation of STC credits to avoid double taxation. Under the net Dividend Tax system it is no longer needed due to the fact that it will only apply at the top company level. So the issue is what happens to all the STC credits that companies have accumulated?

The Dividend Tax system that is going to be replacing STC is fundamentally different. With STC the tax liability was with the company, while with Dividend Tax it is with the shareholder, even though the responsibility stays with the company. It is also different in terms of the base that it is calculated on. STC is calculated on the amount of dividends declared while Dividend Tax is calculated on the amount of dividends that are receivable. If they want to keep STC credits it is going to cause multiple administrative issues due to the above. One advantage is that by doing away with STC credits it takes the big administrative burden of tracking the credits away. Tax payers might be unhappy about this, but they cannot expect to have all the advantages of a classical system in the future, but still keep the STC type credit relief. It must therefore either be a classical model tax in the future or the credit model must stay in place. (SARS, 2008)

SARS has therefore decided that all STC credits that have been accumulated prior to the implementation of the new system will be forfeited. But given the timely nature of the change from STC to Dividend Tax, taxpayers can utilise their STC credits in the interim. (SARS, 2008)

The phasing out of STC credits is a very important part of the implementation of Dividend Tax. If shareholders and companies do not utilize all the credits they have before a five year cut off period (from the effective date of Dividend Tax) they will face a big financial loss. What the process is focusing on, is that STC and Dividend Tax will not be levied more than once on the same profit stream. To enforce this, the STC credits will be attached to dividends declared by one RSA company to another RSA company. Certain declarations will have to be made by the distributing company to the receiving company in order for the attached STC credits to be valid. If this is not done, the receiving company will not receive the STC credit and the distributing company will still lose the STC credit. (Lai King, 2009)

#### **4.12 VALUE EXTRACTION TAX**

Value Extraction Tax (VET) is a new withholding tax that is due to come into effect as part of Dividend Tax. VET is not a new concept due to the fact that is going to be replacing deemed dividends that exists in STC. (Of which debit shareholders loans is the most common).

Listed below are the four types of transactions that will be affected by VET: (Teuchert, 2010)

- Financial assistance – This is in essence a loan or advance that was granted by a company to a connected person at an interest rate below a market related interest rate.

- The waiver or release of any loan obligation that is owed by a connected person to the company.
- The settlement of any debt by the company that was owed by a connected person to a third party.
- If the company stops being a RSA resident.

Financial assistance – VET is calculated by using the market related interest of the assistance minus any interest that is paid. The market related interest rate is deemed to be the average Repo rate plus one hundred basis points.

When comparing VET in financial assistance transactions to the STC regime, VET is more favourable. This is because with VET it is only the market related interest that is subject to tax where with STC it was the entire loan amount. Another major difference is that under STC, financial assistance is deemed to be a dividend if the loan is not repaid by the end of the financial year, while with VET it is going to be payable from inception.

Waiver of loans and settlement of debts – Where a loan is waived that was due to a third party by a connected person the VET is going to be levied on the respective principal amounts.

Ceasing to be a resident – If a company stops being a RSA resident the VET will have to be determined on the day before it stopped being a tax resident. It will be based on the difference between the market value of all the assets on that day and the liabilities plus all classes of issued share capital.

There are a few exemptions to the rule with VET. The biggest ones are where it is affected in favour of a RSA tax company, all spheres of the government, public benefit organisations, pension funds and medical aid funds.

Further exemptions in respect of financial assistance is: (Teuchert, 2010)

- Where the financial assistance is granted for the provision of goods or services in the ordinary trade of the business carried on by the company.
- If the company carries on the business of a money lender and the financial assistance arises in the ordinary course of the business carried on by the company.
- Where financial assistance is granted to an employee share incentive trust.

Another exemption is where there are VET transactions effected by a company in favour of another company, and the company has more than twenty percent shareholding in the other company, but the other company does not have any shares in the lender company, then transactions will also be exempt.

In the latest draft amendments to the tax legislation it is proposed that VET will not apply to certain financial assistance transactions where the financial assistance would have been seen as a deemed dividend under the STC tax system.

VET is going to be payable at a rate of ten percent and must be paid over to SARS at the end of the month that follows the month when the value extraction took place. If the tax is not paid over to SARS the amount that is outstanding will accumulate interest and can be subject to penalties.

#### **4.13 ISSUES REGARDING THE ADMINISTRATION**

Dividend Tax, as with any new law, has many administrative issues that needs to be sorted out before it can be fully implemented. The first issue comes with the change to a withholding tax. This places the burden on the company that is paying out the dividend to collect the tax for SARS. The new law will be found in Sections 64D to 64N in the Income Tax Act but it will also spiral out into other

sections of the Income Tax Act. New anti avoidance provisions has also been built into the new law that creates more administration. (Lai King, 2009)

Companies will have to change all their administration that goes with dividends. The accounting and reporting will have to be done differently with the new law and will have to be built into their accounting software. This can however not be done if they do not have a full understanding of the new law. (Lai King, 2009)

The only up side to the administration as seen above is that there will be no more STC credits so that does not have to be kept tract of any more.

#### **4.14 NORMAL TAX LIABILITY ON DIVIDENDS RECEIVED**

When a shareholder receives a dividend it has to be included in his gross income as per par (k) of the definition of gross income in the Income Tax Act. The dividend can then be deducted again with all the other income that is exempt in terms of Section 10(1)(k) of the act.

#### **4.15 OTHER PROBLEMS**

Companies that are not listed, should be aware that shareholders and directors of the company can be held personally responsible for the payment of Dividend Tax, additional tax, penalties and interest. (Lai King, 2009)

#### **4.16 CONCLUSION**

It is clear that, when looking at the proposed legislation, there are still a few areas which are going to need some attention, but for the bigger part of it, the legislation is looking to be a very positive change for RSA dividends and should make foreign investors more eager to invest in the RSA.

## **CHAPTER 5:**

### **CONCLUSION**

#### **5.1 INTRODUCTION**

The purpose of this study was firstly to find out what problems there are with the legislation around STC and the old definition of a dividend. Secondly is to determine if the new legislation is able to fix the current problems and make sure that it does not cause a set of new problems.

After going into all the details of the recent literature, case law and text books in the previous chapters, the findings can now be summarised as follows.

#### **5.2 SUMMARY OF FINDINGS**

As seen in the above chapters there was a need for new legislation to replace the current STC legislation. The main reasons for this being that foreign investors did not understand STC because we are one of the only countries in the world that still use it and because it made our corporate tax rate seem very high. So this caused that foreign investors did not want to invest money in South Africa.

Dividend Tax is being incorporated to eliminate the problems that there are with STC. By looking at the chapter on Dividends Tax it is going to solve all the issues that there are with the STC legislation.

Dividend tax is still a work in progress but by looking at all the literature around it people are very confident with the new legislation. As discussed in the study there are a few problems around STC credits and the administration process, but

there are solutions to all these problems. So the coming legislation should not be causing any new problems of its own.

The old definition of a dividend was a very complex definition that allowed companies to avoid STC in various ways. There was definitely a need for a new definition. Looking at what is being written about the new definition it is going to solve all the problems that there was with the old definitions and so far there have been no negative comments about it in any of the literature.

### **5.3 CONCLUSION**

The coming legislation around the taxability of dividends and the new definition of a dividend is going to have a positive impact on the way that foreign investors see South Africa. Residents of South Africa should also find the new legislation easier to understand and easier to oblige with. It is a great improvement on the current STC legislation and is a step in the right direction for South Africa.

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