# CORPORATE TAXES
# AND
# THE TAXATION OF DIVIDENDS

THESIS

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# Abstract

The classical system of taxation, whereby companies are taxed without a deduction for dividends paid and shareholders are taxed on their dividend receipts, results in double taxation of dividends. Split rate and imputation systems have been developed in an attempt to mitigate the effects of double taxation of dividends.

Double taxation of dividends and differences between corporate and maximum individual marginal tax rates result in corporate tax systems lacking neutrality. Distortions arise between organisational forms, between debt and equity financing and between the retention and distribution of profits. Various methods of integrating corporate and individual taxes have been advocated to overcome the lack of neutrality caused by corporate taxes.

Following the introduction of the South African Income Tax Act in 1914, a number of taxes relating to dividends have existed. These have included a Dividend Tax, Non-resident Shareholder's Tax, Undistributed Profits Tax and Secondary Tax on Companies, hereafter referred to as STC.

STC is a tax on net dividends declared and results in distributed income being taxed at higher rates than retained income. Despite the implementation of group relief provisions, STC results in an inhibition on the reinvestment of profits within the context of a group of companies. It is also a major cause of the lack of neutrality of the South African corporate tax system.

As a result of the lack of neutrality and inhibition of group reinvestment caused by STC, a full imputation system is suggested as an alternative to replace STC.

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# Chapter One

# Introduction

The need for tax reform has arisen in many countries. By the mid 1980's many countries, both advanced and developing, either had enacted or were considering major tax reforms (Boskin, 1990). In South Africa a number of Commissions have considered the need for tax reform. Their findings were published in the Franszen Commission reports in 1968 and 1970, and the Margo Commission report in 1986. The Katz Commission is still sitting but it has published an interim report in 1994 and two interim reports in 1995.

One of the themes of the world-wide tax reform is the taxation of dividends. The need for reforming the taxation of dividends arises mainly due to double taxation of dividends. Double taxation of dividends commonly occurs with the classical corporate tax system whereby companies are taxed without a deduction for dividends paid and shareholders are taxed on their dividend receipts.

In South Africa, however, the double taxation of dividends is not as a result of shareholders being taxed on their dividend receipts. It is Secondary Tax on Companies (STC) which gives rise to double taxation of dividends as dividends are subject to both corporate Normal Tax and STC but not to individual tax.

Even though this thesis considers corporate taxes in general, the taxation of dividends is specifically focused on. This thesis is limited to considering income taxes only and other direct taxes and indirect taxes are ignored. In this thesis, the term corporate taxes therefore refers only to income taxes.

The question of whether corporations should be taxed is addressed by means of a discussion of various theories that have been developed in an attempt to justify corporations being taxed. Three main types of corporate tax systems are described and five countries' tax systems are summarised and criticised. Reasons for the lack of neutrality of corporate taxes are identified and the impact of the lack of neutrality on organisational forms, corporate capital structure and distribution of profits is discussed. Various methods of integrating corporate and individual taxes are discussed as possible means of overcoming this lack of neutrality.

An overview of the first Income Tax Act which introduced corporation taxation in South Africa is made together with a summary of the modern South African corporate tax. Changes to the taxation of dividends since the introduction of income tax is South Africa are outlined. The recommendations regarding the taxation of dividends made by the Franzsen, Margo and Katz Commissions of enquiry are summarised and discussed. The mechanics of STC, which is the most recent change to the taxation of dividends, is described in detail.

STC has resulted in a number of anomalies arising. These anomalies are identified and discussed. One of the most significant anomalies is the implication of STC for group companies. Possible systems of relief from STC for group companies are discussed and group relief recommended by the Katz commission is summarised. Group relief from STC introduced since the implementation of STC is outlined and the remaining inhibition on group reinvestment is criticised.

Causes for the lack of neutrality of the South African corporate tax system are identified and discussed. Changes in the effective corporate tax rate is analysed and the impact of STC and the changes on the effective corporate tax rate is investigated.

Problems caused by STC result in the need for an alternative system to be found. In its first interim report, the Katz Commission (1994) recommended that various forms of imputation be assessed in order to determine whether a variant of the imputation system could replace STC. As a result of the need to find an alternative system to STC and in light of the Katz Commission recommendation, this thesis concludes with the suggestion and discussion of a full imputation system that could replace STC, as well as a discussion of the simplifications that could be made to this system if a flat-rate individual tax was implemented.

It should be noted that the singular masculine personal pronoun is used throughout this thesis for reasons of style and convenience. The South African tax law no longer recognises gender discrimination.

# Chapter Two

# Introduction to corporate taxes

This chapter discusses the various canons of taxation that are used in assessing the conceptual validity of tax systems, followed by a brief discussion of the nature of different taxes. The chapter concludes with a discussion of the theories that have been used to justify a corporation tax.

## 2.1) The canons of taxation

In determining the conceptual validity of particular tax systems it is necessary to measure the system against some predetermined criteria. Perhaps the most famous criteria are those that were proposed by Adam Smith in 1776 in his "Wealth of Nations". These criteria, or canons of taxation, are:

1. Equity

Equity requires taxpayers to contribute to the state's revenue in proportion to their respective abilities to do so. Writers, for example James and Nobes (1983:83) and Kay and King (1990:41), have distinguished between horizontal and vertical equity. Horizontal equity is achieved when taxpayers in equivalent circumstances are treated in an equal way. Vertical equity is achieved when taxpayers are taxed according to their ability to pay so that the rich will pay a higher proportion of their income in taxes than the poor.

Mill (1965:807) argued that equality of taxation meant an equality of sacrifices, and that this would mean:

> apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of payment then every other person experiences from his (1965:807).

In the case of corporation tax it is also necessary to ensure that there is both "internal" and "external" equity (HMSO, 1982:18). Internal equity refers to equity between corporations while external equity refers to equity between incorporated and unincorporated businesses.

2. Certainty

The tax which each taxpayer is required to pay should be certain and not arbitrary. The time, manner and amount of the payment must be plain and clear to everyone concerned. Smith suggested that a lack of certainty would encourage insolence and corruption amongst the tax collectors. He believed that certainty was a far more important criterion than equity, as is evident from the following quote:

> The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not so great an evil as a very small degree of uncertainty (1904:311).

3. Convenience

Every tax should be levied at a time, or in a manner, in which it is most likely to be convenient for the taxpayer to pay it. An example would be that a landlord should not have to pay taxes on rentals until he has received them.

4. Economy in collection

The cost of collection as a portion of the total revenue raised should be kept to a minimum. Smith mentioned four ways in which this criterion could be violated. Firstly, the levying of a tax may require so many officers to be appointed that their salaries take up a large proportion of the tax collected. Secondly, the tax may act as a disincentive to engage in certain economic activity which results in the diminishing, or destruction, of potential revenue. Thirdly, penalties imposed on people who evade tax may ruin them with the result that the community at large does not benefit from the employment of their capital. Fourthly, taxpayers may be greatly inconvenienced and troubled by onerous examinations by tax gatherers.

The above canons of taxation have obtained general acceptance. Some variations of the above can be found and additional canons are also used. One canon that was not laid down by Smith which is relevant to corporation tax is that of neutrality. Neutrality requires that taxpayers should not be influenced by the tax system in choosing one action above another. Neutrality in relation to corporate taxes is discussed in chapter four. The canons outlined above will be used in assessing the various tax systems and alternatives that will be discussed in later chapters.

## 2.2) The nature of taxes

The impact of taxes varies according to whether they are proportional, regressive or progressive. A proportional tax is one that results in the total taxes paid by each taxpayer taking up the same proportion of his or her income. The tax on corporations in South Africa is an example of a proportional tax. Proportional taxes result in horizontal equity. Regressive taxes result in the total taxes paid by poorer taxpayers taking up a larger proportion of their income than taxes paid by richer taxpayers. Indirect taxes, such as value added tax, are often regressive in nature. Progressive taxes are those that result in richer taxpayers paying a larger proportion of their income by way of taxes than the poor do. Progressive taxes result in vertical equity being achieved.

In modern social theory it has been recognised that a progressive tax is the most equitable tax. This is the reason why individual income taxes are generally progressive with the marginal tax rate increasing as taxable income increases. South Africa has had a progressive individual income tax since the passing of the first income tax act in 1914.

Even though modern social thinking recognises progressive taxes as the most equitable, progressive taxes do have problems associated with them. It has been argued that progressive taxation can lead to a disincentive to work (for example Musgrave and Musgrave 1984:304; James and Nobes 1983:61). This is as a result of taxpayers deciding to do less work so as to pay tax at a lower marginal rate. This is known as the substitution effect. This arises as a result of the cost of leisure being reduced due to the loss of earnings being reduced. It could however also act as an incentive to work harder so as to be able to pay for the increased taxes. This is known as the income effect.

Another undesirable consequence of progressive taxation is that as a result of a large portion of income being taken in the form of taxes and diverted to the state which rarely invests for growth, the amount of capital available in the economy for growth is reduced (Coffield 1970:250). A further problem arises if a comparison is made between fluctuating and constant income. James and Nobes (1983:37-38) give the example of two occupations that provide the same income over the life of the worker. The first occupation yields the same amount of income each year and will as such bear the same amount of tax each year. The second occupation has a lower income in some years and a higher income in others. Over the lifetime the second occupation will bear more tax than the first as a result of the progressive tax structure pushing the worker into higher tax brackets in high income years. The South African tax legislation has, in certain circumstances, made provision for "smoothing out" this undesirable effect of the progressive income tax. An example of this is the rating concession that is available to farmers whereby they are taxed on their average marginal rate over five years.

In arguing against a graduated (progressive) property tax, Mill stated that it was desirable for taxation to be used as a means of mitigating the inequalities of wealth, but that this should not 'relieve the prodigal at the expense of the prudent' (1965:810).

Mill argued that:

> To tax the larger incomes at a higher percentage than the smaller, is to lay a tax on industry and economy; to impose a penalty on people for having worked harder and saved more than their neighbours. (1862:387)

Mill objected to the application, to general taxation, of the principle of levying larger tax rates on higher incomes than on lower incomes (1965:811-812). He did however believe that it would be just and expedient to apply this principle to legacy and inheritance duties (1965:812). Mill believed that:

> taxing people on a larger proportion of their income, because they are better off, does not hold the balance fairly between saving and spending; it is contrary to the canon of equity, and contrary to it in the worst way, because it makes that mode of employing income which it is public policy to encourage, a subject of discouragement (Hollander, 1985:860).

Mill advocated the exemption of a certain amount of income from being taxed. This amount would be sufficient to provide for the necessities of persons normally supported from a single income. Taxpayers would only be taxed, at a flat rate, on income that exceeded the exempt amount. Mill argued that this would satisfy :

> entirely the small amount of justice that there is in the theory of a graduated income tax, which appears to me to be otherwise an entirely unjust mode of taxation, and in fact, a graduated robbery (Hollander, 1985:861).

As income rose the benefit of the income exemption would become less significant, and as a result rich taxpayers would still pay a greater proportion of their incomes in taxes than poor taxpayers would do.

The South African primary rebate which entitles all individual taxpayers to deduct R2 660 (for the 1997 tax year) from their final tax liability is an example of what Mill advocated. In South Africa the rebate does not directly exempt income from taxation but provides for an amount to be deducted from the final tax liability. The final effect is however the same as creating a tax threshold below which no income tax would be payable. The O'Brien Commission (1982), a commission on direct taxation in Ireland, was also opposed to the levying of individual taxes at different marginal rates, and unsuccessfully recommended a flat rate personal income tax. The reason for the recommendation was as follows:

> Almost all the problems in the area of company taxation arise because company profits are charged to tax at a flat-rate, while income tax on individuals is charged at progressive rates. This results in the use of companies for tax avoidance purposes (O'Brien, 1982:39).

## 2.3) The incidence of corporate taxes

Economists have been concerned with the question of who actually bears the tax (referred to as the incidence of the tax) that is levied on corporations. It is possible to distinguish the formal incidence of taxes from their effective incidence.

Hicks (1968:139-140) argued that the formal incidence of taxes is of great social interest in connection with questions of the distribution and redistribution of income. She argued that despite the importance of determining the formal incidence of taxation it did not tell anything directly about the taxpayer's reaction to a change of tax and its consequences. This is however what the concept of the effective incidence of taxation is concerned about.

The formal incidence of a tax falls on the party legally liable for the payment of the tax while the effective incidence falls on the party who is actually out of pocket as a result of the tax (Kay and King 1990:6). The formal incidence of corporate taxes fall on the corporation itself - it is legally responsible for the payment of the taxes. The question of effective incidence is more involved than this.

The effective incidence of corporate taxes cannot fall upon the corporation itself. Musgrave and Musgrave give the following explanation of the effective incidence of corporate taxes:

> The corporation does not have a taxpaying ability of its own in the sense in which individuals do, and all tax burdens are ultimately borne by individuals (1984:406).

It seems logical that the effect of corporate taxes is to reduce the profits attributable to the owners, and as such the effective incidence of corporate taxes would fall on the individual shareholders. Economists such as Kay and King (1990: 153-157); Musgrave and Musgrave (1984:411- 417); and Goode (1951:44-72) however believe that in certain situations corporations are able to pass on the effects of taxes to workers (through lower wages) and customers (through higher prices). This is known as tax shifting. The direction of the tax shift depends on the elasticity of demand and supply of goods and services as well as labour and capital (Margo, 1987:52). Inelasticity in supply, which particularly characterises labour, shifts taxes to the employee, whereas inelasticity in demand shifts taxes to the customer. In management decision theory it is assumed that all taxes are passed on to customers.

The O'Brien Commission realised that there was little agreement on the effective incidence of corporate taxes but "one thing is certain, the tax *(corporate taxes)* is borne by individuals and not by institutions" (1982:24.5).

Even though the incidence of corporate taxes is not necessarily in itself a problem, it is important in determining the acceptability of corporate taxes to consider the effective incidence of the taxes and their possible implications.

**2.4) Should corporations pay tax?**

It has been argued that a corporation itself should not be taxed. Those who argue that corporations should not be taxed often view a corporation as merely a vehicle through which individual shareholders have decided to conduct their business. They argue that a corporation is simply a conduit for transmitting the earnings of a business to the shareholders. It is therefore argued that corporations do not have separate taxable capacities. Others who argue that corporations should be taxed, view a corporation as a separate taxable entity in its own right. This view is based on the fact that corporations, especially large corporations with widespread share ownership, have direct command over economic resources to which the shareholders have no access. Corporations can make economic decisions over which the shareholders have no control. It is argued that because of this independence of action, corporations should be regarded as separate taxable entities in their own right.

The O'Brien Commission (1982:24.4) did not accept the argument that because corporations have this independence of action they are as such separate taxable entities in their own right. The Commission believed that while corporations are legal entities who transmit money to the "Exchequer", they cannot bear the burden of taxes, that is, the effective incidence of corporate taxes does not fall upon the corporations themselves. The Commission argued that corporations merely collect money from individuals, who are their customers, their suppliers, their employees or their shareholders, and transfer it to the state. The Commission realised that it was not possible to tax corporations and leave people untouched.

A criticism of corporate taxes arises from the fact that they are often levied at a flat rate. Certain countries do levy corporation income tax at more than one rate - the United Kingdom and United States are examples of such countries (details of these corporate tax systems will be discussed in chapter three). Where corporate taxes are levied at a flat rate these taxes are not progressive. Dividends received are often taxed in the hands of individuals which does result in a portion of the corporation's profits being subject to individual income tax which is progressive in nature. This so called classical system of taxation, is however the cause of possibly the greatest problem and the most common criticism of taxing corporations, namely double taxation. Double taxation is discussed in chapter three.

Despite the contention of many that corporations should not be taxed, a number of theories have been used to argue that corporations should in fact be taxed. Goode (1951:26-40) discusses four theories that have been used to justify a corporation income tax. They are:

1. <u>Allocation of Social Costs Theory</u>

This theory is based on the argument that a tax is justified to cover certain social costs which are assignable to business but which are not directly chargeable to private business.

Public services that are useful to business can be classified as a social cost. An example would be public education programmes which train workers and health programmes that ensure that the working population is healthy and efficient. The government maintains law and order, civil courts, commercial and industrial legislation and in many ways maintains the market in which business buys and sells. These public services are not provided for the exclusive use of corporations or businesses but are undertaken in the public interest. They do however facilitate the income-producing activities of corporations and private business. Most of the public services provided by the government are provided for at no, or little, cost. This results in corporations and private business not bearing the full cost of these services directly, but only through the tax system.

A second type of social cost is reflected in various inconveniences, hazards and destructive activities that the general public have to bear. Industrial activities can pollute the environment, cause industrial accidents and other undesirable situations. These situations can result in government having to spend large sums to rectify the harm caused. As with the first type of social cost, these costs are sometimes not borne by the businesses to which they are properly assignable.

The benefits derived from public services that facilitate production are spread, however, more widely than simply to corporations. If these costs were to be paid through an equitable tax system, it would be necessary to determine exactly who should be taxed. It would seem reasonable that all business should be taxed. In practice it would be difficult to determine what would be classified as a business and whether any other party would be benefited. This may result in the tax only being extended to corporations. Since corporations are only one of the parties who benefit from public services, a corporation tax would be justified if only part of these costs were financed by this tax. However if the portion of the costs which benefit other parties were financed by a corporate tax it would result in the tax being inequitable.

It would be desirable, where possible, to assign the second type of social cost (the inconveniences etc. caused by business) to the businesses that are directly responsible for them. A specific charge is required on particular businesses, but a tax on all corporations is not justified. Furthermore it can be argued that the necessity of providing for a tax to cover these costs is declining in modern societies. Governments no longer have to bear a large portion of these costs. Laws enforced by governments, pressure exerted by environmentalists, as well as the desire to maintain a healthy public image force corporations to spend large sums of money on preventing and rectifying any harm caused by their activities. Examples are corporations undertaking to purify industrial effluent, plant grass on mine dumps and the use modern technology to keep the emission of harmful chemicals into the atmosphere down to a minimum. The costs are thus borne directly by the organisations responsible for their occurrence.

A further problem in using the allocation of social costs theory to justify a corporation tax arises in defining an appropriate tax base from which the tax could be levied. Profits earned, assets employed or the quantities produced all fail to provide an adequate and acceptable base.

2. Social Control Theory

The social control theory is based on the concept that a necessary part of social control is to prevent, or at least control, the formation of large businesses which could lead to the formation of monopolies and cartels and the resultant harm that is often caused by it. It is asserted that if businesses are allowed to grow and expand beyond certain limits, it could result in their being able to manipulate the market in which they operate, and would often result in the formation of large monopolies. This is in turn held to be extremely harmful to the economy.

It has been argued (Goode 1951:39) that it is not feasible to police business in an attempt to prevent the formation of large businesses and that it is far more effective to control business by means of a corporation tax. Goode argued that subjecting business to a corporation tax and making it labour under tax disadvantages would help "neutralise" the other advantages it enjoys. A progressive corporate income tax with steeply graduated rates, or a high corporate tax rate with a large threshold would assist in controlling large businesses. A high undistributed profits tax which would discourage the retention of profits has also been suggested. This would reduce growth based on retained income.

3. Ability to Pay Theory

The concept of ability to pay has not been clearly defined. It is often used to justify taxes that impose a larger burden on the rich than on the poor. It has also been used to imply the exemption of persons from tax whose income is below the margin of decent subsistence. In academic usage, ability to pay taxes has often been determined in terms of the sacrifice incurred in paying taxes. Therefore a taxpayer who sacrifices little in paying taxes has a greater ability to pay than a taxpayer who sacrifices much.

Goode (1951) makes the point that if ability to pay is interpreted in terms of sacrifices made, a corporation itself will have no ability to pay taxes. Corporations themselves can feel no sacrifices. It is their shareholders, who all have different abilities to pay taxes, that are affected by corporation tax. Poor shareholders will therefore suffer greatly while the rich will hardly feel the effects of a corporation tax.

Goode (1951:34) suggested that interpreting ability to pay as "the capacity of paying with minimum interference with socially approved aims" would result in the soundest and most meaningful interpretation. As pointed out by Goode, this interpretation implies that ability to pay will mean the possession of income that has a low order of social priority and will be socially less useful than other private income or wealth. The revenue authorities would appropriate the socially least useful parts of income and wealth first.

Even if ability to pay is interpreted as the capacity to pay with minimum interference with socially approved aims, a corporation tax would still discriminate against poorer shareholders. A dividend received by a rich shareholder would be socially less important than a dividend received by a poor shareholder. This is due to the rich shareholder having substantial income from other sources to provide for his daily needs, while the poor shareholder would be dependent upon the dividend for daily survival. Both dividends, however, would have been subject to the same corporation tax. It is therefore irrelevant whether ability to pay is interpreted in terms of sacrifices made in paying the tax or in terms of the social importance of the income earned, as both interpretations result in discrimination against the poor.

In the absence of tax shifting to employees or customers the incidence of corporation tax will fall on the individual shareholders. Since poor shareholders have a poor ability to bear corporation taxes while rich shareholders have a greater ability to pay the taxes, the ability to pay theory cannot be used to justify a corporation tax.

## 4. Benefit or Privilege Theory

This theory is based on the fact that a corporation tax is justified as a charge for the benefits and privileges of being able to do business in the corporate form. The corporation is a creation of the State and it is from the State that a corporation receives all its rights, powers and benefits. In addition to the benefit and privilege of existing in the corporate form, corporations enjoy many other specific benefits. Examples of specific benefits are the limited liability of shareholders and perpetual succession. The State conferred benefits of incorporation often enable corporations to grow in size and expand their markets more easily. It is argued that the state is therefore justified in imposing a tax to make corporations pay something for their privileges and benefits.

The benefit theory goes back to the beginning of this century. It was the favourite theory of the courts and was used by the United States Supreme Court in 1909, in the case of *Flint v Stone Tracy Co.*, to uphold an excise tax (*sic*) on corporation net income. The court held that the benefits of incorporation was a special privilege that could be subject to Federal taxation.

Three arguments have been raised against the benefit theory being a justification of a corporation income tax (Goode 1951:28). The first argument is that the benefits associated with the corporate form are only incidental to the government's policy of providing for incorporation as a means of serving the public interest. Customers, it is argued, benefit just as much as owners. For example, customers will have access to large chain stores and the benefits associated with them. The second argument is that it is impossible to measure the benefits received. The benefit theory does not provide any guidance on how and to what extent corporations should be taxed. The third argument is based on the fact that it cannot be said that the benefits or privileges of the corporate form have any economic value. The reason given is that incorporation is an alternative which is available to all, and is available on easy terms.

The argument that customers benefit as much as corporations can be attacked from two different angles. Goode (1951:28) argues that customers do not necessarily benefit from the corporate form as much as owners do. If all the benefits and privileges were to go to customers it would mean that goods would have to be sold at the cost of production. Under modern conditions this theoretical ideal cannot be relied on as a guide for tax policy. Even if customers were to benefit from the corporate form, it has been argued (Goode 1951:44) that taxing a corporation results in some of the taxes being passed on to consumers in the form of higher prices. If this is in fact so, customers will then also be paying taxes, indirectly, for the benefits and privileges that they have received.

Goode (1951:28) attacks the argument that the benefit theory does not provide guidance on how corporations should be taxed on the grounds that this argument has confused the justification for a tax with defining a tax base. He argues that no general theory, for individual or corporate taxes, determines both a tax base and an appropriate rate schedule.

It would, however, be necessary to define an appropriate tax base before a tax justified by the benefit theory could be implemented successfully. Goode argues that if the benefit theory was accepted as justifying a corporation tax, it would seem reasonable to assume that the benefits and privileges received would be closely related to profits earned by the corporation. A tax on net income would therefore be justified. He realises that a problem with this assumption would arise in the situation where corporations have failed to make profits as it could be argued that they have still enjoyed the benefits and privileges of corporate form. He overcomes this argument by countering that if corporations which failed to make profits were also taxed it would simply hasten their dissolution. He argues that it would therefore be reasonable not to tax corporations in these circumstances, and despite such corporations enjoying the benefits of incorporation without being taxed, a tax on net income would still be justified.

The argument that incorporation has no economic value confuses, according to Goode, benefit with exchange value. It is true that incorporation has no exchange value. This is as a result of incorporation being available to all. Incorporation has, nonetheless, still got benefits and privileges associated with it. Those who will not benefit from incorporation will simply not choose that alternative.

The benefit theory is probably the strongest of the four theories discussed. However, the most common defence for a corporation income tax is possibly what Colm (1940) referred to as the "cynical rule of taxation" and not any of the above theories. The cynical rule of taxation states that corporation tax is well established in practice and produces large amounts of revenue, that it would be difficult to raise the same amount of revenue from alternative sources, and it could therefore not be abolished.

It is interesting to note that in justifying the imposition of a separate tax on company profits, the Franzsen Commission (1970:145) in South Africa made reference to both the benefit and social costs theories.

The Meade Committee, a committee investigating direct taxation in the United Kingdom, referred to four considerations that could be used in the justification of a separate corporate tax (1978:227).

The first consideration was the privileges conferred by incorporation, particularly the benefits of limited liability - however refer to the O'Brien Commission below. The second was the tax problem of undistributed profits. Incomes of private businessmen are subject to a progressive income tax even when they are saved and ploughed back into the business. Equality of treatment would require that corporate profits should also be taxed when they are ploughed back into the business. If it is not feasible to allocate undistributed corporate profits to individual shareholders (refer to chapter three), then some special tax on corporate profits is required. There was also the straightforward revenue consideration. Taxes levied on corporate profits at higher rates than on corresponding personal incomes may be a convenient way of raising a considerable tax revenue.

The final consideration mentioned by the Meade Committee was Colm's "cynical rule of taxation". The Committee believed that this in itself constituted a valid argument in favour of the continuation of a corporate tax as its elimination would lead to substantial unexpected windfall gains to existing shareholders. The levying of corporate taxes results in a decrease in the shareholders' return on their investments. As a result of this negative impact, shareholders have already adjusted their required rate of return to account for the decrease. Therefore, it is argued that the elimination of the corporate tax will result in windfall gains to existing shareholders.

The O'Brien Commission (1982:24.10) believed that the only justification for imposing a separate tax on corporations, over and above that levied on unincorporated entities, is that corporations enjoy the privilege of limited liability. The probability of enjoying this privilege is however inversely related to the level of profits earned as the greater the profits earned by a corporation the less likely it is to go insolvent. The Commission therefore did not consider a higher rate of tax on corporate profits to be justified on these grounds.

The Commission realised that if there was no tax on earnings retained by corporations, shareholders would be given an unjustifiable advantage over other taxpayers and it would be possible for tax on corporate profits to be delayed. The Commission concluded that while in principal there was no case for a separate tax on corporate profits, the corporate tax should continue to be collected at the corporate level as a prepayment of shareholders' liability in order to avoid corporations being used as a means of delaying tax due by shareholders.

**2.5) Summary**

The criteria against which tax systems are measured are often referred to as canons of taxation. The most famous canons were those laid down by Adam Smith which referred to equity, certainty, convenience and economy in collection. A further canon which is relevant to this thesis is that of neutrality.

Taxes are either progressive, proportional or regressive. Even though it is believed that progressive taxes are the most equitable they have problems associated with them. These problems include a possible disincentive to work and the reduction of growth due to the transfer of capital to the state.

It is possible to distinguish between the formal and effective incidence of corporate taxes. The formal incidence falls on the party legally liable for the payment of the tax. The effective incidence, however, is more involved than the formal incidence and the effective incidence of corporate taxes does not fall on companies but is ultimately borne by individuals.

A number of theories have been developed to justify the corporation tax. These include the allocation of social costs theory, social control theory, ability to pay theory and benefit theory. Despite the theories developed for justifying corporate taxes, the most common defence for a corporation tax income tax is the "cynical rule of taxation". This rule states that corporation tax is well established in practice and produces large amounts of revenue, that it would be difficult to raise the same amount of revenue from alternative sources, and could therefore not be abolished.

# Chapter Three

# An introduction to the taxation of dividends

This chapter serves as an introduction to the taxation of dividends. The chapter discusses the double taxation of dividends, describes the various corporation tax systems in use and provides practical examples of corporation tax systems.

### 3.1) Double taxation of dividends

The most common occurrence of double taxation of dividends is as a result of dividends received by an individual being subject to both corporate and individual taxes. Double taxation is not incurred from a legal point of view. Legally the corporation is a separate entity that is distinct from its shareholders. Dividends in the hands of a corporation's shareholders can be legally distinguished from the corporation's income. However from an economic point of view it is the same income that has borne both corporate and individual taxes. The double taxation of dividends is therefore an economic and not a legal concept.

Double taxation of dividends results in a number of economic distortions. It results in a bias towards the non-corporate form. It also results in a bias towards financing activities with debt rather than equity. Furthermore, it creates a bias against the distribution of profits. These distortions, and the reasons for them arising, are discussed in detail in chapter four.

### 3.2) Corporation tax systems

A corporation tax system is the method whereby corporations are taxed. Generally the most fundamental differences found in tax systems are related to the manner in which dividends are taxed. Each system has implications on the tax burden relating to the taxation of dividends at both corporate and individual levels. Corporate tax systems are often classified into classical, split-rate and imputation systems.

In considering the impact of corporate tax systems, it is necessary to consider the total tax burden on corporate income paid by both the corporation and the suppliers of capital in order to obtain a meaningful analysis of the tax system.

1. The Classical System

Under this system corporation profits are taxed without a deduction for dividends paid. Dividends received are taxed as investment income in the hands of the shareholders. As a result of the dividends being subject to taxation at both corporate and individual levels, double taxation of dividends occurs.

Due to double taxation of dividends, the classical system results in the distortions referred to in 3.1 above. Both the imputation and split rate systems have been developed in an attempt to mitigate the effects of double taxation of dividends.

2. Split Rate System

Under the split rate system distributed income is taxed, at the corporate level, at a lower rate than at which retained income is taxed. Dividends received by shareholders are taxed as investment income in their hands. Double taxation of dividends is still incurred, but to a lesser extent than under the classical system.

As result of the double taxation of dividends still occurring to some extent, split-rate systems also result in economic distortions occurring. However in contrast to classical systems, a split rate system will encourage the distribution of profits from the corporate point of view. This is as a result of distributed profits being taxed at a lower corporate tax rate than retained profits. From the shareholders' point of view however, a bias against the distribution of profits still occurs as dividends are taxed twice. A conflict between shareholders' and the corporation's interests could thus arise with corporations wanting to declare unwanted dividends! Split rate systems also result in a bias against equity funding and incorporation.

## 3. Imputation System

Imputation systems permit some, or all, of the tax paid by corporations on the income out of which dividends are paid to be treated as tax paid by the recipients of the dividends. Thus when a corporation declares a dividend the recipient of the dividend receives a tax credit for the corporate tax borne by that dividend. This results in corporate taxes being "imputed" to shareholders.

Dividends received by shareholders are grossed up to include the tax credit received. The grossed up amount is then included in the shareholders' taxable income and individual tax is calculated on the gross amount. The individual tax calculated is then reduced by the tax credit received.

Two types of imputation systems exist: partial imputation and full imputation. Under partial imputation only a portion of the corporation tax paid on dividends is passed on to the shareholders as a tax credit. Only partial relief from the double taxation of dividends is provided where the shareholder's marginal tax rate is higher than the rate of corporation tax received as a tax credit.

Partial imputation systems are very similar to split rate systems, and will result in the same total tax burden being borne by dividends. However, whereas split rate systems tax distributed profits at a lower corporate tax rate, partial imputation systems tax retained and distributed profits at the same corporate rate. The benefit of a lower tax rate on distributed profits is obtained when dividends are subject to individual tax by means of the tax credit received. As with classical and split-rate systems, partial imputation systems result in a bias against equity finance and incorporation.

In contrast to partial imputation, full imputation systems result in shareholders being credited with the full amount of corporation tax paid on dividends by means of a tax credit. Full relief from the double taxation of dividends is thus provided for. Full imputation systems will therefore not result in a bias against incorporation, against the distribution of profits or against the use of equity finance.

As a result of a bias towards incorporation caused by classical, split-rate and partial imputation systems, these systems do not achieve external equity. It is only the full imputation system that fully removes double taxation of dividends and thereby results in external equity being achieved. Based on this, full imputation systems are the most equitable of the tax systems discussed.

It should be noted that in discussing the above tax systems the effects of differential corporate and individual tax rates have been ignored. Thus in considering the bias against incorporation, against the use of equity finance and against the distribution of profits, only the impact of these systems as double taxation is considered. The effect of differential corporate and individual tax rates is discussed in chapter four.

### 3.3) Examples of corporation tax systems

1. <u>The United States - an example of the classical system</u>

*Development of the United States corporation tax*

The first income tax act of the United States was the Income Tax Act of 1894. This act was short lived as it was found to be unconstitutional by the Supreme court in the case of *Pollock v Farmers' Loan & Trust Company*. In this case Charles Pollock, a shareholder with only ten shares, raised an action to prevent the company from paying the tax on income that had been imposed by the 1894 Act.

Article 1 section 2 of the United States constitution stated that direct taxes should be apportioned among the States according to their respective population numbers. It also provided for a census every 10 years. It is therefore apparent that if taxes were to be apportioned on the basis of population to the States, an income tax was unconstitutional.

The Sixteenth Amendment to the constitution was thus passed in 1913 to make it possible for Congress to legislate an income tax. The Amendment states:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census...(Merit Students Encyclopaedia, 1970:563)

The next income tax act therefore only appeared in 1913 after the Sixteenth Amendment. However before the passing of the 1913 Act, an "excise tax" (refer to chapter two) of one per cent was introduced on corporate net income.

The 1913 Income Tax Act provided for a normal tax of one per cent on the net income of corporations. Individuals were also taxed at the rate of one per cent. However in addition to this individuals were liable to a surtax on net income exceeding $20 000. Corporations were not subject to surtax until 1936 when surtax was extended to the undistributed profits of corporations.

During the early years of income tax, the corporation tax equalled the maximum individual normal tax rates. However, from 1919 corporation tax rates were higher than individual normal tax rates.

Tax rates increased as a result of the First World War. Corporate income tax, supplemented by excess profits and war profits taxes, provided an important source of revenue. Tax rates decreased during the 1920s, but taxes were still higher than pre-war levels. The need to finance the Second World War was the cause of corporate income taxes rising sharply again, and an excess profits tax was re-imposed on corporation net income. The excess profits tax was repealed immediately after the war and corporation income tax was slightly reduced. A further reduction was made in 1948, but corporate income tax was again increased in 1950.

From 1913 to 1936 dividends received by shareholders were exempt from individual normal tax. The exemption of dividends from normal tax was seen as a method of partially integrating corporate and individual income taxes, and removing the double taxation of dividends.

During 1936 the United States adopted the British system of deduction-at-source. This was extended to include dividends, interest, rent, wages and salaries paid by corporations. This system was short-lived as it was soon to be replaced by the system of information-at-source. As was found in Britain this proved to be one of the worst systems (Coffield 1970:232) as it imposed a huge burden on revenue authorities to correlate large quantities of information. The United States returned to the deduction-at-source system thirty years after it was abolished.

During the 1980's there were two major tax reforms. The first was instituted in 1981 through the Economic Recovery Tax Act, and the second in 1986 through the Tax Reform Act. The main theme of the 1981 reform, as far as it affected corporation tax, was the reduction of capital costs for companies through changes in depreciation rates and an increase in investment tax credits. As a result of the 1981 tax reforms, the effective marginal corporate tax rates dropped (van Sinderen, 1993)

The 1986 Tax Reform Act resulted in major changes to the tax system. These changes were considered to be the most sweeping changes since 1941 (Shoven, 1990). The intention of the reform was to reduce the distortions on the economy which were caused by the tax system (McLure and Zodrow, 1987). As far as it affected corporation tax, the main change due to the reform was the reduction in the corporate tax rate with an increase in the tax base. Investment deductions were abolished and depreciation and research and development costs were restricted (van Sinderen, 1993). The 1986 reform resulted in a shift from the taxation of personal income to corporate income (van Sinderen, 1993).

The classical system was modified to allow for a dividends received deduction (DRD). This entitled the recipient of dividends to deduct a certain percentage of dividends received from his income in determining his tax liability. The DRD was a crude attempt at restricting the double taxation of dividends. For decades the DRD was set at 85 per cent of the amount of the dividend. The DRD was amended in 1987 and provided for a:

- 70 per cent deduction if the shareholding was less than 20 per cent;
- 80 per cent deduction if the shareholding was greater than or equal to 20 per cent but less than 80 per cent; and
- 100 per cent deduction (through the consolidated tax return provisions) if the shareholding was equal to or greater than 80 per cent. (Willens, 1988:23).

*The modern United States corporation tax*

The United States corporation tax system is an example of the classical system. It is also an example of a system that taxes corporate profits at differing marginal rates. The rates of corporation tax as of 31 July 1993 are given in table 3.1.

**Table 3.1 - US Corporation income tax rates**

| Taxable income ($) Between: | | | Tax on lower amount ($) | Percentage on excess |
|---|---|---|---|---|
| 0 | - | 50 000 | | 15 |
| 50 000 | - | 75 000 | 7 500 | 25 |
| 75 000 | - | 100 000 | 13 750 | 34 |
| 100 000 | - | 335 000 | 22 250 | 39 |
| 335 000 | - | 10 000 000 | 113 900 | 34 |
| 10 000 000 | - | 15 000 000 | 3 400 000 | 35 |
| 15 000 000 | - | 18 333 333 | 5 150 000 | 38 |
| 18 333 333 | - | and over | 6 416 667 | 35 |

*Source: Price Waterhouse (1995) Corporate Taxes A Worldwide Summary, page 633*

The 39 per cent tax rate applying to taxable income between $100 000 and $335 000 eliminates the benefit of the 15 and 25 per cent rates. The 38 per cent rate applying to taxable income between $15 000 000 and $18 333 333 eliminates the benefit of the 34 per cent rate (Price Waterhouse, 1995:633). Corporations that are primarily engaged in providing services are taxed at a flat rate of 35 per cent (Coopers and Lybrand, 1996:U-30).

The United States has modified the classical system to some extent. An example of this is the provisions for 'S corporations'. S corporations combine the flexibility of the partnership format with the advantages of operating in the corporate form. Shareholders have to elect S corporation status and this remains in effect until it is revoked or terminated. This status entitles items of corporate income, loss, deduction, credit and tax preference to pass through to shareholders on a pro rata basis. Shareholders are taxed on this income regardless of whether it has been distributed or not (Coopers and Lybrand 1994:U-29). This modification allows for the full integration of S corporation profits with the shareholders' income.

A system known as the alternative minimum tax (AMT), is designed to ensure that companies with economic income pay some federal tax. Tax liabilities are calculated under both the regular tax system and the AMT system and the larger of the liabilities is payable by the tax payer. The AMT broadens the corporate tax base by increasing regular taxable income by tax preferences and adjusting certain deductions, such as depreciation, to eliminate their acceleration in earlier years (Price Waterhouse, 1995a)

In addition to the tax rates outlined in table 3.1, corporations are subject to various state and local taxes. The tax bases and tax rates vary from state to state. The highest state income tax rate is 12 per cent but they are on average lower than this. State and local taxes paid are deductible from taxable income for the purpose of determining the base for federal income tax.

Dividends paid by United States corporations are partially included in the shareholders' income on the basis of the DRD and are subject to personal income tax. The corporation DRD has remained unchanged since its amendment in 1987. The United States system only fully eliminates the double taxation of dividends where the shareholding is greater than 80 per cent (due to the DRD). Where the shareholding is less than 80 per cent, double taxation of dividends is only slight due to a maximum of 30 per cent of the dividend being taxable.

The main criticism of the United States corporate tax system is that it does not fully remove the double taxation of dividends. As stated in 3.1) above, this results in the US system creating biases against incorporation, equity financing and the distribution of profits.

## 2. <u>The United Kingdom - an example of partial imputation</u>

*Development of the UK corporation tax*

Apart from profit taxes levied due to the First and Second World Wars, until 1947 the UK tax system did not distinguish between corporate and non corporate taxpayers (Dilnot and Kay (1990), Wiseman (1980)). Before 1947 companies were taxed as individuals and income tax was levied on all income, at the standard rate, with little regard to the ownership or destination of the income. However when systems of personal allowances and progressive taxation appeared companies did not receive these as they were not individuals.

After the outbreak of the First World War additional taxes were introduced and in 1915 the first excess profits tax was imposed on companies. This was succeeded by a corporation profits tax in 1920, which was levied at a rate of five per cent. The corporation profits tax was repealed in 1924, and from then until 1937 companies were taxed at the standard income tax rate only.

In 1937 a temporary 'National Defence Contribution' was introduced at a rate of five per cent. In 1939, due to the outbreak of the Second World War, excess profits tax was re-introduced. In 1947 the excess profits tax was repealed and the National Defence Contribution was put on a permanent basis under the name of the 'Profits Tax'. The profits tax only applied to companies and was levied at a higher rate on distributed profits than on undistributed profits. The differential rates were abolished in 1958 and Profits tax was levied at a single rate on all company profits.

The income tax and profits tax on companies was replaced by a corporation tax in 1965 (Wilkinson,1992). Company taxation was totally separated from personal income. This system of corporate taxation was a classical system as dividends were taxed as income and no relief was given for the tax paid on the income out of which they were paid.

The next major change made to corporation taxation, in respect of the taxation of dividends, was in 1973 when the imputation system was introduced. Details of the UK imputation system will be discussed below.

A temporary system of "stock relief" was introduced in 1974 to help overcome a liquidity crisis in which the tax payments due in 1975 would have led to serious financial difficulties for many major corporations. Relief was given for additional expenditure on stocks during the year. Relief was granted regardless of whether the additional expenditure was a result of inflationary increases in the price of goods or as a result of increased volumes. This "stock relief" eliminated most of the corporation tax liability of the UK manufacturing industry. In 1981 the allowance was changed to an adjustment of opening inventories based on an "all stock index" published by the government. Even although the system was described as temporary, it was only abolished as part of the tax reform of 1984.

After the introduction of the imputation system in 1973, the next major tax reform was in 1984. This reform brought about two significant changes. The first was the reduction in the corporate tax rate from 52 per cent to 35 per cent. The reduction was staggered over a two year period. The second change was related to capital allowances (Leape, 1993). As table 3.2 indicates, the rate of first year capital allowances increased dramatically until 1981 when there were 100 per cent write off of plant and machinery and 75 per cent write off of industrial buildings in the year of purchase. The 1984 reform replaced these accelerated allowances with allowances more closely related to true economic depreciation. It is interesting to note that in 1984 only about 65 per cent of UK corporations were paying tax (Dilnot and Kay, 1990).

**Table 3.2 - Capital Allowances in the UK: 1970 to 1983**

1. Plant and Machinery:

| | |
|---|---|
| 1970 - 1971: | 60% first year allowances |
| 1971 - 1972: | 80% first year allowances |
| 1972 - 1983: | 100% first year allowances |

Any amount not written off in the first year was subject to a write off of 25 per cent per annum on the reducing balance.

2. Industrial buildings:

| | |
|---|---|
| 1970 - 1972: | 30% initial allowance |
| 1972 - 1974: | 40% initial allowance |
| 1974 - 1981: | 50% initial allowance |
| 1981 - 1983: | 75% initial allowance |

An additional annual allowance of 4 per cent was allowed each year until the full cost had been written off.

*Source: James and Nobes (1983:290)*

*The UK Partial Imputation System*

The tax credit associated with the UK imputation system is equivalent to the basic rate of income tax (Bertram, 1988). This is the reason why the UK system only provides for partial imputation. Shareholders who pay income tax at a rate higher than the basic rate only receive partial relief from double taxation. Dividends are taxed at the shareholder's marginal rate while the tax credit is calculated at the basic rate.

The tax credit is defined as: 'the ratio of the notional tax paid by the company on behalf of its shareholders to the dividend distributed' (Kay and King, 1990:169). The basic income tax rate, for the year 6 April 1995 to 5 April 1996, was 20 per cent. The rate of the tax credit would therefore be expressed as $^{20}/_{80}$ or $^{1}/_{4}$. Thus if a company paid a dividend of £100 to a shareholder the tax credit associated with the dividend would be £25. The shareholder would be required to include the grossed up dividend, i.e. £125, in his taxable income and would be able to deduct £25 from his total tax liability.

With the introduction of the imputation system, the "Advance Corporation Tax" (ACT) was introduced. Whenever a corporation distributes a dividend, it is required to make an advance payment of tax equal to the tax credit that will be granted to the shareholders. Thus ACT of $^{20}/_{80}$ of dividends paid will be payable as the individual basic tax rate is 20 per cent. The dividend together with the ACT paid is referred to as a "franked payment".

ACT is not a separate tax on the corporation but is merely an advance payment of the corporation tax liability. The final amount of tax that a corporation has to pay over to Revenue is known as mainstream corporation tax, and is equivalent to the corporation tax liability less ACT.

ACT that cannot be recovered against the current year's liability for corporation tax may be carried forward or treated as ACT paid for accounting periods beginning in the six years prior to the year in which the surplus arose. Surplus ACT brought forward from an accounting period is not eligible for the six year carry-back. Where the surplus is treated as ACT paid in a previous accounting period, the mainstream corporation tax computation for the prior year is recalculated and the resultant decrease in the mainstream corporation tax paid is refunded (Bertram, 1988:434 - 435). The order of set-off of ACT paid is as follows:

> (a) primarily against corporation tax on income of the accounting period *in which* the distribution is made...;
>
> (b) by election, against corporation tax on income of earlier accounting periods...; and
>
> (c) lastly, by carryforward for set-off against corporation tax on income of subsequent accounting periods... (Topple, 1981:8).

ACT is payable on quarters ending 31 March, 30 June, 30 September and 31 December. In addition to this, ACT is payable for the period ending on the last day of the corporation's accounting year end if this is not on one of the quarter ends mentioned above (Bertram, 1988).

Only individual UK residents are entitled to a set-off of the tax credit against their taxable income. Non-residents are in certain circumstances, in terms of double taxation treaties, also entitled to the set-off of the tax credit against their taxable income (Bertram, 1988:430).

Special provisions regarding tax credits apply where the recipient of a dividend is a corporation. If the recipient corporation is exempt from corporation tax, a repayment of the amount of the tax credit will be made. Where the recipient is a UK resident corporation, the dividend together with the tax credit on the dividend is referred to as "franked investment income".

Franked investment income received by a UK corporation is not subject to corporation tax, and can be set-off against any franked payments made in determining the amount of ACT payable. ACT will then only be payable if the franked payments exceed franked investment income. The total corporation tax liability will nevertheless remain the same regardless of whether the corporation receives a dividend or not. A simple example to illustrate this is if a corporation, with a total taxable income of £500, receives a dividend of £100 and pays a dividend of £300. The corporation paying the £300 dividend can offset £25 (£100 x $^{20}/_{80}$) against the ACT liability of £75 (£300 x $^{20}/_{80}$). ACT of £50 would be paid to the revenue authorities. The total corporation tax liability would however remain at £175 (£500 x 33%) regardless of whether the dividend was received or not. The receipt of a dividend by a corporation will therefore only effect the timing of the payment of the corporation tax liability but will not reduce it.

It was stated above that ACT is payable four times a year and on a corporation's accounting year end if it does not fall on a quarter end. If a corporation has paid ACT in respect of a quarter end within an accounting period, and then receives franked investment income in a later quarter end within the same accounting period, any excess franked investment income over franked payments made in the later return period is repaid (Bertram, 1988:440). If there is any excess franked investment income after it has been set-off against franked payments in any accounting period, the excess is carried forward and is treated as franked investment income in the next period (Bertram, 1988:437 - 438).

James and Nobes (1983:275-278) discuss two reasons for the introduction of ACT. When the classical system was in operation, corporations were obliged to deduct a withholding tax from dividends paid. The withholding tax was paid over to Revenue shortly after the payment of the dividend and thereby enabled Revenue to receive an advance payment of tax. When the imputation system was introduced the withholding tax on dividends paid was abolished with the result that the revenue authorities lost the advance payment of tax. ACT was therefore introduced to enable the revenue authorities to receive an advance payment of corporate taxes before the payment of the corporation's tax liability some time after the financial year end.

The second, and more important, reason for the introduction of ACT was to ensure that sufficient corporation tax had in fact been paid to cover the tax credits that would be granted to shareholders. If a corporation that had a nil taxable income paid a dividend, shareholders would receive a tax credit for the corporation tax paid on the profits from which the dividend was paid. However, in the absence of ACT, no corporation tax would actually have been paid, and shareholders would have received a credit for tax that had not been paid. Since an imputation system provides for a credit for corporation tax paid, it is essential that the corporation tax has been, or will be, paid for the system to work effectively. The payment of ACT ensures that an amount of tax, equivalent to shareholders' basic rate of income tax applied to the dividend declared has been paid over to Revenue. Since the rate of imputation is equal to the basic rate of income tax, shareholders will not receive a tax credit for tax that has not been paid.

A system such as ACT is, however, not always an essential feature of an imputation system. The need to ensure that corporation tax has been paid before tax credits are granted to shareholders will only arise if there is a significant difference between accounting and taxable incomes. This situation was prevalent in the UK in the 1970's and early 80's due to the granting of extremely generous capital allowances.

As indicated by tables 3.3 and 3.4, under the classical system as the dividend pay-out increases, total taxes paid by the company and the shareholder increase. However, under the partial imputation system the total taxes paid remain the same regardless of the dividend pay-out ratio, if the shareholders pay income tax at the basic rate. Where the shareholders pay income tax at a rate above the basic rate the total taxes paid will increase, but the extent of the double taxation of dividends will still be less than that of double taxation under the classical system.

UK corporations were taxed at the rate of 33 per cent for the 1996 financial year. The "small companies rate" of 25 per cent was applicable where total corporate profits were £300 000 or less. Marginal relief was provided for profits between £300 000 and £1 500 000. These limits were reduced for companies in a group or with associated companies (Coopers and Lybrand 1996:U-12).

As with the US corporate tax system, the main criticism of the UK system is that it does not remove the double taxation of dividends. It thus results in biases against incorporation, equity finance and the distribution of profits.

**Table 3.3 - Classical and imputation systems** (basic rate shareholder)

i. Corporation tax:

| | 20% pay out | 60% pay out |
|---|---|---|
| Net income | 100 000 | 100 000 |
| Corporate Income Tax (33%) | 33 000 | 33 000 |
| Net income after tax | 67 000 | 67 000 |
| Dividend | 13 400 | 40 200 |
| Retained income | 53 600 | 26 800 |

ii. Individual tax:

| | Classical system | | Imputation system | |
|---|---|---|---|---|
| | 20% pay out | 60% pay out | 20% pay out | 60% pay out |
| Dividend received | 13 400 | 40 200 | 13 400 | 40 200 |
| Tax credit ($^{20}/_{80}$) | - | - | 3 350 | 10 050 |
| Grossed-up dividend | 13 400 | 40 200 | 16 750 | 50 250 |
| Individual Tax at 20% | 2 680 | 8 040 | 3 350 | 10 050 |
| Less tax credit | - | - | 3 350 | 10 050 |
| Individual tax payable | 2 680 | 8 040 | - | - |
| Corporate tax payable | 33 000 | 33 000 | 33 000 | 33 000 |
| Total tax payable | 35 680 | 41 040 | 33 000 | 33 000 |

**Table 3.4 - Classical and imputation systems** (top marginal rate shareholder)

i. Corporation tax: same as table 3.3

ii. Individual tax:

| | Classical system | | Imputation system | |
|---|---|---|---|---|
| | 20% pay out | 60% pay out | 20% pay out | 60% pay out |
| Grossed-up dividend (table 3.3) | 13 400 | 40 200 | 16 750 | 50 250 |
| Individual tax at 40% | 5 360 | 16 080 | 6 700 | 20 100 |
| Less tax credit | - | - | 3 350 | 10 050 |
| Individual tax payable | 5 360 | 16 080 | 3 350 | 10 050 |
| Corporate tax payable | 33 000 | 33 000 | 33 000 | 33 000 |
| Total tax paid: | 38 360 | 49 080 | 36 350 | 43 050 |

3. Australia - an example of full imputation

From 1940 Australia had a classical system of corporate taxation. In terms of this system companies were taxed as separate legal entities and individual shareholders were taxed on dividends received without any relief for the tax paid by the company on the profits out of which dividends were paid. However, within the corporate sector a dividend rebate existed which effectively exempted dividends received by corporate shareholders from income tax (Glazier *et al*, 1995:13).

In 1987 an imputation system replaced the classical system. For the 1994/95 year the corporate income tax rate was 33 per cent. The imputation system applies to dividends paid by Australian resident companies to Australian resident individuals. The system results in corporate taxes paid on income out of which dividends are paid being imputed to individual shareholders as a tax credit. Dividends would only be subject to individual income tax to the extent that the individual shareholder's marginal tax rate exceeds the rate applied against the company (Waincymer, 1993:414). Due to shareholders receiving a full credit for corporate income taxes paid, the Australian imputation system results in full imputation occurring.

Dividends received by individual shareholders are included in taxable income together with the corporate tax paid on the profits out of which the dividend was paid. Shareholders however receive a tax credit for the corporation tax paid. To ensure that shareholders do not receive a tax credit for corporation tax that has not been paid, the Australian Tax Act creates the concept of franked, partially franked and unfranked dividends (Waincymer, 1993:443).

Whenever a company distributes a dividend, the dividend is franked with the amount of corporate taxes paid. In order to determine the level of franking that can occur, companies are required to maintain a franking account. With effect from the 1994/95 tax year, companies are required to maintain two franking accounts, called class A and class B accounts. This was due to the decrease in the corporate tax rate from 39 per cent to 33 per cent in the 1993/94 tax year. The class A account reflects franking debits and credits in respect of transactions up to 1992/93 and the class B account reflects franking transactions after 1992/93 (Glazier *et al*, 1995:85-86). Credits in the franking account include corporate taxes paid, franked dividends received from other companies and franking surpluses from prior years. Debits to the franking account are mainly made up from franked dividends paid (Waincymer, 1993:444).

In franking a dividend, the company is required to declare the extent to which the dividend is franked, and this information must be provided to shareholders (Glazier *et al*, 1995). When determining the extent to which a dividend distribution can be franked, a company is not limited to the net credit in its franking account as it may make a reasonable estimate of any additional franking credits that it expects to receive later in the year (Waincymer (1993), Glazier *et al* (1995)). If there is a franking account deficit at the end of a year, the company is required to pay a 'franking debit tax' to eliminate the deficit. The franking debit tax can be set-off against the corporation tax payable (Waincymer, 1993:444).

To illustrate the effect of the receipt of a franked dividend assume that an Australian resident individual received a fully franked dividend of $10 000 in the 1995 tax year. Since the dividend was fully franked, the imputation credit associated with the dividend would have been $4 925 (10 000 x $^{33}/_{67}$). An amount of $14 925 would have been included in the shareholder's taxable income, and an imputation tax credit of $4 925 would have been available for set-off against the shareholder's income tax liability. Any unutilised imputation tax credit can be set-off against income taxes in future years, but the unutilised credit is not refundable (Waincymer (1993), Glazier *et al* (1995)).

A major criticism of the Australian imputation arises from the requirement to maintain a franking account. This imposes a large administrative burden on the company, increases the complexity of the tax system, and results in large compliance costs. Dividends paid by different companies will have different tax credits associated with them. Not only does this make the tax system difficult for shareholders to understand, but it also results in a large burden on the tax authorities in assessing the taxation of dividends. Burdens arise from authorities needing to assess the franking accounts. The situation is exacerbated by the requirement of companies to keep a class A and class B franking account. This could result in the tax credit received by shareholders being made up of two rates, namely $^{39}/_{61}$ (as the corporate tax rate was 39 per cent prior to 1992/93) and $^{33}/_{67}$. It is clear that the Australian franking system violates Smith's canons of convenience and economy in collection.

## 4. New Zealand - a further example of full imputation

Prior to 1988 New Zealand had a classical system of corporation income tax. However as part of a fundamental tax reform, a full imputation system was implemented with effect from 1 April 1988. Dividends received carry a credit for the New Zealand tax paid at the corporate level. For the tax year commencing 1 April 1996 resident corporations are subject to income tax at the rate of 33 per cent. Non-resident corporations are subject to tax at a rate of 38 per cent.

The imputation and related legislation consists of three parts, namely an imputation credit account, a dividend withholding payment account and a branch equivalent tax account (CCH Tax Editors, 1995:607). The imputation credit account records income tax paid by a New Zealand company which may be credited to its shareholders. The dividend withholding account records dividend withholding payments made to the Commissioner. These payments are available for allocation to shareholders. The branch equivalent tax account records New Zealand tax paid on income from a foreign company under the international tax regime. Double taxation is avoided as a result of branch equivalent tax credits being available for set-off against dividend withholding payments. (CCH Tax Editors, 1995:607).

Every New Zealand resident company is required to maintain an imputation credit account (CCH Tax Editors, 1995:609-610). The following amounts, *inter alia*, give rise to credits to the imputation credit account:

- New Zealand income tax paid on income derived by the company for the 1989 and later tax years. Penalty taxes paid are excluded;
- imputation credits attached to dividends received by the company; and
- dividend payment withholding credits attached to dividends received if the company does not operate a dividend withholding payment account.

Debits to the imputation credit account arise mainly in respect of refunds of income tax paid and a deficit resulting from the allocation of credits to shareholders which differ from the benchmark dividend imputation ratio (refer below for a discussion of benchmark dividends). If an over allocation of credits leaves the imputation credit account or the dividend withholding payment account in debit at 31 March in any year, the company is required to pay the amount of the shortfall plus 10 per cent to the Department (CCH Tax Editors, 1995:608).

The first dividend paid by a company during a year is referred to as the "benchmark dividend". The payment of the benchmark dividend determines the ratio of the imputation tax credit attached to all subsequent dividends paid during the year. This ratio is the rate at which corporate taxes are imputed to shareholders. A company may allocate credits to a dividend at a different ratio if the Commissioner is furnished with a ratio change declaration. The rate change will only be allowed if a statutory declaration is completed stating that the new ratio is not part of an arrangement to obtain a tax advantage. In allocating credits to dividends, the company can draw from the pool of tax credits in the imputation credit account and the dividend withholding payment account. In an attempt to ensure that credits allocated are not disproportionate to the amount of the dividend, the maximum imputation ratio is limited to $^{33}/_{67}$ (CCH Tax Editors, 1995:613).

If the tax credit carried by dividends paid to resident shareholders is less than 33 per cent, corporations are obliged to deduct a withholding tax until the total imputation credit and withholding tax are equal to 33 per cent. Corporations are obliged to inform shareholders of the amount of the dividend and the categories of credit attached (Coopers and Lybrand, 1996:N-48).

The gross amount of dividends are included in shareholders' income and are liable for personal income tax. The tax credits associated with the dividend received may be used to reduce the total income tax payable by the shareholder. Any excess imputation credits not utilised by the shareholder can be converted to a loss and can be carried forward to reduce taxable income in later years. The loss is calculated by dividing the unused credit by 33 per cent (CCH Tax Editors, 1995:573, 604). Non-resident shareholders do not receive the benefit of any imputation credits. Furthermore, companies which pay dividends to non-resident shareholders are required to deduct non-resident withholding tax from these dividends (CCH Tax Editors, 1995:563).

Foreign dividends received by New Zealand corporations are generally not included in taxable income. Dividends received by one resident company from another resident company have generally been assessable in the hands of the recipient since 1 April 1992. An exception to this is that dividends paid between two companies that are part of a "wholly owned" group of companies are exempt from tax. A wholly owned group is defined as a group of companies that are 100 per cent commonly held. Shares held by employee share purchase schemes that are not greater than 3 per cent are excluded in determining the 100 per cent holding (CCH Tax Editors, 1995:605). Companies that have been assessed on dividends receive a tax credit for any imputation credits attached to these dividends (CCH Tax Editors, 1995:563-564). The tax credits are available to the company to be applied towards any tax payable by it, and will also be available to be credited to the company's imputation credit account (CCH Tax Editors, 1995:573). Companies who receive imputation tax credits generally do not claim a credit of tax but apply the credits to their imputation credit account (CCH Tax Editors, 1995:606).

New Zealand companies are required to file an annual imputation return, a company dividend statement and a shareholder statement with the Commissioner (CCH Tax Editors, 1995:614). The imputation return reflects the imputation credit account's opening and closing balances as well as all debits and credits to the account. The completion of the company dividend statement and the shareholder dividend statement is required whenever a dividend is declared. The company dividend statement reflects, *inter alia*, the total amount of imputation credits attached to the dividend and the imputation ratio of the dividend. The shareholder statement is sent to each shareholder stating the imputation credit attached to the dividend and the amount of withholding tax deducted. This enables the shareholder to claim the appropriate tax credits.

As with the Australian corporate tax system, the New Zealand system can be criticised on the grounds of complexity and high compliance costs. The requirements of maintaining an imputation credit account, a dividend withholding payment account and a branch equivalent tax account are onerous and increase the system's complexity and the compliance costs. Compliance costs are further increased due to the withholding taxes and due to the issue of a shareholder's statement to each shareholder whenever a dividend is declared.

## 5. Germany - an example of a split rate system coupled with imputation

It is believed that the origin of the German corporation income tax might have been the Prussian income tax law of 1891 (Wiseman, 1980:78). After the First World War, the right to levy income taxes was passed to the Reich and the taxation of corporate bodies and natural persons was governed by different statutes (Wiseman, 1980:78).

A split rate system was introduced in 1953 and retained profits were taxed at higher rates than distributed profits. With the effect from 1 January 1977 an imputation system was introduced (Wiseman, 1980:78). In addition to the German corporate tax system providing for undistributed and distributed profits to be taxed at split rates, it also provides for the imputation of corporate taxes paid on distributed profits.

For the 1996 tax year, resident corporations are subject to normal tax at a rate of 48,375 per cent for undistributed profits and a reduced rate of 32,25 per cent for distributed profits. A corporation tax rate of 45,15 per cent is applicable for non-resident corporations (Coopers and Lybrand, 1996:G-2).

When paying a dividend the corporation is required to deduct a 25 per cent withholding tax from the amount of the dividend payable to shareholders. Dividends are included in income for the purposes of determining individual and corporate income tax. Both individual and corporate shareholders may deduct the 25 per cent tax withheld, as well as a tax credit of $^{32,25}/_{67,25}$ of the dividend received (for the corporation tax borne by the dividend) from their total income tax liability. A simple example to illustrate is provided in table 3.5. It is assumed that all of the company's profits are distributed.

The main criticism of the German corporate tax system is the complexity that arises from having a full imputation system as well as a split rate system. The requirement of withholding taxes from dividend payments also increase the costs of complying with the system.

**Table 3.5 - Example of tax computation for dividends**

1. Corporate tax computation:

| | |
|---|---|
| Taxable Income | 100,00 |
| Corporation tax payable | 32,25 |
| Dividend declared | 67,75 |
| Withholding tax (25 per cent) | 16,94 |
| Dividend paid to shareholder | 50,81 |

2. Individual tax computation:

| | |
|---|---|
| Dividend received | 50,81 |
| Plus withholding tax | 16,94 |
| | 67,75 |
| Plus tax credit (67,75 x $^{32,25}/_{67,75}$) | 32,25 |
| Included in taxable income | 100,00 |
| Available for set-off against tax liability: (withholding tax plus tax credit) | 49,19 |

From table 4.1) below, it is evident that there are differences between the corporate and individual maximum marginal tax rates for all five countries whose corporate tax systems were discussed. This results in these systems having a common defect, namely a lack of neutrality between corporate and non corporate forms, between retained and distributed profits and between debt and equity. The reasons for the lack of neutrality arising is discussed in chapter four.

Table 3.6 classifies the corporate tax systems of 66 different countries into one of seven categories. It is interesting to note that the majority of the countries still have a classical system which has been modified to varying degrees to help reduce the effects of double taxation of dividends.

**Table 3.6 - Economic Double Taxation - a seven point classification system** (a survey of 66 countries)

| **Classical** | **Modified classical - partial double taxation** | |
|---|---|---|
| Full corporate and full individual tax | Full corporate and personal tax with partial shareholder relief unrelated to corporate tax | |
| 1 | 2 | 3 |
| Economic double taxation | Spilt rate system or withholding tax | Single rate system |
| Corporate income taxed in corporation's hands and distributed income fully taxed in the hands of domestic individual shareholders | Distributed income effectively taxed at higher corporate rate than undistributed income, and partial relief given to shareholders | Distributed income taxed at same corporate rate as undistributed income, and full relief given to shareholders |
| Czech Republic<br>Egypt<br>Ghana<br>Indonesia<br>Liberia<br>Luxembourg<br>Netherlands<br>Switzerland<br>United States | Chile<br>Kenya<br>Nigeria<br>Thailand<br>Uganda | Bangladesh<br>Belgium<br>Canada<br>China<br>Denmark<br>Iceland<br>India<br>Japan<br>Korea<br>Pakistan<br>Spain<br>Swaziland<br>Tanzania |

*Continued on page 45*

**Table 3.6 - continued**

| **Modified classical - no personal tax** | | **Imputation** | |
|---|---|---|---|
| Full corporate tax but no personal tax other than withholding tax, where applicable | | Full corporate tax and personal tax with shareholder relief for corporate tax | |
| 4 | 5 | 6 | 7 |
| Spilt rate system or withholding tax | Single rate system | Partial imputation | Full imputation |
| Distributed income effectively taxed at higher corporate rate than undistributed income, and full relief given to shareholders | Distributed income taxed at same corporate rate as undistributed income, and full relief given to shareholders | Partial shareholder credit against personal income tax for corporate tax paid on distributed income | Full shareholder credit against personal income tax for corporate tax paid on distributed income |
| Austria<br>Botswana<br>Brazil<br>Dominican Republic<br>Hungary<br>Jamaica<br>Lebanon<br>Poland<br>South Africa<br>Zambia<br>Zimbabwe | Argentina<br>Columbia<br>Greece<br>Guatemala<br>Hong Kong<br>Malawi<br>Mexico<br>Myanmar<br>Namibia<br>Paraguay<br>Peru<br>Philippines<br>Sudan<br>Sweden<br>Turkey | France<br>Ireland<br>Portugal<br>Sri Lanka<br>United Kingdom | Australia<br>Finland<br>Germany<br>Italy<br>Malaysia<br>New Zealand<br>Norway<br>Singapore |

*Notes:*

1. *This does not deal with corporate shareholders, or with non-residents.*
2. *Six countries also give some form of corporate (as opposed to shareholder) tax relief to reduce economic double taxation, namely:*
   a. *Corporate tax credit for dividend withholding tax: Dominican Republic, Botswana and Poland*
   b. *Corporate tax rate reduced for distributed income: Germany*
   c. *Corporate tax deduction for distributed income: Iceland and Spain*

*Source: adopted from: van Blerck, SA tax Review, September 1995.*

### 3.4) Summary

The double taxation of dividends, caused by dividends being taxed at both corporate and individual levels, is an economic and not a legal concept.

Corporate tax systems can be classified into three main categories, namely: classical, imputation and split rate systems. Classical systems result in the double taxation of dividends as dividends are taxed at corporate and individual levels. With imputation systems all, or some as in the case of partial imputation systems, of the tax paid on the profits out of which dividends are paid is imputed to shareholders in the form of a tax credit. Full imputation removes the double taxation of dividends, but partial imputation still results in double taxation of dividends to an extent. Split rate systems tax distributed profits at a lower rate than retained profits. Such a system has the same net effect as a partial imputation system.

The corporate tax systems of the United States, United Kingdom, Australia, New Zealand and Germany were discussed. The United states has a classical system, United Kingdom a partial imputation system, Australia and New Zealand full imputation systems and Germany has a split rate system combined with full imputation.

# Chapter Four

# Neutrality of corporate taxes and the integration of individual and corporate taxes.

Chapter four discusses the lack of neutrality of corporate taxes and the distortions resulting from this. Various methods of integrating individual and corporate taxes are discussed as possible means of overcoming the lack of corporate tax neutrality.

## 4.1) Neutrality of corporate taxes

One of the major criticisms of corporate taxes is that they are not neutral as they give rise to a number of economic and financial distortions. The three main problems that arise are whether to:

- invest in non corporate rather than corporate form,
- finance investments with debt rather than equity, and
- retain rather than to distribute profits (Glenn Hubbard, 1993:117).

1. Organisational Form

There are a number of tax factors that influence investors in their decision as to whether to conduct their business operations through the corporate or non-corporate form.

As a consequence of corporate profits being taxed twice, all other things being equal, the after tax return of an equity-financed corporate investment will be lower than the after tax rate of return of the same “equity” investment if it had been in the non corporate form. This clearly results in a bias against incorporation and will discourage the use of the corporate form even if incorporation would provide other non-tax benefits (Glenn Hubbard 1993:118). The bias against incorporation caused by double taxation will only be incurred in the case of an equity investment - a debt investment has the same consequences for corporate and non corporate taxpayers as both classes will receive a tax deduction for interest paid.

It is not only double taxation of dividends that results in a bias against incorporation. A bias against, or in favour of, incorporation also occurs where there is a difference between the corporate tax rate and the individual investor's average tax rate. In most countries individual taxpayers pay tax at different marginal rates, determined by the level of their taxable income, while corporations are taxed at a flat rate. This results in income from a non corporate investment being taxed at different average rates, while income from a corporate investment is taxed at a flat rate. Depending on whether the investor's average rate is below or above the flat rate at which corporations are taxed, there is a bias either against or in favour of incorporation.

Where the investor's tax rate is lower than the corporate tax rate, a bias against incorporation occurs. This is due to the investment income being taxed more heavily if the investment was made through a corporate form. Conversely a bias towards incorporation occurs where the investor's tax rate is higher than the corporate tax rate.

Harberger (1966) developed a model for determining the costs of the economic distortions caused by the corporate income tax. He argued that the effect of corporate income taxes was that capital is transferred from high productivity applications in the taxed sector to low productivity applications in the untaxed sector (informal sector). The transfer of capital to low productivity applications results in the inefficient allocation of resources. Gravelle and Kotlikoff (1989) investigated the distortions caused by corporate taxes when corporate and non corporate firms produce the same goods. They believed that non corporate entrepreneurs were more efficient than corporate managers, while corporate firms had a technological advantage in producing on a large scale (1989:777).

Glenn Hubbard (1993:118) also referred to the conclusions of Gravelle and Kotlikoff. He argued that distorting the choice between corporate and non corporate forms caused additional costs to the economy. The additional cost arose because corporate and non corporate producers within an industry possessed differential advantages. Corporations would possibly be able to exploit economies of scale (due to their large size), while non corporate organisations would possibly be better able to encourage entrepreneurial skill. Distorting the choice between corporate and non corporate forms could mean the loss of these advantages. This was the point made by Gravelle and Kotlikoff.

## 2. Corporate capital structure

Corporate capital structure is a topic which concerns financial managers. In financing its activities, an organisation has a choice of issuing new equity, using retained earnings or issuing new debt. Organisations usually use a combination of all three. The capital structure of an organisation is the proportion in which it has decided to make use of these various forms of financing.

An organisation's optimal capital structure is considered to be where the debt-to-equity ratio (equity in this context includes new equity and retained earnings) adopted results in the lowest 'weighted average marginal cost of capital' (Correia, Flynn, Uliana and Wormald 1993:583). To determine the average weighted cost of capital it is necessary to determine the cost of each form of financing. Each component is weighted as a proportion of that component of financing to the total of all components of financing used.

Under most corporate tax systems interest payments on debt used to finance investments are paid out of pre-tax income due to interest payments being tax deductible. The cost of debt finance is therefore pre-tax. The cost of equity is further increased where double taxation of dividends occurs. The cost of equity, which is the total of dividends paid and the growth in the share price, is after-tax. This is due to both dividends and retained income, which funds the growth in the share price, being subject to corporate taxes. Furthermore, under the classical system dividends are taxed twice. As a result of the cost of equity being after-tax and the cost of debt pre-tax, the cost of equity will exceed the cost of debt, and projects funded with new equity or retained earnings require a higher pre-tax rate of return than projects funded with debt. This creates a bias against the use of equity finance.

An important principle that is relevant to corporate capital structure is the "pooling of funds". It is unlikely that each individual project will be financed in proportion to the company's capital structure. Quantities of debt and equity are however used in convenient amounts which will only reflect the target capital structure on average over a period of time.

In the *The Economist* article *Taxes for corporate Europe*, the writer was responding to the Ruding report on a harmonised corporate tax for Europe and wrote:

> The real problem with corporate tax is not that it produces distortions across borders but that it distorts across different forms of financing. Harmonising corporate taxes in Europe would simply mean that everyone had the same distortion ... The distortion arises because corporation tax penalises firms for raising their capital through equity rather than debt. The reason: interest payments can be deducted from taxable profits while the return on equity cannot. (1992:20).

In the above quotation the distortions across borders that were referred to were distortions caused by different corporate tax rates in different European countries.

The tax advantages of using debt financing and the corresponding impact on corporations' capital structures have been noted and discussed by many other writers such as Miller (1977); Modigliani (1982); Rangazas and Abdullah (1987); and Thomas and Sellers (1994).

Feldstein, Green and Sheshinski's (1979) analysis showed that the United States tax system induced firms to increase their debt-equity ratio. They however make the following interesting point:

> The extent of the substitution *(of debt for equity)* is limited because every rise in the firm's debt-equity ratio increases the perceived uncertainty of the firm's

> interest and equity payments, and this perceived risk raises the cost to the firm of both debt and equity capital (Feldstein *et al* 1979:427).

It is a well established principle in financial management that increases in the risk of a venture will result in increases to the required rate of return on the venture. With every increase in debt, an organisation's interest repayments will increase. As the interest burden increases, so the organisation's perceived ability to meet the interest payments will decline. This is what causes the organisation's risk to increase and lenders will therefore require a higher rate of return on debt issued. Furthermore, lenders' perception of the risk of an organisation also increases when the debt-to-equity ratio of the organisation increases. They realise that the equity holders of the organisation stand to lose less if the venture fails.

The O'Brien Commission (1982:27.27) also argued that the relative encouragement given to debt capital as a result of the allowance of interest payments as a tax deduction was subject to some constraints in practice. Corporations must have regard to the need to maintain an adequate ratio between debt and equity. This is the point made by Feldstein *et al* above. In addition to the need of maintaining an adequate debt-equity ratio, the commitment to service debt must be met while dividends may vary according to circumstances. However the Commission realised that the tax system operated in a haphazard way in influencing the relative attractiveness of debt and equity finance. The Commission concluded that corporations should be free to choose the form of finance best suited to their needs and that this should not be distorted by tax considerations. It recommended that the rate of imputation be increased to 100 per cent of the underlying corporation tax and that all income be taxed at a single rate.

Glenn Hubbard (1993:116-117) argued that because of the bias towards debt caused by corporate taxes, many taxpayers are encouraged to engage in practices that tend to disguise equity as debt. This represents a wasteful use of resources, and imposes significant administrative costs in attempting to distinguish debt from equity. An example of anti-avoidance legislation aimed at countering the disguise of equity as debt can be found in section 31 of the South African Income Tax Act. This section allows the Commissioner to disallow interest payments as tax deductions if he believes the organisation's debt to be excessive. Refer to chapter six for a more in-depth discussion of this section. Glenn Hubbard (1993:117) argued further that financial decisions, which may leave firms more vulnerable to a downturn in the economy, should be based on economic considerations and not the tax system.

3. Distribution of profits

When distributed profits are taxed more heavily than retained profits, there is a tendency for corporations to retain their profits instead of distributing them to shareholders.

Glenn Hubbard (1993:120) and the O'Brien Commission (1982:27.15) recognised that the level of capital gains tax would influence the decision to retain or distribute profits. If increases in share values as a result of the reinvestment of profits were taxed as capital gains, there would only be a preference to retain profits if the rate of tax on the capital gains was less than the additional tax borne by the distributed profits. For example, if the increase in share values was subject to capital gains tax at a rate of 20 per cent and the shareholders' average tax rate was 30 per cent there would still be a preference to retain profits. This is however a simplistic example as factors such as the timing of the payment of the capital gains tax and shareholders having different average tax rates would also effect the distribution or retention of profits.

Economists, such as James and Nobes (1983:267); Goode (1951:183); and Cope (1972:155), have argued that the most efficient use of the total funds available for investment is most likely to be achieved if corporations distribute all of their profits. Corporations would then submit themselves to a perfect capital market when they needed funds for new investment. This would enable investors to allocate their funds to the most profitable corporations, resulting in more profitable and efficient investment taking place. The greater the proportion of new investments financed from retained profits, the less efficient the allocation of investment funds would be.

It could be argued that as a result of efficient allocation of resources occurring when corporations distribute their profits, the tax system should in fact encourage the distribution of profits and not the retention of profits. However in practice, despite the strong theoretical argument outlined above, the efficient allocation of resources does not necessarily occur when corporations distribute their profits. The O'Brien Commission (1982:27.19), in considering the practicality of corporations distributing all of their profits and then submitting themselves to the capital market for funding of new investments, referred to the following quote from the Harold Wilson Committee:

> the disadvantage of raising equity in the market as against retaining profits, from the directors' point of view, is that they tend to have to commit themselves more about why they need the money and whether the existing equity will be diluted: and they therefore need to feel more certain that their minimum rate of return will be earned and that the returns will come in quickly enough for there to be no reduction in dividend on the increased capital or even their earnings cover for that dividend.

The O'Brien Commission (1982:27.20) found the empirical evidence on the question of whether the distribution or retention of profits affected the efficiency of investment inconclusive. The Commission argued that retained profits were a major source of equity finance, which was a key resource. Equity finance gave corporations independence. If a corporation's interest cover was high, lenders would be willing to accept the corporation's judgement of risks. However, where the corporation's interest cover was low, lenders became nervous about risks and dividends that were postponed for long periods. This would have been regardless of how potentially large the profits are. They realised that if the corporation went bankrupt they would lose all their money, while if it did exceptionally well all they would receive would be the interest payments. In general, the more specialised and longer the term of an investment and the higher the risk of loss, the greater would be the need to rely on equity finance. (O'Brien 1982:27.21).

If this, and the opinion referred to in the above paragraph taken from the report of the Harold Wilson Committee, is taken into consideration, the argument that the distribution of profits results in the efficient allocation of funds is debatable. Therefore if the tax system encourages the distribution of profits, it could result in the inefficient allocation of resources where more efficient allocation would ordinarily have taken place. The tax system should therefore not be used to encourage the distribution or retention of profits, as this simply gives rise to economic and financial distortions. The tax system should not attempt to ensure the efficient allocation of investment funds. This should be left to market forces.

### 4.2) Integration of corporate and individual taxes - a possible solution?

"Integration" of corporate and individual income taxes 'refers to any plan in which corporate income is taxed only once, rather than taxed both when earned and when distributed to shareholders as dividends' (Glenn Hubbard, 1993:115). Perfect integration will occur only when 'the total tax to the corporation and its shareholders equals what would have been paid if the latter had earned the income directly' (Kennedy, 1990:43).

Many writers have advocated various methods of integration that would overcome both the problem of the double taxation of dividends and the problems caused by the lack of neutrality of corporate taxes. Methods of integration suggested include various forms of "dividend relief", a "comprehensive business income tax" (CBIT), and "full integration".

### 4.3) Methods of Integration

1. <u>Dividend relief</u>

Various forms of dividend relief have been discussed by writers such as Thomas and Sellers (1994); Glenn Hubbard (1993) and Kennedy (1990). Dividend relief includes systems of dividend exclusions, dividend deduction, and imputation credits.

*Dividend Exclusion System*

One of the systems of dividend relief is the "dividend exclusion" method whereby shareholders are not taxed on their dividend receipts. No relief from dividends paid is provided for at the corporate level.

As shareholders are not taxed on their dividend receipts, dividends will only be subject to corporate taxes. The double taxation of dividends is thus removed. Both distributed and retained profits are taxed at the same rate - the corporate tax rate, which will result in the disparity between retained and distributed profits being removed.

It has been suggested that it would be necessary to distinguish dividends paid out of profits which had already borne corporate tax from dividends paid out of tax exempt profits (Glenn Hubbard (1993:125), Thomas and Sellers (1994:88)). Only dividends paid out of profits that had borne corporate tax would be excluded from shareholders' taxable income. The suggestion was based on the argument that allowances and incentives granted to corporate taxpayers should not be extended to shareholders as this would result in large amounts of revenue being lost. The loss of revenue would have to be offset by raising other distorting taxes.

If the objective behind the dividend exclusion system was only to remove the double taxation of dividends, then the argument raised above would be a lot stronger. The fact that dividends that had been paid out of exempt income would be taxed at shareholder level would not be a problem as they would not have been subject to corporate tax. The income would still only be taxed once. The question arises as to what the purposes of providing corporate level preferences would be if the resulting savings were taxed at shareholder level. External equity would require tax preferences granted to corporations to be available to the shareholders.

*Dividend Deduction System*

A second method of dividend relief is the dividend deduction system. Under this system dividends and interest payments are treated in the same manner at the corporate level, as a deduction of dividend and interest payments is allowed for tax purposes. Recipients of both interest and dividends payments are taxed at their marginal rates. This results in the removal of the double taxation of dividends as well as the disparity between debt and equity.

A problem with the dividend deduction system relates to exempt shareholders, such as pension funds, and foreign shareholders. Exempt shareholders will be able to extract profits from their corporate investments without the profits being subject to income tax (HMSO, 1982:40). Profits distributed to foreign shareholders would not be subject to tax in the country from which they originated (the domestic country).

Glenn Hubbard (1993:121) argues that the problem of exempt shareholders arose due to corporation taxes taxing corporate income regardless of whether the shareholders were taxable or tax exempt. He argued that if corporate and individual taxes were unified and income that flowed to tax exempt shareholders bore no tax at all it would result in a large loss of revenue. A problem relating to the loss of revenue becomes clear.

Problems with exempt and foreign shareholders could be overcome through the use of withholding taxes on the distribution of corporate income. Exempt shareholders would not receive a refund of any taxes withheld, and distributions received by them would effectively bear tax. Taxes withheld on foreign distributions could be used by the foreign shareholders to offset any tax liability in their country of domicile (provided there was a double taxation agreement), but any excess credit would not be refunded.

Although the dividend deduction system has often been associated with corporations being entitled to a tax relief on dividends declared, Glenn Hubbard (1993:124) points out that the dividend deduction system does not have to be limited to dividends paid. This was a concern which was often expressed by high-technology industries with low dividend payouts. He referred to the proposal of the Capital Taxes Group of the British Institute for

Fiscal Studies for the "Allowance for Corporate Equity" (ACE), as a possible system of dividend deduction.

Freeman and Devereux (1991) summarised the ACE proposal made by the Capital Taxes Group. The Capital Taxes Group recognised that the English corporate tax discriminated between debt and equity. They advocated that the imputation system should be replaced by the ACE system. In terms of their proposal, the allowance would be based on a normal commercial rate of return on the shareholders' investment in the corporation - whether it was in the form of new equity or retained earnings. Corporations would then only pay tax on profits that exceeded the allowance. This would eliminate the bias in favour of debt finance as the ACE system provides for the tax deduction, at the corporate level, for both the cost of financing debt (interest payments), and an allowance for the cost of financing equity whether dividends were paid or not. Shareholders would be taxed on the ACE deduction so as to maintain neutrality with lenders (who are taxed on interest receipts).

In theory the ACE system appears to be very attractive, however in practice the determination of an acceptable rate of return upon which the allowance would be based would result in a number of problems. Examples of problems that would have to be overcome are who would determine the rate, would the rate be industry specific or would a general rate be used or would the rate be adjusted for different levels of risk? It would be equitable for industry specific rates to be used which recognise the different rates of returns of various industries. It would also be equitable to adjust the rate of return for each corporation to reflect the underlying risk of the specific corporation. From this it can be seen that the determination of an equitable rate would be an involved and complex process requiring specialised knowledge. This could outweigh the advantages of the ACE system.

*Imputation Systems*

A third system of dividend relief is the imputation system. The imputation system has been discussed in detail in chapter three. With full imputation the double taxation of dividends is removed. This is because shareholders receive a tax credit for the corporation tax paid on the profits out of which the dividends were paid. As a result of the tax credit being passed on to shareholders, dividends are effectively taxed in the same manner as interest. The only tax that dividends will bear will be the tax borne by the individual shareholders which is the only tax borne by interest. This will result in neutrality being achieved between debt and equity.

With a partial imputation system only a portion of the corporation tax paid on the profits out of which dividends are paid is passed on to shareholders. Where the shareholder's tax rate is greater than the basic rate double taxation occurs as dividends are subject to a portion of corporation tax in addition to individual tax. Interest is however only subject to individual taxes. Partial imputation systems will therefore not result in neutrality being achieved between corporate and non corporate forms, between debt and equity, and between retained and distributed profits.

The lack of neutrality between organisational form, corporate capital structure and distribution of profits are as a result of the double taxation of dividends and differences between the corporate and personal marginal tax rates. Except for partial imputation which still results in double taxation occurring to an extent, the dividend relief systems discussed above remove the double taxation of dividends. As such these systems do have some merits. However where there is a difference between corporate and personal marginal tax rates distortions will still occur. Table 4.1 reflects the corporate tax rates and the maximum personal marginal rates for various countries.

**Table 4.1 - Corporate tax rates vs. maximum personal marginal tax rates**

| Country | Corporate tax rate | Personal marginal rate |
|---|---|---|
| Australia | 33,0 | 47,0 |
| Belgium | 39,0 | 45,5 |
| Canada | 38,0 | 29,0 |
| Denmark | 34,0 | 61,0 |
| France | 33,3 | 56,8 |
| Germany | 32,3 [1]<br>48,3 [2] | 51,5 |
| Ireland | 38,0 | 48,0 |
| Japan | 37,5 | 50,0 |
| Netherlands | 35,0 | 60,0 |
| New Zealand | 38,0 | 33,0 |
| South Africa | 42,2 [1]<br>35,0 [2] | 45,0 |
| United Kingdom | 33,0 | 40,0 |
| United States | 35,0 | 39,6 |

1 This represents the rate of tax on distributed profits
2 This represents the rate of tax on retained profits

From Table 4.1 it can be seen that there are differences between the corporate and maximum marginal tax rates. The corporate tax rate was lower than the personal marginal rate in most of the countries selected. The remainder of this section will discuss the distortions that occur with dividend relief systems where there is a difference between the corporate and personal marginal tax rates.

i) Neutrality between corporate and non corporate forms:

Where corporate profits are not taxed at the personal marginal rate a bias in favour of or against incorporation occurs. None of the dividend relief systems result in retained profits being taxed at the personal marginal tax rate. The dividend deduction and full imputation systems result in distributed profits being taxed at personal marginal rates. This is due to relief for dividends paid at the corporate tax rate being granted at the corporate level and dividends being taxed at shareholder level. The dividend exclusion system results in all profits being taxed at the corporate level as no relief for dividends paid is granted at corporate level and dividends received are not subject to personal tax. As a result of retained profits (and distributed profits in the case of the dividend exclusion system) not being taxed at personal marginal rates all of the dividend relief systems result in disparity between corporate and non corporate forms.

If the corporate tax rate is higher than the personal marginal rate then profits will be taxed more heavily if they were earned through the corporate form. This results in a bias against incorporation. Similarly, if the corporate tax rate is lower than the average personal marginal rate there will be a bias in favour of incorporation.

ii) Neutrality between retained and distributed profits:

As described above, the dividend deduction and full imputation systems result in retained profits being taxed at the corporate rate and distributed profits at the personal marginal rate. Therefore if the corporate tax rate is higher than the personal marginal tax rate, profits will be taxed more heavily if they are retained instead of being distributed. This will result in a bias towards the distribution of profits. Similarly if the corporate tax rate is lower than the personal marginal tax rate a bias against the distribution of profits will occur.

It should be noted that the dividend exclusion system achieves neutrality between retained and distributed profits. This is due to both retained and distributed profits being taxed at the corporate rate. The distribution of profits is therefore not affected by differences in the corporate and personal marginal tax rates.

iii) Neutrality between debt and equity:

With the dividend exclusion system, dividends are paid out of after tax profits as no relief for dividends paid is granted at the corporate level. Shareholders are not taxed on dividend receipts. Interest, however, is paid out of profits before tax as a deduction of interest paid is allowed for tax purposes. Lenders are then taxed on interest receipts at their personal marginal rates. The result is that dividends are taxed at the corporate rate while interest is taxed at the personal marginal rate.

Where the corporate tax rate exceeds the personal marginal tax rate, dividends will be taxed more heavily than interest resulting in a bias against equity. Similarly where the corporate tax rate is lower than the personal marginal tax rate a bias in favour of equity will occur.

The dividend deduction and full imputation systems however result in neutrality between debt and equity due to both dividends and interest being taxed at the personal marginal rate.

Due to all three dividend relief systems resulting in distortions between corporate and non corporate forms, perfect integration will not occur. There will be differences between the total taxes paid depending on whether the income was earned through the corporate or non corporate form. The dividend relief systems cannot be seen as successful methods of integration.

2. <u>Comprehensive Business Income Tax</u>

The comprehensive business income tax moves the dividend exclusion system closer to the equal treatment of debt and equity (Thomas and Sellers, 1994:88). Under this system corporations, which are not entitled to deduct dividend payments, would no longer be allowed to deduct interest payments, and both dividends and interest would be excluded from the recipient's taxable income.

For the same reasons as the dividend exclusion system, it has been argued (Thomas and Sellers, 1994:88) that it would be necessary to differentiate dividends, and in this case interest as well, that have been paid out of income not subject to corporate taxes, from payments made out of taxed profits. Dividend and interest payments made out of income that has not borne corporate tax would not be excluded from the recipient's taxable income.

The inequity of granting exemptions to corporations that are not available to individuals was commented on in 4.3) above when discussing the dividend exclusion system.

The CBIT system eliminates the double taxation of dividends as well as the bias against equity in favour of debt. The elimination of double taxation of dividends is as a result of dividend receipts not being taxed in the shareholders' hands. The elimination of the bias towards debt is as a result of both dividend and interest payments not being tax deductible and both not being taxed in the recipients' hands.

A major concern caused by the CBIT system is that it would be a retroactive tax. Many organisations would already have borrowed funds on the grounds that they would obtain a tax deduction for their interest payments. To subsequently deny the tax deduction of interest payments would be unfair and could cause undue harm. Furthermore, lenders would already have capitalised the cost of the tax payable on their interest receipts in the interest rate that they charge. To exempt interest receipts from tax would result in lenders making windfall gains. The implementation of the CBIT system would be inequitable as it would result in undue harm being caused to organisations that have already borrowed money while resulting in windfall gains to those who have already lent money.

Glenn Hubbard (1993:127) suggested that CBIT would eliminate tax distortions in organisational form, capital structure, and dividend policy more completely than any of the dividend relief systems. He did realise that it would also be a substantial departure from current tax systems and issues surrounding its implementation would require significant additional analysis.

Despite Glenn Hubbard's suggestion discussed above some tax distortions in organisational form and dividend policy can still occur under a CBIT system. As occurs with the dividend relief systems, where there is a difference between the corporate tax rate and the individual shareholders' marginal rates of tax, distortions between organisational form and dividend policy will occur. The CBIT system will therefore not result in perfect integration.

From the discussion of the three dividend relief systems and the CBIT system, it is clear that distortions occur when there is a difference between the corporate tax rate and the individual shareholders' marginal rates. Therefore if any of the dividend relief systems or the CBIT system are to result in perfect integration, it will be necessary for the corporate tax rate to equal the individual shareholders' marginal tax rates so that retained and distributed profits will be taxed at the shareholders' marginal rates.

## 3. Full integration

The ideal tax system would eliminate the double taxation of dividends and it is this that the dividend relief systems and the CBIT system achieve. Under these systems however, a problem still arises - retained profits and distributed profits are not subject to the marginal tax rates of the individual shareholders. The only effective method of eliminating double taxation and ensuring that corporate profits are taxed at the shareholders' marginal rates is to integrate corporate and individual taxation.

Full integration can be described as the system whereby all of the corporation profits are included in the taxable income of shareholders. Integration aims to minimise, or if possible eliminate, the influence of the corporate organisation on the taxation of individual incomes.

Full integration has been supported on equity and economic grounds. Full integration would eliminate the inequitable feature of distributed corporate profits being taxed more heavily than undistributed profits, and would thereby eliminate the tax bias against the distribution of profits. It would enhance a progressive tax system by removing the tax that discriminates against low income shareholders.

A number of economic gains can also be derived from full integration. Due to the removal of double taxation, individuals would increase their investment in corporations resulting in an increased inflow of equity capital. The allocation of investment between enterprises and industries would improve because of the elimination of the tax distortions over the form of business organisation and the means of financing. It has also been suggested that integration would eliminate a tax pressure for higher commodity prices and lower wages (Goode 1951:183).

A simple method of achieving full integration is for corporate profits to be taxed only when they are distributed to shareholders. The distributed profits (dividends) would be subject to individual tax and the corporate tax could be eliminated. The advantage of such a system is its simplicity, but it does have a number of disadvantages. Such a system could result in corporations retaining profits and thus delaying the payment of taxes. This would cause a bias in favour of incorporation, as all profits unearned through a company would only be taxed when distributed and not when earned (as would be the situation if the profits were earned in a non corporate form). The extra profits retained in the company would enable corporations to finance expansion from within. The market value of the corporation's shares could be expected to increase as a result of extra profits from the expansion. Once again this enables shareholders to accumulate wealth over a number of years before being taxed, either when the profits are distributed or when the shares are sold (assuming that realised gains on shares would be taxable). This could be overcome by taxing shareholders on an increase in the market value of the shares. This would be similar to the Capital Gains method discussed below.

Another method of achieving full integration is by means of allocating all corporate profits to shareholders. The allocation would be in proportion to each shareholders' equity holding. The shareholders would include their portion of the corporate's profits in their taxable income. This could result in the corporate tax being eliminated. Since this method is similar to the way in which partnerships are taxed, it is often referred to as the "partnership method".

As opposed to the elimination of the corporate tax, it is possible for it to be kept, but to be treated as a withholding tax. Taxes would be calculated at the corporate level and be paid over by the corporation. The allocated profits would be subject to individual tax in each shareholder's hands but a proportionate share of the corporate tax paid would be deductible from the shareholder's tax liability. This is the same principle as the United Kingdom's Advance Corporation Tax which was discussed in chapter three. Any excess tax withheld could be refunded to the shareholders concerned. An advantage of retaining the corporation tax as a withholding tax is, as described when discussing the dividend deduction system above, that it is possible to ensure that corporate profits allocated to exempt and foreign shareholders are subject to tax.

In South Africa, the 1941 Income Tax Act provided for the apportionment of the income of companies classified as private companies amongst its shareholders. The apportionment was based on the rights of each shareholder to participate in the profits of the company. If the company had an assessed loss it would not be apportioned but carried forward for set-off against future profits. Income apportioned to a non-resident was deemed to be from a South African source. The apportionment of private company income was discontinued for years of assessment ending after 30 June 1951.

Unfortunately in modern economies, it is virtually impossible for the partnership method to be implemented (Kay and King, 1990 and Fu and Mace, 1992). Large numbers of shareholders and holdings that are continually changing hands from day to day during the year make it nearly impossible to allocate corporation profits to shareholders. The problem of allocating profits is further complicated by the possibility of corporations having different types and classes of shares.

The partnership method could be successfully applied to corporations which, due to the simplicity of their capital structure and small number of shareholders, resemble true partnerships. The most likely area in which full integration could be applied is to smaller corporations. It may be possible to apply it to close corporations in South Africa due to their simplicity and limitation of ownership to ten members. It is however doubtful that full integration could be applied to corporations with complex capital structures and many shareholders. The O'Brien Commission (1982:24.12), despite believing that the correct treatment in principle for taxing corporate income would be to allocate it to shareholders, rejected the partnership method because they believed that in practice it would be impossible to allocate corporate profits to shareholders.

Another method of achieving full integration would be by using what is often referred to as the Capital Gains method. As with the partnership method, corporation tax could either be eliminated or be used as a withholding tax. Distributed profits would be taxed by taxing shareholders on dividends paid by corporations. Undistributed profits would be taxed (through taxing the increases in the market values of the shares) as accrued capital gains.

A number of problems with the capital gains method have been identified. It could be argued that there may be some inequity if there is a lag between public recognition of capital gains and the retention of profits that generate them (Prest and Barr 1979:460). Another problem with this method is that it would be difficult to determine the capital gains that have accrued on non-traded equities (Fu and Mace 1992:59). If such shares were not traded on stock exchanges, it would be difficult to determine a market value for the shares.

There are also some problems common to both the partnership and capital gains methods. Musgrave and Musgrave (1984:397) point out that in the absence of taxation at the corporate level, investment incentives would have to be granted at the shareholder level or be given to corporations as a direct subsidy. In modern tax systems this problem would not arise due to investment subsidies no longer being considered appropriate. Another problem is that taxpayers would be taxed on income (undistributed profits) before actually receiving the income. Fu and Mace (1992:60) argue that this would in fact not be a problem as a substantial portion of the tax could be paid by withholding taxes and that the remainder could be financed by the sale of shares if necessary.

With the full integration of corporation profits with shareholders income, the taxation of distributed and undistributed profits would be equalised. The distinction between corporate and non-corporate profits would be eliminated. This would eliminate the distortions caused by the traditional corporate tax. The discrimination against low income earning shareholders would also be removed as their share of income would be taxed at a lower marginal rate. Despite the problems with full integration, it still remains an equitable system of taxing corporation profits.

## 4.4) Summary

Corporate taxes often result in distortions between corporate and non corporate forms, between debt and equity and between retained and distributed profits. These distortions arise as a result of the double taxation of dividends and differences between corporate and maximum personal marginal tax rates. Various forms of dividend relief, a comprehensive business income tax (CBIT) and full integration have been advocated as overcoming these distortions. Dividend relief includes dividend exclusion systems, dividend deduction systems and imputation systems. Methods of full integration include taxing profits only when distributed, the partnership method and the capital gains method.

None of the dividend relief systems nor CBIT remove the disparity between corporate and non corporate forms. The dividend exclusion system is the only dividend relief system that removes the disparity between retained and distributed profits. As with the dividend deduction and imputation systems, the CBIT system does not remove this disparity. The dividend deduction, imputation and CBIT systems remove the disparity between debt and equity but the dividend exclusion system does not. Therefore, dividend relief and CBIT systems cannot be seen as ideal systems of taxation. While full integration removes all of the above distortions, and is thus an equitable system, it is seldom implemented due to the problems associated with it.

# Chapter Five

# Corporate taxes in South Africa

Chapter five discusses the provisions of the first Income Tax Act in South Africa that relate to the taxation of corporate profits. A summary of the modern provisions relating to corporations is given and an analysis of corporate taxes is made.

## 5.1) The birth of corporation tax in South Africa

The Income Tax Act No. 24 of 1914 was South Africa's first income tax act. This act was modelled on the New South Wales Act of 1895. Since it was this act (Act No. 24 of 1914) that introduced corporate income tax in South Africa, a summary of the provisions of the act that relate to corporations is considered to be relevant.

The starting point for computing a corporation's tax liability was the determination of the company's taxable amount. In terms of Section 4(3) of the Act the taxable amount was derived after deducting an amount of £1 000 from taxable income. Section 4(2) defined taxable income as follows:

> "Taxable income" shall mean an income exceeding one thousand pounds, which has been received by, or accrued to or in favour of, any person wheresoever residing from any source whatever in the Union, during the twelve months ended the thirtieth day of June, 1914 (Statutes..., 1914).

It is interesting to see that there was no distinction between natural persons and corporations and that corporations were taxed on a sliding scale. In terms of Section 4(4), the rate of tax payable increased from sixpence for a taxable amount of £1 (which is equivalent to 2,5 per cent), by one two thousandth part of a penny per pound (which is equivalent to 0,0002083 per cent) to a maximum marginal rate of one shilling and sixpence per £ (which is equivalent to 7,5 per cent) for taxable amounts of £24 000 and above. As from 1917 companies were subject to Normal Tax at a fixed rate (Eveleigh, 1917:16).

The deduction of £1 000, at least in 1914, was a considerable sum, and must have excluded most companies from the income tax. This, together with a maximum rate of 7,5 per cent must make modern companies exceptionally envious of the early income tax. The £1 000 deduction was only provided for in the first Act, and the 1915 Act provided for a deduction of only £300, which was only deductible if the company's taxable income was less than £24 300.

Section 4(5) deemed income to accrue to a taxpayer even if it had not actually been paid over to him but was credited to his account or re-invested, accumulated, or capitalised or otherwise dealt with in his name or on his behalf. Taxable income was therefore based on the accrual concept and not on cash received. This Section also deemed the following amounts to be from a source within the Union:

- income received or accrued by virtue of any contract for the sale of goods in the Union of South Africa, whether the goods were delivered in or out of the Union; and
- income received or accrued from any service rendered or work done in the carrying on in the Union of any business, trade, profession or occupation whether payment for the services or work was made by a person resident in or out of the Union and wherever the payment was made.

Prevention of the double taxation of dividends was provided for through Section 5(k). This Section exempted from tax, income that was received or accrued as dividends from any company that had paid income tax in the Union on the profits from which the dividends were paid.

The situation where a taxpayer's business extended beyond the Union was dealt with under Section 10(2). The Section provided for the taxable income from within the Union to be determined by applying to the whole net profits of the corporation, the ratio of the assets of the company in the Union over the total assets of the company. The Section contained a proviso that if either the Commissioner or the company deemed the method of estimating the income inequitable, they could claim the right to assessment on the actual profits derived in the Union.

Section 14 provided for the following amounts to be deducted from the gross amount of the taxpayer's income:

- losses and expenses, including interest, actually incurred in the Union by the taxpayer in the production of his taxable income. Expenses incurred outside the Union in the production of income were deductible if allowed by the Commissioner;
- amounts expended for the repairs of premises that were occupied for the purposes of trade and amounts expended for the repair or alteration of machinery, implements, utensils and articles that were employed by the taxpayer for the purposes of his trade; and
- a wear and tear allowance on machinery, implements, utensils and articles that were used by the taxpayer for the purpose of his trade. The amount of the allowance was at the discretion of the Commissioner. No allowance was made for the depreciation of buildings.

Section 15(1) and 15(2) provided for the circumstances in which no deductions could be made. These circumstances were:

- the cost incurred in the maintenance of any taxpayer, his family or establishment;
- domestic or private expenditure;
- any losses or expenses that were recoverable under any insurance contract or indemnity;
- income tax;
- income that was carried to any reserve fund or that was capitalised in any way;
- amounts that were not wholly or exclusively laid out or expended for the purposes of trade;
- the rent value or cost of repairs or alterations of any premises that were not occupied for the purposes of the taxpayer's trade, or of any dwelling house or domestic premises, except for such part that was occupied for the purposes of trade;
- interest that may have been made on any capital employed in trade; and

- any debts that were owing to the taxpayer, except the debts that could be shown to the satisfaction of the Commissioner to have been bad or doubtful.

**5.2) The modern South African corporate tax**

As from 17 March 1993 corporation taxation in South Africa has been based on a split rate system. In the South African system distributed profits are however taxed at a higher rate than undistributed profits, whereas in most other split rate systems distributed profits are taxed at a lower rate. Distributed profits are taxed at a higher rate as a result of STC, which is payable on dividends declared. STC is discussed in detail in Chapter Seven.

The most recent income tax act is the Income Tax Act No. 58 of 1962, and it is in terms of this act (which is amended yearly) that corporations in South Africa are taxed today.

1. General Characteristics of the 1962 Income Tax Act

In South Africa the same general principles are applied in determining the taxable income of corporate and non-corporate taxpayers. The "gross income" definition which determines gross taxable income applies equally to all forms of income. There are however specific provisions that relate only to corporate taxpayers and not to individual taxpayers and vice versa.

The definition of a company contained in Section 1 of the Act includes in its definition any association, corporation or company that is incorporated under any statute of the Republic or the statute of another country. In the latter case, the company must carry on business in the Republic, derive income from a source within or deemed to be within the Republic, or be a shareholder or member of a company as defined. A close corporation is included in the definition of a company. A domestic company is defined as a company incorporated under Republic statute or a company that is managed and controlled in the Republic.

*General determination of taxable income:*

Taxation in South Africa has always been based on source and not residence. A basic tax called the Normal Tax, which is currently 35 per cent, is levied on taxable income. Taxable income is derived after subtracting all permissible deductions from gross income.

There are two provisions that are central to the determination of taxable income, namely the "gross income definition" and the "general deduction formula".

The gross income is defined in Section 1 as follows:

> "gross income", in relation to any year or period of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during such year or period of assessment from a source within or deemed to be within the Republic excluding receipts or accruals of a capital nature, but including, ... (Statutes..., 1962).

This definition is similar to the definition of taxable income in the 1914 Act. The gross income definition also provides for certain specific amounts to fall within its ambit. The definition quoted above only taxes revenue receipts, however the specific inclusions result in certain capital amounts being included in gross income. The most significant specific inclusions are:

- An amount received as a premium for the use or occupation of land and buildings; use of plant or machinery; or a premium received for the use of a patent;
- An amount received for the imparting of any scientific, industrial, or commercial knowledge;

- If in terms of a rental agreement, the taxpayer has the right to have improvements to his land and buildings then the amount stipulated in the agreement (or if no amount is stipulated then the fair and reasonable value of the improvements).

The general deduction formula is found in Section 11(a) and provides for the deduction of the following amounts in determining taxable income:

> expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature; (Statutes..., 1962).

Expenditure incurred outside the Republic is deductible under Section 11(b) if the expenditure is in the production of income and not of a capital nature.

The general deduction formula only provides for the deduction of expenditure and losses that are not of a capital nature. The Act does contain specific provisions for the deduction of certain capital expenditure. The most significant provisions are discussed below.

For any expenditure (including capital allowances outlined below) to qualify as a deduction the expenditure must have been incurred in the production of income and in the carrying on of a trade. An apportionment between trade and non-trade expenditure is allowed.

As a result of the "trade" requirement having to be fulfilled before expenditure can be deducted, the anomalous situation of income being taxed without a corresponding deduction for expenses incurred can arise. This situation was addressed by the Margo Commission which recommended that the reference to trade should be adjusted to allow deductions in respect of all income as defined. This recommendation was however never implemented. If a taxable loss is made in any year, the loss may be deducted as a set-off against future years' income. There is no limit to the number of years in respect of which losses can be carried forward.

*Capital allowances*

Accounting depreciation is not a permitted tax deduction, but taxpayers receive capital allowances in lieu of depreciation. The most significant capital allowances provided for in the Act relate mainly to wear and tear allowances on plant, machinery and industrial buildings.

Section 11(e) provides for a wear and tear allowance. The allowance is the amount by which the value of machinery, plant, implements, utensils and articles used by the taxpayer has diminished by reason of wear and tear. The amount allowed is in the discretion of the Commissioner for Inland Revenue, but in practice a straight line allowance, dependent on the nature of the asset, is allowed.

A scrapping allowance is provided for in Section 11(o). The allowance is equivalent to the difference between the proceeds received on the scrapping of (*inter alia*) machinery, plant, utensils or articles used in the taxpayer's trade and the tax value of the asset scrapped. The tax value is simply the cost of the asset less the total of all wear and tear allowances received on the asset.

Special wear and tear allowances are provided for in Sections 12B and 12C. These allowances only apply to plant and machinery that are used in a process of manufacture.

Section 12B provided for a deduction in the first year of use of 50% of the cost of the plant and machinery, a deduction of 30% in the second year and 20% in the third year, of the cost of the plant and machinery. Section 12B applies to plant and machinery brought into use on or after 1 January 1989 but before 15 December 1989. Section 12B only applies to plant and machinery brought into use after 15 December 1989 if it is used for farming.

Section 12C applies to all plant and equipment used in a process of manufacture which was brought into use after 15 December 1989. The allowance is equivalent to 20% of the plant or machinery's cost, and is available for five years commencing in the year in which the asset is brought into use.

Wear and tear allowances on industrial buildings are provided for in Section 13(7) and Section 13(1). Section 13(7) provided for an initial allowance of 17,5% of the cost of the building if its construction commenced on or after 1 July 1985 and on or before 31 December 1988. For the taxpayer to qualify for the allowance it was necessary for him to use the building for the purposes of carrying on a process of manufacture. Section 13(1) provides for an allowance of 5% (or 2% prior to 1 January 1989) of the cost of a building used in a process of manufacture.

Section 8(4)(a) provides for the recoupment of capital allowances where an asset is sold for more than its tax value. The amount of the recoupment is equivalent to the difference between the proceeds on the sale of the asset (limited to the asset's original cost) and the tax value of the asset.

*Deemed source*

Generally only receipts or accruals from a South African source are taxed but in certain circumstances non South African receipts or accruals are deemed to be from a South African source.

The deeming provisions are found in Section 9 of the Act. The most significant deeming provisions relate to income received or accrued by virtue of:

- any contract made within the Republic for the sale of goods, irrespective of whether the goods are to be delivered in or out the Republic;
- the use in the Republic of any patent, trade mark or copyright irrespective of where the trade mark etc., has been produced or where payment is made; and

- the imparting of any scientific, technical or commercial knowledge for use in the Republic;

2. <u>Source versus residence as a basis of taxation</u>

It has been stated above that in South Africa the calculation of taxable income is based on source. Therefore, with a few exceptions, income will only be subject to South African income tax if it is earned in South Africa. An alternative basis for the determination of taxable income is the "residence basis". This basis is also known as the "world wide" basis.

In terms of the residence basis, South African residents would be liable for South African tax on all of their income (their world wide income) irrespective of whether it was earned in South Africa or not. The residence basis is based on the principle that the taxpayer who enjoys the comforts and protection provided by the country in which he resides, should have all of his income taxed in the country of his residence. On the other hand, the source basis is based on the principle that income should be taxed in the country whose resources gave rise to that income irrespective of whether the taxpayer resides in that country or not.

South Africa is one of the few countries that taxes income on the source basis and not the residence basis. This has been a source of concern to many parties and has been dealt with by a number of commissions of enquiry. The Steyn Committee (1951) and the Margo Commission (1987) were opposed to moving to the residence basis of taxation, while the Franzsen Commission (1970) was strongly in favour of moving to the residence basis. The question of the choice of a source or residence based system was also raised by the Katz Commission (1994) but no firm recommendations were made by the Commission.

The Steyn Committee (1951:68) gave the following three reasons in support of their recommendation that the source basis should be retained:

- the amount of income received by residents from foreign sources was relatively small;
- complicated provisions would be needed to avoid double taxation of foreign income; and
- it was likely that the tax rates applied in countries from which the foreign income would be derived were not appreciably lower than the South African rates. This would result in only a minimal amount being obtained from the tax concerned once an allowance had been made for the necessary credit for the tax paid in the foreign country.

A significant portion of the Franzsen Commission's second report dealt with the basis of taxation in South Africa. The Commission was strongly in favour of the adoption of the residence basis of taxation. In the Commission's opinion the source basis of taxation could no longer be reconciled with the economic interest of South Africa, especially in the view of the ever-growing international commerce and the realities of the international tax arrangements that were in existence at that time. The Franzsen Commission gave the following reasons why the three reasons given by the Steyn Committee for retaining the source basis were no longer valid:

- the amounts of revenue received by residents in South Africa from abroad in the form of dividends, interest and branch profits had increased twelvefold since the date of the Steyn report (from R7,9 million to R95,5 million);
- double taxation agreements had been entered into or were in the process of being entered into to prevent double taxation; and
- through double taxation agreements, reasonably equitable provisions apportioning the right to tax between the country of source and the country of residence existed.

The Commission believed that the acceptance of a world-wide basis of taxation was necessary if South Africa was to be placed in a more favourable position in the negotiation of double tax agreements that was taking place at that time. As a result of the source basis of taxation, South Africa was limited to the amount of tax that it could levy on income such as interest and royalties. The Commission gave an example of the situation that arose as a result of a double taxation agreement concluded with the United Kingdom in 1969. In terms of the agreement South Africa could only levy a 10 per cent tax on interest received by a UK resident from South Africa. The resident was then taxed in full in the UK subject to credit given for the 10 per cent tax paid in South Africa. However, when a South African resident received interest from the UK he was not subject to tax in South Africa as it would not have been received from a South African source.

The Margo Commission's (1987) recommendation that the source basis be retained was based on its belief that the change to a residence basis would impose considerable administrative burdens. As such, they believed that the change was not warranted at that stage.

The Katz Commission (1994) believed that the basis of taxation could not be resolved responsibly in the time it had available. At the time of the Katz Commission, South Africa was considering removing foreign exchange controls and the Commission took note of the argument that in the absence of exchange controls a residence basis would be necessary. The Commission also took cognisance of the fact that a change to the residence based system would imply immense technical and administrative complexities. The Commission believed that the source based system could be retained, without undue complications, if exchange controls were relaxed. It therefore recommended that the source basis should not be abandoned without the completion of a proper enquiry. The Commission also expressed its opinion that the exchange control authorities need not delay any decision on the relaxation of exchange until the basis of taxation had been reviewed.

### 5.3) Summary

The first income tax act in South Africa was Act 24 of 1914. The most recent act in terms of which corporations are taxed is Act 58 of 1962. This act is amended yearly. The South African system is based on source and not residence like most international systems. South Africa has a split rate system which taxes distributed profits at a higher rate than retained profits. Dividends are exempt from individual income tax.

# Chapter Six

# The taxation of dividends in South Africa

This chapter discusses what constitutes a taxable dividend and outlines the changes in the taxation of dividends, the recommendations made by three commissions of enquiry and the present system of taxing dividends.

### 6.1) The dividend definition

Before discussing the taxation of dividends in South Africa it is necessary to determine what constitutes a dividend for taxation purposes. A dividend is defined in Section 1 of the Income Tax Act No 58 of 1962. The dividend definition is lengthy and is the most complex definition in the Income Tax Act.

A dividend is defined as: 'any amount distributed by a company... to its shareholders...' (Statutes...,1962). An "amount" includes cash and any asset or interest, benefit or advantage measurable in terms of money.

The definition states that the expression "amount distributed" includes:

- any profits, whether of a capital nature or not, distributed by a company that is not being liquidated or wound up. This includes an amount equal to the nominal value of any capitalisation shares, debentures or securities awarded to shareholders;
- where a company is being wound up or liquidated any profits, other than those of a capital nature, that are distributed by the company or its liquidator;
- where a company reduces or redeems its capital, the amount by which the consideration given to shareholders exceeds the amount by which the nominal value of the shares is reduced;
- in the event of the reconstruction of a company, the amount by which the consideration given to shareholders exceeds the nominal value of the shares before the reconstruction.

"Amount distributed" does however not include, *inter alia*:

- the nominal value of capitalisation shares that have been paid up by means of the share premium account,
- the extent to which the distribution represents a reduction of the share premium account (but subject to the second proviso discussed below),
- the nominal value of capitalisation shares issued as part of equity after 1 July 1975.

The dividend definition contains a number of provisos, the most significant of which is the second proviso. The second proviso applies to reserves and undistributed profits transferred to the company's share capital or share premium accounts after 1 January 1974. The second proviso provides that both revenue and capital profits which are capitalised will retain their nature as distributable profits (except for capital profits distributed on the liquidation of a company as these amounts are not distributable profits) and will therefore be treated as a dividend in the event of the cancellation, partial reduction, redemption or reconstruction of the shares. The effect of the second proviso is thus to nullify the effect of capitalising profits in an attempt to avoid them being treated as a dividend when they are distributed to shareholders.

### 6.2) Changes in the taxation of dividends

The 1914 Income Tax Act exempted dividends paid by a company, that had already paid income tax in South Africa on the profits from which the dividends were paid, from tax in the shareholders' hands. This meant that there was no double taxation of dividends.

The situation of no double taxation of dividends did not last for long. The 1916 Income Tax Act introduced a Super Tax. Super Tax was payable on "income subject to Super Tax", and dividends received were included in income subject to Super Tax. This resulted in the double taxation of dividends as they bore both corporate Normal Tax (as dividends were distributed out of after tax profits) and Super Tax. Companies were however exempted from paying Super Tax as dividends were taxed when received by individual shareholders through the levying of Super Tax (Silke, 1957).

Super Tax remained in force until it was repealed by the 1960 Income Tax Act. As a result of the abolition of Super Tax, the system of taxing dividends was amended through the amendment of the dividend exemption from Normal Tax, and through the introduction of a "percentage dividend deduction" (Silke, 1961).

As a result of the amendment of the dividend exemption, only the following dividends were exempt from Normal Tax:

- dividends paid to a company;
- dividends paid to a person (other than a company) who was not ordinarily resident nor carrying on business in South Africa;
- dividends paid by any company not registered in South Africa to a person (other than a company) ordinarily resident in South Africa in respect of shares acquired by the person:
  - i) before becoming ordinarily resident in South Africa for the first time;
  - ii) by inheritance or donation if at the date of donation the donor was a person (other than a company) who was not ordinarily resident in South Africa; or
  - iii) out of funds derived by the person from any trade carried on outside South Africa;
- dividends paid by any company incorporated in South-West Africa (now Namibia). This exemption was repealed in 1969.

From the above exemptions it can be seen that, in most cases, dividends paid to individuals were subject to Normal Tax (resulting in the double taxation of dividends) while dividends paid to companies were exempt from Normal Tax.

The "percentage dividend deduction" varied depending on the taxable income of the recipient of the dividend. When initially introduced, the deduction varied from 100 per cent of the dividend received if the recipient's taxable income did not exceed £1 300 to $33^1/_3$ if the taxable income exceeded £2 300. It is interesting to note that prior to the abolition of Super Tax, the Tax was only payable on incomes exceeding £2 300.

With the introduction of the 1962 Income Tax Act, the percentage deductible varied from 100 percent, for taxable income not exceeding R2 600, to $33^1/_3$ per cent for taxable income exceeding R4 600. When close corporations were originated they were also entitled to this deduction as the dividend exemption was not available to them. The percentage dividend deduction provided marginal relief from the double taxation of dividends.

It is interesting to note that this percentage of dividend deduction was never altered and was still the same in 1990. As a result of inflation, most taxpayers' income would have exceeded R4 600. This meant that most taxpayers would have only received a $33^1/_3$ per cent deduction.

As a result of recommendations made by the Margo Commission, the dividend exemption was extended, in 1990, to exempt dividends paid to individuals and close corporations.

1. <u>The Dividend Tax</u>

A "Dividend Tax" on companies was introduced by the 1917 act. It was payable at a rate of one shilling for every pound (which was equivalent to a rate of 5 per cent) of the taxable amount of a dividend distributed after 1 July 1916. In determining the taxable amount there was an abatement of £2 500 p.a. if the total dividends distributed in any year did not exceed £5 000. The amount of the abatement was decreased by £1 for every pound by which the aggregate dividends distributed exceeded £2 500. The company was entitled to deduct the amount of the dividend tax from the dividend distributed.

The act contained a special provision for private companies limiting the amount of dividend tax payable when added to Normal Tax, to the amount of Normal Tax payable by an individual on a taxable amount equal to the taxable amount of the company. This provision was repealed in 1921.

For the purpose of determining the aggregate amount of dividends declared the following amounts were included in dividends distributed:

- any money paid, allocated, distributed or credited by the company to or amongst its shareholders or members as such;
- any undistributed profits invested outside the principle business of the company;
- any undistributed profits applied to the redemption of capital liabilities;
- undistributed profits which, in the opinion of the Commissioner, had been allowed to accumulate beyond the reasonable needs of the business;
- interest paid in excess of 6 per cent on debentures. This was as a measure to counter thin capitalisation. Thin capitalisation is discussed in chapter nine; and
- distributions among directors of the company in excess of the usual remuneration of such directors.

If a material portion of a company's profits was earned outside South Africa the dividend was apportioned, based on the net profits earned from a source within South Africa.

In the situation of a wholly owned subsidiary, the dividend tax was computed as if the wholly owned subsidiary and holding companies were one company. Dividend tax was then only payable on dividends distributed by the holding company.

The following amounts were exempted from dividend tax:

- dividends distributed by a building or friendly society;
- dividends distributed out of dividends which had already borne dividend tax (i.e. dividends received were deductible in determining the amount of dividend tax payable);
- profits distributed by mutual life assurance companies; and
- dividends on the winding up of a company to the extent that they represented the distribution of capital assets.

The dividend tax was repealed by the 1925 Income Tax Act.

## 2. Non-resident Shareholders' Tax

The 1941 Income Tax Act introduced Non-resident Shareholders' Tax (NRST). The rate of the tax was initially 5 per cent, but was increased to 7,5 per cent in 1943, 10 per cent in 1966 and 15 per cent in 1967. NRST was a withholding tax which was withheld on dividends paid by public companies to:

- an individual who was not ordinarily resident nor carrying on business in South Africa; or
- to a company that was not registered nor carrying on business in South Africa; or
- to a holder of a bearer scrip, irrespective of whether he was resident within or outside South Africa.

NRST was also withheld on dividends paid by private companies in certain circumstances. When NRST was initially introduced, the income of private companies was apportioned to shareholders and taxed in the shareholders' capacities. The 1942 Act however provided that in certain circumstances private company income would not be apportioned to shareholders, and the private company would be subject to "Super Tax". The first related to the situation where NRST was payable by a private company on dividends paid out of income which was allocated to a shareholder which was a public company not registered nor carrying on business in South Africa. The second related to dividends paid out of income that was not apportioned amongst the shareholders and was subject to Super Tax. NRST was extended to all private companies in 1952 when the allocation of private companies' income amongst their shareholders was discontinued.

The provisions for the most recent NRST that was levied were Sections 41 to 47 of the 1962 Act. NRST was levied at a rate of 15 per cent (sometimes 7,5 or 5 per cent in terms of certain tax treaties governing double taxation) on dividends declared to non-residents that were not carrying on business in South Africa. The company paying the dividend was obliged to withhold the tax and pay it over to Revenue. The NRST provided for in these Sections of the Act was very similar to the first NRST introduced in 1941.

If a company derived income from both South African and foreign sources, NRST was only payable on a portion of the dividends paid by the company. The portion was determined by the ratio of South African net profits to total net profits of the company. Due to the need to decrease the nominal rate of tax paid by foreign investors NRST was abolished on dividends declared after 1 October 1995.

3. Undistributed Profits Tax

At various stages companies, excluding close corporations, were subject to Undistributed Profits Tax (UPT). The objective of UPT was to encourage the distribution of income so that it could be subject to income tax in the shareholders' hands.

UPT was initially introduced in 1941. Only public companies were liable for UPT as private company income was apportioned to their shareholders. The rate of UPT payable was 4 shillings (20 per cent) in each pound of distributable income that was not distributed by way of dividends. The rate was reduced by sixpence (2.5 per cent) in respect of each completed eighth of distributable income that was distributed by way of dividends. Where income was earned from sources within and outside South Africa distributable income was apportioned on the basis of net assets in South Africa to total net assets.

UPT was abolished in 1951, and from 1951 to 1954 there was no UPT. It was re-introduced in 1955 and both private and public companies were liable for the payment of UPT. In 1960 UPT on public companies was abolished and only private companies were subject to it. From 1969 public companies were liable for UPT in a limited form.

Before the most recent abolition in 1990, UPT was levied at a flat rate of $33^1/_3$ per cent. The tax was levied on the amount by which distributable income for the year of assessment exceeded dividends paid within the year ended six months after the year of assessment. In the determination of distributable income, plough-backs of 50 per cent of trade income and 50 per cent of net dividend income in the case of public companies were allowed.

The reason for the abolition of UPT in 1990 was the extension of the dividend exemption to dividends paid to individuals and close corporations. A system to encourage the distribution of dividends was therefore no longer necessary.

4. Secondary Tax on Companies

The next change to the system of taxing distributed income was made in 1993 with the introduction of Secondary Tax on Companies (STC). STC was payable on the difference between dividends paid and dividends received. STC was introduced as a tax on companies and not shareholders. Unlike UPT which was introduced to encourage the distribution of profits, STC was introduced to encourage the retention of profits. STC is discussed in greater detail in chapter seven.

### 6.3) Commissions of enquiry

There have been three main commissions of enquiry into the South African tax structure. These are the Franzsen, Margo and Katz commissions.

1. The Franzsen Commission

The Franzsen Commission was appointed in 1967 and made three reports. Only the first two reports dealt with taxation. The first report was published in November 1968 and the second in November 1970.

The Commission examined the existing system of UPT and recommended (1968:335) that the distinction between public and private companies for UPT purposes be eliminated. It recommended that public companies be subject to tax on undistributed profits at a rate of 25 per cent.

In considering the taxation of dividends in its second report, the Commission rejected the dividend deduction method (1970:179). The reason for the rejection was due to restrictions contained in double taxation agreements that would have prohibited the South African fiscus from collecting the full tax levied on dividends distributed to non residents. The implementation of an imputation system was also rejected, but on the grounds of the administrative difficulties associated with such a system (1970:180).

The Commission also rejected submissions that tax should be levied on company profits at a relatively high rate and that dividends would then not be subject to further tax in the hands of the shareholders (1970:181). The reason that this was rejected, despite the advantage of simplicity, was because of the consequences for poorer shareholders. Poor shareholders have a low marginal tax rate due to the progressive rates of individual income tax. If dividends were taxed at a high rate at the corporate level, dividends received by poor shareholders would have been subject to inequitable taxation. The Commission also rejected the implementation of a split rate system as a result of considerable difficulties that would have been encountered in the implementation of the system (1970:182-185).

## 2. The Margo Commission

The Margo commission was appointed in November 1984. The commission published its recommendations two years later, in November 1986.

The Commission considered the various systems of corporation taxation used by different countries. Practical alternatives for the taxation of dividends in South Africa were considered, as the Commission perceived the existing system of taxing dividends as a defect in the tax system. The Commission considered whether the shareholder or the company should be regarded as the "dominant" party, as it would be the dominant party that would then be liable for the tax on dividends.

It was suggested by the Commission that the adoption of the shareholder as dominant in South Africa would create serious problems. This was due to a large number of shares being held by tax-free or tax-relieved institutions and also due to a significant portion of shares being held by non-residents. It was claimed that pension funds and life insurance companies (which were tax-free and tax-relieved institutions) in South Africa were acquiring too powerful a position in the economy and that the tax system should not assist this. If the shareholder was dominant, it would result in dividends that had been distributed to tax-free institutions not being taxed at corporate level or in their hands. The amount of tax that could be levied on distributions to non-residents was severely restricted in terms of double tax treaties. Thus if the shareholders were dominant, a significant portion of corporate profits would leave South Africa without bearing any tax. The commission therefore decided that it would be appropriate to consider the company as dominant and not the shareholder.

The problem that the majority of shares in public companies are held by tax-free and tax-relieved institutions mentioned by the Commission is, at least in theory, non existent. Most of the exempt institutions in question would have been incorporated and as discussed in chapter two, the incidence of corporate taxes ultimately falls on individuals. Therefore distributions to tax-free and tax-relieved corporations would ultimately bear income tax once they had been distributed to the individual beneficiaries of these institutions. A counter-argument is that the collection of this tax would be delayed by many years and that there is no capital gains tax in South Africa. Capital gains are largely generated by the retained profits. A large amount of capital gains could thus be accumulated without being taxed.

A practical solution to the problem of tax-free and tax-relieved institutions would be to provide for withholding taxes on all distributions. Taxes withheld on behalf of tax-free institutions would not be refunded to those institutions, and as such the tax system would not provide further assistance to them. Unfortunately withholding taxes result in large administrative and compliance costs.

The following alternatives for taxing dividends were considered by the Commission:

1. withholding taxes on dividends paid to individuals and insurance companies;
2. withholding taxes on all dividend distributions; and
3. total tax exemption of dividends

(Margo, 1987:195-196).

Withholding taxes on all dividend distributions would imply a tax on dividend income in the hands of companies. Dividends from wholly-owned subsidiary companies would be exempted. The Commission pointed out that the resultant cumulative tax on dividend flow would create a motive for the eradication of minorities within a group situation, and this would lead towards large divisionalised companies. This was considered to be a great disadvantage.

It was noted by the Commission that an advantage of the total exemption of dividends was that tax neutrality between individuals and corporations would be achieved and the economic double taxation of dividends would be eliminated. Tax legislation could be simplified and UPT could be repealed.

With regard to the taxation of dividends, the Margo Commission's final recommendation was that dividends paid to resident individuals, close corporations and life insurers should not be taxed. UPT could therefore be abolished. The Commission stated that the main considerations motivating this decision where those of neutrality and simplicity (1987:197).

As stated above, this recommendation was implemented in 1990.

3. <u>The Katz Commission</u>

The Katz commission is the most recent commission on taxation in South Africa and was appointed in August 1994. Its first report was released in 1994 and the second and third reports in 1995.

Part of the Commission's first report dealt with NRST, and these recommendations are discussed in chapter five. The remaining recommendations made in the first report are discussed in chapter seven. The second report's recommendations are discussed in chapter nine and the third report's recommendations are discussed in chapters seven and eight.

### 6.4 The current system of taxing dividends

The Income Tax Act contains a number of provisions relating to the taxation of dividends. Dividends received, regardless of their source, are specifically included in the definition of income. This special inclusion is nullified by Section 10(1)(k) which exempts dividends received from tax.

The present system of taxing dividends provides for the Secondary Tax on Companies (STC). It has been argued that STC is not a tax on dividends but on income. STC is however only payable when dividends are declared and as such is, for the purpose of this thesis, classified as a tax on dividends.

STC is levied on companies in terms of Section 64B and 64C. STC is currently payable at a rate of 12,5 per cent on net dividends declared. STC will be discussed in more detail in chapter seven.

### 6.5) Summary

There have been various approaches to the taxation of dividends in South Africa, including a Dividend Tax, Non-resident Shareholders' Tax (NRST), Undistributed Profits Tax (UPT) and Secondary Tax on Companies (STC).

The Dividend tax was abolished in 1925, UPT in 1990 and NRST in 1995. STC is currently levied at a rate of 12,5 per cent on dividends declared.

# Chapter Seven

# Secondary tax on companies

Chapter seven discusses STC. A summary of the taxing provisions is given, certain anomalies associated with STC are highlighted and discussed, and a discussion of the Katz Commission's findings regarding STC is given.

**7.1) Introduction**

STC is a tax on net dividends declared and applies irrespective of the recipient of the dividend. As mentioned in chapter six, STC was implemented in South Africa on 17 March 1993. STC is a company tax unique to South Africa.

It is interesting to note that STC is very similar to the dividend tax that was implemented by the 1917 Income Tax Act, which is discussed in chapter six, as both are taxes payable on the distribution of profits. It is also interesting to note that the dividend tax was only payable by the holding company of a group of wholly-owned subsidiaries. Dividends paid by these subsidiaries to the holding company was exempt from dividend tax. Until its amendment in 1994, STC was payable on dividends declared by wholly-owned subsidiaries to their holding company. This gave rise to a large amount of criticism. STC and group companies is discussed in chapter eight.

The introduction of STC was accompanied by a reduction in the Normal Tax rate, that was applicable to companies, from 48 per cent to 40 per cent. STC was initially introduced at a rate of 15 per cent. The rate of STC was increased to 25 per cent as from 22 June 1994. The announcement of the STC rate increase was once again accompanied by an announcement of a decrease in the companies' Normal Tax rate from 40 per cent to 35 per cent. The rate of STC was lowered to 12,5 per cent for dividends declared on or after 14 March 1996. This was not accompanied by a change in the Normal Tax rate.

In announcing the implementation of STC the Minister of Finance pointed out in his budget speech that a fast growing company observing a 3:1 payout ratio would pay tax at a *de facto* rate of 43 per cent which was equivalent to the maximum marginal rate for individuals at that time.

There were two main reasons for the implementation of STC. There was a large amount of pressure on the Minister of Finance to reduce the abnormally high nominal corporate Normal Tax rate to a more internationally competitive rate. The nominal tax rate was therefore reduced from 48 to 40 per cent. The first reason for the introduction of STC was therefore to help compensate for the loss in revenue that resulted from the decrease in the nominal rate. The second reason was to encourage companies to retain profits in order to promote growth through being able to finance expansion from within.

The second reason for the implementation of STC, namely to promote growth, can be criticised on a number of grounds. There is an argument that more efficient investment occurs if corporate profits are distributed to shareholders who can then re-invest these profits in the most profitable investments - however refer to chapter four for reservations on this theory.

It is also interesting to note that Poterba and Summers' (1983:163-164) research provided strong support for the view that dividend taxes in fact discouraged corporate investment. Their data decisively refuted the hypothesis that raising the cost of paying out funds to shareholders through dividend taxes would encourage investment through the retention of profits.

A further criticism of STC promoting growth is the political and economic uncertainty in South Africa. South Africa's first democratic election was held in April 1994. This gave rise to a large amount of political and economic uncertainty during both the pre-election and post election periods. Political and economic uncertainty has remained in the years subsequent to the election. Therefore, even if companies retained more profits, it is suggested that this uncertainty has resulted in companies being hesitant to expand locally and as such either held on to cash resources or invested them in foreign countries.

### 7.2) Sections 64B and 64C - the mechanics of STC

Section 64B provides for the actual levying of STC while Section 64C contains specific anti-avoidance provisions.

In terms of Section 64B STC is payable on the "net amount" of any dividend declared. The net amount of a dividend is the amount by which the dividend declared exceeds the sum of dividends received during the "dividend cycle". The dividend cycle is the period commencing immediately after the previous dividend was declared and ending on that date on which the current dividend accrues to the shareholders. If in any dividend cycle, dividends received exceed the dividend declared the excess is carried forward to the following dividend cycle.

In determining the net amount of a dividend declared the following dividends received are not deductible from the dividend declared:

- dividends from a "fixed property company" that are allowed as a deduction in the determination of its taxable income;
- the amount of a dividend distributed by a company being liquidated, wound up or deregistered, as is shown to be a distribution of profits derived during any year which ended not later than 31 March 1993; and
- the portion of a dividend from a "unit portfolio" which represents interest.

The portion of the dividend not deductible as a result of a company being liquidated, wound up or deregistered, may be deducted when the company which received the dividend is itself liquidated, wound up or deregistered.

The effect of STC only being payable on the net dividend declared is that the double taxation of distributed income is avoided within the corporate sector. This is due to STC on income that is distributed only being payable when the initial dividend is declared.

Section 64B(5) provides for the following amounts to be exempted from STC:

- dividends declared by companies whose entire receipts and accruals are exempt from tax;
- dividends declared by a fixed property company that are allowed as a deduction in the determination of its taxable income;
- the amount of any dividend paid in the course of liquidation, winding up or deregistration of a company that represents profits earned during any year of assessment ending on or before 31 March 1993; and
- the amount of any distribution by a unit portfolio that represents a distribution of interest.

If a company derives profits from sources within and outside South Africa, any dividends declared are apportioned for the purposes of determining the STC liability. The apportionment is based on the net profits earned from a South African source as a ratio of the total net profits. All dividends received are excluded in determining net profits.

In the South African income tax case *ITC 1306*, the courts distinguished the deregistration of a company from the liquidation of a company (Ogilvie Thompson *et al*, 1980). Before its amendment in 1995, Section 64B exempted such amount of a dividend distributed in the course of the liquidation or winding up of a company that represented profits derived before any year of assessment ended 31 March 1993. Therefore if a company was deregistered as opposed to liquidated this exemption would not be available. The 1995 amendments extended this exemption to the situation when a company was being deregistered.

Section 64C(1) deems certain amounts paid by a company to a "recipient" to be a dividend for the purposes of STC. A recipient in relation to a company is defined in Section 64C as:

> *(a)* any shareholder of such company;
> *(b)* any relative of such shareholder; or
> *(c)* any trust of which such shareholder or relative is a beneficiary
>
> (Statutes..., 1996)

The following distributions are deemed by Section 64C(3) to be dividends for the purposes of STC:

- any cash or asset distributed by a company to or for the benefit of a recipient;
- any obligation, measurable in money, which is owed to the company by a recipient from which the recipient is released;
- any debt owed by a recipient that is settled by the company; and
- any amount used or applied by the company for the benefit of a recipient.

Section 64C(4) provides for the following to be excluded from being a deemed dividend:

- an amount distributed that constitutes remuneration in the hands of the recipient ;
- the settlement of a debt owed to the recipient by the company;
- any amount to the extent that it exceeds the profits available for distribution. Any limitations contained in the memorandum or articles of association of the company on the distribution of income are however ignored in determining profits available for distribution;
- any loan granted in respect of which a market related interest is payable by the recipient;
- any loan granted to a recipient who is an employee of the company if the loan was made in compliance with the normal terms and conditions of a loan scheme generally available to employees of the company who are not shareholders;
- any loan granted to a recipient if the loan is repaid by the end of the following year of assessment and the amount is not included in a subsequent loan and the

provisions of this paragraph had not applied before. Initially this exclusion only applied to loans granted to a shareholder of the company. It was however illogical and inequitable for the exclusion to apply to shareholders only and not to all recipients;

- a loan granted by a company to its holding company or any other company if they have the same holding company. The loan must be utilised in South Africa; and
- any loan granted to a trust by a company to enable the trust to purchase shares in the company for the purposes of reselling the shares to employees of the company under a share incentive scheme operated by the company for the benefit of employees.

Where a loan granted by a company to a recipient which was deemed to be a dividend is thereafter wholly or partially repaid, the amount repaid is deemed to be a dividend received by the company for the purposes of determining the net dividend declared. This results in the company receiving a credit for the STC paid on a loan to a recipient as and when the loan is repaid. This provision originally only applied to loans granted to a shareholder and not any other recipient. The amendment made in 1994 to extend this provision to loans granted to all recipients was an important one as it was inequitable to deem loans to all recipients to be dividends distributed and then only to deem the portion of such a loan repaid by a shareholder to be a dividend received. A company will now effectively receive an STC credit on the repayment of all deemed loans.

**7.3) STC anomalies**

1. <u>Timing of the changes in the rates of Normal Tax and STC</u>

STC is payable on dividends declared on or after 17 March 1993. The reduction in the normal tax rate was effective for years ending from 1 April 1993 in the case of the reduction from 48 per cent to 40 per cent, and 1 April 1994 for the reduction from 40 per cent to 35 per cent. The 25 per cent STC rate applies to dividends declared on or after 22 June 1994 and before 14 March 1996. As a result of the effective dates of the change in normal tax rates differing from the change in STC rates two anomalies arise.

Firstly, with the initial introduction of STC companies, such as The South African Breweries Limited, who had a 31 March year end were faced with paying normal tax at 48 per cent and with paying STC at 15 per cent on any final dividend declared. This resulted in an nominal tax rate of 54,8 per cent (48% + ((100 - 48) x 15 ÷ 115)%) on distributed profits.

Unlike the first anomaly which punished some companies, the second anomaly favours some companies. Dividends declared before 22 June 1994 out of profits earned between 1 April 1994 and 22 June 1994 will attract STC at 15 per cent and normal tax at only 35 per cent.

2. <u>Profits earned before the introduction of STC</u>

A dividend which is declared on the liquidation, winding up or deregistration of a company out of profits earned during any year of assessment ending on or before 31 March 1993 is exempt from STC. A company which is not being liquidated, wound up or deregistered which declares a dividend out of profits earned before this date could be subject to a punitive tax rate. Normal Tax could have been paid at a higher rate applicable before the introduction of STC (a rate as high as 50 per cent), and would in addition be liable for STC on the dividend declared at a rate of 15 per cent, 25 per cent if the dividend was declared after 22 June 1994 and before 14 March 1996 or 12,5 per cent if the dividend was declared on or after 14 March 1996. Such a dividend could therefore be subject to a tax rate as high as 60 per cent (50% + (50 x 25 ÷ 125)%).

3. <u>Capitalisation issues</u>

Companies often offer shareholders the option of receiving capitalisation shares in lieu of a cash dividend in order to prevent incurring the liability for STC. The increase in capitalisation issues in lieu of cash dividends as a result of STC was recognised by Maspero (1994).

Shares which have the right to unlimited participation in the profits or in the assets on liquidation will be classified as equity shares. The definition of a dividend specifically excludes the nominal value of any capitalisation shares which form part of the company's "equity share capital". In relation to capitalisation shares, nominal value is defined in the Income Tax Act to include reserves applied in paying up any share premium Therefore if a company has a capitalisation issue of equity shares at market value, no liability for STC will arise as no dividend would have been declared (Wilson, 1994).

A shareholder who chooses the capitalisation shares can still obtain cash through the sale of the shares. The receipt from the sale will not be taxable, unless the shareholder is a share dealer, and so it would have the same individual tax effects as the shareholder who receives a dividend. The shareholder therefore does not necessarily lose out in opting for the capitalisation issue, and the company benefits through a reduction in its liability for STC. A large amount of potential revenue is lost through capitalisation issues in lieu of dividends, and the effectiveness of STC is thereby reduced.

Wilson suggested that where a company wishes to avoid an STC liability by means of offering shareholders the option of a capitalisation issue in lieu of a cash dividend, the announcement of the offer needs to be worded carefully. He gave the following two scenarios as an example of this:

- Company X declares a dividend to shareholders, announcing that any shareholder who so elects may, in lieu of a payment in cash, receive an issue of capitalisation shares in the company.
- Company Y declares an award of capitalisation shares to its shareholders, announcing that any shareholder who so elects may receive a dividend in cash in lieu of an issue of shares. (1994:114)

Wilson suggested that Company X has declared a dividend and that the capitalisation issue was merely one method of paying the dividend. STC would therefore be payable on both the capitalisation shares and the cash dividend. Company Y would however not be liable for the payment of STC on the capitalisation shares issued it would not constitute a dividend. STC would however be payable on the portion of the dividend paid in cash. As yet there has been no formal ruling stating that STC would be payable in Company X's situation and not in Company Y's situation. It would seem inequitable for the liability for STC to be dependent upon the wording of the dividend declaration. It is thus likely that if this situation came before the courts, the two situations would not be distinguished from each other.

4. Section 64C

Stein (1994) discussed some of the theoretical and practical problems posed by Section 64C. Most of the problems he highlighted were related to the exemptions from the provisions of this Section which deemed certain amounts to be a dividend. An amount distributed that constitutes remuneration in the hands of the recipient is excluded from being a deemed dividend. Stein suggested that it was doubtful whether Section 64C exempts an interest free or low interest loan that gives rise to a taxable fringe benefit as the loan does not constitute remuneration. Where an interest free or low interest loan is granted, the net interest benefit is included in the recipient's taxable income. STC would also be payable on the loan and the result is that the same loan gives rise to both Normal Tax and STC if the "recipient" is an employee.

The amount by which a distribution exceeds the "profits available for distribution" is also exempted from being a deemed dividend. The problem is that the exemption does not provide for the profits available for distribution to be reduced by past deemed dividends (Stein, 1994). Therefore if a company lends R200 000 to a recipient and profits available for distribution are only R150 000, only R150 000 would be a deemed dividend. If the company then lends another recipient R250 000, R150 000 of that would still be deemed to be a dividend. The total deemed dividends would total R300 000. The profits available for distribution would only be R150 000. If the loan had been made to one recipient only R150 000 would have been a deemed dividend.

A loan which was granted at a market related interest rate is also exempted from the provisions of Section 64C. A problem could arise if subsequent to the granting of the loan, interest was discontinued or was charged at a rate below the market rate. When the loan was initially granted it would have been exempt from STC, and Stein (1994) submitted that Inland Revenue could not subject the loan to STC as a result of subsequent events. The loan could also not give rise to a deemed dividend in a later period as it would not have been made in that period, unless a new loan had been made in law.

5. STC and groups of companies

STC has a number of unfortunate implications for group companies. These implications are discussed in detail in chapter eight.

### 7.4) The Katz Commission recommendations

In examining STC in its first interim report, the Commission considered the advantages and benefits as well as the disadvantages of STC. A discussion of these advantages and disadvantages will be given below. The Commission (1994) stated that it was not in a position to recommend the abolition of STC. The Commission realised that, despite the strong arguments made for the abolition of STC, if STC was abolished the loss of revenue of R1,4 billion would create pressure for an increase in the corporate tax rate. This would destroy much of the advantage which had been gained through the lowering of the basic corporate tax rate over the past few years.

In the Commission's view STC brought the following benefits:

- the major advantage of STC was that it enabled the basic corporate tax rate to be reduced to 35 per cent. STC had raised revenue of R876 million in 1993/4 and it was budgeted to raise revenue of R1 440 million in 1994/5. It had therefore been correctly argued that without the introduction of STC it would not have been possible for the government to have dramatically reduced the corporate Normal Tax rate from 48 to 35 per cent as had occurred in the past few years;
- STC was designed to ensure that the rate of consumption of companies' shareholders would be penalised at the expense of investment. This was as a result of retained profits only being taxed at the basic Normal Tax rate while dividends declared would be taxed at the additional STC rate. This had two benefits:
  i) a significant strengthening of the balance sheets of companies; and
  ii) an enhancement of the South African tax base. As new investments took place the entire economy grew and the corporate and individual tax base increased;
- STC served as a minimum tax as companies with a low effective rate of tax paid a minimum of 25 per cent (now 12,5 per cent) on profits which were distributed;
- given the fact that many shares in South Africa were held by exempt institutions notice must be given to the argument for a dividend relief system that did not automatically extend relief to this class of shareholder;
- small and medium enterprises which were incorporated could benefit from the lower rate of 35 per cent without the additional burden of STC as these enterprises often ploughed back profits.

The Commission received a number of submissions which criticised STC for the following reasons:

- STC was counter-productive in the case of wholly owned subsidiaries. It inhibited the cash flow within a group. This was a bottle neck which could not be adequately addressed through internal loans. Section 64B has subsequently been amended and dividends declared by wholly owned subsidiaries are now exempt from STC. This criticism is therefore no longer valid, however in other group situations STC causes an inhibition on group reinvestment. STC and groups of companies is discussed in chapter eight;

- STC had created an over-abundance of capitalisation issues by means of scrip dividend declarations to avoid STC. The Katz Commission believed that this was not necessarily a disadvantage as it had, inter alia, strengthened the balance sheets of companies;
- one of the objectives of STC was to encourage companies to retain profits for internally generated growth. It was submitted to the Commission that STC did encourage retention but not for funding internal growth and was more likely to encourage take-overs. It was argued that growing companies did not need encouragement to retain funds, as they were commercially compelled to do so. It would, however, be helpful to them in raising new capital if investment markets were more liquid. Discouraging dividend payments meant that the markets had less investable money because it had been retained by stagnating predators;
- STC taken together with Non-resident Shareholders' Tax (NRST) had profound disadvantages for non-residents. NRST was abolished on 1 October 1995 and thus the effective corporate tax rate for non-residents is the same as for residents;
- STC was often not recognised by foreign jurisdictions in the granting of tax credits. The reason for this was that as STC was a tax on net distribution and not income, it was not a tax "substantially similar" to any of the taxes covered by double tax treaties. However, this situation has subsequently changed - for example the United Kingdom has announced that it would recognise STC as an income tax for the purpose of the existing double tax treaties (Katz, 1995:87).
- STC was an unusual system of taxing dividends and it was thus not well known to foreign investors. It relied on the complex definition of a dividend contained in the Income Tax Act which had created uncertainty and potential for avoidance. Tax avoidance practices would doubtless require amending legislation which would add to the complexity of the system;
- it was contended that STC was a retroactive tax and had created problems for those companies which chose to issue preference shares to raise capital and since the introduction of STC faced adverse consequences.

In the Commission's opinion, STC had served a very real and useful purpose in South Africa since its introduction. Despite the Commission stating that it was not in a position to recommend the abolition of STC, it considered it to be desirable to seek better ways to achieve its objectives. The Commission (1994) suggested that the prudent approach in seeking an alternative to STC would be to examine the effect of base broadening and an assessment of the various forms of imputation tax in order to determine whether a variant of the imputation system could replace STC.

In its third interim report, The Katz Commission (1995:83-95) re-addressed STC. The Commission's findings are discussed in more detail in chapters eight and nine. Due to the additional administrative burden and greater complexity, for both revenue authorities and the corporate sector, the Commission (1995:94) did not recommend the implementation of an imputation system, but recommended that STC be retained. It did however in principle favour a progression towards some form of imputation system.

In addition to the recommendation that STC be retained, the Katz Commission (1995:94) made a number of other recommendations which it believed were necessary to improve the STC system. These were:

- amendments to reduce the inhibition caused by STC on group reinvestment;
- the removal of the formal STC obligation on foreign branches; and
- a substantial reduction in the rate of STC.

The recommendations to reduce the inhibition caused by STC are discussed in chapter eight and the removal of the STC obligation on foreign branches is discussed in chapter nine.

The reason for the Commission's favouring a substantial reduction in the STC rate was:

> ... regardless of the merits of the STC concept, a major part of the problem lies in the perceived burden that arises from the combined effects of the basic corporate rate of 35 per cent and the STC rate of 25 per cent.
>
> This problem is two-fold. In the first place, the combined corporate and STC rate is too high, and secondly, the STC component itself is too high. Indeed most of the

> conceptual difficulties with regard to STC have existed from its inception in 1993, but it was only after the increase in the rate from 15 percent to 25 per cent that these problems assumed significant proportions ... excessive overall rates and an excessive rate upon distribution will accentuate the disadvantages and obviate the advantages of such a system (1995:83).

The Commission (1995:91) believed that a reduction in the STC rate would likely result in an increased volume of cash dividends, and hence the revenue yielded by the lower STC rate would be reduced less than proportionately. It believed that cash dividends had been held back due to delayed dividend declarations and capitalisation issues and that this had led to pressure for cash dividends. A decrease in the STC rate would therefore result in the increased volume of cash dividends. This recommendation was implemented through a dramatic decrease in the STC rate from 25 to 12,5 per cent in 1996.

### 7.5) Summary

STC is payable at a rate of 12,5 per cent on the net amount of a dividend declared within a dividend cycle. In determining the net amount of a dividend declared, dividends received within the dividend cycle are deducted from the dividend declared. This avoids the double taxation of distributed income.

STC was considered by the Katz Commission in their first and third interim reports. In its first interim report, the Commission stated that it was not in a position to recommend the abolition of STC but it suggested that an assessment of imputation systems be made to determine whether STC could be replaced by an imputation system. In the third interim report, the Katz Commission stated that in principle it was in favour of progressing towards some form of imputation. The Commission however argued that an imputation system would result in additional administrative burdens and greater complexity. It therefore recommended that STC be retained.

# Chapter Eight
# STC and group companies

STC has a number of implications for group companies. This chapter discusses these implications. Two possible systems of STC group relief are considered. The development of group relief provisions implemented since the introduction of STC are discussed and the Katz Commission recommendations regarding group relief for STC are summarised and discussed.

## 8.1) Introduction

In discussing STC in the group context, reference will be made to Clegg's (1995) article *Possible STC relief for groups of companies*. In this article Clegg discussed the recommendations made by the South African Chamber of Business on resolving the problem of STC payable within a group of companies.

It was stated in chapter seven that one of the purposes of STC was to encourage companies to retain profits for reinvestment. Clegg pointed out that profits earned by companies within a group were sometimes used to fund investments by other companies within the same group and that it was often sound business practice to do so. Operating subsidiaries would usually distribute their profits as a dividend to the group holding company who then ensured that the funding of the reinvestment was undertaken in an appropriate manner. The dividend was however invariably subject to STC. The STC paid reduced the funds available for reinvestment within the group and was thus in contradiction with the intention of STC stated above.

Section 64C exempts, from its deeming provisions, a loan made by a wholly owned subsidiary to its holding company or to another company which is a wholly owned subsidiary of its holding company. In the situation of a wholly owned subsidiary, it was therefore possible for STC to be avoided as the subsidiary could grant a loan, as opposed to declaring a dividend, to its holding company.

Clegg argued that the use of inter-company loans was not always acceptable as:

- a proliferation of inter-company loans became confusing;
- the forced use of loan capital would lead to imbalances in debt-equity ratios; and
- often companies which were conventionally viewed as wholly-owned in fact had minority holdings (typically where employees of the company participated in share incentive schemes) and were therefore not entitled to the STC exemption. The 1996 amendments however extended the exemption to ignore shares held in terms of a "share incentive scheme".

The exemption of STC on loans made to shareholders did not apply to subsidiaries that were not wholly owned. This, in addition to Clegg's arguments stated above, resulted in the use of inter-company loans not overcoming the problem of group reinvestment caused by STC. The implementation of a system of group relief for STC which prevents the inhibition on group reinvestment is thus necessary.

**8.2) Systems of group relief for STC**

In determining appropriate relief for STC in the group context it is necessary to determine from which level of shareholding relief should be granted. Clegg stated that the general consensus was that relief should only be allowed where a company itself could control the declaration of dividends out of a company whose shares it held. It was only then that it was possible to truly recognise a common controlling mind that made decisions to move profits within a group in a businesslike fashion. It was therefore recommended that group relief be based on the definitions of a holding and subsidiary company contained in the Companies Act.

Clegg set out two possible solutions to the problem of STC in a group context, namely, a refund system and an exemption system. The refund system involved the company receiving a dividend being entitled to a cash refund of any excess credit over dividends paid instead of the excess being carried forward to the next dividend cycle as was provided for in Section 64B. If no dividend was declared during the year of assessment then a claim for a refund could be made on the last day of the year of assessment.

The refund system cannot be seen to be ideal. The group subsidiary would still have paid the STC. The group's funds available for distribution would thereby be reduced until such time as the group holding company declared a dividend. It is thus possible that there would be a substantial delay before the "full" funds were available for reinvestment. Furthermore, a large number of refunds would increase the administrative burden and complexity of the STC system.

Under the exemption system discussed by Clegg, any "group subsidiary" that declared a dividend to its "holding company" would be exempted from paying STC on that dividend. If a "group subsidiary - holding company" relationship was based on less than a 100 per cent holding, dividends declared to minority shareholders at the same time would still be liable for the payment of STC on the relevant amount. "Exempt" dividends (i.e. dividends that have not borne any STC) received by a holding company would not qualify as a dividend received for the purposes of determining the net dividend paid by the holding company.

Clegg recognised that complications would arise where a group subsidiary received dividends from minority holdings in non-group companies. Normally dividends received carried an STC credit that would be available for set-off against the next dividend declared by the company receiving the dividend. However in the situation of a group subsidiary, the next dividend would be declared to the holding company and would therefore be exempt from STC. As the dividend declared did not trigger an STC liability, the dividend received would not be set-off against the dividend declared. The complication that arises is whether the STC credit for the dividend received by the subsidiary should: be passed on to the holding company; simply fall away; or whether the STC exemption should be available at all in these situations.

As recognised by Clegg, the most equitable option would be for the STC credit to be passed on to the holding company. If this was to happen, it would be necessary to keep track of "deemed" STC credits from lower corporate levels until they could ultimately be utilised by the group holding company. Clegg suggested that this could be achieved through including an additional line on the STC return to record dividends accrued that carried deemed STC credits from accruals at lower corporate levels. This option would however increase the administrative burden of STC.

A possible option is for any STC credits that had accrued up to the date of the declaration of an exempt dividend simply to fall away. At first this may seem inequitable, but Clegg pointed out that if a group subsidiary received a dividend which had an associated STC credit, it could merely re-declare this dividend to its holding company. When declaring the dividend, the subsidiary would not elect the STC exemption. No STC would be payable by the subsidiary as the dividend declared would equal the dividend received. The holding company would receive a dividend which had not been exempted from STC and would therefore carry the associated STC credit. The group subsidiary could then elect the STC exemption on dividends declared out of operating profits and dividends received from sub-subsidiaries without any harm.

An alternative to the STC credits being passed up to the group holding company, is for the STC exemption on dividends declared to holding companies not to be available to subsidiaries which received dividends from minority holdings. Even though this is a more simple option, Clegg was not in favour of it, as minority holdings in groups were common and this alternative would simply reinstate the precise conflict which it sought to remove as it would result in a reduction of the group profits available for reinvestment. This would be the least equitable option.

### 8.3) Group STC relief introduced since the initial implementation of STC

STC relief on dividends declared by a group subsidiary was implemented in 1994 through amendments made to Section 64B. The legislature chose the exemption system as opposed to the refund system, and dividends declared by a wholly-owned subsidiary to its holding company were, at the election of the subsidiary, exempt from

STC. The exemption was amended in 1995 to exclude any dividend declared by a company to any other company if:

- the holding company, at the date of declaration and for the twelve months prior to the declaration of the dividend, held for its own benefit all of the equity share capital of the subsidiary;
- the holding company had its place of effective management in South Africa and its profits, excluding profits derived by way of dividends, were derived solely from a South African source; and
- the dividend was declared solely out of profits earned by the subsidiary during any period in which all of its equity share capital was held by the holding company.

In determining the net amount of a dividend declared by a holding company, a dividend received from a subsidiary that had been exempted from STC under the above exemption, could not be deducted from the dividend declared.

From the above provisions, it is evident that relief from STC was only granted in the case of a 100 per cent share holding. There are many groups of companies in South Africa where there are minority share holdings. This is particularly prevalent with companies that have share incentive schemes which hold shares on behalf of employees. This results in minority holdings even though the company may essentially be wholly owned by its holding company. Furthermore, only subsidiaries that were wholly owned directly by one company were included in the above relief. The situation where a subsidiary was wholly owned through two or more companies which were also wholly owned subsidiaries of the same holding company was not covered. Thus even though a subsidiary may have been wholly owned from a group perspective, group relief was not extended to the subsidiary.

Due the above mentioned problems, the group provisions introduced were only seen as partial relief to the problem of STC in the group context. In its third interim report, the Katz Commission (1995:91) realised that the STC system did not fully cater for group reinvestment. It stated that one possibility would be to reduce the exemption requirement of a 100 per cent shareholding. Another possibility was the credit refund system. As discussed above, the refund system cannot be seen to be an ideal system. Fortunately the Commission recommended that such a system be further investigated before it was be implemented.

As interim measures to reduce the inhibition on group reinvestment the Katz Commission (1995:92) recommended that:

- the requirement that the company should derive its profits "solely" from a South African source be amended to refer to "substantially all" and to clarify the period over which there may be no non-South African profits. A period not encompassing more than one year of assessment prior to the year in which the dividend was declared was recommended. This recommendation was considered necessary as no time period for which there could be no non-South African profits was specified in the Act. This had resulted in an amount of uncertainty;
- "wholly owned" be defined to allow for employee shareholdings in terms of share incentive schemes. It recommended that such holdings should not exceed 10 per cent of the equity share capital; and
- the group STC relief be extended to include a group subsidiary whose shares are wholly owned through one or more group companies which are themselves wholly owned subsidiaries. This would include indirect holdings.

Most of these recommendations were implemented through amendments to the Income Tax Act in 1996. The provision requiring all of the profits to be derived from a South African source was amended and now only requires 90 per cent of profits, excluding dividends, to have been derived from a South African source. Even though the provision does not refer to "substantially all" profits as recommended by the Katz Commission, including an actual percentage results in more certainty and is thus preferable. The provision was further amended to require that there be no non-South African profits during the three years of assessment preceding the date of the dividend declaration. The Katz Commission recommendation of one year was thus ignored.

The Katz recommendation regarding employee shareholdings was implemented in its entirety. A definition of a "holding company" was inserted into Section 64B(1) and is defined as:

> any company which holds for its own benefit whether directly, or indirectly through one or more intermediate companies, together with shares held in terms of a share incentive scheme, all the equity share capital of any other company; (Statutes..., 1996)

A share incentive scheme is defined as:

> a scheme in terms of which not more than 10 per cent of the equity share capital is-
> *(a)* held by the full-time employees of such company in terms of a share incentive scheme carried on for their own benefit;
> *(b)* held by a trustee for the benefit of such employees, under a scheme referred to in Section 38(2)(*b*) of the Companies Act, 1973; or
> *(c)* collectively held by both such full-time employees and such a trustee. (Statutes..., 1996)

The Katz Commission recommendation regarding indirect holdings was also implemented. STC relief to group companies has thus been extended to include subsidiaries whose entire share capital is held indirectly by the group holding company. This is as a result of the recognition of share holdings held by intermediate companies. In this situation the entire share capital of the intermediate companies must be held, directly or indirectly, by the group holding company. Provision for shares held in terms of a "share incentive scheme" is once again made.

The STC exemption only applies to dividends declared to a "holding company" or "intermediate company". STC will therefore be payable on dividends declared to minority shareholders whose shares are held in terms of a "share incentive scheme". It will be interesting to see whether this will be enforced. As a result of shareholdings in terms share incentive schemes being limited to 10 percent, the STC revenue from these dividends would be negligible. It is therefore submitted that the revenue generated from these dividends would not justify the administrative burden involved in collecting this revenue.

From the 1996 amendments it is evident that for a company to avail itself of the STC exemption, the requirement of a 100 per cent shareholding has been reduced to 90 per cent if the remainder of the shares are held in terms of a "share incentive scheme". Only 90 per cent of profits, as opposed to all, have to be earned from a South African source. The time period for which this requirement must be complied with has been limited to three years prior to the year of assessment in which the dividend was declared. The exemption has been further extended to include group subsidiaries that are wholly owned through one or more group companies which are wholly owned subsidiaries.

There is an unfortunate implication for a company that avails itself of the STC exemption on a dividend declared to its holding company. Any STC credits associated with dividends accruing to the subsidiary, during a dividend cycle ending with the declaration of an "exempt" dividend from holdings that do not meet the requirements for group relief, will be lost. The reason for this is that these dividends accrued will not be able to be carried forward for credit in any future dividend cycle, and they do not qualify for credit at the holding company level. As suggested by Clegg, these STC credits can be passed on to the holding company if the subsidiary re-declares the dividend to the holding company and does not elect the STC exemption. However, in this context the subsidiary would have to re-declare dividends received from all holdings that did not qualify for group relief from STC and not merely from minority holdings.

Despite the relief provided, STC still results in group reinvestment being inhibited. This is as a result of relief only being extended to wholly owned subsidiaries (with an allowance for shares held in terms of a share incentive scheme). Any other subsidiary which declares a dividend to its holding company will be liable for the payment of STC. This results in the group funds which are available for reinvestment being decreased by STC paid on dividends declared by subsidiaries to group companies.

A major implication of extending STC relief on dividends declared by all subsidiaries to their holding companies is that this would increase the complexity of the STC system. This was recognised by the Katz Commission (1995:91). It is doubtful whether the South African Revenue Service would be able to deal with the increased complexity. It is therefore likely that the inhibition of group reinvestment will remain as a defect in the tax system until STC is abolished.

**8.4 Summary**

The absence of relief for STC paid by group companies results in an inhibition on group reinvestment. Systems of relief for STC in the group context includes a refund system and an exemption system.

Subsequent to the introduction of STC in 1993, the Income Tax Act has introduced an exemption system to provide relief for STC paid by group companies. Section 64B has been amended to implement recommendations made by the Katz Commission. For a group company to be exempted from paying STC on a dividend declared the following conditions have to be met:

- the holding company must hold, directly or indirectly, the entire equity share capital of the group company. Allowance is made for shares held in terms of an "employee share incentive scheme". The number of shares held in terms of such a scheme is however limited to 10 per cent;
- the company who is declaring the dividend must have derived at least 90 per cent of its profits, during the three years of assessment immediately preceding the date on which the dividend was declared, from a South African source; and
- the profits out of which the dividend was declared were earned while the company held the required number of shares stated above.

Despite the relief provided for, STC still causes group reinvestment to be inhibited. Due to the further extension of STC relief being prevented by a resultant increase in complexity, the inhibition of group reinvestment will remain as a defect in the tax system until STC is abolished.

# Chapter Nine
# The neutrality of the South African corporate tax

This chapter discusses the lack of neutrality of the South African corporate tax system. Reasons for the lack of neutrality are identified and discussed.

### 9.1) Introduction

Chapter four discussed the general lack of neutrality that existed within corporate tax systems. The South African corporate tax system also lacks neutrality in many respects. The lack of neutrality was recognised by the Margo Commission (1987). The Commission believed that the cumulative impact of the differential between corporate tax rates and the maximum marginal tax rates of individuals, coupled with the method employed in taxing dividends, could make it more attractive to trade through the non-corporate form. Both the Margo (1987) and Katz (1994) Commissions were concerned about the distortion between debt and equity caused by the differential treatment of dividend and interest payments. The South African corporate tax system still lacks neutrality, despite recommendations made by the Margo and Katz Commissions and numerous changes to the Tax Act. The remainder of this chapter discusses the causes of the lack of neutrality in the South African corporate tax system.

### 9.2) Differences between corporate and individual marginal tax rates

As explained in chapter four, where there is a difference between the corporate and maximum individual marginal tax rates and a dividend exclusion system is used (which is prevalent in South Africa since 1990), distortions between corporate and non corporate forms and between debt and equity occur.

During the 1970's the maximum individual marginal tax rate was considerably higher than the corporate tax rate. This situation was reversed in the 1980's with the corporate tax rate exceeding the maximum individual marginal tax rate. Despite the reduction in the nominal corporate tax rate to 40 per cent in 1993, the simultaneous introduction of STC resulted in a combined corporate tax rate of 48 per cent. This was still higher than the maximum individual marginal tax rate.

A reduction in the rate of STC from 25 per cent to 12,5 per cent was announced in the budget speech in March 1996. This has resulted in a combined corporate tax rate of 42,2 per cent, which is lower than the maximum individual marginal rate of 45 per cent.

The differences between the South African corporate and maximum individual tax rates therefore result in a bias towards incorporation and the use of equity finance. Even though the difference between the corporate and individual tax rates result in a bias towards the use of equity finance, it is more likely that the South African tax system would generally result in the bias against equity finance. This is discussed with thin capitalisation below.

### 9.3) Lack of neutrality caused by STC

1. Distribution of profits and capital structure

Even though the South African system does not tax dividends at the shareholder level, distributed profits are taxed more heavily than retained profits because of the levying of STC on dividends declared. The levying of STC also results in the double taxation of dividends despite dividends being exempt from individual income tax. The double taxation of dividends occurs as a result of dividends being subject to both corporate Normal Tax and STC.

Due to the double taxation of dividends, STC results in a bias against the distribution of profits. It will however not necessarily result in a bias against equity finance. In

South Africa, dividends are subject to corporate income tax and to STC but are exempt from individual tax. On the other hand interest is subject to individual income tax but is not subject to corporate income tax as companies receive a tax deduction for their interest payments. The result is that dividends are taxed at the combined corporate Normal Tax and STC rates while interest is taxed at the individual marginal tax rate. STC can only be said to cause a bias against equity finance where the corporate Normal Tax rate equals the individual marginal tax rate. STC payable on dividends declared would then result in dividends being taxed more heavily than interest. Where the corporate Normal Tax rate and individual marginal tax rate differ, distortions between debt and equity results from the difference between corporate and individual tax rates and not from STC.

## 2. Thin capitalisation

As discussed in chapter four, corporate taxes often result in corporations making extensive use of debt finance. This results in their equity capital being small in comparison to its debt finance. This situation is often referred to as thin capitalisation.

The problem of thin capitalisation is particularly prevalent in South Africa. Non residents, both natural and corporate, who do not carry on a business in South Africa are not taxed on their interest receipts. Therefore if a South African company raises a foreign loan, the company will obtain a tax deduction for its interest payments and the foreigner will not be taxed on the interest received. If the company had however raised equity finance, the dividend payments would not be tax deductible and in addition would be subject to STC (the dividend would not be subject to South African tax in the shareholder's hands). The use of foreign debt capital as an effective tax avoidance device becomes clear.

As a result of recommendations made by the Katz Commission (1995:8) in its second interim report, the 1995 amendments to the Income Tax Act introduced measures to overcome, in certain circumstances, the practice of thin capitalisation. The Act, through Section 31, now provides the Commissioner (the person responsible for the administration of the Income Tax Act) with power to disallow a portion of an interest payment made if the Commissioner believes that the debt capital of the corporation making the interest payment is excessive in relation to the corporations fixed capital. Section 64C was amended to deem the amount disallowed as a deduction to be a dividend for the purposes of STC.

The discretion granted to the Commissioner offends Adam Smith's principle of certainty. It is a waste of time and money of both the Revenue Service and taxpayers by giving rise to increased litigation in the tax Appeal Courts.

Section 31 will only apply to loans granted, directly or indirectly, in the following circumstances:

- the party granting the loan (the investor) must not be ordinarily resident in South Africa; and
- the person receiving the loan (the recipient) is ordinarily resident in South Africa and is:
  i) a connected person in relation to the investor; or
  ii) any other person in whom the investor has a direct or indirect interest which entitles him to:
  iii) participate in at least 25 per cent of the dividends, profits or capital of the recipient; or
  iv) is entitled to exercise at least 25 per cent of the votes of the recipient (the reason for including this requirement is not clear as such a person would meet the definition of a connected person!)

Section 31 will therefore only apply if a loan is granted by a person who is a non resident to a person who is a South African resident. Furthermore, the parties need to be connected persons and the Commissioner must consider the debt capital of the recipient to be excessive. In this situation Section 31 removes the tax advantage of using debt finance as the portion of interest that is considered to be excessive is effectively treated as a dividend at the discretion of the Commissioner.

It is unfortunate that this provision, which increases the administrative complexity and costs of the tax system, was implemented. A more effective solution to the problem of thin capitalisation would have been to remove the tax distortions between debt and equity which causes the practice of the thin capitalisation.

3. Foreign branches

In the Katz Commission's first interim report, it was pointed out that there was no STC payable on the repatriation of branch profits to an offshore head office, but STC was payable on a dividend declared by a company to an offshore holding company. As a result a non-resident may have preferred to operate through a branch instead of a South African company as STC would be avoided. It was contended that this unfairly prejudiced investors who preferred or were required to trade through the structure of a company and as such was inequitable. STC was therefore not a neutral tax.

STC was technically payable on a dividend declared by an offshore company out of South African source profits. This would result in branch profits being subject to STC. This however was simply not being enforced. The Katz Commission believed that it was difficult in practice for Inland Revenue authorities to apply this legislation as:

- Inland Revenue was not normally notified of dividend declarations made by offshore companies; and
- when such a dividend was declared, it was difficult to contend that the dividend was made up of South African profits if there were other profits available for distribution and particularly if the directors specifically minuted in the dividend declaration that the dividend was declared from non South African profits.

In its third interim report, the Katz Commission re-addressed this problem. It believed that "an almost institutionalised disregard for the law is wholly unacceptable" (Katz, 1995:88). In an attempt to overcome this problem the Commission considered the implementation of a branch profits tax and the removal of the obligation for STC to be paid on foreign branch profits.

The Commission argued that a branch profits tax was only relevant in the STC context. In the context of the recommendation regarding the future implementation of an imputation system, the Commission (1995:89) was not in favour of a branch profits tax. With the implementation of an imputation system the branch profits tax would become inappropriate and would have to be discontinued. The Commission (1995:88) believed that this would send out an unfortunate message of instability in the tax system.

The Commission therefore concluded that the negative implications of a branch profits tax would outweigh the revenue and structural disadvantages inherent in the STC system. It therefore recommended that the formal STC obligation on branch profits be removed. This recommendation was implemented in 1996 through an amendment to Section 64B(5).

With this amendment, STC's lack of neutrality between foreign branches and companies operating in South Africa has been formalised. The Katz Commission's argument that this amendment was the best option reinforces the need for an alternative system for STC to be found.

### 9.4) Summary

The South African tax system lacks neutrality in many respects. One of the causes is the difference between the corporate and maximum individual marginal rates. Since the corporate tax rate is lower a bias in favour of incorporation and the use of equity finance arises. Another cause of the lack of neutrality is STC.

As a result of double taxation of dividends, STC results in the bias against the distribution of profits. STC, combined with the fact that foreigners are not taxed on their interest receipts, results in a bias against the use of equity finance. The practice of using debt finance in preference to equity finance is often referred to as thin capitalisation. Complex legislation was introduced in an attempt to nullify the practice of thin capitalisation. STC also results in a bias in favour of the use of foreign branches as opposed to foreign companies in South Africa. This is as a result of STC not being payable on dividends paid out of profits earned in South Africa by a foreign branch.

The difference between the corporate tax rate and the maximum individual marginal rate is less than 3 per cent. It is therefore unlikely that this difference will result in significant distortions. The same cannot be said of STC. The distortions caused by STC are far more significant. It is therefore possible to conclude that the major cause of the lack of neutrality of the South African corporate tax system is STC.

# Chapter Ten

# Analysis of South African corporate tax rates

In this chapter, a summary of the changes in the corporate tax rates is given, an analysis of corporate tax paid and revenue generation is made and international corporate tax rates are compared. The chapter concludes with an analysis of the effects of STC on the effective corporate tax rate.

### 10.1) Changes in the rate of corporate taxes

In determining the effective corporate tax rate, it is necessary to take account of two stages of corporate taxes. The first stage is the Normal Tax on corporate profits and the second is the taxation of dividends. Until the introduction of STC, the taxation of dividends, if any, was levied on the shareholders. STC is however payable by the corporation declaring the dividend, and is only payable by the shareholder indirectly through the necessary reduction of the amount of the dividend.

The effective rate of tax which corporations and their shareholders bear has increased significantly from the low rate of 7,5 per cent in 1914 when corporate taxes were initially introduced. Table 10.1 reveals that the effective rate has been declining over the past eight years since reaching a high of 66,7 per cent in the years 1985 to 1987. The total effective rate is currently 42,3 per cent.

**Table 10.1 - Effective corporate tax rates in South Africa: 1981 - 1996**

| Year (ending 28 February) | First stage % | Second stage % (effective) | Total rate % (effective) |
|---|---|---|---|
| 1981 | 42,0 | 19,3 | 61,3 |
| 1982 | 42,0 | 19,3 | 61,3 |
| 1983 | 46,2 | 17,9 | 64,1 |
| 1984 | 46,2 | 17,9 | 64,1 |
| 1985 | 50,0 | 16,7 | 66,7 |
| 1986 | 50,0 | 16,7 | 66,7 |
| 1987 | 50,0 | 16,7 | 66,7 |
| 1988 | 50,0 | 15,0 | 65,0 |
| 1989 | 50,0 | 15,0 | 65,0 |
| 1990 | 50,0 | 15,0 | 65,0 |
| 1991 | 50,0 | 0 | 50,0 |
| 1992 | 48,0 | 0 | 48,0 |
| 1993 | 48,0 | 0 | 48,0 |
| 1994 | 40,0 | 7,8 | 47,8 |
| 1995 | 35,0 | 13,0 | 48,0 |
| 1996 | 35,0 | 7,2 | 42,2 |

**Notes:**

1) Loan levies have been included as part of the tax rate despite the fact that they were repaid. They represented a cash outflow and have therefore been included for this reason.
2) The first stage relates to taxes on corporate profits, and the second stage to tax on dividends

*Source: Adapted from: 40% or 47.83% v 43%, Tax Planning vol. 8 (1994:34)*

The loan levies included in the above rates were effectively taxed through the erosion of inflation during the period of the loan, and the low rate of interest which was far below the real required rate of return.

### 10.2) Amount of corporate taxes paid and revenue generation

In most countries the amount of revenue generated by corporate taxes forms a significant portion of government revenue. South Africa is no exception and corporate taxes are a vital source of government revenue. Table 10.2 summarises the amounts of corporation income taxes collected in South Africa.

**Table 10.2 - Income tax revenue in South Africa**

| | 91/92 | 92/93 | 93/94 | 94/95 | 95/96 |
|---|---|---|---|---|---|
| **Source of Revenue** | | | | | |
| Company | 12 491 | 12 126 | 10 359 | 12 119 | 13 310 |
| STC | - | - | 877 | 1 440 | 1 760 |
| Mines | 1 572 | 997 | 1 131 | 1 943 | 2 298 |
| Individual | 29 935 | 33 791 | 37 786 | 44 763 | 49 755 |
| **Total Income Tax** | 43 998 | 46 914 | 50 153 | 60 265 | 67 123 |
| Indirect Taxes | 23 138 | 22 840 | 31 716 | 35 411 | 39 312 |
| Customs & Excise | 10 808 | 13 180 | 14 985 | 15 874 | 16 556 |
| Other Receipts | 809 | 1 143 | 1 406 | 1 | 1 200 |
| **Total Revenue** | 78 752 | 84 077 | 98 260 | 111 151 | 124 191 |
| **GDP** | 278 137 | 309 085 | 345 949 | 385 092 | 430 424 |

**Note:**

1) All amounts are in millions of Rand.
2) Figures extracted from Republic of South Africa Bulletin of Statistics and from the South African Budget Review.
3) The 1995/96 figures are figures estimated by the Department of Finance.

**Table 10.3 - Corporate tax and individual tax percentages**

1. The percentage of corporate taxes to:

| | 91/92 | 92/93 | 93/94 | 94/95 | 95/96 |
|---|---|---|---|---|---|
| **Total Income Tax** | 28,4 | 25,8 | 22,4 | 22,5 | 22,5 |
| **Total Revenue** | 15,9 | 14,4 | 11,4 | 12,2 | 12,1 |
| **GDP** | 4,5 | 3,9 | 3,2 | 3,5 | 3,5 |

2. The percentage of individual taxes to:

| | 91/92 | 92/93 | 93/94 | 94/95 | 95/96 |
|---|---|---|---|---|---|
| **Total Income Tax** | 68,0 | 72,0 | 75,3 | 74,3 | 74,2 |
| **Total Revenue** | 38,0 | 40,2 | 38,5 | 40,3 | 40,1 |
| **GDP** | 10,8 | 10,9 | 10,9 | 11,6 | 11,6 |

**Notes:**

1) In determining the percentage of corporate taxes to total income tax, total revenue and GDP, income taxes collected from mining companies has been excluded due to the special tax system related to their taxation. STC has however been included due to it being classified as a tax on companies.

A number of conclusions can be drawn from table 10.2 and table 10.3. It can be seen that the rand amount of corporate taxes collected has increased from 1991/92 to 1995/96. However this in itself is misleading. It can be seen that in comparison to 1991/92, in 1995/96 corporate taxes have made up a decreasing proportion of income tax revenue, total revenue and gross domestic product. The 1994/95 and 1995/96 proportions are fairly similar. Despite corporate taxes still contributing a significant amount of revenue, in the light of the above it could be concluded that corporate taxes are beginning to play a less significant role in terms of their contribution to government revenue.

The same cannot be said of individual taxes. In comparison to 1991/1992, in 1995/96 individual taxes have made up a larger proportion of income tax revenue, total revenue and gross domestic product. Therefore, in comparing individual and corporate taxes, corporate taxpayers are bearing a decreasing proportion of the total tax burden and are as such being taxed less heavily than individual taxpayers.

**10.3) International comparison**

International comparisons of corporation taxes is problematic. Many writers (for example Katz (1994) and Cope (1972)) have warned against the simplistic comparison of nominal tax rates, and that conclusions drawn from such comparisons should be treated with caution. Simplistic comparison of tax rates can be misleading due to the existence of different types of taxes, such as state and local taxes, differences in departmental practices, special incentives and allowances available in one country that are not available in others. The definition of taxable income may also vary significantly, for example by the inclusion or exclusion of capital gains.

To overcome the problems caused by simply comparing nominal tax rates, it has been suggested by many (for example Cope (1972)) that comparisons should be made by comparing the total tax burden in terms of revenue actually collected by the respective governments. The tax revenue collected is often expressed as a percentage of Gross National Product (GNP). Even though there are theoretical and practical difficulties in calculating GNP, expressing tax revenue as a percentage of GNP overcomes the need for currency conversion, and as such facilitates the making of comparisons between different countries (Cope 1972:61).

The Katz Commission was very concerned about the fact that the rate at which corporations were taxed in South Africa was high in comparison with other countries.

There was a basic rate of 35 per cent, a transitional levy of 5 per cent (which was only applicable for the year of assessment ending between 1 April 1994 and 31 March 1995), STC of 25 per cent and NRST of up to 15 per cent. As can be seen from table 10.4, this resulted in South African profits distributed to foreign investors being taxed at a combined tax rate of 59,2 per cent. The Commission considered that the only long-term solution would be to gradually bring the total corporate tax rate down to competitive levels. The Commission believed that in the interim it was important to soften the negative impact of the South African corporate tax burden on foreign investors.

**Table 10.4 - Combined corporate tax rate for foreign investors**

| | % |
|---|---|
| Taxable Income | 100,0 |
| Less: Normal Tax | |
| (35 % + 5% transitional levy) | 40,0 |
| | 60,0 |
| Less: STC | 12,0 |
| | 48,0 |
| NRST | 7,2 |
| Net Income after tax | 40,8 |
| Total Taxes | |
| (Normal Tax, STC and NRST | 59,2 |

The Katz Commission considered various solutions that would solve the problem of the high tax rate. Possibilities considered were adjusting the tax rates, adjusting the tax base, and the granting of incentives. The Commission believed that a solution to the high tax burden had to be found through adjusting the corporate tax rates. The Commission believed that general incentives to promote foreign investment were not appropriate as they would be more disruptive of the system as a whole.

In determining an appropriate tax rate for foreign investors the Commission considered that differentiating between foreign and domestic investor was not desirable. In the Commission's opinion, a more favourable tax rate for foreign investors would send a negative message to the domestic investor and business community and would bring about an undesirable competitive distortion. In the Commission's view any relief given to foreign investors needed to be through NRST.

With the levying of NRST, South Africa was in a fairly unique situation amongst competing developing economies in that non-resident equity investors were taxed at a comparatively higher rate than domestic equity investors. This was widely perceived as a tax disincentive. This and the fact that NRST increased the imbalance between debt and equity investment were the main considerations in the Commission's recommendations that relief be found in abolishing NRST.

The Commission gave consideration to possible ways of limiting the loss of revenue as a result of relief being granted from NRST. Two possibilities were considered. These were a reduction in the rate rather than the elimination of NRST, and the use of qualifying requirements for NRST relief.

The Commission favoured the use of qualifying requirements as it had the advantage of being able to target relief more effectively at committed investors rather than at mobile portfolio investment. The Commission recommended that companies with a required minimum investment of 25 per cent in the company be exempted from NRST on dividends received from that company. It was also recommended that the onus of proving qualification for relief from NRST should rest on the shareholder, and that individuals, regardless of their holding, should not qualify for the relief.

It seems strange that only corporate investors should qualify for exemption from NRST and the Commission's reasoning behind the recommendation that individuals should not qualify for relief was not clear. Fortunately the high rate of 59,2 per cent calculated in table 10.4 has already been reduced. The transitional levy of 5 per cent no longer applies, NRST was abolished on dividends declared after 1 October 1995 and STC has been reduced to 12,5 per cent. This has resulted in the total corporate tax rate decreasing to 42,3 per cent. An important consequence of the abolition of NRST, in addition to the lowering of the tax rate, is that foreign and local shareholders are taxed at the same rates on their corporate profits.

Tables 10.5 and 10.6 give a comparison of international corporate tax rates.

**Table 10.5 - Nominal corporate tax rates of South Africa and its major trading partners**

| Country | Nominal Rate 1996 [1] | Capital Gains Taxed |
|---|---|---|
| Belgium | 40,2 | Yes |
| France | 36,7 | Yes |
| Germany | 32,3 [1] | Yes |
| Italy | 53,2 | Yes |
| Netherlands | 35,0 | Yes |
| Taiwan | 25,0 | Yes |
| United Kingdom | 33,0 | Yes |
| United States | 42,8 | Yes |
| South Africa | 42,2 [2] | No |

*Notes*

[1] Significant local taxes have been included in the above nominal rates.
[2] Nominal rate on distributed profits

*Source: Adapted from Third interim report of the commission of inquiry into certain aspects of the tax structure of South Africa (Katz: 1995).*

**Table 10.6 - Nominal Corporate tax rates of countries with which South Africa competes for foreign capital**

| Country | Nominal Rate 1996 [1] | Capital Gains Taxed |
|---|---|---|
| Chile | 35,0 | Yes |
| China | 30,0 | Yes |
| Czech Republic | 39,0 | Yes |
| Korea | 32,3 | Yes |
| Malaysia | 30,0 | Yes |
| Mexico | 34,0 | Yes |
| Poland | 40,0 | Yes |
| Singapore | 27,0 | No |
| Thailand | 30,0 | Yes |
| South Africa | 42,2 | No |

*Notes*

1 Significant local taxes have been included in the above nominal rates.

*Source: Adapted from Third interim report of the commission of inquiry into certain aspects of the tax structure of South Africa (Katz: 1995).*

From tables 10.5 and 10.6, it can be seen that South Africa's nominal rate of taxation is comparatively high. With the exception of Italy and the United States (although the United States' nominal rate is only marginally higher than South Africa's), South Africa's nominal corporate rate is higher than its major trading partners' rates. The South African economy is in desperate need of foreign capital and a significant factor deterring foreign investment is the fact that the South African corporate tax rate is higher than any of the countries with which South Africa competes for foreign capital. It can be seen that the South African nominal corporate tax rate is still unacceptably high.

The caution expressed above regarding the simplistic comparison of nominal rates needs to be borne in mind. An example of this need is the fact that, with the exception of Singapore, all countries listed in tables have some form of capital gains tax whereas in South Africa capital gains are not subject to corporate taxes. The comparison of nominal corporate tax rates in the context of foreign investment is however important as preliminary decisions are often based on a simplistic comparison of nominal rates.

### 10.4) Effect of STC on corporate tax rates

The effect of STC in determining the rate of company tax paid (i.e. Normal Tax and STC), involves a number of factors. The effective rate of tax payable is dependent on the "net amount" of dividends paid. This results in each company having an unique rate of tax, and the rate of tax for each company can vary from period to period without there being a change in the basic rate of Normal Tax or STC. The net amount of dividends paid is dependent upon both the dividend declared and the amount of dividends received. In the case of minority holdings, the company has no control over dividends received, and it is debatable whether the directors of a company have absolute control over dividends declared. This leads to a large amount of uncertainty in determining future tax rates for the purposes of financial and managerial planning.

Complications arise in determining the effective rate of corporate taxes. It was stated above that the effective tax rate is dependent upon the net amount of dividends paid. Figure 10.1 calculates the effective tax rates under a number of different dividend policies, before the introduction of STC and for STC at 15 per cent, 25 per cent and 12,5 percent. In calculating the tax rates reflected in figure 10.1 it has been assumed that no dividends were received. This results in the effective rate being calculated in the "worst case scenario". Figure 10.2 reflects tax rates based on calculations taking into account the receipt of dividends making up different proportions of net income before tax.

A comparison between Figure 10.1 and Figure 10.2 indicates that the receipt of dividends has the effect of reducing the effective corporate tax rate. This is due to dividends received being deducted from dividends declared in determining STC, thereby reducing the effective rate. Furthermore, since dividends received are exempt from tax, the receipt of dividends does not increase the effective Normal Tax rate. The overall effect is thus a reduction in the total effective corporate tax paid. It is also evident that the greater the dividends received, the more dramatic the effect on the effective rates of tax. The effective rate of total tax will be reduced even further where dividend credits (resulting from dividends received exceeding dividends paid) from prior periods are utilised in the current period.

Figure 10.1 indicates that the effective corporate tax rate was lowered by the introduction of STC. The increase in the rate of STC to 25 per cent and decrease in Normal Tax rate to 35 per cent had the effect of reducing the effective corporate tax rate in comparison with the STC and Normal Tax rates of 15 per cent and 40 per cent respectively. The reason for this is that since the introduction of STC and reduction in Normal Tax rates, undistributed profits have been taxed at a lower rate than before, and the total taxes born by distributed profits, namely 48 per cent, is the same as before. The result is that companies who do not receive any dividend income, have benefited from the reductions in the Normal Tax rates from 48 per cent to 40 per cent and then to 35 per cent despite the implementation of STC at 15 per cent and its subsequent increase to 25 per cent. It is obvious that the decrease in the STC rate to 12,5 per cent has decreased the effective corporate tax rate.

**Figure 10.1 - Effective tax rates (No dividends received)**

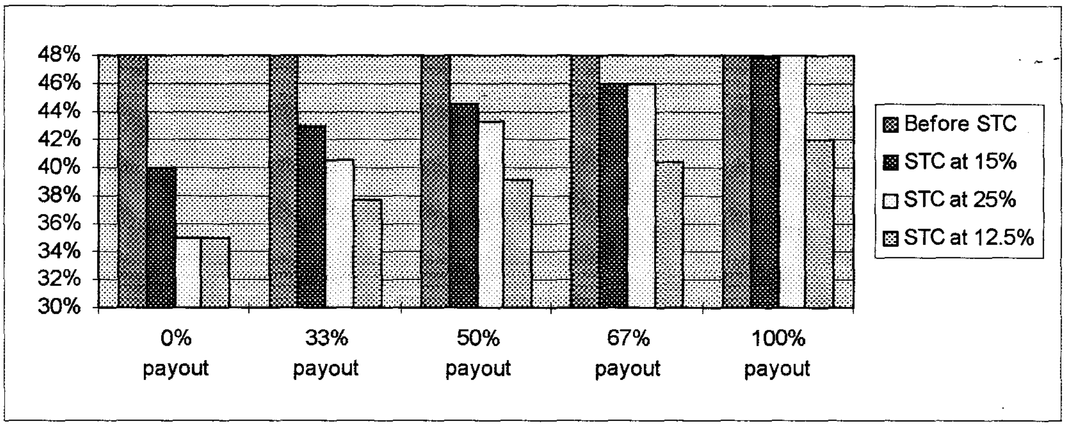
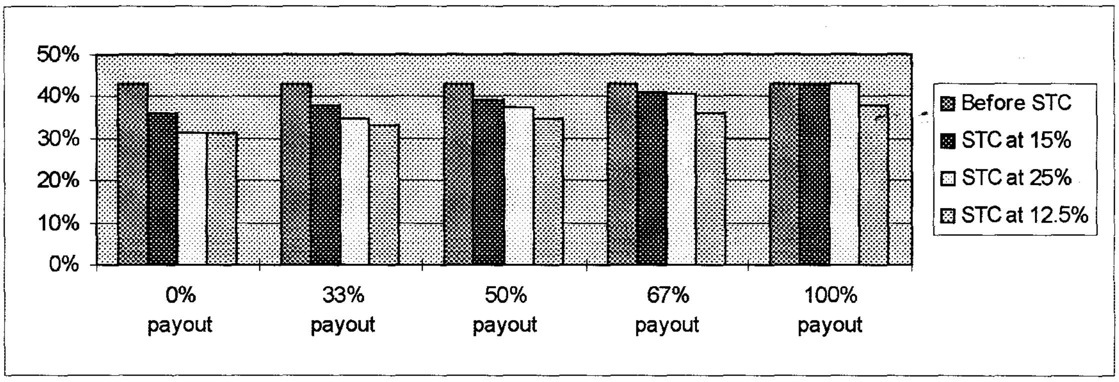
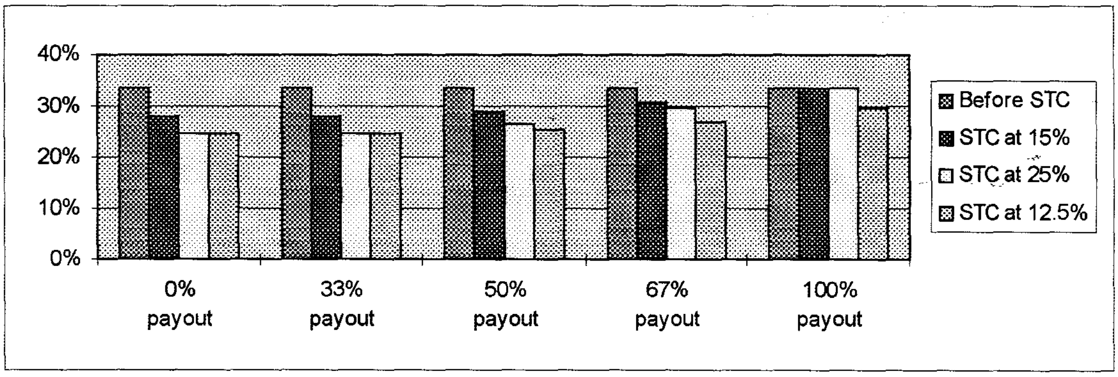


**Figure 10.2 - Effective tax rates (Dividends received)**

1. Dividends received = 10% of Net Income Before Tax:




2. Dividends received = 30% of Net Income Before Tax:




3. Dividends received = 80% of Net Income Before Tax:

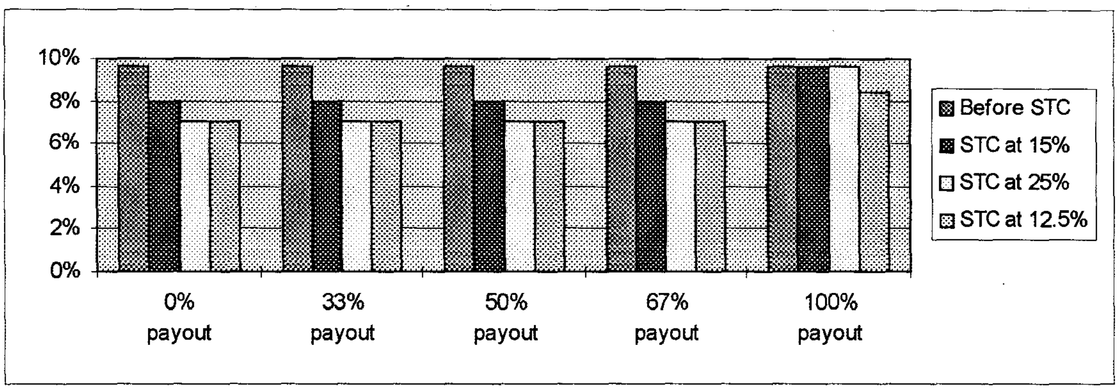



Figure 10.2 however reveals a slightly different situation. Before the reduction in the STC rate to 12,5 per cent, companies only benefited from a lower effective corporate tax rate

where they did not declare all of their after tax profits as dividends. Most companies however distribute a relatively small percentage of their profits, and it would be reasonable to assume that most companies benefited from a lower effective tax rate. With the latest reduction in the STC rate to 12,5 per cent, all companies, irrespective of the proportion of profits distributed, benefit from a lower effective rate.

It was stated above that one of the purposes of introducing STC was to help finance the loss of revenue as a result of the reduction in the Normal Tax rate from 48 per cent to 40 per cent (and to 35 per cent in the following year). From the above discussion it is evident that in most situations, since the introduction of STC, companies have benefited from a lower effective corporate tax rate. Despite this, the levying of STC would have alleviated the loss of revenue resulting from the reduction of the Normal Tax rate. It is interesting to note that table 10.3) reveals that since the introduction of STC the proportion of corporate taxes to total income tax revenue, total revenue and GDP.

Since it has been noted that the effective corporate tax rate has decreased since the implementation of STC, it is possible to conclude that from a corporate perspective, companies have benefited from the introduction of STC.

**10.5) Summary**

The total effective tax, including Normal Tax on corporate income and the tax borne by dividends, increased steadily from the low rate of 7,5 per cent in 1914 to a high of 66,7 per cent in 1985 to 1987. The effective rate has decreased from this to its present rate of 42,2 per cent. In South Africa, corporate taxes collected have made up a decreasing proportion of total income taxes, total revenue and GDP, while individual taxes have made up a larger proportion of total income taxes, total revenue and GDP.

The South African nominal corporate tax rate is unacceptably high in comparison with other countries. One of the reasons for the introduction of STC was to make a lower nominal corporate tax rate possible. A theoretical analysis of effective corporate tax rates under varying conditions indicates that the effective corporate tax rate has in fact been lowered since the introduction of STC. From the corporate perspective, it is therefore possible to conclude that corporations have benefited from the implementation of STC.

# Chapter Eleven

# An alternative system to replace STC

This chapter suggests and discusses an alternative system which could replace STC.

### 11.1) Introduction

In chapters eight and nine it was concluded that STC resulted in group reinvestment being inhibited and that it was the major cause of the lack of neutrality in the South African corporate tax system. As a result of these problems, the need to find an alternative system to replace STC becomes clear. This need, as discussed in chapter eight, was recognised by the Katz Commission in its first and third interim reports.

As stated in chapter seven, the Katz Commission was in principle in favour of moving towards some form of imputation. However they believed that it was not possible for an imputation system to be implemented in South Africa at that stage because such a system would have increased the administrative burden and complexity of the tax system. The Commission (1995:94) recommended continued research into alternative systems to replace STC. In this chapter an imputation system for South Africa will be suggested that would not result in prohibitive administrative burdens or increased complexity.

### 11.2) Conceptual arguments in favour of imputation systems

The Katz Commission recognised the following reasons for theorists' preference for an imputation system:

(a) it recognises that only individuals ultimately carry a tax burden;

(b) it treats the company as merely the vehicle for generating the earnings of individual shareholders and paying tax on a provisional basis, on their behalf;

(c) in its purest form, it allows even corporate earnings to be taxed at progressive personal rates rather than at a flat corporate rate;

(d) in attaching tax consequences to the variable characteristics of individual shareholders, it is seen as more equitable;

(e) it avoids economic double taxation; and

(f) it has other perceived economic advantages, such as enhancing neutrality with regard to investors' portfolio decisions or corporate funding. (1995:84)

### 11.3) Full imputation versus partial imputation systems

In the South African context, it could be tempting to argue that a partial imputation system would be a more appropriate alternative for STC than a full imputation system. The implementation of a partial imputation system would limit the loss of revenue resulting from imputing tax credits to shareholders. The disadvantages of partial imputation systems however outweigh the advantage of a limited loss of revenue.

It has been argued that partial imputation systems result in increased administrative complexity of the tax system (Katz, 1995:87). In addition to this, partial imputation systems still result in a lack of neutrality between organisational forms, corporate capital structure and distribution of profits occurring. Due to a lack of neutrality still remaining, the implementation of a partial imputation system in South Africa as an alternative to STC would be pointless. It is therefore suggested that a full imputation system be implemented in South Africa.

### 11.4) Corporate tax rates

An essential feature of the suggested imputation system is the rate at which companies would be taxed. As stated in chapter four, differences between corporate tax rates and individual maximum marginal rates result in the lack of neutrality between organisational forms, corporate capital structure and the distribution of profits. It is therefore essential for the corporate tax rate to equal the maximum individual marginal rate if the suggested system is to result in complete neutrality.

Gavin (1997) noted that there were several common themes running through the tax reforms in many countries. These included closing the gap between company and maximum individual marginal tax rates. It would therefore not be out of line for the suggested imputation system to close the large gap between corporate and maximum individual marginal rates.

The application of this principle to the suggested imputation system would result in a dramatic change to the current tax rates. This is evident if the basic corporate tax rate of 35 per cent is compared to the maximum individual marginal rate of 45 per cent. Possible options are for an increase in the Normal Tax rate, a decrease in the maximum individual marginal rate or for an increase in the corporate rate coupled with a decrease in the maximum individual marginal rate. It is unlikely the South African Treasury could afford a dramatic decrease in the maximum marginal rate from 45 per cent to 35 per cent.

The Katz Commission (1995:90) was against increasing the corporate Normal Tax rate. The Commission did not agree with submissions that the Normal Tax rate be increased to 40 per cent so that the STC rate could be reduced to below 15 per cent. It believed that this would be a move against the reduction of the total corporate tax rate which it believed was necessary. Furthermore, it believed that an increase in the corporate Normal Tax rate would send a negative message to foreign investors. This was however in the context of the combined basic corporate and STC rate, and in the context of an imputation system, companies would not be subject to the payment of STC. The increase in the basic corporate rate would thus not necessarily result in an increase in the total corporate tax burden. Therefore, as long as the increase was not excessive, the corporate Normal Tax rate could be increased despite the Katz Commission's argument against an increase in the Normal Tax rate.

In the context of the South African Treasury not being able to afford a dramatic decrease in the maximum marginal tax rate, and due to the ability to increase the corporate Normal Tax rate slightly due to STC not being payable, it is suggested that a slight increase in the corporate Normal Tax rate coupled with a decrease in the maximum individual marginal rate would be the most appropriate alternative.

Gavin (1995) suggested that the taxation of both companies and individuals should be on the basis of a flat-rate tax. He suggested a flat rate of 40 per cent, with a threshold of R14 000 (Gavin 1997). The adoption of a flat-rate individual tax in South Africa would result in a major change to the individual tax structure. As it is thus possible that a flat-rate tax would be rejected, the suggested imputation system will initially be discussed assuming that the 40 per cent rate applies to the maximum individual marginal rate. However, if the flat-rate tax suggested by Gavin was adopted it would enable the suggested system to be simplified to a large extent. The simplifications which would be possible are discussed in 11.7) below. The choice of a rate of 40 per cent would result in a reasonable decrease in the maximum individual marginal rate whilst not being an excessive increase in the corporate rate.

**11.5) The mechanics of the suggested imputation system**

1. Rate of imputation

It was suggested above that a full imputation system should be implemented in South Africa. It was further suggested that an appropriate corporate Normal Tax rate would be 40 per cent. In the light of this, the suggested imputation system would provide for a tax credit of $^{40}/_{60}$ to be attached to dividends received by shareholders. This would result in shareholders receiving full credit for Normal Tax paid by companies. In line with the nature of imputation systems, the tax credit would be available for set-off against the shareholder's final tax liability.

## 2. Excess tax credits

The situation may arise where the tax credit attached to a dividend exceeds the total shareholder's tax liability. In this situation it would be necessary for the suggested system to provide for an appropriate treatment of the excess tax credit over the total tax liability. Four possible options for the treatment of the excess are considered, namely a refund of the excess, for the excess to simply fall away, a carry-back of the excess to prior tax periods or a carry-over of the excess to following tax periods.

The most equitable option would be for the excess tax credit to be refunded to the shareholder. The refund of the excess would recognise that the shareholder in this circumstance has a poor ability to pay taxes, and would provide him with immediate relief for high corporate taxes paid on the dividend received by him. The major disadvantage of this option would be the increased administrative burden resulting from cash refunds having to be made.

The option of excess tax credits simply falling away would be the least equitable option. This does not recognise the fact that the shareholder in this situation has a poor ability to pay taxes as it results in the shareholder paying the same rate of tax on dividends as a shareholder with a large income. The advantage of this option is that no refunds would have to be made or records kept of credits carried forward. This would thus not result in administrative complexities or burdens.

The option of excess tax credits being carried back to prior tax periods would have a similar effect to the refund system, as the shareholder would have to receive a refund of the excess if he had already been assessed in the prior years. This option has thus the same disadvantage of an increased administrative burden. It could be possible to limit the carry-back to periods for which the shareholder has not been assessed and for which the carry-back would not result in the necessity of a refund of tax already paid. It is however suggested that this would unnecessarily complicate the tax system.

The option of excess credits being carried forward to the following tax period does recognise, to a certain extent, shareholders' different abilities to pay taxes. A poor ability to pay taxes is recognised through the benefit of the excess credit being able to be utilised in future tax periods. This will however not be the case where a shareholder's total tax liability is always less than tax credits attached to dividends received. However it is suggested that the incidence of this would be low. Despite this option resulting in a larger administrative burden than the option of excess credits falling away, due to records having to be kept of excess credits carried forward, it would result in less of an administrative burden than the refund of excess credits. The carry-forward of excess burdens thus results in a suitable compromise between equity and administrative burden. It is therefore suggested that excess tax credits be carried forward to future tax periods.

## 3. Imputation and tax exhaustion

As described in chapter three, a problem with imputation systems arises where tax exhaustion occurs. Since no corporation tax has actually been paid in this situation, shareholders receive a tax credit for tax that has not been paid. This will lead to a large loss of revenue. This is why UK ACT is payable when dividends are paid.

The Australian and New Zealand systems of maintaining franking and imputation credit accounts was discussed in chapter three. These systems result in the credit associated with the dividend being limited to the effective rate of corporate tax paid. Each dividend paid could therefore have a different credit associated with it. These systems result in large administrative burdens and large compliance costs on companies due to their complexity. Therefore, even though they overcome the problem arising from tax exhaustion they could not be implemented in South Africa.

Another system which overcomes the problem caused by tax exhaustion is the United Kingdom's ACT system. As described in chapter three, when a company pays a dividend it is required to make an advance payment of tax which is equal to the tax credit that will be granted to shareholders.

The ACT system may initially also appear to be complex and result in administrative burdens. However since the rate at which corporate taxes are imputed to shareholders is the same rate at which ACT is payable, ACT does not need to be treated as a withholding tax. It is not necessary for companies to provide revenue officials with details of ACT paid on dividends to each shareholders as is the case with withholding taxes. Furthermore, if ACT is compared to STC it becomes evident that if a system similar to ACT was introduced in South Africa it would not result in any significant additional administrative burdens, compliance costs or complexity. The suggested imputation system will therefore provide for the payment of ACT (the UK term ACT will be used in the remainder of the chapter for convenience). The conversion of STC into ACT is discussed in 11.6) below.

It is necessary to determine the rate at which ACT would be payable. The UK ACT rate is equivalent to the rate of the tax credit to dividend with which it is attached. If a rate of $^{40}/_{60}$ was prescribed in South Africa, it is likely that the business community would consider this excessive and it could create the impression that STC was merely being increased to 40 per cent. This would result in a large amount of resistance to the suggested system. However it should be noted that ACT is part of Normal Tax whereas STC is a tax in addition to Normal Tax.

If ACT was payable at a rate of less than $^{40}/_{60}$, shareholders could receive a tax credit for corporate taxes that have not been paid. This is precisely the situation that ACT would seek to avoid. It is acknowledged that the receipt of tax credits for corporate taxes that had not been paid would occur to a lesser extent than if no ACT had been paid at all. Furthermore, if a rate of $^{40}/_{60}$ was not prescribed, it could result in the purpose of the ACT system not being understood due to a difference between the rate of imputation and the rate at which ACT would be payable.

If a rate of $^{40}/_{60}$ was prescribed, the possibility of abolishing provisional tax payments could be considered. Currently companies are required to make two provisional tax payments during the year (with an optional third payment). Since most companies declare interim and final dividends, the payment of ACT would have a similar effect as the payment of provisional tax. The option of provisional tax payments would help in decreasing the administrative burden of the suggested system, and would lessen the resistance to the payment of ACT at a rate of $^{40}/_{60}$. A rate of $^{40}/_{60}$ is therefore suggested.

The payment of ACT at a rate of $^{40}/_{60}$ will also have the benefit of acting as a minimum tax on all companies distributing dividends. This would help reduce the loss of revenue arising from abolishing STC and the reduction of the maximum personal marginal tax rate from 45 to 40 per cent. The ability to pay dividends should be considered to be an indication of the ability to pay taxes. It would therefore be equitable for companies who could pay dividends to be subject to a minimum tax even if they do not have any taxable income.

4. <u>Group relief from the payment of ACT</u>

In chapter eight it was concluded that STC resulted in an inhibition of group reinvestment. This was considered to be a major defect in the tax system. It is therefore necessary for the suggested imputation system to provide for group relief from the payment of ACT.

The UK imputation system provides for group relief where there is a 51 per cent or greater shareholding. In terms of these provisions a parent company and a subsidiary can jointly elect that the subsidiary will pay dividends to the parent without accounting for ACT. Both companies are required to be resident in the UK. The election may also be made by fellow subsidiaries. (Bertram, 1988:441).

It would be possible for the suggested imputation system to provide for similar relief. It is important that relief be allowed from a 51 per cent shareholding upward in order to ensure that group reinvestment is not inhibited. The definition of a subsidiary could therefore be based on the company law definition. It is suggested that the election of group relief be optional. The election of not accounting for ACT would result in the parent companies not obtaining a tax credit for dividends received from group subsidiaries.

5. Dividends paid to corporate shareholders

It is suggested that tax credits associated with dividends received by corporate shareholders should be allowed to be set-off against ACT payable on the declaration of a dividend. The reason behind this suggestion is that since ACT has already been paid, it would be equitable for a corporate shareholder to receive the cash flow benefit of the ACT paid (in the form of the tax credit) on dividends received in determining the ACT payable on dividends declared by it. This would be as an alternative to the shareholder only receiving the benefit of the tax credit when paying its Normal Tax liability.

6. Dividends paid to tax exempt shareholders

Imputation systems often have special provisions for recipients of dividends that are exempt from corporate taxes. An example is the UK imputation system which provides for the refund of tax credits attached to dividends received by exempt shareholders. In South Africa most corporate shareholders who are exempt from Normal Tax are pension, retirement annuity and provident funds. The large size of the retirement industry was recognised by the Katz Commission (1995). It is therefore necessary for cognisance to be taken of the retirement industry in suggesting an imputation system for South Africa.

A number of options for the treatment of these tax credits exist. The credits could be passed onto to the retirement funds' beneficiaries or could fall away. The option of the credits passing on to beneficiaries would increase the complexity and administrative burden of the suggested imputation system. It would be necessary to apportion each fund's dividend income between each beneficiary so that a portion of the tax credit can be passed on to beneficiaries. The increased complexity and administrative burden becomes clear. Even though this option recognises that retirement funds are merely a vehicle used by beneficiaries to secure a future income, the administrative burdens and complexity prohibit the suggestion of this option.

The special tax treatment received by the retirement industry has enabled the industry to gain considerable control over the South African economy. The undesirability of the industry's special tax treatment was recognised by the Margo (1987) and Katz (1994, 1995) Commissions. It is therefore suggested that the industry should not benefit from the refund of tax credits but that these credits should fall away. An advantage of the credits falling away is that it would act as a tax, which would not be excessive, on the industry without the need for implementing a special tax such as the 30 per cent tax on retirement fund trade income as recommended by the Katz Commission (1995:78). The falling away of the tax credits would be a simpler form of taxation and would result in less administrative burdens than a tax on retirement fund income.

## 7. <u>Dividends paid to foreign shareholders</u>

Special provisions are necessary for dividends received by foreign shareholders. It is likely that most foreign shareholders would have a small South African tax liability. This would result in the large accumulation of excess tax credits, and it is unlikely that shareholders will ever benefit from these credits. It is therefore suggested that dividends received by foreign shareholders should be exempt from tax in South Africa. The tax credits attached to dividends received would then simply fall away. This would have the advantage of simplifying the administration of the South African tax system with regards to foreign shareholders. This would also be consistent with the UK imputation system.

### 11.6) The conversion of STC into an ACT system

The basic mechanics of STC and the UK's ACT are very similar. It is therefore suggested that the STC system be converted into an ACT system that would be appropriate for South Africa. This would decrease the administrative burden and complexity of the suggested imputation system as both Revenue authorities and corporate taxpayers are familiar with STC.

As with the present STC system, whenever a company declares a dividend it would be required to make a tax payment to the Revenue Service. Unlike STC, which is a final tax, this payment would be an advance payment of tax which would be available for set-off against the company's final tax liability.

1. <u>The "net amount" of a dividend declared</u>

It was suggested above that corporate shareholders should be allowed to set-off tax credits received against their own ACT liability. The STC system operates in a similar way by providing for STC to be paid on the "net amount" of the dividend declared, i.e. dividends declared less dividends received. Where dividends received exceed dividends declared the excess is carried forward to the following "dividend cycle". If the concept of ACT being payable on the net amount of a dividend declared was to be retained in the suggested imputation system, corporate shareholders would receive the benefit of setting off tax credits received against their ACT liability. This is as a result of ACT being payable on the net amount of the dividend declared.

The situation could arise where tax credits received exceed the ACT liability. Possible options for the treatment of this excess are similar to those discussed for excess tax credits in 2. above. However, the excess in this context refers to the excess of tax credits over ACT and not over the final tax liability. The options discussed in 2. above were a refund of the excess tax credits, a carry-back of the excess to prior tax periods, a carry-over of the excess to following tax periods, or for the excess to fall away.

In discussing the excess tax credits over the shareholder's own ACT liability it is appropriate to amend the options of a carry-back to prior periods and of a carry-over to following tax periods to provide for a carry-back of excess tax credits to prior dividend cycles and a carry forward of the excess to following dividend cycles. These amendments are appropriate as a company may have a number of dividend declarations within one tax period. It would thus be equitable for the set-off of the excess against a dividend declared in the same tax period to be allowed. In addition to the options discussed in 2. above, a further option is for the excess to be set-off against the shareholder's final tax liability.

The refund of excess credits, the carry-back of excess credits to prior dividend cycles and the falling away of excess credits can be rejected for the same reasons as discussed in 2. above. It is therefore suggested that the option of a carry-over to following dividend cycles be adopted. It is however suggested that this option contain a proviso that any excess tax credits over ACT payable should be available for set-off against the shareholder's final tax liability. If any excess still remained after the set-off against the final tax liability, this excess should be carried over to following dividend cycles.

2. <u>Group relief provisions</u>

With the adoption of the group relief suggested in 4. above, it would be necessary for Section 64B to be amended to provide for this relief. Even though this would result in increasing the administrative burdens and complexity, it would enable the existing group relief provisions contained in Section 64B, which are in themselves complex, to be abolished. There would thus only be a slight increase in complexity and administrative burden.

3. Anti-avoidance

It is suggested that the anti-avoidance provisions of Section 64C be retained in their present form to prevent the avoidance of the payment of ACT.

In chapter seven the use of capitalisation issues and bonus issues was discussed as a means of avoiding STC. It is suggested that the dividend definition be amended so that capitalisation issues and bonus issues are included in the definition. This will prevent the abuse of capitalisation and bonus issues and will increase the amount of ACT received by the Revenue Service. This would be in line with the Australian dividend definition which includes capitalisation and bonus issues (Waincymer, 1993:441)

**11.7) The impact of a flat-rate individual tax**

In 11.4) above, it was stated that if a flat-rate individual tax was adopted in South Africa the suggested system could be simplified to a large extent. Where income excluding dividends equals or exceeds the tax threshold, the individual tax payable on dividends would exactly equal the tax credit attached to the dividends. This would be as a result of the rate at which dividends would be subject to individual tax being equal to the rate at which corporate taxes would be imputed to shareholders. Including dividends received in shareholders' taxable income and providing for a tax credit would therefore be pointless. Excluding dividends from individual tax would result in companies paying tax on behalf of shareholders and would have the same effect as including dividends in shareholders' income and imputing corporate taxes to the shareholders. It would therefore be possible for dividends to be excluded from shareholders' income and for corporate taxes not to be imputed to shareholders.

There would only be one circumstance where imputing corporate taxes to shareholders would have any noticeable effect. This would be where a shareholder's taxable income, excluding dividends, was less than the tax threshold. In this situation all, or part, of dividends received would fall within the tax threshold. The shareholder would not be liable for individual taxes on the portion of the dividend falling below the tax threshold. This portion of the dividend would however have been subject to corporate taxes, and an excess tax credit would thus arise. If the total income, i.e. including dividends, was less than the tax threshold then the excess would equal the full tax credit. Where total income exceeds the threshold, the excess would be equal to the tax rate multiplied by the difference between the threshold and income excluding dividends.

As an example to illustrate the above situation, assume that a shareholder who has an income, excluding dividends, of R13 000 receives a dividend of R3 000. Further assume the tax rate of 40 per cent and tax threshold of R14 000 suggested by Gavin (1997). There would be a tax credit of R2 000 (R3 000 x $^{40}/_{60}$) attached to the dividend. The grossed up dividend of R5 000 would be added to the income of R13 000 to obtain a total income of R18 000. The threshold of R14 000 would be deducted from total income to obtain a taxable income of R4 000. The shareholder's individual tax liability would therefore be R1 600 (R4 000 x 40 per cent). The shareholder would however receive a tax credit of R2 000 and thus an excess credit of R400 (R2 000 - R1 600) arises. The excess credit could also be calculated as R1 000 (R14 000 - R13 000) x 40 per cent.

The likelihood of a shareholder's income, excluding dividends, not exceeding the tax threshold is remote. It is thus suggested that the incidence of excess credits arising would be very low. If this situation was disregarded, it would be possible for the suggested system not to provide for corporate taxes to be imputed to shareholders. This would result in a number of changes to the system suggested above being able to be made. None of the features discussed in 11.5) and 11.6) above would be necessary and the whole of the STC system could be abolished. The resultant simplification of the suggested system is evident.

If the situation mentioned above of a shareholder's income, excluding dividends, not exceeding the tax threshold was to be taken into account, it would be necessary for the suggested system to still provide for corporate taxes to be imputed to the shareholder and to provide him with relief for the excess credit. The simplification of the system would thus not be possible. Forfeiting this simplification for this unlikely situation is thus not justified.

Instead of the suggested system being a full imputation system, it could now be classified as a dividend exclusion system. Since the corporate and individual tax rates would always be equal, the lack of neutrality between corporate and non corporate forms, between debt and equity and between distributed and retained profits would not occur. The dividend exclusion system and the reasons for the lack of neutrality not occurring was discussed in 4.3).

**11.8) Summary**

In this chapter an imputation system for South Africa was suggested. As a result of the lack of neutrality caused by partial imputation systems, a full imputation system was suggested. It was suggested that the corporate tax rate and maximum individual marginal tax rate should be equal. This was also motivated by the need to ensure neutrality. A rate of 40 per cent was considered a fair compromise between the option of an excessive corporate tax rate increase and a massive decrease in the maximum individual marginal rate.

In order to prevent tax credits being granted to shareholders for corporate taxes that had not been paid, it was suggested that a system similar to the UK's ACT be adopted in South Africa. Due to the similarities in the mechanics of STC and ACT systems, it was suggested that the STC system be converted into an ACT system. This would lessen the administrative burden and complexity of the suggested system.

If a flat-rate individual tax was adopted it would enable the full imputation system suggested to be simplified into a dividend exclusion system. Due to the corporate and individual tax rates always being equal, a lack of neutrality would not arise.

# Chapter Twelve

# Conclusion

Irrespective of various theories developed to justify corporations being taxed, it is possible to conclude that corporate taxes should continue to exist due to Colm's (1940) cynical rule of taxation. This rule states that corporate taxes are well established in practice and produce large amounts of revenue which would be difficult to raise from alternative sources.

In order to ensure that corporate taxes are neutral, various dividend relief systems, a comprehensive business income tax and various forms of integrating corporate and individual taxes have been suggested. It can however be concluded that for corporate taxes to be neutral it is necessary for there to be no double taxation of dividends and for the corporate tax rate to equal the maximum individual marginal tax rate.

From a theoretical analysis and comparison of effective corporate tax rates before and after the introduction of STC, it is possible to conclude that the effective corporate tax rate has decreased since the introduction of STC. However, in comparison to other countries, the South African nominal corporate tax rate is unacceptably high. As a result of STC being a major cause of the South African corporate tax not being neutral and due to it causing an inhibition on group reinvestment, the need to replace STC with an alternative system arises.

The Katz Commission (1995) believed that the implementation of an imputation system to replace STC would not be possible in South Africa due to increased administrative burdens and complexity in the tax system. Despite this belief, the implementation of the full imputation system suggested in chapter eleven would not result in prohibitive administrative burdens or complexity. It can thus be concluded that a full imputation system could be implemented in South Africa as an alternative system to STC.

If a flat-rate individual tax was implemented in South Africa, it would be possible for a dividend exclusion system to be implemented instead of the suggested full imputation system. As a result of the corporate and individual tax rates always being equal, the dividend exclusion system would not cause a lack of neutrality to arise. The dividend exclusion system would be a simpler system than the full imputation system.

# Appendix 1

# Calculation of effective corporate tax rate

# - no dividends received.

This appendix contains the calculation of the effective corporate tax rate assuming a 0%, 33%, 67% and 100% dividend payout. The effective rate is calculated before STC was introduced, STC at 15%, 25% and 12,5%. In each calculation it is assumed that no dividends have been received.

The effective rates calculated below were the rates used in Figure 10.1.

1. 0% Dividend Payout:

| | Before STC was introduced | STC at 15% | STC at 25% | STC at 12,5% |
|---|---|---|---|---|
| Net income before tax | 100 | 100 | 100 | 100 |
| Normal Tax | 48 | 40 | 35 | 35 |
| Dividend declared | - | - | - | - |
| STC | - | - | - | - |
| Effective tax rate (Normal Tax plus STC) | 48% | 40% | 35% | 35% |

2. 33% Dividend Payout:

| | Before STC was introduced | STC at 15% | STC at 25% | STC at 12,5% |
|---|---|---|---|---|
| Net income before tax | 100 | 100 | 100 | 100 |
| Normal Tax | 48 | 40 | 35 | 35 |
| Dividend declared | 17 | 20 | 22 | 22 |
| STC | - | 3 | 5,5 | 2,8 |
| Effective tax rate (Normal Tax plus STC) | 48% | 43% | 40,5% | 37,8% |

3. 50% Dividend Payout:

| | Before STC was introduced | STC at 15% | STC at 25% | STC at 12,5% |
|---|---|---|---|---|
| Net income before tax | 100 | 100 | 100 | 100 |
| Normal Tax | 48 | 40 | 35 | 35 |
| Dividend declared. | 26 | 30 | 33 | 33 |
| STC | - | 4,5 | 8,3 | 4,1 |
| Effective tax rate (Normal Tax plus STC) | 48% | 44,5% | 43,3% | 39,1% |

4. 67% Dividend Payout:

| | Before STC was introduced | STC at 15% | STC at 25% | STC at 12,5% |
|---|---|---|---|---|
| Net income before tax | 100 | 100 | 100 | 100 |
| Normal Tax | 48 | 40 | 35 | 35 |
| Dividend declared | 35 | 40 | 43 | 43 |
| STC | - | 6 | 11 | 5,4 |
| Effective tax rate (Normal Tax plus STC) | 48% | 46% | 46% | 40,4% |

5. 100% Dividend Payout:

| | Before STC was introduced | STC at 15% | STC at 25% | STC at 12,5% |
|---|---|---|---|---|
| Net income before tax | 100 | 100 | 100 | 100 |
| Normal Tax | 48 | 40 | 35 | 35 |
| Dividend declared[1] | 52 | 52,2 | 52 | 57,8 |
| STC | - | 7,8 | 13 | 7,2 |
| Effective tax rate (Normal Tax plus STC) | 48% | 47,8% | 48% | 42,2% |

1 The dividend declared is calculated as:

$$\frac{\text{Net income after tax}}{1 + \text{rate of STC}}$$

# Appendix 2

# Calculation of effective corporate tax rate

# - dividends received.

This appendix contains the calculation of the effective corporate tax rate when a corporate income includes dividends received. The effective rate is calculated based on dividends received making up 10 %, 30% and 80% of Net Income Before Tax and assuming a 0%, 33%, 67% and 100% dividend payout. The effective rate is calculated for before STC was introduced, STC at 15%, 25% and 12,5%. Where dividends received in the year of assessment exceed dividend declared in that year, a STC credit will be carried forward to the following year. This will have the effect of reducing the effective corporate tax rate in the following year.

The effective rates calculated below were the rates used in Figure 10.2.

1. <u>0% Dividend Payout:</u>

| | Before STC | | | STC at 15% | | |
|---|---|---|---|---|---|---|
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 43,2 | 33,6 | 9,6 | 36 | 28 | 8 |
| Dividend declared | - | - | - | - | - | - |
| STC | - | - | - | - | - | - |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 36,0% | 28,0% | 8,0% |
| | **STC at 25%** | | | **STC at 12,5%** | | |
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 31,5 | 24,5 | 7 | 31,5 | 24,5 | 7 |
| Dividend declared | - | - | - | - | - | - |
| STC | - | - | - | - | - | - |
| Effective tax (Normal Tax plus STC) | 31,5% | 24,5% | 7,0% | 31,5% | 24,5% | 7,0% |

2. <u>33% Dividend Payout:</u>

| | Before STC | | | STC at 15% | | |
|---|---|---|---|---|---|---|
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 43,2 | 33,6 | 9,6 | 36 | 28 | 8 |
| Dividend declared | 19 | 22 | 30 | 21 | 24 | 31 |
| STC | - | - | - | 1,7 | 0 | 0 |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 37,7% | 28,0% | 8,0% |
| | **STC at 25%** | | | **STC at 12,5%** | | |
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 31,5 | 24,5 | 7 | 31,5 | 24,5 | 7 |
| Dividend declared | 23 | 25 | 31 | 23 | 25 | 31 |
| STC | 3,3 | 0 | 0 | 1,6 | 0 | 0 |
| Effective tax (Normal Tax plus STC) | 34,8% | 24,5% | 7,0% | 33,1% | 24,5% | 7,0% |

3. <u>50% Dividend Payout:</u>

| | Before STC | | | STC at 15% | | |
|---|---|---|---|---|---|---|
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 43,2 | 33,6 | 9,6 | 36 | 28 | 8 |
| Dividend declared | 28 | 33 | 45 | 32 | 36 | 46 |
| STC | - | - | - | 3,3 | 0,9 | 0 |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 39,3% | 28,9% | 8,0% |
| | STC at 25% | | | STC at 12,5% | | |
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 31,5 | 24,5 | 7 | 31,5 | 24,5 | 7 |
| Dividend declared | 34 | 38 | 47 | 34 | 38 | 47 |
| STC | 6,0 | 2,0 | 0,0 | 3,0 | 1,0 | 0 |
| Effective tax (Normal Tax plus STC) | 37,5% | 26,5% | 7,0% | 34,5% | 25,5% | 7,0% |

4. <u>67% Dividend Payout:</u>

| | Before STC | | | STC at 15% | | |
|---|---|---|---|---|---|---|
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 43,2 | 33,6 | 9,6 | 36 | 28 | 8 |
| Dividend declared | 38 | 44 | 60 | 43 | 48 | 61 |
| STC | - | - | - | 5 | 2,7 | 0 |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 41,0% | 30,7% | 8,0% |
| | STC at 25% | | | STC at 12,5% | | |
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 31,5 | 24,5 | 7 | 31,5 | 24,5 | 7 |
| Dividend declared | 46 | 50 | 62 | 46 | 50 | 62 |
| STC | 9,0 | 5 | 0 | 4,5 | 2,5 | 0 |
| Effective tax (Normal Tax plus STC) | 40,5% | 29,6% | 7,0% | 36,0% | 27,0% | 7,0% |

5. 100% Dividend Payout:

| | Before STC | | | STC at 15% | | |
|---|---|---|---|---|---|---|
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 43,2 | 33,6 | 9,6 | 36 | 28 | 8 |
| Dividend declared[1] | 56,8 | 66,4 | 90,4 | 57 | 66,5 | 90,4 |
| STC | - | - | - | 7 | 5,5 | 1,6 |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 43% | 33,5% | 9,6% |
| | **STC at 25%** | | | **STC at 12,5%** | | |
| Operating income | 90 | 70 | 20 | 90 | 70 | 20 |
| Dividends received | 10 | 30 | 80 | 10 | 30 | 80 |
| Normal Tax | 31,5 | 24,5 | 7 | 31,5 | 24,5 | 7 |
| Dividend declared[1] | 56,8 | 66,4 | 90,4 | 62 | 70,4 | 91,6 |
| STC | 11,7 | 9,1 | 2,6 | 6,5 | 5,1 | 1,4 |
| Effective tax (Normal Tax plus STC) | 43,2% | 33,6% | 9,6% | 38% | 29,6% | 8,4% |

1 The dividend declared is calculated as:

$$\frac{\text{Net income after Normal Tax} + (\text{rate of STC x dividend received})}{1 + \text{rate of STC}}$$

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