national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

SARS

MEDIA STATEMENT

REVISED TAXATION OF DISTRIBUTED PROFITS:

CONVERSION OF THE SECONDARY TAX ON COMPANIES ("STC") TO A SHAREHOLDER DIVIDENDS TAX

20 February 2008

1. BACKGROUND

In South Africa, the taxation of distributed profits is achieved through the Secondary Tax on Companies ("STC"). The STC liability falls on the company distributing the profits. In most tax systems, tax is imposed on the shareholders receiving a dividend. Unfamiliarity with the STC's different mechanics seems to be a hurdle for foreign investors according to many commentators. At a more substantive level, the STC liability adversely impacts a South African company's accounting income statement because the company distributing the dividend must subtract this tax charge from its profits. Arguments have also been raised by the private sector that the STC raises the cost of equity financing.

In the 2007 *Budget Review*, Government proposed to phase-out the STC in favour of a final withholding tax falling on shareholders receiving dividends. This shift will occur in two phases.

1.1 Phase one

In the first phase of reform, the rate of STC was reduced from 12.5 per cent to 10 per cent with effect from 1 October 2007. This reduction was coupled with a broadening of the tax base through the closing of commonly exploited loopholes. A further broadening of the base is planned for 2008 (see the discussion document on "*the Secondary Tax on Companies: Revising the Base*").

1.2 Phase two

The second phase of reform entails the actual conversion of the STC into a dividend tax on shareholders. As stated in the 2007 *Budget Review*, the implementation of this second phase is contingent on the revision of international tax treaties that limit withholding tax on dividends to zero per cent.

The tax treaties at issue are Australia, Cyprus, Ireland, Kuwait, The Netherlands, Oman, Seychelles, Sweden and The United Kingdom. Most of these treaties have been renegotiated and are awaiting executive signatures and parliamentary ratification. It is anticipated that this phase will be completed by 2009.

2. PROPOSED DESIGN

2.1 General concepts

The new regime will follow the classical system of taxing distributed profits. As a general matter, shareholders will be subject to the new tax. The rate of the new tax will be 10 per cent as is currently the case for STC. This dividend tax will be a separate final withholding tax and dividends will not form part of shareholder income (the latter of which is taxable at marginal rates). As with the STC, the new tax will apply to distributions during the life of the company as well as in liquidation.

2.2 Exemptions/deferrals

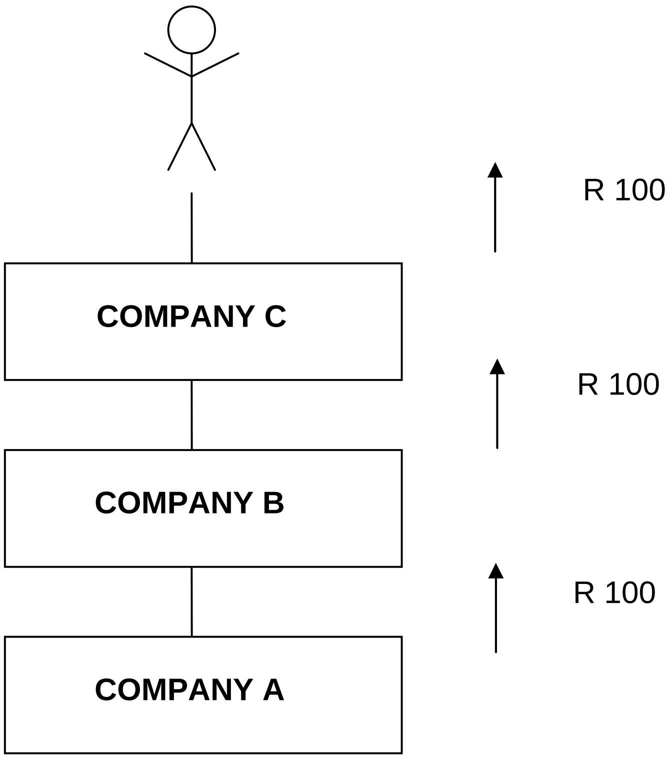
Non-corporate and non-resident shareholders will generally be subject to tax at a 10 per cent rate on the full amount of dividends received. However, limited exemptions and deferrals from this withholding tax will be applied as described below. The net effect of these exemptions and deferrals will amount to an estimated loss to the fiscus of R6 billion in the first year.

- *Distributions to exempt entities* – Company distributions to entities that are fully exempt from income tax will similarly be exempt from the new dividend tax. These entities notably include pension funds and Government. Entities that are partially subject to income tax will benefit from an exemption on dividends only if these entities are fully exempt in respect of investment (i.e. non-trading) income. Therefore, public benefit organisations will be exempt from dividend tax, but recreational clubs will be taxed on their dividends because clubs are only exempt from tax on investment income up to a monetary limit.

- *Treaty relief* – The dividend tax rate for non-resident shareholders may be limited if a tax treaty exists between South Africa and the shareholder's country of residence. Depending on the proposed renegotiation of treaty rates, a 5 per cent limit may apply.

- *Intra-company dividends* – As a general rule, underlying company profits should only be subject to one level of tax on distribution. This principle is critical when profits pass through two or more company levels. The STC system achieves this result in two ways. The first is by taxing the first company that declares the underlying profits as dividends while exempting subsequent dividends associated with these profits via the STC credit system. The second is by permitting an election that STC will not apply in the case of certain intra-group distributions. In a classical system, tax applies only on the last company level. The classical system achieves this result by exempting all inter-company dividends between resident companies (regardless of percentage shareholding) with the tax applying only at the level where dividends are declared to persons other than companies or to non-residents.

  Example:



Facts. Company A distributes R100 of profits to Company B. Company B distributes those profits to Company C. Company C in turn distributes those profits to Individual.

STC result. Under the current paradigm, Company A is subject to the STC when distributing profits to Company B (assuming group relief does not apply). Subsequent distributions from Company B to Company C and from Company C to Individual are exempt via the STC credit system.

New dividend tax result. Under the proposed paradigm, no dividend tax applies when Company A declares dividends to Company B nor when Company B declares dividends to Company C (regardless of whether these companies form a group of companies). The dividend tax applies only when Company C declares a dividend to Individual (or to a non-resident).

* * *

As shown above, both sets of rules provide cascading relief but in a slightly different way. The new system has an administrative advantage in that it eliminates the tracking required for STC credits. Taxpayers benefit under the new system because the new system allows for substantial deferral. To ensure that this deferral is not excessive, an anti-avoidance measure will be applied for closely-held passive holding companies used to accumulate passive dividend income (e.g. as a means for delaying the receipt of dividends by individuals for long periods of time).

2.3 Administration

To the extent the new dividend tax applies, the company declaring the dividend will be required to withhold the tax upon declaration. This tax will be payable by the company to the South African Revenue Service ("SARS") on or before the end of the month following the month in which the dividend was declared. For example, if a company declares the dividend at any time during the month of February, the tax withheld will be payable to SARS on or before 31 March.

3. TRANSITIONAL ISSUES

3.1 STC credits

As discussed above, the STC system allowed for an accumulation of tax credits to avoid cascading. Under the new system, there is no need for credits as the new tax will apply only at the top company level. At issue is the continuing existence of STC credits.

While the new dividend tax system replaces the STC system, the systems are fundamentally different. In terms of the STC, the tax liability falls on the company; whereas the tax liability for the new dividend tax falls on the shareholder (even though the company retains a withholding responsibility). In terms of the base, the STC is calculated with reference to the amount of dividends declared while the new dividend tax will be calculated with reference to the amount of dividends receivable.

Retention of transitional STC credits will give rise to multiple administrative complications. One key advantage of the proposed classical system (and its attendant deferral) is to eliminate STC credit tracing. Taxpayers cannot expect to receive the best of both worlds – a classical system going forward in addition to STC type credit relief. The proposed regime should, therefore, either be a classical model going forward or a credit model should be retained (with the new tax being imposed in all cases when a dividend is first declared).

After careful consideration it has been decided that STC credits accumulated prior to the implementation of the new system will be forfeited. However, given the delayed timing of the change, taxpayers can still utilise STC credits in the interim.

3.2 Gold mining companies

The taxation of gold mining companies is based on two regimes. Under the basic regime, gold mining companies are subject to an income tax rate of up to 34 per cent on gold mining profits with the STC applying when dividends are declared. However, companies may elect to be exempted from STC but at the cost of a higher income tax rate on gold profits of up to 43 per cent.

The 43 per cent option for the mining companies will be discontinued with the enactment of the new system. This election was possible under the STC because the incidence of both the income tax and the STC was on the gold mining company. Under the new system, the tax switches to a shareholder level. Again, the question arises as to what happens to companies that were previously subject to the higher 43 per cent gold formula.

For reasons discussed above, it has been decided that STC credits will have no place going forward, even in the case of mining. It is noted that much of the perceived unfairness may be more theoretical than real. While many gold mining companies chose the 43 per cent formula, the formula had no practical impact for companies with taxable losses.

4. REQUEST FOR COMMENT

While the proposed withholding tax will generally be fairly simple for companies to administer (with the 10 per cent charge being based on the nature of the payee), tracing issues will arise if dividend payments are made to nominees and other parties acting on behalf of other investors. If a payment is made in this fashion, the question arises as to the status of the true economic owner. The distributing company will probably not know the identity nor the tax status of this party. This 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.

The following possible options have been identified and are being studied in this regard:

Option 1: All dividend payments that are made to persons who are not beneficial owners (e.g. to nominees) will be subject to 10 per cent withholding with an “escape hatch”. Under the escape hatch, the company declaring the dividend to the nominee could reduce or eliminate the withholding if provided with sufficient proof that the economic owner has preferred status. However, any error would mean that liability rests with both the company and the beneficial owner.

Option 2: Under this option, the nominee could be granted the authority to withhold the tax because the nominee should know the identity of the economic owner. If empowered, the withholding liability would shift from the company payor to the nominee. 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.

National Treasury and SARS invite public comment on the contents of this media release, particularly the preferred option for withholding tax where payment is made to a nominee. Comments in this regard should be sent to Thabo Legwaila by email at thabo.legwaila@treasury.co.za or by fax to 012 315 5516. Please ensure that the comments reach us by 31 March 2008.