
Please find below SAICA’s comments, which have been provided by members of our National Tax Committee, to National Treasury and the South African Revenue Service (“SARS”) to the Media Statement – Revised Taxation of Distributed Profits: Conversion of the Secondary Tax on Companies (“STC”) to a Shareholder Dividend Tax (“media statement”) and the Dividends vs. return of capital: Revising the Base for Taxable Distributions document (“dividend tax document”) issued on 20 February 2008.

We refer to our submission dated 19 February 2008 on the conceptual outline for STC reform which we attach as background and for information purposes.

1. Media Statement

1.1 Background – Phase two

1.1.1 It is stated in the media statement that the implementation of the second phase is contingent on the revision of international tax treaties that limit withholding tax on dividends to zero percent. We are aware of a number of such countries which have indicated that they are not prepared to revise their treaties with South Africa. If the second phase is contingent on the revision of those international treaties, what is the plan of action in the event that one of those countries refuses to revise its treaty with South Africa?
1.2 Exemptions or deferrals

1.2.1 Specific comments

1.2.1.1 In the media statement point 2.2 the last paragraph refers to anti-avoidance measures in respect of dividends to closely-held passive holding companies. Further clarity as to how this will work should be provided, i.e. what the measures would be and how it would be applied?

1.2.1.2 Point 2.3 – Mention is made that the tax will be payable by the company to SARS on or before the end of the month following the month in which the dividend was declared. Currently with STC, the payment period is triggered from the Last date to register (LDR) date and not the dividend declared date e.g. if a dividend was declared on 31 March with a LDR date 3 April, STC is payable end of May. In this proposal dividend tax would be payable end of April.

1.2.2 Employee share ownership schemes

1.2.2.1 A number of employee share ownership schemes ("schemes"), and in particular schemes aimed at previously disadvantaged employees, use a formula to determine the strike price of shares offered to these employees. The formula often includes a deduction for dividends or special distributions declared by the company. The previously disadvantaged employees currently does not bear any tax costs associated with the dividends or special distributions declared by the company as the company declaring the dividends or make the special distributions bears the tax associated with the dividends or special distributions in the form of secondary tax on companies. The full dividend therefore qualify as a deduction, however, if the dividend is subject to a shareholder tax, then clearly only the after-tax dividend should be deducted or alternatively, the affected employees will have to fund the tax out of their other after-tax earnings.

1.2.2.2 The proposed change to a shareholder tax on dividends could have significant implications for these previously disadvantaged employees who are participating in these schemes.

1.2.3 Comments Regarding Records Of Shareholders Maintained By Companies

1.2.3.1 Any company which declares a dividend will be required to withhold tax upon declaration of the dividend. The company will have to pay the tax withheld to the South African Revenue Service ("SARS") on or before the end of the month following the month in which the dividend is declared.

1.2.3.2 It is proposed that the new shareholder based dividend withholding tax will make provision for a number of exemptions and deferrals. These include:

1.2.3.2.1 Distributions to exempt entities such as:
1.2.3.2.1.1 Retirement funds
1.2.3.2.1.2 Government
1.2.3.2.1.3 Public Benefit Organisations which are fully exempt in respect of investment income
1.2.3.2.2 Distributions to non-resident shareholders if treaties exist between South Africa and the various shareholders’ country of residence
1.2.3.2.3 Intra-company dividends

1.2.3.3 National Treasury and SARS recognise that there are a number of administration issues regarding dividend payment which are to be made to nominees and other parties acting on behalf of other in paragraph 4 of the media statement dealing with the revised taxation of distributed profits issued on 20 February 2008. They further recognise that the payor company does not necessarily know the identity or tax status of their shareholders and that the issue not only arises in the case of agents, brokers and trading intermediaries but also when payments are made to entities such as collective investment schemes.

1.2.3.4 We are however of the opinion that the administration issues are significantly greater than National Treasury and SARS realise.

1.2.3.5 In the first instance it is noted that whilst unlisted or "closely held" companies may "own" their share registers, the majority, if not all, listed companies do not "own" their share registers.

1.2.3.6 In addition, due to the fact that we have a mixture of paper (10% of shares owned) and dematerialised/electronic shares (90% of shares owned), the maintenance of the share registers is performed by a number of service providers.

1.2.3.7 Strate is the authorised Central Securities Depository for all the dematerialised/electronic shares traded on JSE in South Africa. Strate is therefore the custodian of the dematerialised share register of all companies listed on the JSE. It is noted that paper shares will only convert into dematerialised shares when the shareholder disposes of the shares held.

1.2.3.8 Details of shareholders who still have the paper shares are held maintained by a large number of service providers. The service providers include the 5 major banks, all stockbrokers who operate managed accounts for their clients and share transfer registrars.

1.2.3.9 Based on the above, if a company wants details of all its shareholders, it is clear that a company has to obtain information from a number of sources. The companies further have not control over the quality of the information maintained by the various parties. Consequently, these companies usually pay the total amount of any dividend declared to Strate and Strate then distributes the dividends to the shareholders on its
record and the other parties noted above, who in turn distribute the dividends to the beneficial owners.

1.2.3.10 It is noted that two options are considered regarding the liability for the withholding tax. The first option provides that the liability will rest with both the company and the beneficial owner. Whist this option will be workable in the case of unlisted or "closely held" companies, it will not be a workable due to the fact that the companies do not "own" their share registers. The second option provides that the nominees could be granted authority to withhold the tax because the nominee should have the details of the beneficial owner on record. The nominee would have to meet certain criteria in order for SARS to be satisfied that the nominee has sufficient substance to stand in for the company. It is not clear what the situation would be if SARS found that the nominee does not have sufficient substance to stand in for the company. Either way, both these options would have to be discussed in detail with the various parties as it is clear that any workable solution will require significant changes to the systems of these parties and possibly increases in administrative support to deal with the additional burden of compliance that will be placed on these parties. The additional administrative support will obviously also represent an additional cost to these companies.

1.3 Transitional Issues – STC Credits

1.3.1 STC was introduced during early 1993 and became effective from 17 March 1993. There were a number of reasons stated at the time for the introduction of STC, such as facilitating the lowering of the company rate of tax at that time and the collection of tax on dividends and most importantly **STC was intended to act as an incentive for growth in companies and therefore stimulate job creation and domestic demand through self-financing by way of retaining profits.**

1.3.2 A significant number of companies embraced this incentive and not only did they not declare all their profits as dividends, they also did not declare all the dividends received which were subject to STC when paid to them, as dividends. They opted to re-invest the profits and dividends retained into projects aimed at job creation and improved returns for their shareholders.

1.3.3 The decision to eliminate the STC credits not utilised when the new dividend tax system is introduced will result in the companies which embraced the opportunity to create jobs and develop the economy of South Africa to be severely punished for their patriotism. Admittedly, some of the companies with large STC credits have migrated some of their operations off-shore, however, they have remained patriotic. Comments have been made that some of these companies should rather focus their investment effort in South Africa rather than offshore. One of the unintended consequences of eliminating the STC credits not utilised is that companies which did not head the need to re-invest their profits and consequently create jobs and further grow the economy are rewarded. Comments have been made on a number of occasions that some of the companies with large STC credits and which now hold significant investments offshore are unpatriotic. Regrettably, actions like the
proposed elimination of their STC credits causes the South African government to lose credibility with these entities and may actually create the situation where more of these entities opt to invest offshore rather than in South Africa.

1.3.4 It is noted that SARS and National Treasury is of the opinion that the STC credit issue is insignificant as "given the delayed timing of the change, taxpayers can still utilise STC credits in the interim". Reality is that this solution to the STC credit problem is not that simple. Very few companies have significant retained earnings and excess cash resources which could be used to fund dividends. The solution that a company could declare a dividend and credit the amount due to a loan account ignores human nature. Any small shareholder will require a cash payout and is unlikely to accept having the amount reflected as a loan by him/her to the company. Also, the company may, due to liquidity and solvency requirements, not be in a position to declare exceptional dividends.

1.4 Option 1 and 2

1.4.1.1 Option 2 would result in more administrative issues, as one would need to make sure that the nominee meets SARS’ criteria etc. Option 1 is therefore preferred, although the company carrying joint liability in case of an ‘error’ could be a deterrent.

2. DIVIDENDS VERSUS RETURN OF CAPITAL: REVISING THE BASE FOR TAXABLE DISTRIBUTIONS DOCUMENT

2.1 Detailed Discussion of Proposal

2.1.1 A. Proposed definition

2.1.1.1 It is stated that the Income Tax Act ("the Act") is aimed at taxing profits. This is not correct. It is, and has always been accepted, that the Act is aimed at taxing an artificial concept known as "taxable income". The taxable income of a company bears no relation to its accounting profits.

2.1.1.2 It is further stated that one shortcoming of the current system is that company law/accounting takes into account items other than shareholder contributions, such as reserved profits. The focus should not centre on shareholder contributions from company law/accounting principles, but from tax principles. Company law/accounting focuses on value, whereas the tax calculation should focus on the tax cost of contributions. These comments seem to ignore a number of issues. In the first instance, it ignores the disclosure requirements for annual financial statement purposes of share holder contributions as regards issued capital – whether at par of for no par value – and if issued at a par value, any share premium. It is noted that the share premium may be tainted, but companies had to keep track of any reserves capitalised as share premium. In addition, the reserves that do not comprise share capital or share premium are disclosed separately. In addition, the tax costs of the shares are not the concern of the company but rather the concern of the shareholders!
2.1.3 The commentary then carries on stating "(C)ompany law/accounting allows this form of reserving as a way of providing additional protection for company assets against unwarranted shareholder withdrawals. The tax law has no place for this form of reserving. It is accordingly proposed that tax-free returns of capital be limited solely to shareholder contributions of cash or assets (hereinafter referred to as "contributed tax capital"). With respect, this is no different from the current system, unless the objective is to tax "undistributed profits" which is a different – and somewhat outdated – tax altogether.

2.1.4 The comments made regarding the utilisation of the certain of the corporate rules, i.e. company formations, amalgamations and unbundlings and the contributed tax capital are fundamentally flawed.

2.1.5 Currently, where taxpayers use the abovementioned corporate rules to restructure their operations, no distinction is made between the accounting and tax value of the contributed capital in the hands of the company which issued the equity shares. This is relevant in the case where assets are acquired in terms of one of these corporate rules at a value which differs from the tax value of the assets acquired. It is noted that the shareholder is however treated as having acquired the shares at the tax value of the asset transferred, irrespective of the value at which the asset was transferred for accounting purposes.

2.1.6 It is suggested that the fact that the equity shares may be reflected at a value which is more than the tax values of the assets transferred creates a situation in terms of which the company can reduce or redeem the equity shares without any tax being collected on the difference. It is therefore intended to tax this difference as a dividend in terms of the proposed dividend tax system, that is, the equity capital will have a tax value which differs from the accounting value, i.e. the tax value will be equal to the tax value of the assets acquired. This value will be referred to as the "contributed tax capital".

2.1.7 This perception is incorrect in the sense that it only looks at one aspect of the tax implications of the reduction or redemption transactions, i.e. that of the company. It is clear that no consideration is given to the tax implications for the shareholder nor has consideration been given to the tax implications should the assets acquired in terms of the corporate rules be disposed of and the tax deferred collected.

2.1.2 1. Formations

2.1.2.1 It is proposed that, in the case of tax-free contributions, the shareholder's base cost needs to roll over into the company's contributed tax capital. We are of the opinion that this proposal is flawed. This can be illustrated as follows using current definitions incorporated in the Act to a set of facts and comparing it to the tax results if the proposals are introduced, using the same set of facts.
Illustration – Current definitions:

Example 1 (Part 1): Facts. Taxpayer forms Newco. Taxpayer is a company. In exchange for the Newco shares (200 equity shares with a par value of R1), Taxpayer contributes cash of R90 and land with a value of R110. Taxpayer purchased the land for R60. Taxpayer realised a capital gain of R50.

Result (Part 1): Newco has contributed tax capital and accounting capital of R200. This is made up of the R90 cash plus R110 for the land. Taxpayer holds equity shares with an accounting and a tax cost of R200.

Example 1 (Part 2): Facts. Newco has excess cash and resolves to return 25% of its equity share capital, i.e. R50, being 50 equity shares at par.

Result (Part 2): The return of capital is not a dividend in the hands of Newco and has no other tax consequences for Newco. Taxpayer will however have to account for the disposal of part of the shares held. Taxpayer will determine that capital gain or loss as the difference between the proceeds, being the R50 received from Newco and the base cost of 50 equity shares issued to him at a par value of R1, also R50. Taxpayer will have no capital gain or loss.

Example 2 (Part 1): Facts. The facts are the same as Example 1 (Part 1), except that the parties applied section 42, i.e. an asset for share transaction. In this instance, the accounting values were used for accounting purposes.

Result (Part 1): Newco has accounting capital of R200. This is made up of the R90 cash plus R110 for the land (accounted for at is market value). The tax value of the land is however R60, i.e. the tax value of the land in the hand of Taxpayer. Taxpayer holds equity shares with an accounting cost of R200 and a tax cost of R150, made up of the R90 cash and R60 for the land.

Example 2 (Part 2): Facts. The facts are the same as Example 1 (Part 2).

Result (Part 2): The return of capital is not a dividend in the hands of Newco and has no other tax consequences for Newco. Taxpayer will however have to account for the disposal of part of the shares held. Taxpayer will determine that capital gain or loss as the difference between the proceeds, being the R50 received from Newco and the base cost of 50 equity shares issued to him. The tax cost of the 50 equity shares is R37.50 (25% x R150). Taxpayer will therefore realise a capital gain of R12.50. Taxpayer will therefore have to pay CGT of R1.75. Taxpayer will have to reflect an accounting loss as a result of the return of capital by Newco of R1.75.

The net results of example 1 and 2 are summarised as follows:
2.1.2.3

Illustration – Proposed treatment:

If the suggested treatment is followed, i.e. that the share capital of the company, the results of example 2 will be affected. The situation will then be as follows:

Example 2 (Part 1): Facts. The facts are the same as Example 1 (Part 1), except that the parties applied section 42, i.e. an asset for share transaction. In this instance, the accounting values were used for accounting purposes.

Result (Part 1): Newco has accounting capital of R200. This is made up of the R90 cash plus R110 for the land. Newco will have a "contributed tax capital" of R150 made up of R90 cash plus R60 for the land. Taxpayer holds equity shares with an accounting cost of R200 and a tax cost of R150, made up of the R90 cash and R60 for the land. Taxpayer will not be liable for CGT on the accounting profit of R50 realised on the transfer of the land.

Example 2 (Part 2): Facts. The facts are the same as Example 1 (Part 2).

Result (Part 2): The return of capital will be a dividend in the hands of Newco to the extent that it exceeds the tax cost of 25% of the contributed tax capital, i.e. R37.50, i.e. R12.50 of the capital returned will be a dividend. A dividend tax of R1.25 will be payable. The return of capital will have no other tax consequences for Newco. Newco's accounting profit will be reduced by the R1.25. Taxpayer will however have to account for the disposal of part of the shares held. Paragraph 35 of the Eighth Schedule to the Act provides that a taxpayer should deduct any amounts that comprise "gross income" be deducted from proceeds. Proceeds in this instance will therefore be R37.50, being R50 – R12.50. Taxpayer will determine that capital gain or loss as the difference between the proceeds, being the R37.50 received from Newco and the base cost of 50 equity shares issued to him. The tax cost of the 50 equity shares is R37.50 (25% x R150). Taxpayer will therefore not realise a capital gain or capital loss. No CGT will be payable.

The total taxes payable are summarised as follows:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer capital gain</td>
<td>0.00</td>
</tr>
<tr>
<td>Newco STC/dividend tax</td>
<td>1.25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1.25</strong></td>
</tr>
</tbody>
</table>
2.1.2.4 Comparison of current definition vs. proposal

2.1.2.4.1 The difference of the tax collected in terms of example 2 of the proposed definition will be:

<table>
<thead>
<tr>
<th>Tax</th>
<th>Current</th>
<th>Proposal</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayer capital gain</td>
<td>1.75</td>
<td>0.00</td>
<td>1.75</td>
</tr>
<tr>
<td>Newco STC/Dividend tax</td>
<td>0.00</td>
<td>1.25</td>
<td>(1.25)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1.75</td>
<td>1.25</td>
<td>(0.50)</td>
</tr>
</tbody>
</table>

2.1.2.4.2 SARS is therefore **forgoing tax** if the proposal is carried out, as the dividend tax rate will be less than the effective CGT rate payable.

2.1.2.4.3 The proposal has similar implications as regards amalgamations, share issues, liquidations and unbundlings.

2.1.3 C Ordering Rules

2.1.3.1 The Canadian option in respect of when a payment is a return of capital (page 21) would be clearer and easier to follow than the purist option.

2.1.3.2 Mention of the deeming of interest in respect of interest free shareholder loans is concerning (page 22) as this may act as a disincentive for small business. Many small entities are funded by means of interest free loans from the shareholders, often exhausting the resources of the shareholder. To tax the shareholder on deemed interest earned when the shareholder may not have the cash resources to fund the tax (as they have poured all their resources into their company), may prevent the growth of small business.

No mention is made of the proposed time of implementation of the changes. An indication should be given in this regard.

Please do not hesitate to contact me should you require further information.

Yours faithfully

M Hassan CA(SA)

**PROJECT DIRECTOR: TAX**

*The South African Institute of Chartered Accountants*