19 February 2008

Mr K Engel
National Treasury
P O Box 115
PRETORIA
0001

By email: keith.engel@treasury.gov.za

Dear Sir

CONCEPTUAL OUTLINE FOR SECONDARY TAX ON COMPANIES (STC) REFORM

INTRODUCTION

In his 2007 Budget Speech, the Minister of Finance announced the likelihood that STC would be reformed in 2007 (including a rate decrease to 10%) and that STC would possibly be replaced in 2008 by a dividend tax on shareholders, in the form of a final withholding tax. The first aspect was implemented in 2007, while the second is due to be implemented towards the latter part of 2008.

SAICA has formed a task team to assist National Treasury with the technical aspects of this transition. This document purports to be a Conceptual Outline by this task force, for purposes of pre-empting a process of consultation between representatives of the SAICA National Taxation Committee and National Treasury.

The proposed abolition of STC and the subsequent introduction of a withholding tax on dividends is welcomed. It is accepted that the primary benefit of STC is that it provides for
administrative ease for the Commissioner for the South African Revenue Service (SARS),
companies and shareholders.

SAICA accepts the contentions put forward by National Treasury that STC is generally
misunderstood by the international investor communities who often see this tax as a
disincentive for investment, given its impact on the combined corporate tax rate. Hence,
SAICA concurs that the proposed abolition of STC should contribute to clear up international
misperception about South Africa’s tax system and will hopefully encourage foreign
investment.

Due to the substantive change that this new tax will cause, we would strongly urge an
extended period for submission of comments on proposed amendments as well as additional
time for adequate consultation with interested parties.

INTERNATIONAL TRENDS

It should be noted that the task team has not been made aware of the extent to which
National Treasury has conducted research on other systems similar to the proposed dividend
tax on shareholders. It is therefore important to encourage National Treasury to benchmark
its proposals against that of countries imposing systems of a withholding tax on dividends,
paid to shareholders. This to:

- prevent the proposal of a system unique to South Africa that deviates from
  international best practice; and
- learn critical administrative, legislative and practical lessons from the experiences of
  other countries.

The task team accepts that any system proposed by National Treasury would have to be
adapted to the exigencies of the South African taxation system.

Extensive research into the international experience of such a withholding tax should,
however, help to ensure the quality of the legislation required to allow both the transition to
and subsequent application of such a new system.

In summary, there would appear to be two obvious alternatives, namely:

A. ‘MIMIC’: A SHAREHOLDER TAX THAT MIMICS STC

This would involve replacing STC with a new Shareholder Dividend Tax (SDT) which largely
mimics the structure and logic of STC, while moving the incidence of tax from the company
to the shareholder.

**Advantages:** The primary advantage would be that, if carefully structured, this
alternative would retain much of the existing simplicity and efficiency of
STC, with only limited additional legislation, while (a) resulting in an
effective drop in the corporate tax rate, and (b) avoiding most of the potential anomalies inherent in Alternative B below.

**Disadvantages:** No disadvantages are apparent, but some legislative complexity is inevitable.

**B. SEA CHANGE: A SHAREHOLDER TAX THAT MATERIALLY DIFFERS FROM STC**

This would involve replacing STC with a new Shareholder Dividend Tax (SDT) which is far removed from the structure and logic of STC, while moving the incidence of tax from the company to the shareholder.

**Advantages:** No advantages over Alternative B are apparent.

**Disadvantages:** Considerable legislative complexity is inevitable.

**CURRENT CONCERNS OF TAXPAYERS**

Irrespective of the selection of option A or B (above), a number of common issues regarding the proposed withholding tax on dividends, however, require clarity and it is hoped that these issues would be addressed in any discussion document prepared by National Treasury or proposed legislation drafted to give effect to the transition.

1 The first issue relates to the manner in which the withholding tax will be dealt with as the dividend flows through a chain of companies, in order to avoid a cascade of the tax. Clearly it is unthinkable that each shareholder company along the chain should bear the tax without some form of recognition of the withholding tax in the companies below the chain. SARS and the tax-paying public are used to measures to prevent such a cascade, remembering that STC and VAT operate on such a basis. The following are some alternatives:

1.1 No withholding tax is payable on dividends to a corporate shareholder which is a resident of South Africa. This is the simplest form of preventing the cascade effect, so that the withholding tax will be imposed for the first time when a non-corporate shareholder (which, for this purpose, would include a corporate which is a non-resident of South Africa) receives the dividend. Although this has the benefit of simplicity, it has the disadvantage of a potentially lengthy deferral of the tax.

1.2 At the very least, there should be an exemption for dividends flowing within a group of companies. For this purpose the threshold for a group of companies should be lower than 70%.

1.3 Where no exemption is available, the simplest methodology which ‘mimics’ STC would be to treat the withholding tax on dividends received in much the same way as input tax on a VAT system. Accordingly, when a company declares a
dividend it will incur a liability to SARS for the withholding tax on behalf of its shareholders, but it will deduct from that withholding tax, the withholding tax actually paid by it on the incoming dividend. In this way, only the net amount of the withholding tax, if any, will be payable to SARS.

1.4 Of course, a question arises where the withholding tax paid by the company (which is akin to input tax) is less than the withholding tax on the dividend declared (which is akin to output tax). Can a refund be claimed from SARS? Ideally the answer should be yes, but whether this will be acceptable is a matter of policy.

1.5 Certainly where the withholding tax is less than 10%, in circumstances where the shareholder is a non-resident of South Africa, entitled to a lower rate, there must be a refund by SARS. If, for example, the incoming dividend to a holding company is R100, on which R10 was withheld by the subsidiary, and the outward dividend is R100 on which R6 is payable by the holding company to a South African shareholder on R60, but R2 (5%) is payable to a non-resident shareholder in a treaty country on the R40, the difference between the R8 withheld and the R10 suffered (that is, R2), will have to be refunded by SARS.

1.6 Currently, a non-resident South African company, earning South African source income through a branch or permanent establishment in South Africa, is subject to normal tax at a rate of 34% and is exempt from STC (as the enforcement and collection of STC is complex and impractical). When the STC rate was reduced from 12.5% to 10% on 1 October 2007 the normal rate of tax for these non-resident companies operating through branches/permanent establishments remained unchanged at 34%. How will the introduction of the new dividend tax affect non-resident companies and will the rate of normal tax for these companies be adjusted to take account of the reduced rate of the dividend withholding tax?

1.7 Another issue relates to withholding taxes on incoming exempt foreign dividends. If a foreign withholding tax of, say, 20% is payable, on an incoming dividend of R100, R80 will be received and R20 will be the tax withheld. If the R80 is on-declared, there will be a further R8 deducted, pushing the effective rate to the shareholder of the South African company to 28%. Some countries allow for foreign dividends to pass through the South African holding company to foreign shareholders without suffering withholding tax. Failing this, South Africa becomes very unattractive as a holding company jurisdiction, for example, for Africa.

1.8 Another alternative is to require every company along the chain to suffer the withholding tax, but then give the company a mechanism to reclaim it. For example, if it cannot be reclaimed against an outgoing dividend, it might be treated as a credit against the next provisional tax payment; or failing such
provisional tax payments, or if they are inadequate, against the assessed tax liability; or if there is an inadequate assessed liability, the credit could be reflected as a credit on the assessment, to be refunded in the same way as if provisional tax paid exceeded the actual liability. Clearly this method is much more complex and involves more verification processes. Indeed, SAICA believes that this method is equitable.

1.9 Section 64C of the Income Tax Act currently makes provision for deemed dividends which are subject to STC. Clarity is required on how so-called ‘deemed dividends’ will be treated in terms of the proposed dividend tax.

2 Clearly, it is necessary to consider a ‘conversion’ of STC credits into credits claimable against the payment of the new withholding tax. What is not clear, however, is how one identifies credits within a chain of companies where the dividend is declared after the implementation of the withholding tax. The following examples illustrate the issue:

2.1 Assume that there are three companies in the chain, from top to bottom being A, B and C.

2.2 Before the withholding tax is introduced into the Income Tax Act, C declares a dividend to B and pays STC. After the new withholding tax is introduced, B on-declares the dividend to C. The new law could say something along the lines that the dividend will be exempt from the withholding tax if the dividend received from company C could have been deducted under section 64B(3) of the Income Tax Act, had that section not been repealed. Alternatively, the dividend from C will be deemed to have suffered a withholding tax (which amounts to the ‘conversion’ of STC credits to withholding credits).

2.3 It becomes a little more difficult, however, if B had also declared the dividend to A before the withholding tax became effective, and then A on-declared the dividend to its shareholders. Remember here that the STC was payable by C, although the dividend receivable by A came from B. In other words, the legislation must be framed in such a way that the credit/exemption follows the dividend up the chain even though the STC was originally paid several companies below.

2.4 Clearly, it would be inequitable not to grant credit for unutilised STC credits at the date of changeover to the dividend withholding tax. If not, the dividend will have suffered economic double taxation.
The next question relates to whether tax-exempt institutions, such as retirement funds and PBOs, will be required to suffer the withholding tax or if they will be exempt. An argument for exemption is that, if they are liable to suffer the withholding tax, clearly these entities cannot be described as tax-exempt. Note, the recent abolition of tax on retirement funds is grounds to argue that these entities should not be liable for the proposed withholding tax on dividends. One could perhaps argue that there ought to be no effective change in the net amount received, even if the withholding tax is suffered, provided that the investee company grosses up the dividend (that is, it declares as a dividend an amount equal to the aggregate of the dividend and the STC under the previous system). In any event, this is unlikely to be consistently applied by all investee companies. In a similar vein, serious consideration should be given to granting exemption from the withholding tax on dividends to taxpayers below the tax threshold.

When STC was reduced from 12,5% to 10%, there was an overall reduction in the effective corporate rate of tax. It is clear, however, that when the withholding tax is substituted for STC, the combined effective corporate tax rate will increase. This is best illustrated by way of an example. On a dividend of R100, the STC will be R10, giving a total cost to the company of R110, with the shareholder receiving R100. After the transition, assuming that the company is prepared to retain its total cost of R110, this will be the amount of the dividend. The withholding tax at 10% will be R11, giving the shareholder a net receipt of R99. This will be 1% less than the shareholder previously obtained under the STC regime. To maintain parity, the dividend withholding tax rate should be reduced to 9% (that is, R110 less 9% tax yields R100).

A similar message emerges when one looks at this from the investee company's perspective. It is also worthwhile examining the numerical effect of the proposed changes:

- Prior to the reduction in the rate of STC at 12,5%, the combined effective corporate tax rate of normal tax and STC was 36,89%. After the reduction of STC to 10%, this reduces to 35,45%.

- In the case of Capital Gains Tax, because STC is payable on post-1 October 2001 capital gains, the combined effective corporate tax rate is 24%, but after the reduction of the STC rate, the combined effective corporate tax rate will be 22,27%.

- When STC is abolished and the withholding tax is introduced, the combined effective corporate tax rate on revenue profits will thus increase from 35,45% to 36,1% (that is, 29% + [10% of 71%]); while on capital gains, the effective corporate tax rate increases from 22,27% to 23,05% (that is, 14,5% + [10% of 85,5%]).
SAICA submits that it would be sending the wrong message to reflect an effective increase in the combined effective corporate tax rate (and an increase in the tax take). Hence, a withholding tax rate of 9% should be seriously considered.

PRACTICAL ISSUES – FOREIGN INVESTORS

The following comments relate to the way the new dividend withholding tax is likely to interface with non-resident recipients of dividends declared by South African investee companies:

- The current process of renegotiating our existing Double Tax Agreements (DTAs) to provide for a minimum 5% dividend withholding tax remains relevant.
- Consideration should be given to requesting foreign shareholders who are potentially entitled to a 5% withholding rate, to lodge an annual ‘entitlement form’ with the investee company in which they hold shares, stating the basis of their claim. Without such a form the South African investee company should be obliged to withhold the dividend tax at 10%. This entitlement form should also be lodged whenever the shareholder’s circumstances change, to qualify (or disqualify) the shareholder for the 5% tax. The impact of this additional administration burden on share transfer secretaries of listed companies needs to be considered.
- The investee company could remain entitled to claim a credit at the 10% rate, even where the foreign shareholder is entitled to the 5% rate. This ensures that the underlying withholding taxes in these cases are capped at 5%.
- Nominee companies who hold shares as agents on behalf of foreign shareholders who are potentially entitled to a 5% withholding rate should be obliged to lodge entitlement forms on behalf of these underlying foreign shareholders. Such a system does raise particular administrative difficulties. For example, where the nominee has lodged an entitlement form on behalf of a non-resident shareholder A, A changes residence between foreign countries and does not inform the South African nominee company. The relevant DTA provides for a greater withholding tax based on the new residence status of A. As the withholding tax was based on the earlier entitlement form, the investee company failed to withhold the correct rate of tax on dividends. A number of issues arise namely: who is responsible for the payment of any difference? Will any mechanism exist to collect such unpaid tax? Will the nominee company be absolved from any subsequent penalties and interest on the underpayment of the withholding tax? Will a distinction be made between the taxpayer that unintentionally omits to update such entitlement form from the taxpayer that intentionally omits to update the form?

CONCLUSION

The form W-8BEN required by the US Internal Revenue Service is a good example of such a form.
In the interest of transparency and collaboration, SAICA looks forward to a consultative process in the course of the transition from STC to the withholding tax on dividends.

Yours faithfully,

MUNEER HASSAN
Project Director – Taxation
The South African Institute of Chartered Accountants

cc: Mr M Preiss (mark.preiss@treasury.gov.za)
   National Treasury