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TAXATION OF FOREIGN DIVIDENDS

1 PURPOSE

The purpose of this memo is to report on the discussions which took place between delegates from SARS, the Department of Finance and the parties who made presentations on the taxation of foreign dividends during the hearings on the Taxation Laws Amendment Bill, 2000.

2 BACKGROUND

During the hearings on the Taxation Laws Amendment Bill, 2000 the following persons made representations:

- David Lermer and Osman Mollagee - PricewaterhouseCoopers
- Marius van Blerck - Anglo American
- Anthony Chait – BRAIT
- Des Kruger – Deloitte and Touche

At the hearings you proposed that a follow-up meeting be arranged to discuss the issues raised by them to avoid delaying the parliamentary process on the Bill.

The issues raised by the individuals can be divided between fundamental tax policy issues and less fundamental issues. On 29 May 2000 a meeting was held between delegates from SARS, the Department of Finance and the parties who made representations.
The meeting took place in a constructive manner and although it was not possible to meet their concerns relating to fundamental tax policy issues such as delaying the implementation of the proposal or exempting pre-23 February 2000 profits, we did manage to agree on a number of other issues thereby meeting some of their concerns.

It was brought to their attention that, from a tax policy perspective, the reasons for introducing income tax on foreign dividends are-

- to broaden the tax base;
- to phase in a residence basis of taxation;
- to limit tax avoidance schemes effected by interposing entities in tax haven countries;
- to introduce internationally accepted tax principles for taxing foreign dividends; and
- to do this in a manner that does not result in double taxation in respect of operating profits from foreign direct investment.

3 FUNDAMENTAL TAX POLICY ISSUES

3.1 DELAY IMPLEMENTATION

Contention:

This measure penalises South Africans for bringing home their foreign earnings. If the effective date is to be delayed, there would be a massive inflow of foreign currency as multinationals would (so it is argued) hasten to repatriate profits tax-fee for the last time - with significant knock-on effects for the economy.

Implications / discussion in bullet form:

- This would go against the announcement by the Minister on Budget day.
- A further delay will contribute to more uncertainty around the introduction of this matter as a whole, for Revenue, taxpayers and consultants. The sooner the rules are now known to everybody, the better.
- It is not always clear why amounts were not repatriated prior to Budget day when it could have been done in a tax neutral manner. Most surplus profits are required to be repatriated in terms of exchange control provisions. During the discussions it was, however, raised that foreign holding companies need to keep sufficient funds offshore to produce healthy balance sheets in order to finance their offshore operations in subsidiaries or branches.
- Amounts repatriated during a proposed window period may be “paper” repatriations or may immediately be reinvested offshore, which will result in a neutral position as far as SA foreign currency reserves are concerned.
- It will effectively also allow many entities who took part in transactions to exploit the South African tax base to complete their transactions without tax consequences.

Outcome:

SARS and the Department of Finance’s views were that the request for delay cannot be accommodated. Although the tax consultants were not completely satisfied with our view, there was general acceptance that it is important to provide certainty on the matter as soon as possible.

3.2 EXEMPT PAST RESERVES (Pre 23 February 2000)

Contention:
Most South African multinationals have undistributed foreign reserves in foreign subsidiaries. The reserves accumulated prior to 23 February 2000, should be able to be repatriated free of tax to South Africa in the form of dividends.

Implications / discussion in bullet form:

- This proposal is to a large extent linked to the first issue and will also have the effect of negating the Budget proposal by the Minister to tax all foreign dividends.
- For many years into the future record will have to kept of which reserves were accumulated prior to the effective date and this will add to the administrative burden.
- A further reason for the proposal to tax foreign dividends is to counter tax avoidance schemes. It is a well known fact that many transactions were routed through tax haven countries to the detriment of the South African tax base and to characterise taxable income into non-taxable income. Schemes entered into prior to the Budget announcements resulted in the accumulation of profits offshore. The granting of a window of opportunity will have the effect that these transactions can be completed without tax consequences for the shareholders receiving dividends on or after 23 February 2000. Conceding this issue will effectively grant a pass to all such transactions.
- The taxation of foreign dividends will not result in double taxation of profits generated by foreign direct investment as credits (or exemptions) will be allowed for the underlying taxed paid.
- The proposed tax on foreign dividends will therefore be triggered only by events or actions occurring from 23 February 2000, i.e. the declaration of a dividend. This is not tantamount to taxing on a retro-active basis. A different taxpayer, i.e. the shareholder will be taxed on dividends accruing on a prospective basis, i.e. from the date of announcement on 23 February 2000.
- The tax position of the company declaring the dividend will not be affected and the shareholder as a separate taxable entity will be subject to tax on foreign dividends.
- It should be noted that when STC was introduced in 1993, it was imposed on all dividends declared from 17 March 1993, irrespective of the composition of the underlying profits distributed.
- The same principles applied when the rate was first increased from 15% to 25% and later reduced to 12,5%.
- When all dividends were exempted from income tax in 1990 the amendment to the law came into effect on a specific date in respect of dividends received or accrued to taxpayers and the question of when the profits distributed were generated, was irrelevant.

Outcome:

Although the tax consultants argued that from the perspective of a group of companies, profits generated prior to Budget date are being taxed retroactively on distribution by way of a dividend, SARS and the Department of Finance held a different view on the basis as set out above. The intention is therefore to proceed with the legislation on the basis of taxing all dividends received or accrued on or after 23 February 2000.

3.3 GRANT UNILATERAL TAX SPARING

Issue:
Where a South African company invests through a subsidiary in substantial business operations (e.g. a mine) in a country which imposes no tax or a low rate of tax, the profits distributed back to South Africa will be taxed at the normal South African tax rates.

It is argued that this will in effect nullify the tax incentives granted in the foreign country. The request is, therefore, that such dividends should effectively be exempt from South African tax or alternatively tax sparing should apply. Tax sparing provisions in essence mean that the profits from the subsidiary are deemed to have borne tax at a higher rate and the tax imposed on the dividend by South Africa is correspondingly reduced by the notional tax "imposed", but not paid, in the foreign country.

Implications / discussion in bullet form:
- The current proposals do grant deferral relief as operational profits reinvested by the operating company are not taxed. Only actual distributions to the shareholder who is a resident or a controlled foreign entity (CFE) will be taxed.
- The tax policy stance over the last number of years is to limit tax incentives in the system. However, tax sparing provisions, if to be granted, should rather be provided for in tax treaties and not in South Africa's domestic tax legislation.
- SA currently has granted tax sparing benefits in tax treaties with Egypt, Iran, Mauritius, Romania and Thailand. The Mauritius experience is already problematic for South Africa and is open to large scale manipulation. South Africa has already invited Mauritius to discuss the matter with a view to re-negotiate the tax sparing provisions.

Outcome:
Although the parties would have preferred a general clause in the legislation granting the Minister of Finance the power to allow relief, on a case by case basis, it was conveyed to them that the principal legislation is not the place for this. Martin Grote will take this matter up with the Minister of Finance after input from the OECD and meetings with the SADC tax subcommittee. The Minister of Finance will also take the matter up with some of his counterparts in SADC and arrangements have already been made to discuss the issue with certain

SADC member states. Should the policy ultimately be to grant relief, it should rather be accommodated in bilateral agreements for the avoidance of double taxation.

3.4 INTERNATIONAL HOLDING AND HEADQUARTER COMPANIES

Contention:
Introduce a special tax status for international holding and headquarter companies which conduct their substantive operations outside SA and the shareholders of which more than 80% are non-residents. The benefits requested relate to taxation on the source basis, exemption of foreign dividends, special treatment of specific intra-group services and exemption from capital gains tax on foreign assets.

Implications / discussion in bullet form:

- This is a matter that was raised by the Katz Commission in its report on international tax and was highlighted as an important issue for South Africa as the existing source basis of taxation and no withholding tax regime, serves as an attractive incentive for foreign multinationals to set up their holding company regimes, especially as a springboard into Africa.
- The introduction of a residence basis of taxation coupled with the taxation of foreign dividends will have a detrimental impact on international groups of companies wishing to set up South African holding companies as a platform from which they will launch their activities and operations into Southern Africa.
- Groups with existing holding structures in South Africa may reconsider and move their tax residence offshore.
- Informal inquiries have indicated that the number of such structures in SA is limited and that non-tax issues are a disincentive to setting up such structures.
- A number of countries have introduced measures to ease the burden on foreign holding companies, for example Belgium, Denmark, Luxembourg, Mauritius and the United Kingdom.

Outcome:
The matter is subject to a joint investigation by SARS and the Department of Finance, but should not be incorporated in the Taxation Laws Amendment Bill. The Reserve Bank will also play a role in this regard.7

4 LESS FUNDAMENTAL TAX POLICY ISSUES

4.1 REMOVE PROFIT PRIORITISATION RULES

Contention:
An inflexible Last-in-First-Out (LIFO) rule is provided to ascertain the underlying foreign tax credit to which the resident shareholder is entitled. In accordance with standard company law principles,

companies should be able to nominate the reserves out of which dividends are being declared.

Implications / discussion in bullet form:

- The draft legislation provides that dividends are declared first from profits generated in most recent financial years and thereafter in a chronological order and that any operating profits and dividends received by a company will be applied on a pro-rata basis when a dividend is declared by a company.
- Profits available for distribution are most likely to be recent profits as older profits would have been reinvested.
- A company which is given the choice, will distribute profits which would either be exempt or carry enough foreign tax credits to limit South African tax liability. Mixing of profits taxed at high rates with profits taxed at low rates to exactly cover SA tax will take place.
- The relaxation of prioritisation rules will result in a reduction in potential tax collected from taxable foreign dividends.
- Nevertheless, the view is held that some form of relief should be granted in this regard, especially in view of the fact that the mixing of profits between countries will not be allowed at this stage.

Outcome:

Relax the prioritisation rules in the following manner. Retain the requirement that dividends are distributed from profits derived in most recent financial years and dividends and operating profits are distributed on a pro-rata basis in cases where the taxpayer has not proved the specification from which profits a dividend is declared. Allow companies to elect the financial year from which profits are distributed.

4.2 CARRY-BACK AND CARRY-FORWARD OF EXCESS FOREIGN TAX CREDITS

Issue:

Where a foreign dividend is subject to tax in South Africa, foreign tax payable on the profits which have been declared as a dividend and withholding taxes in respect of the dividend, will be allowed to be set-off against the South African tax liability. Where the foreign taxes exceed the SA tax, the excess is currently forfeited.

Contention:

Allow excess foreign tax credits to be carried backwards for a maximum of two year and forwards indefinitely.

Implications / discussion in bullet form:

- Currently the tax credit provisions do not provide for the utilisation of credits against normal tax other than during the year of assessment income forms part of taxable income.

- The carry forward of unused tax credits to future years of assessment is allowed in a number of countries, e.g. Australia, Canada, UK and the US. The carry-back of credits to previous years of assessment is, if allowed, limited to two or three years.
- Currently tax credits as a general rule arise in respect of service and passive investment income. By phasing in the taxation of worldwide income and specifically business income it is necessary that the carry-forward of excess foreign tax credits be reconsidered. The reason is that foreign taxes paid may not reflect the actual profits generated by business operations as a result of the type of industry, product life cycles, capital allowances granted and the timing difference between the generation of profit and distribution to shareholders. Where the resident is in an assessed loss position the foreign tax credits will generally be forfeited unless the election is made that foreign dividends be taxed on a net basis.
- The carry-back of credits has the implication that tax assessments of prior years cannot be finalised until the period of carry-back lapses.

Outcome:

- Excess tax credits will be allowed to be carried forward for a period of 3 years for set-off against income from those specific countries.
- No carry-back of excess foreign tax credits will be allowed.
- This matter will be reviewed again when the introduction of the full residence principle is considered.

4.3 TAX DIVIDENDS FROM CAPITAL GAINS AT A LOWER RATE

Contention:
Where reserves comprise capital gains, the tax rate on the relevant portion of the foreign dividend should be restricted to the corresponding rate on domestic capital gains.

Implications / discussion in bullet form:

- Dividends represent income of a revenue nature (income from an investment in shares).
- The character of the profits from which it is distributed should not affect the rate at which it is taxed.
- Currently STC is imposed on capital profits distributed to shareholders by way of a dividend.
- For accounting purposes an underlying capital profit loses its capital character once it becomes part of profit available for distribution in the normal course of operations.
- This can be contrasted with a taxpayer who under the full residence basis of taxation realises a capital profit in South Africa and a capital profit in a foreign country. In this instance the tax treatment of the profits should be treated on a consistent basis for tax purposes.
- If a dual rate system for foreign dividends in respect of capital/revenue profits were to be introduced, special tax rates on dividends out of profits from mining, insurance, small business and other special regimes may also be requested.
- This will complicate the system considerably.
- The draft legislation makes provision for a company in liquidation to declare a liquidation dividend from profits of a capital nature which will not be taxable in the hands of a shareholder.
- UK case law supports the fact that a dividend declared out of capital gains is subject to income tax.

Outcome:
Some of the tax advisors argued that the distinction should be retained in order to apply different tax rates to portions of the dividend , but M van Blerck acknowledged that such a distinction is not international practice. Foreign dividends are income of a revenue nature and are taxable irrespective of the capital or revenue nature of the profits out of which they are distributed. This proposal is not acceptable.

4.4 APPLY EXEMPTIONS TO INDIRECT SHAREHOLDINGS

Contention:
The exempt nature of the relevant dividends should be retained where the dividends flow through a further corporate entity.

Implications / discussion in bullet form:

- The exemption provisions already allow for a situation where profits are generated in a designated country and is distributed through a chain of companies to the resident.
- Even where a dividend is not exempt a credit is granted for underlying taxes on income payable by companies in a chain of companies with a direct holding of 10% or more in each company in the group structure.

Outcome:
No change is required as this principle is already contained in the draft legislation.

4.5 ALLOW FOREIGN MINING ROYALTIES AS A CREDIT AGAINST SA TAX

Contention:
Clarify wording of tax credit provisions to allow mining (including oil and gas) royalties paid to foreign governments to qualify as a credit against SA tax.

Implications / discussion in bullet form:

- Royalties and other severance taxes are not taxes on income and do not qualify for credits against South African tax liability in terms of the current tax credit provisions or in terms of the tax treaties entered into by SA.
- Mining royalties may be payable on the volume or value of minerals extracted and bear no reference to the income or the profitability of the mining company.
- All forms of foreign taxes on income will qualify as creditable taxes, which includes capital gains taxes and taxes on income imposed by national and lower tiers of government.
- Where the foreign jurisdiction has an income tax in addition to a royalty regime, the royalties paid will probably be allowed as a deduction in determining the liability for income tax purposes. To allow the royalty as a credit will result in a dual benefit to the taxpayer.
- If it is deemed necessary to grant relief for royalties paid provision can be made in the relevant tax treaty. Currently none of the SA treaties contains such a provision.

Outcome:
It was stated that some countries impose a royalty in lieu of an income tax. However, in principle royalties will not be allowed as a credit unless specifically provided for in a specific tax treaty.

4.6 EXEMPT DIVIDENDS FROM CERTAIN COUNTRIES

Contention:
Allow dividends from substantial investments in countries which have comprehensive worldwide tax systems to flow into South Africa without further tax consequence and without a test in respect of the rate at which the company declaring the dividend has actually been taxed.

Implications / discussion in bullet form:
- Such a list would include a very limited number of countries.
- Even in the case of the countries listed, the tax treatment of certain types of entities may create the opportunity for international groups to interpose entities in order to obtain beneficial tax treatment.
- Examples of these entities are found in the countries with special rules for allowing foreign tax credits on a mixed basis, international holding and headquarter companies as referred to in 3.4, limited liability corporations in the US and companies in countries which apply a dual rate of tax to certain entities.

Outcome:
Do not introduce a list of countries from where dividends are automatically exempt. Although it at first glance appears to be an attractive option to reduce administration, it is open to manipulation.

4.7 EXEMPT CERTAIN FOREIGN PORTFOLIO DIVIDENDS

Contention:
Exempt dividends received by or accrued to portfolio investors from certain countries subject to an approved tax rate levied under an approved tax system.

Implications / discussion in bullet form:
- In line with the UK system, the credit and gross up provisions have been extended to all companies in a group structure where a company holds a direct interest of not less than 10 per cent in the company in the next tier.
- A number of countries apply the 10 per cent test to limit the required grossing up and granting of underlying tax credits, including Australia, the UK and the US.
- As far as exemption is concerned this is not practical as underlying taxability of profits at a statutory rate of at least 27 per cent must be tested and this is not practical for portfolio investors.
- Investors who are individuals will be able to make use of the R3 000 / R4 000 exemption of foreign dividends per annum.

Outcome:
In view of the fact that an exemption is not automatically granted to dividends declared from companies in certain countries and in line with internationally accepted practice not to exempt portfolio investors, the proposal cannot be accepted.

4.8 CONNECTED PERSONS' INTEREST OF 10%

Contention:
Equity share capital held by connected persons should be taken into account in determining the 10% requirement for exemption.

Implications / discussion in bullet form:

- A foreign dividend is taxable in the hands of a resident shareholder which is a separate taxable entity in terms of SA tax law; SA does not tax on a group basis.
- In the case of the JSE exemption the benefit of the exemption is not afforded to connected persons who collectively hold a 10 per cent or greater interest.
- A group of companies with an effective shareholding of 10 per cent or greater (but not individually by residents) in a foreign company wishing to make use of the exemption for designated countries can in the first instance rationalise their shareholding into the name of a single resident in order to exceed the 10 per cent shareholding. In this regard the rationalisation of the group may possibly qualify for exemption from the payment of stamp duties, transfer duty and STC in terms of the provisions of section 39 of the Taxation Laws Amendment Act, 1994.
- Nevertheless, the view is held that it would be fair to allow accumulation in the case of a group of companies as defined in South Africa's rationalisation provisions.

Outcome:
It was agreed to apply the 10 per cent test to determine the exemption, gross-up and credit provisions, by aggregating the shareholding of entities in a group of companies as defined in South Africa's rationalisation provisions.

4.9 DO NOT DETERMINE EXEMPTION BASED ON EFFECTIVE TAX RATE

Contention:
The current proposals already require the calculation of the effective tax rate before the exemption is granted and so affords no reduction in administration.

Outcome:
No changes are required as the references in the draft legislation dealing with the designated countries refer to the rate of tax, which is interpreted to mean statutory and not effective rate of tax.

4.10 EXEMPTION FOR FOREIGN INTERMEDIATE HOLDING COMPANIES

Contention:
Introduce a specific exemption for foreign intermediate holding companies for dividends, royalties, interest and other inter-group charges that are paid out of trading profits of the holding company's subsidiaries.

Implications / discussion in bullet form:

- Currently passive income in the form of interest and royalties of CFEs are already taxed in terms of section 9D.
- A guiding principle in drafting the foreign dividend provisions was that investment income of a CFE should be taxed when it is received by or accrues to the CFE.
- A deferral of tax until the repatriation of the income to the resident is therefore not provided for.
- The controlled foreign entity provisions do not apply to foreign holding companies that have substantive business operations and where the income can be attributed to a permanent establishment of the holding company in the foreign country.
- The income of the CFE taxed in the hands of a resident will not be taxed again if it is subsequently distributed to another CFE of the resident or to the resident.

Outcome:
The acceptance of this proposal will create opportunities for avoidance of the CFE provisions and cannot be supported.

4.11 CREDIT FOR TAX ON DISTRIBUTIONS BY CFE

Contention:
Grant tax relief for foreign tax that will arise on the distribution of profits (after it has been imputed) from a CFE back to South Africa in determining tax liability of a resident in respect of the income of a CFE.

Implications / discussion in bullet form:

- Investment income received by or accrued to a CFE is taxable during the relevant year of assessment in the hands of the resident on an imputed basis. Qualifying foreign taxes will be taken into account in determining the SA tax liability of the resident during that year of assessment. No normal tax liability will arise on repatriation as the investment income has already been taxed and the dividend from the CFE will be exempt to that extent.
- However, any foreign taxes paid subsequent to the repatriation of the profits to the resident cannot be carried back and will be forfeited.
- To provide relief in this regard it is proposed that the excess of foreign tax credits may be set-off against a future Secondary Tax on Companies (STC) liability. To that extent a carry-forward of excess foreign tax credits for STC purposes is already provided for.

Outcome:
Provide for foreign taxes paid in respect of foreign profits after it has been imputed to the resident, to be set-off against a STC liability on repatriation of such profits to the resident.

4.12 WAIVE 10% REQUIREMENT FOR INSURANCE AND INVESTMENT FUNDS

Contention:
The 10 per cent equity shareholding requirement to qualify for a credit of underlying taxes on the profits received as a dividend should be waived for portfolio investments by insurers and investment funds.

Implications / discussion in bullet form:

- The UK has made an exception in respect of the insurance industry.
- It will be difficult to justify the granting of special tax treatment which is limited to one industry. Other industries such as the unit trust industry, pension funds and others will request the same treatment.

- The waiver of the 10% limit for the insurance industry will result in a significant increase in the administrative burden on these taxpayers in order to determine the gross up and underlying tax credits. Similarly there will be a further obligation on SARS officers to check this.
- The insurance industry is taxed by applying the trustee principle. However, the R3 000 exemption in respect individuals will not be available for set-off against the tax liability of the insurers as foreign dividends will accrue to the insurer and not the individual policyholders.

Outcome:
Do not waive the 10 per cent requirement for insurers and investment funds as this is an internationally accepted norm and exceptions to the general rule appear to be limited.

4.13 EXTEND JSE EXEMPTION TO CFE SCENARIO

Issue:
The draft legislation provides for an exemption of dividends accruing to resident shareholders of companies listed on the JSE. Where these resident shareholders directly or indirectly control a foreign entity the investment income of the entity is taxable (imputed) in the hands of the residents.

Contention:
In situations where the JSE exemption applies it must be extended to the CFE situation and also apply to the JSE company and its subsidiaries.

Implications / discussion in bullet form:

- In the case of companies with secondary listings on the JSE this proposal will result in the underlying profits, which may have been generated in low tax countries, not being subject to South African tax.
- A South African resident company listed on the JSE will in any case be taxed on foreign dividends from subsidiary operating companies.
- The effect of the application of the CFE provisions is to include foreign dividends accrued to the CFE in the income of residents. The on-declaration of such profits by the foreign company to residents will be exempt in terms of the JSE exemption.
- South Africa will give away all its taxing rights in respect of these foreign sourced profits in order to address the administrative implications and avoid possible market distortions.

- Distinction should, however, once again be made between portfolio investors (less than 10 per cent) and investors owning 10 per cent or more of the shareholding. It is in the latter case which it will be dangerous to make a concession. As far as portfolio investors are concerned relief may be considered in order to fall in line with the JSE-exemption.

Outcome:
The existing provisions will be amended to extend the relief also to portfolio investors who would be taxable on investment income of the listed controlled foreign entity and its subsidiaries. The effect thereof will be to eliminate the administrative burden of taxing portfolio investors in JSE listed companies and will bring the controlled foreign entity provisions in line with the JSE-exemption.

4.14 APPLY EXEMPTIONS TO PROFITS TAXED AND NOT GENERATED IN CERTAIN COUNTRIES

Contention:
The exemption provisions linked to the 10 per cent shareholding should refer to profits which have been taxed in a designated country instead of generated in a designated country.

Implications / discussion in bullet form:

- Even where a dividend is not exempt a credit is granted for underlying taxes on income payable by companies in a chain of companies with a direct holding of 10% or more in each company in the group structure.
- To link an exemption to companies subject to tax in countries from where a dividend is declared, instead of the current rule of where profits are generated would result in a system that allows the mixing of foreign tax credits.
- The mixing of foreign tax credits should not be allowed as it could result in profits generated in low or no tax jurisdictions, not being taxed, if the profits are channeled through a country where those profits are mixed with profits taxed at a high rate, for example through the Netherlands, and the profits in aggregate are taxed at 27 percent.
- Apart from the fact that mixer companies can easily be introduced in group structures to obtain the benefit of cross crediting of foreign tax payable, South African policy has always been not to allow pooling of foreign tax credits.
- Tax liability is determined with reference to specific income and the foreign tax paid in respect of that income.

- The United Kingdom announced that their system of allowing foreign tax credits will be changed from April 2001 when the current system of pooling of tax credits in respect of dividends from offshore holding companies will be discontinued and a look-through approach will be introduced. It does, however, appear that resistance is building up in the United Kingdom in respect of this proposal.
- Countries such as the US and Japan allow mixing of foreign tax credits where a dividend flows through a mixer company.
- The greater portion of foreign dividends is declared from business profits and the country where the fixed place of business is situated normally tax the operating profits attributable thereto.
- It is possible for a company to be a tax resident in more than one country and a test based on the "source" of profits is deemed to be more appropriate.
- To allow a tax resident test as proposed may result in dividends arising from untaxed profits and flowing through a designated country, not being taxed and that a pooling system of foreign tax credits will effectively be allowed.

Outcome:
Consideration will be given to whether further mixing of foreign tax credits is to be allowed when the full residence basis of taxation is introduced.

5 SUMMARY

- Major issues
  - Delay implementation – Not accommodated.
  - Exempt past reserves – Not accommodated.
  - Grant unilateral tax sparing – Dept. of Finance to discuss with SADC.
  - International holding and headquarter company regime – Investigate further.
- Other issues
  - Remove profit prioritisation rules – company can specify profits from specific financial year to be distributed as a dividend.
  - Carry-forward and -back of credits – allow 3 year carry-forward, but no carry-back.
  - Tax dividends from capital gains at lower rate – Not accommodated.
  - Apply exemptions to indirect shareholdings – Done.
  - Allow mining royalties as a credit – Not accommodated.
  - Exempt dividends declared from certain countries – Not accommodated.
  - Exempt certain foreign portfolio dividends – Not accommodated.
  - Add interest of connected persons to determine exemption – Allow aggregation in group situation.
  - Do no base exemption on effective tax rate – Done, apply statutory rate.
  - Exemption for foreign intermediate holding companies – Not accommodated.
  - Grant credit for foreign tax on profits distributed by CFE – Allow to be set-off against subsequent STC liability.
  - Relief for portfolio investments by Insurers and Investment Funds – Not accommodated.

- Extend JSE-exemption to CFE scenario – Exemption for resident portfolio shareholders in JSE-listed company.
- Apply exemptions to profits taxed and not generated in certain countries – Not accommodated.

6 RECOMMENDATION

From the above it is clear that no changes are proposed in respect of the more fundamental policy issues in respect of which requests for changes have been made. As far as the less substantive issues are concerned, changes in relation to about 7 areas can be entertained.

The issues raised in this letter were forwarded to the Minister and discussed with him on 30 May 2000. The Minister did not have any objections to the outcomes in respect of the issues and agreed that we proceed on the basis as proposed.

We are in the process of changing the foreign dividend legislation to incorporate the outcome of the discussions.

In the light of the fact that a number of the tax advisors' concerns could be addressed and thereby reduce the impact of the provisions on residents in receipt of foreign dividends, it is recommended that the foreign dividend provisions be incorporated in the Bill, which it appears will now be tabled on 13 June 2000.

For your interest I also attach an annexure A as background to the different forms of taxation of dividends in general, to put the matter in perspective.

J J LOUW

GENERAL MANAGER: LAW ADMINISTRATION
SOUTH AFRICAN REVENUE SERVICE

Taxation of Dividends – Background **Annexure A**

It is useful to consider the possibilities for taxing dividends in general when considering the specific issues around the taxation of foreign dividends. The three main possibilities discussed in the literature are the classical, full integration, and exemption systems.

1. Classical System

The classical system is based on the premise that each taxpayer is a separate entity and should be taxed without reference to the taxation of other entities. An element of economic double taxation is thus inherent in the system. The USA still uses this system and South Africa used a modified version of the system up until 1990. An advantage of the system is that it is relatively easy to administer although compliance issues are encountered with shareholders' declaration of dividend income.

Example

The first column deals with a company with a net income of R1 000 with a corporate tax rate of 30% that declares a dividend of R200 to a shareholder with a marginal rate of 40%.

The second column deals with the same situation except that the company has declared a dividend of R700.

Company				
Net Income		1 000		1 000
Tax	30%	300	30%	300
After Tax		700		700
Dividend		200		700
Retained		500		0
Shareholder				
Dividend Received		200		700
Tax	40%	80	40%	280
After Tax		120		520
Total Tax				
Company		300		300
Shareholder		80		280
Total		380		580
Effective Rate		38%		58%

2. Full Integration

Full integration is based on the premise that companies are the economic proxies of their shareholders and that the income of the companies should therefore be taxed in the hands of the shareholders. Taken to its logical conclusion this means that shareholders should be taxed on the income of their companies as it arises, whether or not a dividend has been declared.

This is administratively difficult and ignores the question of whether or not shareholders have the funds to pay the taxes levied. As a result this approach is usually reserved for limited cases as an anti-avoidance rule. Examples in the international context are the so-called Controlled Foreign Company or CFC rules, which find their counterpart in South Africa in the section 9D Controlled Foreign Entity or CFE rules.

An alternative approach to full integration, which does not abandon taxation at the corporate level, is discussed after the example dealing with the first approach.

Example

The first column deals with a company with a net income of R1 000 that declares a dividend of R200 to a shareholder with a marginal rate of 40%. The company is fully exempt from tax and accordingly pays no tax.

The second column deals with the same situation except that the company has declared a dividend of R1 000.

Company				
Net Income		1 000		1 000
Tax	0%	0	0%	0
After Tax		1 000		1 000
Dividend		200		1 000
Retained		800		0
Shareholder				
Net Income of Company		1 000		1 000
Tax	40%	400	40%	400
Dividend Received		200		1 000
Tax		400		400
After Tax		-200		600

Total Tax

Company		0		0
Shareholder		400		400
Total		400		400
Effective Rate		40%		40%

As a result of the difficulties with the above approach an alternative approach is to tax the net income of the company in the company. The net income is then also taxed in the hands of the shareholder but only as dividends are declared. A credit for the proportionate share of the underlying tax paid by the company is granted in order to avoid double taxation. This is still administratively difficult but takes into account the question of whether or not shareholders have the funds to pay the taxes levied. It is often used internationally where foreign dividends are taxed, although *de minimis* shareholding requirements are usually imposed in order to reduce administrative difficulties.

Example

A company with a net income of R1 000 with a corporate tax rate of 30% declares a dividend of R200 to a shareholder with a marginal rate of 40%.

The second column deals with the same situation except that the company has declared a dividend of R700.

Company

Net Income		1 000		1 000
Tax	30%	300	30%	300
After Tax		700		700
Dividend		200		700
Retained		500		0

Shareholder				
Underlying Net Income of Company Distributed[1]		286		1 000
Tax	40%	114	40%	400
Credit for Tax Paid in Company	30%	86	30%	300
Net Tax Payable		28		100
Dividend Received		200		700
Net Tax Payable		28		100
After Tax		172		600
Total Tax				
Company		300		300
Shareholder		28		100
Total		328		400
Effective Rate		33%		40%

3. Exemption System

The exemption system implicitly retains the premise that each taxpayer is a separate entity but avoids the double taxation of the classical system by exempting the dividends received by shareholders. South Africa has used this system from 1990. An advantage of the system is that it is relatively easy to administer. However, where the company has escaped tax there is no backstop at the shareholder level to ensure that the fisc still gathers tax, as is the case with the other systems.

Example

A company with a net income of R1 000 with a corporate tax rate of 30% declares a dividend of R200 to a shareholder with a marginal rate of 40%. The shareholder is exempt from tax on dividends and accordingly pays no tax on the dividends.

The second column deals with the same situation except that the company has declared a dividend of R700.

[1] Of its net income of R1 000 the company has a total of R700 available for distribution after tax. Thus each 70 cents of dividend represents R1 of net income earned by the company or, put another way, each R1 of dividend represents R1.43 of net income earned by the company. If the company has distributed R200 of dividends, this represents R286 of underlying net income. If it has distributed R700 of dividends this represents R1 000 of underlying net income.

Company				
Net Income		1 000		1 000
Tax	30%	300	30%	300
After Tax		700		700
Dividend		200		700
Retained		500		0
Shareholder				
Dividend Received		200		700
Tax	0%	0	0%	0
After Tax		200		700
Total Tax				
Company		300		300
Shareholder		0		0
Total		300		300
Effective Rate		30%		30%

One unusual element of the South African income tax system, which does not affect the principle of the exemption system but merely its application, is the Secondary Tax on Companies. In 1993 the company tax rate was reduced and STC was introduced in order to encourage the reinvestment of company income. The above example ignores STC but if it were to be included the company would adjust the dividend declared slightly and total tax paid would be as follows.

Total Tax		
Company	322	378
Shareholder	0	0
Total	322	378
Effective Rate	32%	38%

4. Conclusion

As noted above South Africa adopted the exemption system for dividends in 1990. Where both shareholders and companies are based in South Africa, SARS can monitor the operations and tax charges of the companies declaring the dividends. However, where a dividend is received from a foreign company, SARS is not in a position to do this. Thus it is possible for the profits concerned to escape taxation both at the company and shareholder level.

The current proposals move to address this weakness. Where the foreign company generates its profits in a country with a tax system on par with South Africa and the profits have been subject to tax at the specified rate, the exemption system remains in place. Where this is not the case, the dividend is subject to South African tax and a credit granted to a greater or lesser extent for the foreign taxes paid.