# DIVIDENDS VERSUS RETURN OF CAPITAL:

# REVISING THE BASE FOR TAXABLE DISTRIBUTIONS

## EXECUTIVE SUMMARY


The Income Tax Act seeks to tax net enrichment. In the case of company distributions to shareholders, not all distributions represent net enrichment. Shareholders can withdraw their initial tax contributions, or shareholders can withdraw excess funds generated out of company profits (i.e. growth). The tax system (currently in the form of the Secondary Tax on Profits) seeks to tax only profits – not returns on initial investment. The question is how to distinguish between the two.

At a more technical level, the current distinction between profits and return on initial investment unfortunately does not yield a quick and easy answer. In theory, dividends represent profit distributions; whereas, capital distributions represent a tax-free return of initial investment. Unfortunately, both the profits and return of capital concepts originate without regard to the tax system. Both terms instead derive their meaning from company law/accounting.

In order to remedy these concerns, the discussion document proposes that the tax law should precisely define "return of capital" giving rise to tax-free shareholder returns (which would be referred to as "contributed tax capital"). This amount would be limited to shareholder contributions of cash or assets to the company. More importantly, this concept would be based on tax contributions -- not on market value distributions.

The new regime will also contain a key simplifying assumption. The discussion document proposes that all distributions should be treated as taxable dividends unless the parties specifically withdraw funds from contributed tax capital. The concept of profits would no longer be utilised. To obtain tax-free treatment, taxpayers would be required to prove that the distributed sums relate to contributed tax capital; distributions not relating to contributed tax capital would automatically be subject to tax. The proposed discussion document also covers ordering rules. As a general matter, these ordering rules would require withdrawals of contributed tax capital to come out last.

As a final matter, the discussion document raises a number of collateral issues, such as the allocation of contributed tax capital to particular shares, the problem of interest-free loans, and questions about how to deal with foreign dividends. A final important issue is how to deal with the transition from the old system of calculating dividends to the new system.

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# I. INTRODUCTION

## A. The 2007 Tax Proposal

The Minister of Finance announced in February 2007 that the Secondary Tax on Companies ("STC") would be reformed. For purposes of this reform, two major problems were identified.

First and foremost, the STC is generally out of line with international tax norms. The STC is a tax on the company declaring a dividend. The liability for STC falls on the company distributing the dividend as opposed to the shareholder receiving the dividend.[1] This difference adversely impacts South African company accounting profits because the company distributing the dividend must subtract this tax charge against those profits. Taxation at the distributing company-level also means that tax treaty limits on dividend rates have no effect. There are concerns that foreign investors are not familiar with STC and its mechanics. Moreover, arguments have been raised that the STC raises the cost of equity financing to the detriment of economic growth.

As a collateral matter, major problems are being experienced in respect of the tax base to which the STC relates. The STC base effectively adopts a blanket reliance on company law/accounting concepts. Tax law principles have only been added at the margins. These problems have given rise to distortions and unnecessary complexity. Therefore, a new simplified (yet comprehensive) base is being considered.

In order to resolve both of these problems, the Minister announced a two-phased approach for STC reform:

Phase 1: This phase entails the reduction of the STC rate from the current 12,5 per cent to 10 per cent with effect from 1 October 2007. This reduction will be coupled with a revised tax base for distributions beyond the current narrow dependence on the availability of profits in the company from which a distribution is made. The initial elements of this phase are included in the Revenue Laws Amendment Act, 2007.

Phase 2: This phase entails the replacement of the STC with a new tax at shareholder level. This phase will commence in 2008. However, implementation will depend on the renegotiation of several international tax treaties.

The purpose of this discussion document is to examine the issues associated with Phase 1.

## B. The importance of the base

The starting point for the determination of any tax is a solid conceptual framework for the underlying tax base. As with the Income Tax, the tax on distributions is levied with

[1] It should be noted that the STC is not a tax on the dividend. It is merely calculated with reference to the amount of the dividend distributed.

reference to the net accretion of wealth. When taxing company distributions, a distinction is accordingly made between return of shareholder contributions versus distributions out of company profits. Taxes on distributions are generally levied with reference solely to the profits of a company. No tax applies to other distributions because other distributions do not represent a net accretion to wealth. A shareholder could hardly be considered enriched if that shareholder merely withdraws funds stemming from prior contributions (or other non-revenue sources).

Given the above, a clear understanding of profits is essential if taxes calculated with reference to distributions are to be applied properly. Unfortunately, the current STC relegates the profit definition to general company law/accounting concepts – both of which take a somewhat loose approach to the matter. Moreover, this reliance on profits is problematic because company law/accounting has different considerations than the tax system. This lack of precise policy definition has naturally led to uncertainty as well as to distortions. This discussion document accordingly seeks to create a new comprehensive regime from which the STC, and ultimately the new dividend tax at shareholder level, can be determined.

## II. OVERVIEW OF CURRENT LAW

### A. Historical background

In the 1993 Budget the introduction of a dual tax on all companies was announced. It would consist of one part being levied on the declared profits forming taxable income and the other on distributed profits. STC was described as a tax on companies on all income distributed in the form of dividends. Furthermore, it was specifically stated that the tax should not be regarded as being levied on shareholders.

The STC came into operation on 17 March 1993.[2] These provisions are contained in sections 64B and 64C of the Income Tax Act 58 of 1962 (hereinafter referred to as "the Act"). The STC was introduced at the rate of 15 per cent, and the corporate income tax rate was simultaneously reduced from 48 per cent to 40 per cent. The STC rate was increased to 25 per cent in June 1994[3] and reduced to 12,5 per cent in March 1996. The STC was designed to fall on companies (as opposed to falling on the recipient shareholders) so as to encourage companies to retain (and reinvest) their profits instead of declaring dividends.

### B. Basics of the STC

The STC is a tax on the profits of a company when they are distributed; it is not a tax on all distributions by companies. This limitation is achieved by reliance on the definition of a dividend in the Act, which is linked to the underlying profits of the company making the distribution (see discussion below). The trigger for STC is the declaration of a dividend.

[2] Prior to the STC, a proportion (reducing to ⅓) of dividends was taxed at marginal rates (up to 45 per cent)

[3] The company tax rate was reduced to 35 per cent. The non-resident shareholders' tax (NRST) was repealed on 1 October 1995.

The STC applies to resident companies (i.e. companies incorporated in or with their place of effective management within South Africa). Non-resident companies are wholly free from the STC (but dividends paid to South African shareholders from these non-resident companies are taxed at the shareholder level as part of shareholder ordinary revenue).

In addition to its impact on actual dividends (see section 64B), the STC contains a mechanism aimed at preventing the avoidance of the STC (see section 64C). This anti-avoidance mechanism applies when companies provide benefits to their shareholders (or connected persons thereto), which potentially act as disguised dividends. Company loans to shareholders often fall within this disguised dividend characterisation.

Special rules are required to prevent multiple STC charges on dividends passing through multiple companies, all of which stem from the same underlying profits. In this case, the STC will be payable only in respect of the original declaration of dividends. No STC will be payable on those underlying profits when the receiving company on-declares those profits as dividends to another company. In more technical terms, the STC applies only to the extent that the dividends declared by a company exceed those received by or accrued to that company.[4]

The STC regime also contains intra-group tax relief. A company may elect to be exempt from STC on a dividend declared if the dividend is declared to a company which is part of the same group of companies (but only to the extent the company receiving the dividend is potentially subject to the STC). This intra-group rule essentially reverses the timing of the STC liability. Instead of charging the STC with reference to the initial distribution of profits and exempting successive distributions of those profits, intra-group relief exempts the initial distributions with the STC applying only once those profits leave the group.[5]

## C. Payment of the STC

The STC is paid in dividend cycles. More specifically, the STC applies on the amount by which the dividends declared by a company in a dividend cycle exceed the deductible dividends accrued to that company during that same cycle. A new dividend cycle then starts on the next day until a new dividend is declared. The STC liability is payable before the end of the month following the month in which a dividend cycle ends (i.e. the end of the month following the month a dividend is declared).[6]

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[4] This offset for dividends received is often informally referred to as an "STC credit."

[5] For example, assume Holdco is a listed company. Also assume Holdco owns all the shares of Sub 1, and Sub1 owns all the shares of Sub 2. If an intra-group STC election is made, dividends from Sub 1 and Sub 2 are free of STC, but Holdco is subject to the STC when declaring those same profits as dividends to listed shareholders. On the other hand, if no election is made, the normal STC rules would apply. In this latter circumstance, the STC would be charged once on the lowest level subsidiary (i.e. the charge would fall on Sub 2), and "STC credits" would be carried up to the ultimate listed shareholders.

[6] Dividend cycles are not fixed. The duration of the dividend cycle depends on the period that lapses between the distributions.

## D. Concept of a dividend

As stated above, the STC is based on the net amount of company dividends declared. The mere distribution by a company will not lead to the STC unless that distribution is classified as a dividend. This dividend determination is therefore essential.

### *1. Regular dividends*

A dividend is generally defined in section 1 as "any amount distributed by a company" to its shareholders. The term "amount" is given a wide meaning. The term "amount" includes not only money, but also the value of every form of property given to a shareholder.

In terms of company law, dividends may freely be distributed only out of current or accumulated profits. However, dividends generally may only be distributed out of contributed share capital or share premium (or out of reserved profits) upon special company resolution (due to articles of incorporation typically utilised for most companies).[7] Both share capital and share premium essentially represent the contributions shareholders make to a company in exchange for newly issued shares. The share capital of a company represents the nominal value of the shares in that company. The share premium consists of the amounts paid in excess of nominal value.[8] Another related concept is stated capital, which is the share capital/share premium counterpart for no par value shares (i.e. the total amount received on issue of no par value shares).

The dividend definition (paragraph (b)) specifically includes going-concern dividends (despite the redundancy of the inclusion in lieu of the comprehensive opening language of the dividend definition). This inclusion refers to "profits distributed." "Profits" means profits available for distribution – both realised and unrealised profits. In other words, profits need not be reflected in the company's financial statements to be viewed as

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[7] More specifically, the Companies Act provides for the acquisition by a company of its own shares and also authorises the use of share premium account to pay a premium on the acquisition of those shares. The Companies Act provides for payments to be made to a company's shareholders without restricting or qualifying the reason for such payment, with the effect that the capital of the company may be reduced subject to the solvency and liquidity restrictions.

From an accounting point of view, share capital is capable of being reduced in ways that do not involve an acquisition of shares or a payment to shareholders. In the absence of any restrictions or formalities in the Companies Act regarding the reduction of capital, the company articles of association would determine the terms and conditions of the reduction.

Finally, the Companies Act allows a company to issue redeemable preference shares which are liable to be redeemed by the company. These shares are redeemable out of the profits of the company which would otherwise be available for dividends or out of proceeds of a fresh issue of shares made for purposes of a redemption. If the redemption is not paid for by proceeds of a fresh issue, a corresponding amount (equal to the nominal or book value of the shares) is transferred from profits to a capital redemption reserve fund.

[8] For example, if the nominal value of a share is R1 and the shareholder pays R10 for the issue of the share, the share capital created will be R1 whilst R9 will form part of share premium.

profits available for distribution. If a company distributes an asset *in specie* to a shareholder, the company is treated as having disposed of the asset to the shareholder for proceeds equal to its market value on the date of the distribution (i.e. the profits associated with the gain on the distributed asset would be added to profits for purposes of the dividend calculation).

Distributions falling outside the dividend definition will be treated as a "capital distribution" for capital gains tax purposes. With the enactment of the Revenue Laws Amendment Act, 2007, the net result is to treat all these distributions as part disposals. Hence, for distributions occurring from October 2007, most of these capital distributions will trigger capital gains with a partial offset for the base cost in the distributing shares.

### *2. Liquidations*

Realised and unrealised profits distributed in the course of, or in anticipation of a liquidation, winding up, deregistration or final termination of a company generally constitute a section 1 "dividend." In essence, the dividend rules for liquidations operate much in the same way as the dividend rules for operating distributions. The main difference relates to profits arising before certain effective dates. More specifically, liquidating dividends do not include any pre-1 October 2001 capital profits. Although still falling within the dividend definition, distributions of pre-March 1993 profits are also specifically exempt from the STC. The Revenue Laws Amendment Act, 2007 removes these transitional exemptions as part of the base broadening effort. This removal will be effective for all distributions from 1 January 2009.

On liquidation (dissolution, etc…), a shareholder is deemed to dispose of all the shares held in a liquidating company, thereby triggering gain or loss. Any capital distribution of cash or assets received or accrued in respect of those shares afterwards is treated as a capital gain.

### *3. Redemptions and reductions of share capital*

Companies may buy back, acquire or otherwise redeem their own shares from their shareholders. Companies may also reduce their capital by paying back to the shareholders a portion of the value of their shares. Prior to 1 October 2007, both sets of transactions were subject to special rules. In the case of buybacks, acquisitions and redemptions, the dividend portion of the distribution was limited to the part of the repurchase price exceeding the nominal value of the redeemed share.[9] In the case of a reduction, the dividend portion of the distribution equaled the amount by which the payment exceeded the reduction in the value of the share.

The Revenue Laws Amendment Act of 2007 again does away with these distinctions. All redemptions (etc…) and reductions of capital are now treated the same as any other operating distribution for purposes of the dividend definition.

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[9] The nominal value of a share is generally the share's par value. If the shares do not have a par value, the nominal value is the hypothetical par value of the shares if the shares were converted into shares having par value.

On redemption (buyback, etc…), capital gains/loss also becomes an issue in addition to the dividend treatment resulting from the distribution. The capital gain/loss issue arises because the shareholders will be disposing of their shares. All capital gains and losses will be determined by measuring the proceeds received less the base cost of the shares surrendered as if disposed of to another shareholder. However, adjustments must also be made for the distribution itself. All amounts classified as a dividend will be excluded from the proceeds calculation.[10]

### *4. Issue of capitalisation shares*

A company may issue additional shares to their shareholders as a distribution. This form of distribution is known as capitalisation shares. While no underlying cash or assets leave the company, the issue of capitalisation shares typically results in the conversion of profits or reserves to share capital or share premium. As a general matter, the issue of capitalisation shares does not give rise to a dividend in recognition of the fact that the company retains the same level of underlying assets. However, any share capital or share premium resulting from the shift in profits arising from the capitalisation will retain the profits taint for purposes of further distributions. More specifically, the section 1 "dividend" definition (para (i) of the first proviso) ensures that the profits and reserves so transferred remain available for distribution. In essence, available relief for capitalisation issues amounts to deferral, not a permanent exemption.

In terms of the capital gains tax system, if a company issues capitalisation shares to a shareholder, those shares are treated as having been acquired by the shareholder for expenditure of zero (paragraph 78 of the 8th Schedule). However, if the issue of capitalisation shares constitutes a dividend (see above), the shares are treated as having been acquired by the shareholder at a cost equal to the amount of the dividend received (paragraph 78 of the 8th Schedule).

## III. GENERIC SOURCES OF COMPANY DISTRIBUTIONS: THEORETICAL CONSTRUCT

In terms of general principles, company distributions must stem from one of the following three sources:

(i) Distributions out of profits;
(ii) Distributions out of capital (i.e. share capital and share premium); and
(iii) Distributions out of loan proceeds.

[10] For example, assume taxpayer owns shares with a R100 value, a R20 base cost and an allocable contributed tax capital of R30. On redemption, R70 is treated as a dividend and the remaining R30 is treated as a capital distribution, with a R10 capital gain.

## A. Profit distributions

Most distributions stem from company profits. A company's profit represents accumulated company income and loss. Profit distributions can be made either from accumulated realised income or the unrealised growth from the company's appreciated assets.

Accumulated net income generally arises from business operations; this net income is largely taxed as ordinary revenue as that income arises. Profits can also arise from the appreciation of company assets. The disposal of assets triggers realised profits; whereas the mere appreciation of assets is unrealised and could either be recognised in the company's financial statements or not. Appreciated property gives rise to ordinary revenue or capital gain depending the facts and circumstances. Either way, the amount becomes profits that form part of the dividend calculation.[11]

## B. Return of capital

Capital (i.e. share capital and share premium) essentially represents the total investment contributions to the company by the shareholders (other than by way of shareholder loans). The return on this investment is not viewed as a dividend because the shareholders are merely receiving their initial contributed corpus. This treatment could be viewed as similar to the return of principal on a loan. It is for this reason that the STC must not apply because the return of capital lacks any element of economic gain.

It should be noted that company capital is to be distinguished from the purchase price for shares. The purchase of shares amongst shareholders has no impact on the underlying capital. Only shareholder contributions to the underlying company create capital.[12]

## C. Distributions of loan proceeds

A third category of funds potentially giving rise to a distribution (often not discussed) is the distribution out of proceeds stemming from loans (from shareholders and/or third parties). Subject to company law restrictions as outlined below, a company may make a distribution out of loan proceeds. An example of this situation is illustrated below.

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[11] For example, assume a company buys land worth R100, and the land appreciates to R150. The company then distributes that appreciated land. In this case, the company realises the R50 for purposes of the distribution, which is added to the profits available for distribution. If cash were instead borrowed and distributed, the company would again have R50 of unrealised profits, and this R50 amount will still be taken into account for purposes of the dividend definition.

[12] For example, assume Shareholder A forms Newco by contributing R100 of cash. Newco then grows to a value of R500, and Shareholder A sells all the Newco shares to Shareholder B for R500. In this circumstance, Newco has capital of only R100. The purchase by Shareholder B has no impact on Newco's capital because Shareholder B has not contributed any funds to Newco.

Assume that the company's balance sheet is as follows:

| ASSETS | LIABILITIES |
|---|---|
| Gross Assets 80 | Debt 60 |
| | Capital 20 |

If R20 is distributed, the company making the distribution can take the funds from two available sources. The R20 can come from the initial shareholder capital or the debt. The debt may or may not be the real source of the profits, depending on the situation. If the gross assets of R60 merely represent cash principal obtained from the debt, the distribution of the R60 cannot be profits (i.e. said to stem from the growth of the company). On the other hand, utilising a slightly different example, if the company purchased an asset for R10 which grew to a value of R60, a subsequent distribution of R60 of borrowed proceeds against the asset would be said to stem from R50 of unrealised profits.

There is no explicit rule in South African legislation that prohibits a company from making a distribution out of debt or a loan account (as opposed to other sources). However, section 90(2) of the Companies Act 61 of 1973 prohibits a company from making any distribution to its shareholders if the company would, after making such payment, be unable to pay its debts as they become due in the ordinary course of business. A company may also not make a shareholder distribution if the company's assets would be less than the company's liabilities after the payment.

In terms of the new Companies Bill (as presently proposed), a company will not be able to make any distributions if it cannot meet the "solvency and liquidity" tests. In terms of solvency, a distribution meets this test as long as the value of total company assets exceeds total liabilities upon completion of the distribution. A distribution would meet the liquidity test if the company can pay its debts as they become due in the ordinary course of business for a period of 12 months after the date of distribution.

There are no restrictions from which account distributions must come in terms of loan proceeds. Therefore, taxpayers can choose to dilute the debt account first as long as total assets are sufficient to protect creditor interest.

## IV. BRIEF INTERNATIONAL COMPARISON

### A. Australia

In Australia, a dividend for tax purposes must be out of profits. This calculation is determined with reference to company accounts or financial statements. Distributions that are treated for corporate law purposes as repayment of share premium are generally tax-free and reduce the tax cost of the shares, with any excess being taxable as a capital gain. The tax authorities can reconstruct the accounts of corporations that do not maintain adequate records to establish their requisite profits.

### B. Canada

In the Canadian system, a dividend for tax purposes is generally said to exist unless the taxpayer can be said to be withdrawing capital, known in the Canadian system as "paid-up capital" ("PUC"). PUC is a tax calculation that relies on the company law concept of stated capital as the starting point. However, the PUC concept contains many adjustments that seek to ensure that the capital contributed represents recognised tax contributions as opposed to simple market value contributions. For instance, in the case of a tax-free rollover upon transfer of assets to a company in exchange for shares, the PUC equals the tax cost contributed as opposed to total market value contributed.

PUC is initially determined with reference to a class of shares as opposed to the whole of the company. The PUC of a share of a particular class is then calculated by dividing the PUC for the particular class by the number of issued shares in the class. All the shares of a particular class will have the same PUC per share.

### C New Zealand

New Zealand considers any transfer of value from a company to a shareholder as a dividend (if the transfer is performed by virtue of the shareholder relationship). A going concern distribution of "available subscribed capital" is allowed. This distribution does not constitute a dividend if: (i) accompanied by a proportional cancellation of the company's shares, and (ii) the cancellation of the shares satisfies the tests that distinguish between genuine returns of share capital and dividend substitutions. On-market share repurchases are not a dividend.[13]

### D. United Kingdom

In the United Kingdom, the concept of a "distribution" is central for determining the tax treatment of company distributions. Like the Canadian system, distributions will

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[13] In **France**, the definition of taxable corporate distributions encompasses much more than dividends in cash or property distributed to the shareholders in proportion to their capital interests. A taxable distribution is deemed to occur whenever a corporate decision results in a disinvestment (i.e. a decrease in the value of the corporation's net assets to the benefit of the shareholder even if the corporation does not have available earnings).

In **Sweden**, no connection exists between the earnings of the company and the taxation of corporate distributions. In the **Netherlands**, any economic benefit received by the shareholder as such is taxable without regard to the financial results of the corporation.

generally trigger dividend tax unless the distribution operates as an authorised return of capital. In general, the distribution concept is broader than the corporate law concept of dividend and covers almost all transfers of assets from a corporation to shareholder. However, the authorised return of capital concept is mainly a creation of company law/accounting.

### E. United States of America

Distributions are only taxable as a dividend if they are made from "earnings and profits." To the extent that a distribution exceeds earnings and profits, the distribution is treated as a tax-free return of shareholder's tax cost in the shares. The term "earnings and profits" is a tax term, which is based on accumulated taxable income with various adjustments (such as a subtraction for income taxes paid). Corporate law characterisation of a distribution as a formal dividend, a capital reduction, or even an illegal distribution which impairs capital is irrelevant.

## V. PROPOSAL FOR 2008 – THE GENERAL CONCEPT

Like many other countries, South Africa uses profits as the starting point for differentiating between dividend distributions and other forms of distributions. Unfortunately, this tracing of profits is a tedious process. In order to properly perform this tracing, taxpayers must know the whole history of the company's profits less prior distributions. Further adjustments over this life history are required for the tax calculation.

The second problem stems from the fact that the term "profits" relies on company law and accounting. This reliance on non-tax concepts means that a core aspect of the tax system is outside of the system's control for policy, interpretation and enforcement purposes. As a result, changes in company law or accounting indirectly impact the taxation of dividends. These changes are most often made without regard to this indirect tax impact. This mixing of different systems inevitably creates unintended loopholes or unintended difficulties.

In order to remedy these problems, it is proposed that all distributions be treated as dividends unless those distributions come from capital. Capital is easier to measure than profits because fewer events impact on capital over the life of a company. This focus on capital also means that distributions out of loan proceeds could trigger dividend treatment. As discussed above, Canada (and the U.K.) uses capital as the same starting point.

The starting point for capital can either be share capital from a company law/accounting point of view with adjustments or solely a tax concept that accounts for shareholder contributions. From an audit viewpoint, reliance on company law/accounting is an easier starting point. This is the reason that Canada has chosen this form of reliance. However, many of these benefits are undermined for the same reason that the current reliance on company law/accounting for the profits determination has caused difficulties. The audit benefits are also limited because of the multiple tax adjustments required to preserve the integrity of the tax system. It is for this reason that the proposed system for South Africa should be a regime that uses tax concepts as the sole departure point.

## VI. DETAILED DISCUSSION OF PROPOSAL

### A. Proposed definition

The Income Tax Act is aimed at taxing profits. In terms of the dividend definition, the tax laws ensure that investors are not taxed on their initial contributions or total cost of assets contributed – only amounts received above those contributions (i.e. the net economic benefit from the investment). It is therefore important that these shareholder contributions should not be subject to tax.

One shortcoming with the current system is that the "capital" concept originates without regard to the tax system. 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.

Another shortcoming of the current system is that company law/accounting takes into account items other than shareholder contributions, such as reserved profits. Company 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").

#### *1. Formations*

From a purist point of view, contributed tax capital of a company should represent the former tax cost of that capital in the hands of the contributing shareholders. Stated differently, tax-free repatriation should only represent a return of previously taxed investments.

In the case of cash, the full cash contributed should be added to shareholder capital (because the full amount represents previously taxed amounts). In the case of other assets, the situation becomes more complex. The starting point will be the initial tax cost to shareholder (acquisition cost plus improvements). Base cost for capital gains tax purposes is useful in this regard because the capital gains tax often acts as a rough counterpart for the STC. Subtractions are then required for deductions that have been allowed to the shareholder in respect of the asset (e.g. capital allowances deductions). Additions will then be required for any gain, recoupment or income triggered on the contributing transfer to the company.[14]

The net impact of this tax cost system will depend on how the contributed tax capital is made. Taxable contributions will generally trigger a market value result. Tax-free contributions will generally mean that the shareholder's base cost rolls over into the company's contributed tax capital (like the base cost rollover rules of section 42).

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[14] This rule may require a market value ceiling to prevent artificial elevations in contributed capital if the shareholder recognises excessive gain. One situation in which this problem could arise is if the contributing shareholder has excessive losses to offset the gain.

*Example 1. Facts.* Taxpayer forms Newco. In exchange for the Newco shares, Taxpayer contributes cash of R90 and land with a value of R110. Taxpayer purchased the land for R60. Taxpayer has R50 of capital gain.

*Result.* Newco has contributed tax capital of R200. Newco obtains contributed tax capital of R90 for the cash plus R110 for the land (taxpayer's starting cost of R60 plus R50 for the capital gain).

*Example 2. Facts.* The facts are the same as Example 1, except that the parties elect section 42 rollover treatment.

*Result.* Newco has contributed tax capital of R150. Newco obtains contributed tax capital of R90 for the cash plus R60 for the building.[15]

This system for calculating contributed tax capital would also mean that a shareholder issue of a promissory note for the shares of a company would generally yield zero contributed tax capital until payments come through on the notes. Similarly, a cross-issue of shares by two companies would generally yield zero contributed tax capital for both parties. For both sets of transactions, see section 24B.

Although the above approach is preferred for determining contributed tax capital, the above approach admittedly has administrative difficulties. For instance, if the recipient company is listed or widely held, it would be difficult for the receiving company to trace the tax cost of the contributions made by the smaller contributing shareholders (such as a contribution of shares of the target company in a share-for-share type transaction). In these circumstances, the contributed tax capital would have to equal the market value of assets received by the company (because the receiving company only has the practical ability to measure value as opposed to the contributing shareholder's tax computations). Alternatively, the system should arguably treat all assets as generating a market value result for contributed tax capital unless the contributing shareholder and company are connected persons.

It should be noted that the same cash/assets can result in duplication of share capital if those same amounts are pushed down through multiple tiers of companies. In these circumstances, each tier would obtain contributed tax capital equal to the same cash/assets received.[16]

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[15] Current reliance on company law/accounting would yield the same R200 result in both cases. Company law/accounting would generally focus on total cash plus the market value of other contributed assets.

[16] For example, assume Taxpayer transfers cash/assets with a R100 tax cost to Newco 1 in exchange for Newco 1 shares. Newco 1 does the same with Newco 2, and Newco 2 does the same with Newco 3. Upon completion of the transaction, Newco 1, Newco 2 and Newco 3 each have R100 of contributed tax capital.

### 2. *Amalgamations*

In an amalgamation, two or more companies merge into one. In terms of contributed tax capital, the effect of an amalgamation should be the same as the situation where the two merged companies have been initially formed as one. As a result, it is proposed that the contributed tax capital of each company should retain their nature as they merge into one.

*Example.* Assume the status of two amalgamating companies is as follows:

COMPANY A

| | |
|---|---|
| Gross Asset Value | 400 |
| Gross Asset Tax Cost[17] | 310 |
| | |
| Contributed tax capital | 50 |
| Debt | 60 |
| Realised Profit | 200 |

COMPANY B

| | |
|---|---|
| Gross Asset Value | 500 |
| Gross Asset Tax Cost | 390 |
| | |
| Contributed tax capital | 100 |
| Debt | 140 |
| Realised Profit | 150 |

On amalgamation, the balance sheet of the newly formed company will be as follows:

| | |
|---|---|
| Gross Asset Value | 900 |
| Gross Asset Tax Cost | 700 |
| | |
| Contributed tax capital | 150 |
| Debt | 200 |
| Profit | 350 |

With this retention of character, artificial creation of share capital through amalgamation is eliminated. If one had taken a more formalistic view (i.e. with the newly formed company viewed as issuing shares in exchange for the assets of both pre-existing companies), the contributed tax capital of the newly created company would be R900. The problem with this approach is that it allows the parties to convert the gross asset value of the two companies into contributed tax capital, which can then be distributed free of tax to the shareholders.

### 3. *Share issues*

A company can issue additional shares to current shareholders without those shareholders making any additional contributions to the company (i.e. as a type of distribution in lieu of cash or other underlying company assets). This type of distribution is typically accompanied by a shift of company law/accounting profits to share capital.

[17] The gross asset tax cost consists of the section 11(a) cost and the capital gains tax base cost.

Two options are envisaged. One option would be to treat the new issue of shares as an event free of tax on distributions without any corresponding change in contributed tax capital. A second option would be to treat the new issue as an event subject to a tax on distributions with a corresponding increase in contributed tax capital. The first option is preferred as being more consistent with the current and proposed regime for tax on distributions regimes. Under current law, share issues are often free of STC and any shift of profits to share capital is essentially ignored. Under the new regime, the question is whether any underlying withdrawal of assets has occurred and whether any additional assets are contributed. In the case of a share issue (without any consideration received in exchange of the share), none of these events has occurred, thereby justifying this share issue as a non-event.

However, this approach does allow for deviations that depend on form. For instance, a company can declare a cash dividend with the shareholders contributing the cash back to the company in exchange for more company shares. Under this scenario, the cash dividend would be taxable with the re-contributed cash adding to contributed tax capital. An issue to be considered in this regard is whether a company should be allowed to move amounts from profits to contributed tax capital at the price of immediate tax upon conversion. In essence, the question is whether dividends can essentially be converted to contributed tax capital.

### *4. Liquidations*

On liquidation, a company's corporate existence comes to an end. The company's assets are used to settle outstanding debts. Any remaining amounts are returned to the shareholders in proportion to their share ownership. These amounts may be distributed as a dividend or as a return of contributed tax capital.

Liquidations essentially unwind contributed tax capital (the reverse of a formation which creates capital). The receipt of liquidation proceeds by a company shareholder (like the receipt of any other distribution) has no impact on the company shareholder's contributed tax capital. The capital of the liquidating company is eliminated.

### *5. Unbundlings*

In the case of an unbundling, one company is essentially distributing the shares of another company. As a general matter, the distribution subjects the distributing company to the tax (or a reduction of capital) like any other distribution; the unbundling has no effect on the capital of the company whose shares are distributed. Although this rule makes sense for taxable distributions, at issue is the impact of a tax-free unbundling.

In terms of a tax-free unbundling, the proposed regime requires the pro rata allocation of contributed tax capital of the distributing company if the unbundling is tax-free via the company reorganisation rules (i.e. section 46). The unbundling company will pro rate its contributed tax capital between itself and the unbundled company based on their relative market values. This pro rata approach matches the base cost rules for tax-free unbundlings.

> *Example 1. Facts.* Holding company owns Sub 1, and Sub 1 owns Sub 2. Sub 1 has contributed tax capital of R120 and Sub 2 has contributed tax capital of

R80. Sub 2 has a value of R50, and Sub 1 has a value of R150 (taking into account its Sub 2 holdings). Sub 1 distributes the shares of Sub 2 in a tax-free unbundling.

*Result.* Sub 1 must pro rate its R120 contributed tax capital between itself and Sub 2 based on relative market values after the unbundling (R100 for Sub 1 and R50 for Sub 2). This pro rata allocation means that Sub 1's R120 contributed tax capital is reduced to R80 (2/3rds of R120), and Sub 2 has contributed tax capital of R40 (the previous R80 amount is eliminated).[18]

In essence, the tax-free unbundling comes at a price. While immediate tax is avoided, contributed tax capital of the unbundled subsidiary is lost. This loss essentially creates a larger STC deferred liability at a later date. This deferral is consistent with the intent of rollover relief (tax treatment at the time of the transaction with the tax rolling over until the subsequent disposal).

## B. Allocation of contributed tax capital

### 1. Current situation - allocation per company

Under current law, it appears that capital can be freely allocated to specific shares even if that capital arose from other sources (i.e. arose with respect to shares other than shares involved in the distribution). Taxpayers are seemingly using this free allocation to disguise shareholder sales in the form of simultaneous shareholder contributions and distributions. The Revenue Laws Amendment Act, 2007 contains a number of anti-avoidance measures that seek to minimise the tax benefits of this practice. However, these amendments are largely *ad hoc* measures that fail to address the underlying cause of the problem.

### 2. Allocation per share

The purist option for contributed tax capital carrying the least manipulation is to treat contributed tax capital as specifically allocable to specific shares, much like base cost for capital gains tax purposes. As long as contributed tax capital can freely be shifted among different shares, this shift can be used to artificially reduce taxes on distributions. In essence, this approach would mean that contributed tax capital is determined per share based on the shareholder contribution with respect to that share. Therefore, no more contributed tax capital can be withdrawn from a share than the amount contributed with respect to that share. For example, if a shareholder contributed R50 for 50 shares worth R1 each, each share would have R1 of contributed tax capital. Distributions in respect of each share would be limited to the R1 contributed tax capital amount (even if contributed tax capital otherwise exists elsewhere in the distributing company).

[18] If the unbundling instead falls outside the tax-free unbundling rules, Sub 1 would treat the unbundling as any other distribution. If no intra-group election were taken, the distribution would be subject to the STC (or Sub 2 could choose to reduce its contributed tax capital by R50). If an intra-group election were taken, the unbundling would be free of STC, but Holdco would be without STC credits upon receipt of Sub 2 (i.e. essentially left with a deferred tax charge).

### 3. Allocation per class

The main difficulty with the per share method is administrative. It will be difficult for a distributing company to know the contributed tax capital for a specific share if the company has received multiple contributions. For instance, if a company receives a R100 contribution for the new issue of 100 shares and later receives a R300 contribution for another 100 shares, how does the company know which shares should be allocated R1 of contributed tax capital per share versus R3 of contributed tax capital per share (especially once the shares start trading hands among shareholders)? This problem of tracing is especially problematic for identical shares of the same class.

As a compromise approach, the specific allocation could be performed per class. More often than not, companies with different classes of shares effectively divide the capital of the company into share classes of different values. Admittedly, some risk exists that companies may seek to shift capital between classes, but this shift would seemingly require a change in the underlying nature of the shares (e.g. from preferred to ordinary, ordinary to preferred). This change in the underlying nature of the shares would generally trigger an upfront capital gains charge (undermining the tax benefit of capital shift intended to avoid taxes). While some flexibility exists for companies to change the nature of their shares, this flexibility is limited. Shares can be consolidated or divided within a class free of any capital gains tax, but one class cannot be transformed into another (see paragraph 78 of the $8^{th}$ Schedule).

Under the per class approach to allocating contributed tax capital, an open issue remains on how to deal with the allocation of contributed tax capital among the shares of the same class. This per class rule would clearly have to be supplemented with anti-avoidance rules that limit per share tracing. Without an anti-avoidance rule, new shareholders could obtain control of a class by contributing large amounts of contributed tax capital, which are then withdrawn (free of STC) by pre-existing shareholders.

One measure that could limit the shifting of share capital between shares of the same class would be a percentage ceiling. Under this ceiling, contributed tax capital allocated to any share within a class could not exceed the pro rata percentage of that share in relation to the total class of shares.

> *Example. Facts.* Company has one class of ordinary shares. Initially, one group of shareholders contributed share capital and share premium of R15 000 for 100 of ordinary shares. Two years later, a second group of shareholders contributed share capital and share premium of R30 000 for another 100 ordinary shares. In a subsequent year, Company redeems the 100 of initial shares held by the first group of shareholders for a R25 000 distribution.
>
> *Result.* In order to limit undue shifts of contributed tax capital, the pro rata rule limits the contributed tax capital of the redeeming group to 50 per cent of the total contributed tax capital allocable to the class. In this case, the total contributed tax capital is R45 000 so, the contributed tax capital allocable to the redemption cannot exceed R22 500.

While the rule will reduce the potential for avoidance, some opportunities for manipulation will remain. For example, the redeeming parties above are still receiving partial benefit from the contributed tax capital associated with the second contribution.

At issue is whether certain anti-avoidance rules will be required to address matching contributions and distributions seeking to benefit from this partial shift (see paragraph 79 of the 8th Schedule, as repealed by the Revenue Laws Amendment Act, 2007).

## C. Ordering rules

Once a decision is made that return of contributed tax capital does not attract tax, there arguably needs to be a firm rule that determines when a payment is a return of capital as opposed to a dividend. In other words, if capital is available, should capital come first or last or under some other method? Many options are possible. Provided below are the two options holding the most promise.

### 1. The purist option

In respect of the purist option, if a company undertakes a going concern distribution, the contributed tax capital is deemed to be distributed last. This view is predicated on the notion that a shareholder will withdraw the initial underlying investment only after the growth has been withdrawn.

This policy result can be achieved by utilising a balance sheet approach. Under this approach, operating distributions will always be viewed as a dividend subject to tax unless the distribution reduces total gross assets to a level below the company's contributed tax capital. In this latter circumstance, return of contributed tax capital equals the amount by which the distribution reduces the gross assets to a level below the contributed tax capital.

For example, assume the balance sheet of a company is as follows:

| ASSETS | LIABILITIES | |
|---|---|---|
| Gross Assets 100 | Debt | 30 |
| | Capital | 25 |
| | Profit | 45 |

*Result.* If the company distributes R30, the distribution would be a dividend. Similarly, a distribution of R65 would be a dividend. However, if the company distributes R90, R75 would be viewed as a dividend, and R15 would be viewed as a return of capital.[19]

[19] If a return of contributed tax capital is made, subsequent company profits would not restore the contributed tax capital lost. In the above example, should the company make profits subsequent

The measure of gross assets against distributions required for the purist option can be accomplished in one of two ways. The assets can be measured utilising market values or tax cost (e.g. their capital gains tax base cost and/or their revenue expenditure (section 11(a)) expenditure). Of the two measurements, tax cost is preferred. Tax cost is easier to measure than value. More importantly, contributed tax capital is a tax concept that requires measurement against the same base.

On redemption, a proportionate amount of contributed tax capital must be allocated to the distribution. All amounts distributed in excess of this proportionate amount are viewed as a dividend.

On liquidation, an argument could be made that the same principles should follow as outlined above. All distributions before share cancellation must be weighed against the balance sheet like operating distributions. The cancellation of shares would follow the redemption rules. Any distributions after cancellation would be viewed as a dividend (because all contributed tax capital will already be withdrawn). On the other hand, one could argue that all contributed tax capital should be deemed to come out first because uncertainty exists about total values (with all excess viewed as dividends once contributed tax capital is fully withdrawn).

### 2. Canadian option

In Canada, two sets of rules exist for determining the dividend status of operating distributions. Operating distributions by listed companies are largely viewed as dividends. Operating distributions by unlisted companies allow for a return of capital if supported by a company resolution (i.e. a return of capital is essentially elective by the parties). The elective nature of unlisted company distributions stems from the freedom in which unlisted companies can often assume shareholder loans (see the shareholder loan discussion below).

Redemptions and liquidations do not depend on the listed or unlisted status of the distributing company. In a redemption, a pro rata share of paid-up capital is allocated to the redeemed share with any excess above the pro rata amount viewed as a dividend. On liquidation, the paid-up capital is deemed to have been distributed first with any excess taxed as a dividend.

The Canadian method has the advantage of administrative simplicity. Taxpayers need not make any balance sheet calculations. The Canadian method essentially takes a rough justice approach that reflects the probable reality once all available planning opportunities are fully taken into account.

### 3. Note on interest-free shareholder loans

Shareholder investments via loans versus equity contributions raise issues concerning the preferential treatment of debt over equity. In many financing structures (especially of smaller unlisted companies), shareholders are free (as a practical matter) to capitalise their companies with equity contributions or with interest-free shareholder loans. These

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to the R90 distribution, the previous reduction of contributed tax capital of R15 is not restored (i.e. recouped)? Again, only contributions by shareholders add to contributed tax capital.

structures often involve proportional contributions of equity and loans so that the overall relative entitlements to company management and dividends are maintained. Given the choice of shareholder contributed tax capital or interest-free loans, restrictions on the withdrawal of capital indirectly give taxpayers an even stronger incentive to capitalise the company with the interest-free loans (the latter of which can be freely withdrawn).[20]

One option of dealing with this potential problem is to accept that debt and equity are treated for tax purposes as fundamentally different items. This added difference admittedly creates planning opportunities, but little more so than pre-existing differences. Hence, the decision to proceed with proposed restrictions on contributed tax capital withdrawals should be utilised regardless.

Alternatively, one could tighten the treatment of shareholder loans. For instance, a pure approach to an interest-free shareholder loan can be adopted. In this case, an interest-free loan is deemed to bear interest. This deemed interest would generate a deduction for the company. The shareholder is then deemed to have received the interest and reinvested that interest in the company. The shareholder would generally be taxed on the interest and the add-back would create a corresponding increase of contributed tax capital in the company.

## D. Specialised entities

The tax treatment of dividends not only affects the distribution by companies in the strictest sense but also affects other entities treated as companies for tax purposes. For the purposes of this discussion document, the main deemed companies at issue are collective investment schemes and co-operatives. Furthermore the taxation regime is also relevant for distributions by foreign companies.

### 1. Collective investment scheme distributions

Most (if not all) South African collective investment schemes operate in the form of unit trusts, which hold one or more portfolios. Under current law, each of these portfolios operates as a deemed company with resultant distributions to investors treated as deemed dividends. An exception from this dividend treatment currently exists for redemptions (etc…), meaning that these transactions fall solely under the capital gains tax system.

It is suggested that redemption and liquidation distributions be treated as solely giving rise to capital gains/loss without regard to the dividend system. Operating collective investment scheme distributions should continue to be treated as dividends without any possibility of generating a return of contributed tax capital. The net effect would be to keep collective investment schemes wholly outside the contributed tax capital system that is the main subject of this discussion document. These proposed adjustments would best reflect current operational practice.

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[20] For example, assume two shareholders wish to form a company by investing R100 each. They could each contribute R100 in exchange for ordinary shares. Alternatively, they each could contribute R1 for the same ordinary shares containing the same rights while simultaneously making a R99 interest-free loan. Restrictions on capital contribution withdrawals would mean that the simultaneous equity/loan structure is preferred.

### 2. Co-operative distributions

Co-operatives are not designed to give rise to profit and loss for their members vis-à-vis their capital investments in co-operative membership. The benefits of co-operative membership are instead intended to be passed along to the members based on their interaction with the co-operative (e.g. discounted bargain purchases, services). Hence, “for profit” dividends should theoretically not be an issue. Moreover, the mutuality principle (which is the essence of a genuine co-operative) would seemingly suggest an approach that differs from the classical separate entity model for companies (giving rise to a tax on dividends). Therefore, this area will require a wholly separate examination falling outside the scope of this discussion document.

### 3. Foreign company distributions

The treatment of foreign distributions poses unique challenges. These distributions are declared by foreign companies out of a foreign country with tax regimes (and company law regimes) that are totally different in application from the South African paradigm. In these circumstances, the question accordingly arises as to how the tax jurisdiction should determine the classification of a distribution (i.e. as a dividend or a return of capital).

It is proposed that this classification for foreign company distributions should be determined solely with respect to South African tax principles. This approach is consistent with the current section 1 dividend definition, which also applies South African tax principles to classify foreign distributions. This approach is also consistent with other aspects of the South African income tax. For example, South African tax law determines the level of section 9D income generated by foreign subsidiaries that qualify as controlled foreign companies for South African residents. This income calculation is wholly separate from the potential tax calculations required of the foreign company by its home country.

This approach is a suitable assertion of a country’s tax sovereignty. Furthermore, this practice makes the calculation easily ascertainable and administratively feasible. Applying the tax systems of foreign jurisdictions would mean different results for the same conceptual dividend calculation, which would depend on the country involved. Not only would this result create administrative enforcement and compliance difficulties, it would also mean a loss of South African control over the tax base.

## E. Transitional issues

Like any other major change to the tax system, the proposed change in the tax base gives rise to transitional effective date issues. These transition rules can be divided into two parts. Firstly, it needs to be determined how much of the pre-existing share capital recognised can be viewed as contributed tax capital in accordance with the new rules. Secondly, this pre-existing share capital has to be allocated to different share classes in terms of the new rules.

### 1. Pre-existing amounts constituting contributed tax capital

Pre-existing amounts of share capital and share premium (as well as stated capital) will generally act as the starting point for the contributed tax capital calculation under the new system. However, the term contributed tax capital will exclude any amount that has been transferred from reserves or undistributed profits. This exclusion will mainly cover profits/reserves transferred to share capital/share premium stemming from the issue of capitalisation shares.

Reliance on pre-existing share capital (etc…) has the advantage of administrative simplicity with enforcement and compliance turning to pre-existing accounting treatment. The downside is that pre-existing weaknesses in the capital contribution system will carry over into the new system and will slowly fade away only with the passage of time. The net result is a two-track system for an extensive period of time (with many of the old weaknesses continuing for the near-term).[21]

### 2. Allocation of pre-existing amounts

As previously discussed, the preferred approach for allocating contributed capital will be to allocate that contributed tax capital according to a per share class system. Currently recognised share capital (etc…) will accordingly have to be allocated on this per class basis as the new tax base is implemented.

The proposed allocation will have two prongs. First, any specific allocation of share capital (etc…) to a share class created upon the issue of shares by agreement or articles of incorporation will be respected. This specific allocation will be common for preference shares. Second, share capital and share premium lacking this specific allocation will be spread among the share classes of a company based on the relative market values of those classes of shares on the implementation date for the new system.

[21] This two track system may require some transitional anti-avoidance rules that prevent last minute attempts by taxpayers to artificially inflate their share capital before the new regime goes into effect. (See paragraph 97 of the Eighth Schedule for transitional anti-avoidance rules that disregard artificial sales before the enactment of capital gains taxation).