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A Critical Analysis of the Desirability and Efficacy of Secondary Tax on Companies in South Africa

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A dissertation submitted to the Faculty of Law, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Laws in Taxation.

Johannesburg, September 2005

ABSTRACT

This thesis debates the issue of whether Secondary Tax on Companies is a desirable and efficacious tax and whether it is compatible with other government policies and programmes.

Secondary Tax on Companies is a tax imposed on resident companies and close corporations, currently at the rate of 12.5%, on dividends declared or deemed to be declared by the company to its shareholders.

It has proved to be a deeply contentious form of tax in many quarters although it has been declared to be a non negotiable tax as far as the government is concerned. It has been held by many authors that this tax inter alia distorts the financial decision making process and inhibits investment in South Africa.

It was concluded by the writer that Secondary tax on Companies is probably not compatible with other important government programmes such as Black Economic Empowerment and employment creation, as well as contributing to South Africa’s uncompetitive corporate tax rate.

It was therefore concluded that Secondary tax on Companies should be gradually phased out.

CERTIFICATE

I certify that this dissertation is my own unaided work. It is submitted for the degree of Master of Laws in Taxation in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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Adrian Gary Skuy

9 September 2005

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The writer would just like to thank his family and friends, whose support he appreciates.

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CHAPTER 1

1. The Context Of The Study And Problem Statement

The writer wished to answer a certain "problem" as regards Secondary Tax on Companies ("STC"), namely is it a form of taxation that is not only desirable and efficacious in and of itself but whether it is also compatible with other government policies? Alternatives to this tax, which was introduced in a 1993 amendment to the Income Tax Act 58 of 1962 ("Income Tax Act"), will also be discussed. This so-called problem arose for the writer due to the exceedingly negative response of many to the very concept of STC. Some would possibly like STC to be immediately abolished but this would not be desirable if it truly does meet the objectives set out for it and helps the corporate world fulfil some of its responsibility towards society and its upliftment as a whole.

Therefore STC will not only be analysed and discussed in isolation but will be looked at in the context of taxation policy as well as other policy. The tax policy of the government is stated to be "creating a more competitive direct tax regime capable of supporting investment and economic growth".[1] The writer submits that this philosophy links tax policy to other policies of government even by government itself.

STC is a tax that is levied on the company and not on the individual shareholder. Once a dividend has been declared or deemed to have been declared by the company

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[1] Business Day. (2005) Never Mind the Technicalities of Tax Let's Hear the Philosophy.
Available from: http://allafrica.com/stories/printable/200504120276.html

the company is liable to pay to the South African revenue Service ("SARS") 12.5% on such dividends over and above the dividend declared.

One of the stated objectives of STC was to get companies to adopt a dividend policy that would favour re investment of capital and profits as opposed to declaring same as dividends. It was hoped in some quarters, particularly at government level, that STC would result in re investment and a subsequent creation of employment, unemployment being at extremely high levels in South Africa.

STC at first was levied at 15% on all dividends declared or deemed to be declared on or after 17 March 1993 and before 22 June 1994; and later at 25% on any dividend before 22 June 1994 and before 14 march 1996 and at a rate of 12.5% on any dividends after 14 march 1996.

2. Hypothesis

An hypothesis as defined by the Collins dictionary is "… a suggested explanation for a group of facts, accepted either as a basis for further verification or as likely to be true."[2] As regards the meaning of hypothesis in research the meaning might be considered a little wider. An hypothesis could be considered as an unproven proposition or supposition that tentatively explains certain facts or even as a possible solution to a problem.[3] Bearing this meaning of the word 'hypothesis' the hypothesis postulated by the writer is that if STC meets the objectives for its introduction as well

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[2] Collins Paper Back English Dictionary. (1995) (3rd ed.) Glasgow : Harper Collins Publishers.
[3] Zikmund, W. G., (2000) Exploring Marketing Research. (7th ed.) Fort Worth : Dryden Press.

as being compatible with other important government policies then it will be considered to be a desirable and efficacious tax.

It will be necessary to discuss at the appropriate time the opinions of economists and legal writers as regards the desirability of certain forms of taxation generally and STC particularly. The writer is of course aware that this thesis is one that should overwhelmingly concentrate on the jurisprudential elements of STC but STC and the reasons therefore are intimately connected with economic, political and social policy and these must be discussed and taken into account in the analysis.

The international environment must also be briefly discussed particularly when comparing South African corporate tax rates and forms of corporate tax with that of foreign jurisdictions. This will have some bearing on South Africa as a desirable location for investment in the international sphere and the creation of employment, which has also a social and political element.

Once this has been done the writer will reach certain conclusions as to the desirability and efficacy of STC and whether it is compatible with other government policies.

3. Aim And Purpose Of The Study

The objective of this thesis is to analyse whether STC as a form of taxation fulfils the objectives it is supposed to fulfil and is compatible with and supporting of other important government programmes and policies. What will be further discussed will be alternatives, if any, to STC. Should STC meet the above criteria the writer will then consider STC to be both a desirous and efficacious form of taxation.

4. Research Methodology

The writer, due to the nature of this thesis, will undertake no primary research but the writer shall engage in the following secondary research; researching necessary legislation, court decisions as well as the opinions of appropriate academic writers in the juristic field as well as a limited amount of opinions of writers in the field of economics and finance. STC will then be measured against the results of this research.

5. Structure Of The Thesis

The thesis will consist of the following chapters.

Chapter one, which will consist of an introduction to the area of law covered in the thesis including inter alia a problem statement and an hypothesis.

The writer proposes in this first chapter, as an introduction, to briefly discuss some of the relevant sections of the Income Tax Act, as amended, which introduced STC. These sections and other parts of the relevant legislation will be discussed in greater detail in the subsequent chapter containing the literature review.

Chapter two, which will be the literature review, and will include appropriate legislation, court decisions as well as the writings and opinions of appropriate writers in the above mentioned areas.

Chapter three will include a critical analysis of the contents of the literature review.

Chapter four will set out the recommendations of the writer and specify the shortcomings of the thesis.

STC is provided for in section 64 of the Income Tax Act. A brief overview of the more important aspects of STC as well as important concepts in its application are useful in understanding the implications of STC as a tax. Far greater detail and discussion of the appropriate sections in the Income Tax Act 58 of 1962 ("Income Tax Act") as they relate to STC will appear in Chapter Two but it is necessary at this stage to have a general understanding of the legislation and STC's place in our law.

Section 64B provides for the levy and recovery of STC at the rate of 12,5 % of the net amount of any dividend declared. It is important to note that a close corporation that makes distributions will also incur STC liability, as the term 'company' in terms of section one of the Income Tax Act will include a close corporation. STC will only be paid by a resident company as non resident companies are not subject to STC.

In calculating the net amount of a dividend declared or deemed to be declared, dividends which have accrued to the company in any particular dividend cycle are deducted from the amount declared by the company. A discussion of the meaning of a dividend cycle appears in Chapter Two.

STC may be seen partly as a social premium or quid pro quo for limited liability and a tax to be paid by the more economically well off to subsidise the less well off. The writer submits that this is clear from the statements of the Minister of Finance where

he describes STC as a “tax on the rich”.[4] Unless the Minister is describing the companies that declare dividends “the rich” he is clearly referring to those persons who would benefit from dividend declarations as “the rich”. If this supposition is correct then the Minister is tacitly admitting that although strictly speaking the company that declares the dividends is responsible for payment of STC it is ultimately the investor / shareholder who bears the burden of STC. As will be seen in the Literature Review this is one of the criticisms levelled against STC as inter alia it will discourage investors from investing in South Africa.

Another criticism of STC, allied to the above criticism, in the opinion of some is that it affects the financial decision making process of both the company and of investors and potential investors and in the end does not assist the government in fulfilling its policies as well as rendering South Africa uncompetitive internationally as far as its corporate tax rates are concerned.

The question then to be asked might be whether STC suffers from the defects of its purported virtues? In other words does it do the opposite of what it is supposed to do, such as encourage companies to re invest their surplus funds and create more employment and assist the less well off members of society? Is the cost of this tax on “the rich” justified by the benefits it provides to those who would be described by some as “the poor”?

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[4] Ensor, L. (2005) Secondary Tax here to Stay-Manuel. Available from: http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=1401046

These are some of the issues, which will be discussed in greater detail, in later chapters in the thesis.

The writer in the following chapter will set out the literature review.

CHAPTER 2

1. Literature Review

The purpose of this thesis is to come to a conclusion as to whether STC is a desirable and efficacious tax, with some emphasis as to whether it is or able to meet its stated objectives and is compatible with other important government policies and supportive thereof. This must be integrated into the relevant theory as is reflected in the relevant literature, legislation and court decisions. The literature review further informs the reader of available thoughts on a topic. A global application as well as the most recent thinking will be covered.

The literature review allows one to distil the ranges of thought and synergise them to deliver the most impact for the study.

2. Various Tax Systems

It is necessary to briefly discuss the various forms of tax systems available as some of the writers' criticisms of STC propose a different system of taxation and presuppose a knowledge and understanding of the various systems. Knowledge of the various systems is also useful as STC does not exist in a vacuum but is part of a system of taxation and knowledge of the various systems will enable one to more adequately understand and analyse STC.

These various systems appear below.[5]

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[5] Honiball, M. (2005) International Taxation Notes.

2.1. Classical System

The company is first taxed on profits that it makes and then any dividends are taxed in shareholders hands. Therefore there is an element of economic double taxation.[6] This system obviously finds favour with many corporations particularly when compared to the system that includes STC as in this system the burden of tax for dividends is placed squarely on the shoulders of the shareholder. This system further emphasises the element of limited liability of the company.

In the USA they have several forms of business entities that include the advantages of limited liability and separate legal personality, such as an S Corporation as well as a limited liability company, which are companies in law but a partnership for tax purposes. This might be a type of entity that could be considered for South Africa to answer the perceived problems faced by some smaller businesses that may be dissuaded from utilising the corporate entity due to STC concerns. This is discussed further below in the thesis.

2.2. Full Integration System

In this system profits are only taxed once, either in the hands of the company or the shareholder. South African domestic companies are examples of this system. STC qualifies for categorisation within a full integration system.

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[6] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

2.3. Imputation System

All or part of the tax that is paid by the company is passed on to the shareholder as a credit. A deemed credit is attached to a dividend and the company will pay what the learned author describes as an Advanced Corporation Tax.[7]

There are certain perceived advantages to the imputation system such as the risk of non reporting will be less than under a classical system because the additional tax payable by top rate shareholders on dividend income will be higher than under a classical system than under an imputation system.[8]

Some theorists favour an imputation system due to a number of factors:

i. It recognises that only individuals ultimately carry a tax burden;
ii. It treats the company as merely the vehicle for generating the earnings of the shareholders and paying tax on a provisional basis, on their behalf;
iii. In its purest form it allows even corporate earnings to be taxed at a progressive rate rather than a flat rate;
iv. It avoids economic double taxation;
v. It is seen as fairer as it attaches tax consequences to the variable characteristics of individual shareholders;
vi. It further has a number of economic advantages, for example it enhances neutrality with regard to investors' portfolio decisions or corporate funding.[9]

2.4. Split Rate System

The distributed profits are subject to a lower tax rate than retained profits. STC gives an opposite effect to this system. That is STC is ostensibly in place to encourage companies to retain profits for expansion and job creation.

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[7] Irish Government. (1998) Discussion Document on Withholding Tax on Dividends.
Available from: http://www.finance.gov.ie/viewtxt.asp?DocID=1439&CatID=18&M=&StartDate=01+Ja...
[8] Irish Government. (1998) Discussion Document on Withholding Tax on Dividends.
Available from: http://www.finance.gov.ie/viewtxt.asp?DocID=1439&CatID=18&M=&StartDate=01+Ja...
[9] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

2.5. Dividend Deduction System

This system is similar in effect to the split rate system. Here a company gets a tax reduction because of a tax deduction in respect of dividends declared, which is an overall lower effective rate of tax.

3. Withholding Tax

A radically different philosophy to that underpinning that of STC exists for a withholding tax. In this system a company will be actively discouraged from retaining profits, as it will be taxed on this retained income. The philosophy behind this is to get companies to declare their profits as dividends to the shareholders. A further advantage of this tax is that it provides "an efficient collection mechanism for income tax due at shareholder level and reduces the risk that dividend income will not be reported by the recipients."[10] The option of doing away with STC and replacing it with a final withholding tax was discussed in the Katz Commission Report. [11] It was concluded that in the domestic context this change would have minimal impact but in the international context there would be a significant effect. As a final withholding tax would be subject to treaty provisions, tax would in many cases be reduced to zero. The report further goes on to state that the first priority of tax reform is to lower the corporate tax rate and therefore any material reduction in tax collected would inhibit progress in this regard.[12]

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[10] Irish Government. (1998) Discussion Document on Withholding Tax on Dividends. Available from: http://www.finance.gov.ie/viewtxt.asp?DocID=1439&CatID=18&M=&StartDate=01+Ja...

[11] Katz Commission. (2004) Report of the Katz Commission into Tax Reform. Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

[12] Katz Commission. (2004) Report of the Katz Commission into Tax Reform. Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

4. Income Tax Act Provisions

Before attempting to further analyse STC it is necessary to discuss in greater detail the provisions of the Income Tax Act that apply to STC. The writer will discuss in some detail those sections, which are relevant to an understanding of the operation of STC, with some emphasis on those sections or sub sections that have generated litigation. The STC provisions are contained in sections 64B and 64C of the Income Tax Act.

Section 64 of the act contains inter alia the following relevant provisions:

4.1. Levy And Recovery Of STC (Section 64B)

It is instructive to note that distributions made by a Close Corporation ("CC") fall under "declared" in relation to dividends. What this means in essence is that amounts distributed by a CC to a member will be subject to STC. A company is defined in section one of the Income Tax Act and includes a CC. There are implications due to this inclusion as many of the writers, discussed below, mention the negative impact on small business due to the application of STC and CCs generally concern small businesses. An answer to this, as discussed above, may be an introduction of an S Corporation or limited liability company, as in the United States, where the company enjoys limited liability but pays tax as a natural person. This would avoid the payment of STC and encourage small businesses to utilise the corporate form of business entity, which enjoys certain legal and economic advantages over that of a sole proprietor or partnership. This can be of some importance as it is expected in many

quarters that small and medium businesses will provide many of the jobs that South Africa so badly requires. [13]

Subsection one of section 64B contains two definitions, which are important in the understanding of the impact and application of STC.

The first such definition is on the meaning of 'declared.' This is in relation to any dividend (including a dividend in specie) means the approval of the payment or distribution thereof by the directors of the company or by some other person under authority conferred by the memorandum and articles of association of the company.

As indicated above this would include amounts distributed by a CC to its members.

It is further noteworthy that not all dividends come about due to a declaration. As discussed below certain distributions are deemed to be dividends. This could happen for example when a company has a partial reduction or redemption of share capital or buys back shares and distributes cash or assets, which have a value greater than the nominal amount of the reduction.

The second definition is that of 'dividend cycle', which the writer discusses in some detail below. It is defined in section 64B(1) and the dividend cycle relates to every dividend declared. In other words there is a separate dividend cycle for every dividend declaration. As the net dividend is the amount on which STC is paid it is of course of

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[13] Sunday Times Business Times. (2005) Katz Lauds Job Creation Benefits in Tax Cut. Available from: http://www.btimes.co.za/99/0221/btmoney/money02.htm

importance to calculate the net dividends in any particular dividend cycle. When calculating the amount of the net dividend declared, dividends which have accrued to the company in a particular dividend cycle, are subtracted from the total dividend amount declared by that company. It is therefore of some importance to be aware of when a dividend cycle begins and ends.

This leads on to the meaning of '*dividends*'.

4.2. Dividends

Dividend is defined in section one of the Income Tax Act as inter alia any amount distributed by a company to its shareholders or any amount distributed out of the assets of the company. A CC, as mentioned previously, is specifically included in the legislation.

The case of ITC 1632[14] dealt with the question as to what a dividend is. It does not deal specifically with STC but is noteworthy for the purposes of this thesis as the concept of a dividend is relevant when discussing STC, as STC is not incurred by the tax payer until a dividend is declared or deemed to be declared.

The tax payer in the above case was a director of a company from which he had received an amount, which amount had been reflected in the company's balance sheet as a loan.

[14] 60 SATC 71

This loan was to be interest free and no conditions of repayment were attached.

The fiscus deemed the sum to be a dividend and levied tax on it.

The court held that the purpose of a payment or distribution could only be determined at the time it was initially made and further that entries on a balance sheet and the manner a transaction was entered into were strong indicators that the purpose of the distribution in this matter was not to confer similar benefits to that which would attach to a loan, but rather to that of a dividend. Therefore the transaction here fell on the continuum far closer to a dividend than a loan. The tax payer therefore failed.

This matter shows, in the writer's submission, that the inclusion of deemed dividends being subject to STC has prevented some abuse of the separate legal personality of a company. In essence without STC the director would have received an amount, which would not be subject to income tax or any other direct tax. In essence he would have received income without ever paying tax on it and possibly ever paying back the loan, which would be to the detriment of the company. This is further in the writer's submission a positive aspect of STC.

In respect of both a company and CC a dividend is declared at the time when the decision is taken to release amounts or specie for the benefit of the shareholders or members, or an appropriate entry is made to the shareholders loan accounts. STC becomes payable once a dividend is declared and not when it is paid.

These issues were discussed in the case of ITC 1688.[15] One of the important issues in this matter was when a dividend should be regarded as having being declared for the purposes of section 64B.

The court stated that this was a question of fact, which would have to be determined in every matter separately. In this case the tax payer company had declared a dividend to its shareholder in terms of an agreement and it had been credited to the shareholder's loan account in the company's books.

In this situation the court held that the payment of the dividend had been affected on the date on which the agreement had been concluded and when the necessary resolution declaring the dividend had been passed.

This further emphasised the importance of the fact that STC becomes payable when a dividend is declared or deemed to be declared and not when it is paid over to the shareholder.

4.3. Taxing Provision (Section 64B(2))

This particular section contains the actual taxing provision, which provides that STC is currently levied at the rate of 12.5% of the net amount of any dividend declared, including preference dividends on or after 14 March 1996. This would only apply if the company were a South African resident as non residents are not subject to STC.

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[15] 62 SATC 478

A South African resident company is defined in section 1 of the Income Tax Act as a "person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic, but does not include any person who is deemed to be exclusively a resident of another country for the purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation".

As will be seen below a serious criticism of STC is that it confuses foreign investors as well as in some instances subjecting them to double taxation. This criticism, in the writer's submission, is partly answered by this section, which exempts certain companies from being liable for STC in terms of double taxation agreements, which are entered into between South Africa and other countries. This is done by deeming them to be non residents and therefore not subject to STC.

Section 64B contemplates two types of dividend declaration;

- dividends that are formally declared
- dividends that arise as a result of a distribution of cash or assets which constitute a dividend in terms of the dividend definition.

As STC is calculated on the net amount of any dividend declared the net amount definition is important.

Net amount is defined in section 64B(3) as the amount by which a dividend declared exceeds the sum of dividends, which have accrued to the company during the dividend cycle in which the dividend was declared.

Where the dividends accrued during the dividend cycle is greater than the dividends declared the balance is carried forward to the next dividend cycle and is treated as a dividend accruing in that dividend cycle.

4.3.1. Dividend Cycle

Dividend cycle means, in terms of section 64B(1)(a), the period commencing on the later of

- 1 September 1993;
- the day following the date of declaration of the last dividend declared by the company prior to 17 March 1993;
- the date the company was incorporated, formed or established;
- the date on which the company becomes resident;

and ending on the date on which such first dividend accrues to the shareholder or on which the amount is deemed to have been distributed as contemplated in section 64C(2) in relation to any subsequent dividend declared the period commences immediately after the previous dividend cycle and ending on the date on which such dividend accrues to a shareholder or on which amount is deemed to have been distributed in terms of section 64C(2).

In calculating the net amount of a dividend declared, dividends, which have accrued to the company in the dividend cycle, are subtracted. It is therefore important to identify the starting date and completion date of any particular dividend cycle.

It is important to note that a dividend cycle does not necessarily co- incide with a company's financial year. As an example it is possible to have more than one dividend cycle in any financial year and for example if dividends are declared thrice in one year three dividend cycles will exist in that financial year.

4.3.2. Dividends Which Can Not Be Deducted (Section 64B(3a))

This section stipulates which dividends received can not be deducted when calculating the net amount. This section came into operation from June 2004.

Included in this is inter alia;

- any dividend contemplated in subsection (5) (b), (c) or (f); (briefly this covers dividends declared by a fixed property company, liquidations and group companies)
- any dividend to the extent that the dividend is taxable by virtue of section 10(1)(k)(i)(bb); (dealing with collective investment schemes)
- any dividend which accrued to a borrower as contemplated in the definition of securities lending arrangement in respect of a share which was borrowed in terms of that arrangement;
- any foreign dividend, with certain exceptions.

4.4. Deeming Provisions (Section 64B(4)(C))

This section deals with certain deeming provisions and is important in the event of liquidation. It states that any cash / assets are transferred or distributed by a company to its shareholders otherwise than by way of a formal declaration or in the course of liquidation and the amount of cash and assets in whole or in part constitutes a dividend as defined such dividend is deemed to be declared on the date that the shareholder becomes entitled to the cash or the assets.

4.5. Exemptions From STC (Section 64B(5)(C))

Covered in this section are exemptions from STC of "so much of any dividend distributed in the course or in anticipation of the liquidation or winding up or deregistration of a company…"

The below mentioned case concerned inter alia the question as to whether the dividends declared were exempt from STC. The answer to this question will be of concern not only to the shareholders but often also to the creditors of a company facing liquidation as it may materially affect repayment of their debts and a possible contribution to the costs of the liquidation.

In the matter of ITC 1781[16] the tax payer company was placed in voluntary liquidation and declared a liquidation dividend to its shareholders. The tax payer had previously received a dividend from its wholly owned subsidiary and then capitalised it by way of book entries to the share capital and share premium accounts.

The question then arose as to whether such dividends comprising part of the total liquidation dividend declared by the tax payer amounted to a distribution of profits of a capital nature as contemplated in section 64B(5)(c) of the Income Tax Act and therefore be exempt from STC.

The court held in this matter that the dividends when received by the tax payer was clearly of a revenue nature and the dividend retained that character in spite of it being journalised and made temporarily part of capital. In conclusion the dividend was of a revenue nature and was subject to STC.

This in the writer's submission would not necessarily be welcomed either by the company, its shareholders or the creditors.

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[16] 66 SATC 363

4.6. Long Term Insurers (Section 64B(5)(G))

This sub section was inserted into the legislation in 1994 and concerns the exemption of STC for any dividend declared by a company, which carries, on a long term insurance business out of profits derived during any year of assessment commencing prior to 1 July 1993. This section will naturally be of less and less impact in the litigation sphere as it deals only with a specific type of business and is very clear in its meaning.

But the case of Sage Life Ltd v Minister of Finance and Another[17] dealt with two important issues which have a wider impact than just companies directly affected by this subsection, namely the payment of interest on outstanding amounts owed by the fiscus to a tax payer as well as prescription.

In 1993 the tax payer, a long term insurer, had paid STC. As mentioned above in 1994 section 64B of the Income Tax Act was amended and section 64B(5)(g) was inserted to provide an exception to payment of STC for long term insurers. This amendment was back dated, which meant that the tax payer should not have paid STC. The amount paid was repaid by the fiscus in September 1997. A question before the court was whether interest was payable by the fiscus on the amount refunded.

The fiscus was held by the court to be in mora ex persona as from the date when demand to pay interest was made. More specifically interest was therefore only due from the date on which the tax payer had requested SARS to pay interest, in this case January 1995.

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[17] 66 SATC 181

This judgment is interesting in the writer's submission, as SARS had maintained that it was not obliged to pay interest at all on outstanding amounts. It is clear from this case that SARS, like a taxpayer, is obliged in certain circumstances to pay interest on amounts that it owes.

On the matter of prescription the court held that in the case of a debt in respect of tax (STC in this case) was 30 years, even if the debt was owed by SARS to a tax payer.[18] Therefore the defence of prescription by SARS failed.

The issue of assessment by SARS, and the meaning thereof, has been debated in the case of ITC 1740.[19] In terms of section 64B(8) of the Income Tax Act, where the commissioner is satisfied that any amount of STC has not been paid in full he may estimate the unpaid amount and issue to the company a notice of assessment of the unpaid amount. In this case the commissioner did exactly this and the tax payer took issue with the assessment on a number of grounds.

Here the tax payer, a company, appealed against an assessment for STC, which had been raised by SARS.

On an appeal the tax payer inter alia raised a factual allegation that the dividend had been declared and paid on 22 February 1993 and therefore section 64B(2) would not apply as it was on dividends declared on or after 17 March 1993 that STC was made payable.

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[18] S 11(a)(iii) of the Prescription Act 68 of 1969
[19] 65 SATC 98

Later a point in limine was raised that there had never been an assessment in regards to the STC. This referred to section 64B(8) that allows the fiscus, if it is satisfied that any amount of STC has not been paid in full, to estimate the unpaid amount and issue to the company a notice of assessment for the unpaid amount.

Further as the tax payer was obliged to furnish its cheque when rendering its return, when it failed to do so it could not be compelled to pay unless and until an assessment had been raised by the commissioner.

In this particular case the SARS computer was not able, due to technical difficulties, to issue an assessment but only generated a draft assessment, which draft was sent to the tax payer.

The court held that no assessment had been issued as assessment referred to a final assessment and the tax payer therefore succeeded in its appeal and the point in limine was upheld.

5. Special Tax Payers

Section 64B(12) deals specifically with gold mining companies. These companies may decide not to be subject to STC but will then have to pay corporate tax based on a higher percentage than that paid by companies, which are subject to STC. This in the writer's submission is a tacit admission by the government that STC does increase the corporate tax rate quite substantially as when STC is excluded the rate of tax paid is increased substantially.

The case of long term insurers has been discussed elsewhere in this thesis.

6. Prevention Of Avoidance Of STC (Section 64C)

This section deals with the prevention of avoidance of section 64B as well as detailing the position as regards certain distribution matters.

Section 64C is inter alia aimed at preventing certain schemes that would distribute the assets of a company in a way other than through a declaration of a dividend or a deemed dividend. An example of this would be the providing of a loan. In this respect the writer refers the reader to the case of ITC 1632[20] which dealt with the granting of a loan. This case was discussed in detail above. The anti avoidance slant of this section is further emphasised in that it aims in preventing the non payment of STC through the payment to persons who are not shareholders. It does this by including these non shareholders, who are connected to the shareholder, when calculating STC.

7. Deemed Dividend Declaration In Terms Of Section 64C(2)

As mentioned above this section deems certain transactions to be dividend declarations and therefore subject to STC.

Section 64C(2) states that for the purposes of section 64B an amount shall, subject to subsection (4) be deemed to be a dividend declared by such company to that shareholder in certain circumstances. It further states that a deemed distribution to a person connected to the shareholder in all the circumstances below is deemed to have been received by that shareholder.

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[20] 60 SATC 71

The section inter alia mentions the following, which are deemed to be a distribution of dividends.

(a) any cash or asset is distributed or transferred by that company to or for the benefit of that shareholder or any connected person in relation to that shareholder;

(b) the shareholder or any connected person in relation to that shareholder is released or relieved from any obligation measurable in money which is owed to that company by that shareholder or connected person, to the extent that the amount so owed was not already deemed to be a dividend declared by that company in terms of paragraph (g);

(c) any debt owed by the shareholder or any connected person in relation to that shareholder to any third party is paid or settled by that company;

(d) any amount is used or applied by that company in any other manner for the benefit of the shareholder or any connected person in relation to that shareholder;

This section therefore aims to prevent avoidance of STC in numerous ways, which include giving of loans and payments of obligations on behalf of the shareholder or connected person.

A practical application of this section was dealt with in the case of Commissioner SARS vs. Dyefin (Pty) Ltd.[21]

During 1994 – 1995 the tax payer made unsecured long term loans to a trust, which loans remained unpaid. The fiscus in terms of section 64C(2) and section 64C(3)(a) deemed these loans to have been dividends distributed to the trust and therefore subject to STC. (Kindly note that section 64C(3)(a) has subsequently been deleted in terms of section 59(1)(c) of Act 45 of 2003.)

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[21] 2002 (4) SA 606 (N)

In the Income Tax court it was held that the effect of the tax payer being the sole beneficiary in the trust was that the tax payer was a shareholder in itself and therefore the loans by the tax payer to the trust were loans to itself. Therefore STC was not payable.

Fiscus appealed this decision to a full bench of the High Court.

The court held that the tax payer was not at all material times in reality the beneficial owner of the shares and therefore the trust was a shareholder and that a distribution had taken place in terms of section 64. The appeal was therefore allowed.

In coming to its decision the court discussed the meaning of the word ‘distributed’ and cited a description in ITC 356[22] where it was stated that the ordinary meaning of the word distributed is the paying out of the amount in question to each shareholder and the receipt by them of this amount.

8. Inter Company Loans

Section 64 also deals with the issue of inter company loans. The writer will briefly discuss this below.

Certain loans between subsidiaries and between the holding company and subsidiaries are not subject to STC providing inter alia the holding company holds at least 75% of the equity shares in the subsidiary.

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[22] (1936) 9 SATC 95

As regards certain other loan transaction they may be subject to STC, depending on the circumstances. In any event the writer submits that the existence of STC does sometimes complicate transactions between companies and often may increase the costs of same.

9. Exemptions

This was partly dealt with previously but will here be mentioned in greater detail and with a different emphasis.

Section 64B(5) lists when dividends are exempt from STC. The writer proposes to list merely some of them, as they are quite detailed.

The following dividends are exempt from STC in terms of section 64B(5):

a) dividends declared by companies whose receipts and accruals (other than those from investments) are exempt in terms of section 10. (Section 10 deals inter alia with receipts and accruals of government, provincial administrations and scientific institutions.)

b) Any dividend declared by a fixed property company contemplated in section 11(s) which is deductible in terms of that section.

c) So much of any dividend distributed in the course or in anticipation of the liquidation or winding up or deregistration of a company, as is shown by the company to be a –

    (i) distribution of profits derived during any year of assessment which ended not later than 31 March 1993… or
    (ii) distribution of profits of a capital nature…
    (iii) distribution of profits derived by that company before that company became a resident…

In terms of Section 64B(2) STC is payable on any dividend declared on or after 14 March 1996 at a rate of 12.5% by any company which is a resident.

Therefore as a general rule any company, whether foreign or not will pay STC as long as it is considered a resident of South Africa. The definition of resident in terms of section one of the Income Tax Act was discussed above.

10. Net Amount Of Dividend (Section 64B(3A)(D))

It must also be noted that in terms of Section 64B(3A)(D) of the Income Tax Act that in determining the net amount of any dividend which has accrued to a company no regard is to be had to any foreign dividend other than a foreign dividend which accrued to that company…

(i) in circumstances other than as contemplated in subparagraph (ii) to the extent that the profits from which the dividend is distributed relate to an amount which has been subject to tax in the Republic in terms of this act without reduction as a result of the application of any agreement for the avoidance of double taxation…

(ii) to the extent that the foreign dividend arose directly or indirectly from any dividend declared by a company which is resident… and which was subject to secondary tax on companies…

11. Financing Of A Company

To fully understand the effects of STC on a company it is important to know that a company can generally be financed in one of three ways.

- by issuing shareholder equity
- by debt
- by a hybrid security such as a convertible debenture

The writer submits that whichever mechanism is chosen by the company there must be a return commensurate with the cost and risk involved.

There are of course advantages and disadvantages to any of the ways to finance a company. Issuing shareholder equity is cheaper than incurring debt, at least initially,

as no interest or security in the conventional sense has to be paid or given. But this method dilutes ownership and voting rights in the entity, which may not always be desirable. A hybrid security may involve both the advantages and disadvantages of debt and equity depending on whether it has been converted to equity or not.

The writer submits that whichever method is used will usually be a function of the market. STC will play a role here as naturally STC is paid on any dividends declared or deemed to be declared and will influence the method used. The existence of STC will thus affect whether shares will be issued to finance a company and whether a potential investor will purchase the shares due to the impact of STC on declaration of dividends.

As mentioned in the first introductory chapter although this thesis will concentrate on the juristic aspects of the topic due to the very nature of the topic covered it will be necessary to briefly discuss elements of economics (as well as social policy and politics) to ensure that the topic is dealt with holistically.

The famous economist Adam Smith set a number of requirements that a tax must satisfy for it to be considered a good tax.

A good tax is:

- convenient
- cost effective
- certain
- equitable (that is levied on ability to pay)

Later writers added two further principles, namely:

- a good tax minimises the disincentive effect on levels of effort and enterprise
- a good tax will be compatible with other tax regimes.[23]

Later in the thesis the writer will when analysing STC take into account the above requirements of a good tax.

Now that we have traversed in some detail the most important provisions of STC from the act itself, it will be useful to discuss the opinions of writers and other relevant parties as to the desirability of STC, which unsurprisingly are roughly divided into those broadly in favour of STC and those not in favour.

12. Views In Favour Of STC

Needless to say the Katz Commission into Tax Reform, particularly in chapter nine discusses several of the concerns of the critics of STC as well as briefly discussing the alternatives to STC.[24] A number of the concerns follow below.

The first major criticism dealt with is that STC is not recognised internationally and this then results in the unavailability to overseas investors of foreign or double taxation treaty relief against foreign taxes. This is conceded but it is stated that SARS has taken action to mitigate against this in the following ways:

- new double tax treaties bring STC within their scope as income
- negotiations to persuade foreign revenue authorities to recognise STC as an income tax for treaty purposes

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[23] Davies, B., Hale, G., Smith, C., Tiller, H. (1996) Investigating Economics. London: MacMillan Press Ltd.
[24] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

It is further stated in the report that both the above actions have been successful.[25]

That the above actions have not been wholly successful is shown by the attempt of certain multi national corporations to argue that STC is not payable on dividends declared to non resident group companies. The Minister of Finance, who has declared that it was never the government's intention to provide a tax regime which was more beneficial to these multi nationals than to South African companies, has forcefully opposed this.[26]

Another criticism is that a Final Withholding Tax on dividend distribution should replace STC. This would have a minimal impact in the domestic context but would reduce tax in the international context to zero, which would in return inhibit progress in lowering the standard corporate tax rate. This in the Commission's opinion would be detrimental for foreign investment.

The next criticism dealt with is that the corporate and STC rates are too heavy a burden and a tax on distribution (STC) has distorting effects on dividend policy and both foreign and local investment.[27]

It seems the commission is of the opinion that as the STC rate has been reduced from 25% to 12.5% these negative effects have been ameliorated substantially.

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[25] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

[26] SARS. (2004) SARS Briefing Note on the Minister of Finance's Press Release on Multinationals and Secondary Tax on Companies of 26 August 2004.
Available from: http://www.ftomasek.com/p260804b.html

[27] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

Katz states that if STC is included in South Africa's tax rate, then you must add in dividend tax on other countries' rates and it will be seen how competitive South Africa is.[28]

This theme is also discussed by the Treasury's Director of Tax Policy, Martin Grote, estimated that the effective corporate tax rate, that is the rate companies are really paying tax, is between 13-16%, which is very competitive.[29]

A final criticism dealt with is that STC is a minimum tax in that companies pay it no matter whether they have made a taxable profit or not. This might be considered by some to be inequitable, in the writer's submission.

The commission recommended that the above condition continue as any changes would introduce complexity into the system particularly in the case of capital gains where there would have to be a complex system of identification of underlying sources of each dividend.[30]

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[28] Sunday Times Business Times. (2005) Katz Lauds Job Creation Benefits in Tax Cut. Available from: http://www.btimes.co.za/99/0221/btmoney/money02.htm

[29] Business Day. (2005) Never Mind the Technicalities of Tax Let's Hear the Philosophy. Available from: http://allafrica.com/stories/printable/200504120276.html

[30] Katz Commission. (2004) Report of the Katz Commission into Tax Reform. Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

13. Solutions To The Problems Of STC

The Katz Commission concludes that the current system has its problems and there are two contrasting approaches available to deal with same.[31]

Either you could mitigate some of the problems or introduce an imputation system, which was discussed above. The commission stated that you could mitigate some of the problems particularly reducing the combined rate of corporate tax and STC. It is worthwhile to note that when the commission made this recommendation the STC rate was higher than it is today.

The commission is in favour of introducing an imputation system eventually but believes that the complexities of such a system would ensure that it would not be practical at this moment.

The writer submits that STC also does help to prevent certain unsavoury practices, which may result from the manipulation inter alia of separate legal personality. As an example in the case of Cir v Nemojim (Pty) Ltd[32] a dividend stripping scheme was attempted and although it was disallowed by the court, if STC had existed at the time it is far less likely that such a scheme would have been attempted due to the STC implications involved.

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[31] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

[32] 1983 (4) SA 935 (A)

14. Anti STC Views

These views are many and varied and are expressed by a number of parties and cover several areas of issues with STC. The writer proposes to discuss most of them fairly briefly but will discuss several, which he considers of greater import, in more detail.

14.1. STC Harms Small Businesses

The writer has discussed this problem previously. The contention is that STC adds to the running costs of small businesses, which are expected to provide most of the new employment created, and therefore will discourage entrepreneurship and the creation of employment. It will further discourage entrepreneurs from utilising the corporate entity when creating their businesses and force them to utilise other forms of business entity, such as partnerships, which suffer from legal and financial disadvantages.[33]

14.2. STC Negatively Affects The Efficiency Of The Financial System In Allocating Capital

Not Only will STC possibly affect the manner that capitalisation of a company could take place, as discussed previously, but it is alleged it will distort the capital markets negatively as companies will hold on to surplus capital. It will further dampen corporate demand for credit. In general it is seen as having a distorting effect on corporate decision making.[34]

[33] O'Grady, K. (2005) Business News.
Available from: File://A:STC%2011.htm
[34] Joffe, H. (2005) Secondary Tax on Companies here to Stay.
Available from: http://www.netassets.co.za/equities/nacols/colDetail.asp?co1ID=1413

15. STC Generally Viewed Negatively Internationally

This would include such diverse attitudes that inter alia state that STC not viewed positively internationally and is not understood.[35] It further ensures that South Africa's corporate tax rate is higher than the global average and unlikely to boost foreign direct investment.[36]

STC is seen as a highly complex and inefficient tax by some authors.[37] The writer submits that STC is not overly complex or inefficient. The state believes, with much justification, that it is a highly lucrative tax, which seems clear by the amount collected in the annual budget and the writer submits that it is not a particularly complex tax. It has generated very little litigation for such an unpopular tax and much of the administration is placed on tax payers in any event.

16. Discourages Investment

Dividend policy also affects the share value / price of a company, as far as the traditional financial analysts are concerned. Therefore any effect of STC on dividend policy, which creates a high retention policy of the company, which STC is supposed to do, will adversely affect share value. Taxation will almost always be an important consideration when making an investment decision.[38]

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[35] Werksmans Attorneys. (2004) Dividends Taxation Scares Off Multinationals.
Available from: http://www.werksmans.co.za/a-sndmsg/news-view.asp?PG=11&I=60496&M=O&CTRL...

[36] Temkin, S. (2005) Company Tax Cut Misses Mark.
Available from: http://www.estates.co.za/index.asp?articleid=1177

[37] Joffe, H. (2005) Secondary Tax on Companies here to Stay.
Available from: http://www.netassets.co.za/equities/nacols/colDetail.asp?co1ID=1413

[38] Atrill, P. (2000) Financial Management for Non Specialists. (2nd ed.). Harlow: Prentice Hall.

17. STC An Impediment To Black Economic Empowerment ("BEE") Deals

One of the government's important cornerstone policies is that of affirmative action in terms of the Employment Equity Act 1998 as well as a policy of Black Economic Empowerment ("BEE").[39]

The policy of BEE is permitted in terms of the Constitution of South Africa Act 1996 in section 9(2) which states that "To promote the achievement of equality, legislative and other measures designed to protect or advance persons, or categories of persons, disadvantaged by unfair discrimination may be taken". As can be seen this policy is of such weight that it appears in the highest law of the land, the Constitution.

Certain problems exist in structuring Black Economic Empowerment deals due to the existence of STC.

Funding for BEE deals often depends on a flow of dividends to service the debt. But if a company has to pay STC on the dividends declared they do not have much of an incentive to maximise the dividends and at the end of the day it all gets loaded on to the cost of doing BEE deals. In effect we have a 12.5 % empowerment premium.

A further problem exists in structuring BEE deals. In terms of the applicable legislation a company may not provide financial assistance to anyone for the purposes of purchasing shares in itself.[40] Therefore the company can not assist potential BEE investors in purchasing shares in the company. Often potential BEE investors do not

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[39] Joffe, H. (2005) Secondary Tax on Companies here to Stay.
Available from: http://www.netassets.co.za/equities/nacols/colDetail.asp?co1ID=1413
[40] S 38 of the Companies Act 61 of 1973

have the resources available to purchase significant equity in the company and to make it affordable current shareholders would have to so called “shrink the target”, by declaring much of the surplus capital and other assets as dividends before the BEE deal could take place. This would reduce the value of the company and make the BEE deal more affordable. This would obviously result in STC being levied and therefore inhibit certain BEE deals by making them more expensive than they would be in the absence of STC.

As is clear from the above that STC is an inhibitory factor for BEE deals to take place. Due to the fact that the government places such emphasis on the importance of BEE this must be a serious factor to consider when coming to a conclusion as to the desirability and efficacy of STC and its compatibility with other government policies.

18. STC And The Debt Equity Distinction

The learned author in this article discusses the disparate treatment of interest and dividends in the tax legislation.[41] This has some bearing on the ways that a corporate entity can finance itself, which was discussed above in the thesis.

The tax payable by the company and the investor depends on whether the capital is advanced to the company in the form of debt or equity.

Dividends in the hands of shareholders are usually exempt from income tax in terms of S10(1)(k) of the Income Tax Act and STC is paid by the company on dividends

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[41] Boltar, J.T. (1996) ‘Corporate Taxation and the Interest – Dividend Dilemma’, South African Law Journal, vol. 113, pp 455 – 467.

declared or deemed to be declared but is denied any deduction from its income in respect of these dividends. As no STC is payable on undistributed profits companies are encouraged to obtain equity capital from internal sources and not from external markets with new issues of shares. One of the results of this is that companies have a strong incentive to retain their excess earnings, which is then not available for new developing firms and therefore harms the economy.

A further problem is that as dividends are not deductible for tax purposes and that they are subject to STC investors may be discouraged from using the corporate form for new businesses. This is inefficient for the economy as other forms of business enterprise, such as partnerships and sole proprietorships suffer from defects such as limited economies of scale.

The learned author then suggests that if dividends, like interest, were deductible and STC were abolished a company would be taxed only on its undistributed profits.

This in the writer's opinion is a strong argument for the abolition of STC as STC is negatively affecting other government policies such as economic growth and the creation of employment.

19. Corporate And STC Tax Rates

The Report of the Katz Commission into Tax reform states, "… the reduction of the burden of the combined effect of the current level of both company tax and STC is the

real priority".[42] Katz was further quoted, at a later stage stating at the time when the corporate tax rate was dropped from 35% to 30% that this reduction would make South Africa more competitive and would lead to job creation among small and medium enterprises.[43] The general attitude is that a reduction of the rate of STC would benefit small business.[44]

The above report further states that the presence of a tax on distribution, which STC is, whether it be a tax on the company or on the shareholder has distorting impact on companies' dividend policy and investment, both foreign and local.

For example it has been said that a reduction of the tax rate should assist in attracting foreign direct investment ("FDI") and enhancing the desirability of South Africa as an investment destination and that it is disappointing that no provision has been made for the scrapping of STC. The same learned author stated that assuming that all profits are distributed South Africa would have an effective corporate tax rate of 36.89% from April 2005 with a current effective tax rate of 37.78%.[45] This rate is said to be 7.8% higher than the global average.[46] The negative effect of STC on dividend policy as well as impacting on investment is well documented.

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[42] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

[43] Sunday Times Business Times. (2005) Katz Lauds Job Creation Benefits in Tax Cut.
Available from: http://www.btimes.co.za/99/0221/btmoney/money02.htm

[44] O'Grady, K. (2005) Business News.
Available from: File://A:STC%2011.htm

[45] Ernst and Young SA. (2005) Surprise Reduction of Corporate Tax rate.
Available from: http://www.ey.com/global/content.nsf/South_Africa/23-Feb-05

[46] Temkin, S. (2005) Company Tax Cut Misses Mark.
Available from: File://A:\STC8-1.HTM

Despite the controversy over the very concept of STC the Minister of Finance has not always approached the matter in a dispassionate manner and answered the critics in an open minded way. He has made a statement as recently as April 2005 that STC as a tax on the rich is fundamental to African National Congress ("ANC") policy and that it will remain as long as the ANC is in government.[47] This in the writer's submission gives the distinct impression that STC is a tax implemented purely on political grounds and that the government of the day will maintain it even if it is not justified on juristic, economic or financial grounds. This further undermines confidence in the very concept of STC and certainly does not adequately answer the criticisms of those opposed to STC.

The following chapter will contain the critical analysis of the literature review.

[47] Ensor, L. (2005) Secondary Tax here to Stay-Manuel.
Available from: http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=1401046

CHAPTER 3

1. Critical Analysis

1.1. Rationale For STC And Objectives Thereof

The writer submits that an important yardstick to measure whether STC has been successful is whether it has met the objectives that were expected of it and whether it is compatible with other government programmes and principles. Have government objectives been fulfilled and has the tax proved an efficient and desirable tax?

In this regard it is also useful to have a look at what government says that its tax policy ought to be. It has been stated earlier in this thesis that the tax policy of government is “creating a more competitive direct tax regime capable of supporting investment and economic growth”.[48] It is common cause between the writers on STC and the government that an important reason for introducing STC is to get companies to adopt policies that favour re investment of profits and capital and therefore create employment. Thus when looking at the desirability and efficacy of STC the above must be taken into account.

The writer proposes to analyse the literature review initially by looking at the arguments against and in favour of STC and discussing them under appropriate headings.

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[48] Business Day. (2005) Never Mind the Technicalities of Tax Let’s Hear the Philosophy. Available from: http://allafrica.com/stories/printable/200504120276.html

2. International Recognition

An initial criticism raised by a number of writers is that STC is not recognised internationally. Even the Katz Commission in their report accepts this.[49] The writer submits that this is a valid and serious criticism of STC as the government in terms of their policies wishes to attract investment and negative views of STC will if anything discourage international investment in South Africa. The Katz Commission in their above report, as stated above, acknowledges this but states that this has been ameliorated to a great extent due to the negotiation of new tax treaties that make provision for STC, and negotiations that have been entered into between the South African Government and foreign governments to recognise STC for tax treaty purposes. This is correct, in the writer's submission, particularly that STC will be recognised for tax treaty purposes, but the attitude to STC must be analysed taking into account issues other than ignorance as to the details of STC on the part of foreign companies. That the attitude to STC is not overwhelmingly positive on the part of international companies is shown by the fact, as discussed in Chapter Two above, that certain multinational corporations were claiming that STC was not payable on dividends declared to non resident group companies, which was vehemently opposed by the Minister of Finance.

In conclusion, as regards international recognition, the writer submits that although awareness of STC and its implications are far better understood now than before, this is not necessarily a positive thing as regards investment.

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[49] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

This issue must be understood in conjunction with other issues that impact on the decision of companies as to whether they will invest in South Africa or not.

3. Discourages Investment Generally

Supplementing the above attitude to STC is the belief that it discourages investment and negatively affects share value. It is trite to state that tax almost always will be an important consideration when making an investment decision.[50] This criticism is best dealt with when discussing tax rates below.

4. Tax Rates

Both sides of the debate as to the competitiveness of South Africa's corporate tax rate agree, as discussed above in the Literature Review, that it is vital to have a competitive tax rate to successfully compete internationally for investment. But not surprisingly both sides disagree as to the competitiveness of South Africa's corporate tax rate.

The Katz Commission has stated that if STC is included in South Africa's rate of tax then the dividend tax of other countries must be added to their tax rate. Katz then concludes that South Africa's rate is competitive. Martin Grote, the Treasury Director of Tax Policy, who has stated that the effective tax rate of companies in South Africa is between 13 and 16 per cent, supports this conclusion.[51]

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[50] Atrill, P. (2000) Financial Management for Non Specialists. (2nd ed.). Harlow: Prentice Hall.
[51] Business Day. (2005) Never Mind the Technicalities of Tax Let's Hear the Philosophy. Available from: http://allafrica.com/stories/printable/200504120276.html

This is denied by most other writers and it has been stated that South Africa's effective tax rate is 37.78%.[52] This has been held to be 7.8% higher than the global average.[53]

In the writer's opinion this latter view seems to be the most correct bearing in mind that the Katz Commission itself has stated that the reduction of the corporate tax rate is a real priority.[54] This is re enforced by the fact that gold mining companies, who do not pay STC, pay tax at a far higher rate than companies which are subject to STC. It seems to the writer to be a tacit admission that the corporate rate of tax is not globally competitive. If the writer is correct in this then STC is contributing to a tax rate, which is uncompetitive and inhibiting investment and possibly the creation of employment.

5. Effect Of STC On Small Business

It was stated previously that a significant percentage of growth in job creation is expected to come from the small business sector.

It seems to be an almost universal opinion that the mere existence of STC harms small business.[55] It has also been stated in the Literature Review that a CC is subject to STC. As CCs are overwhelmingly for small and medium enterprises, with a maximum of ten natural persons as members, there is an impact by making them subject to STC.

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[52] Ernst and Young SA. (2005) Surprise Reduction of Corporate Tax rate.
Available from: http://www.ey.com/global/content.nsf/South_Africa/23-Feb-05

[53] Temkin, S. (2005) Company Tax Cut Misses Mark.
Available from: File://A:\STC8-1.HTM

[54] Katz Commission. (2004) Report of the Katz Commission into Tax Reform.
Available from: http://www.polity.org.za/html/govdocs/commissions/katzdoc.html?rebookmark=1

[55] O'Grady, K. (2005) Business News.
Available from: File://A:STC%2011.htm

This in the writer's opinion will discourage certain persons from utilising the corporate form of business enterprise, which in itself will have negative consequences, such as not having the protection of limited liability and separate legal personality. This may further discourage entrepreneurs from entering business at all and thus further impact on the creation of employment. This is obviously contrary to government policy in creating a climate to encourage the creation of employment and contrary to one of the reasons for introducing STC in the first place, namely to create further employment. A compromise would be to make CCs not subject to STC or introduce a South African equivalent of the American S Corporation or limited liability company as discussed in chapters one and two.

In the writer's submission this is a serious criticism of STC in its present form.

6. Potential Distorting Effects Of STC On Financing Of A Company

As mentioned in the previous chapters a company can be financed in one of three basic ways; by issuing shareholder equity, by debt and by issuing a hybrid security. The existence of STC will have an effect on which manner a company will utilise, as STC is payable on dividends declared and not on interest on a loan taken out. This issue was touched upon in an article dealing with this debt / equity distinction.[56] In short debt would refer to capital advanced pursuant to the conclusion of a contract of loan for consumption and equity would refer to the company raising capital by the issue of shares. Dividends are not deductible in determining taxable income and are subject to STC, while interest is deductible. This inter alia distorts the efficient

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[56] Boltar, J.T. (1996) 'Corporate Taxation and the Interest – Dividend Dilemma', South African Law Journal, vol. 113, pp 455 – 467.

allocation of capital as excess earnings are retained and are then not available for developing businesses. This in the writer's submission supports the argument of those opposed to STC in the arguments raised under other headings above, more particularly those stating that STC inhibits growth of businesses and the creation of employment. The learned author then concludes that if dividends were deductible and STC is abolished a company would then only be taxed on its undistributed profits. This in the writer's submission would be compatible with the abolishment of STC and its substitution with a withholding tax on undistributed profits.

7. Economic Argument

The writer set out in the previous chapter what the famous economist Adam Smith (and supplemented by modern writers) believes the criteria a good tax must fulfil; which were as follows:

- it must be convenient,
- it must be cost effective,
- it must be equitable (that is levied on ability to pay),
- it must minimise the disincentive effect on levels of effort and enterprise,
- it must be compatible with other tax regimes.

The writer stated previously that economic argument must play a secondary role in this thesis as juristic argument would be paramount, but due to the very nature of the topic and the objectives set out for it as well as the criticisms thereof, economic argument must to some extent be covered to adequately answer the problem posed in Chapter One of the thesis and test the hypothesis postulated.

It certainly seems that STC is convenient and cost effective, at least so far as the fiscus is concerned. In the writer's submission it is also a certain tax as the calculation thereof is in most, although by no means in all cases, fairly clear. By and large,

despite some confusion, the writer submits due to South African government negotiations in the tax treaty area, STC is compatible with other tax regimes.

On the other hand the writer does not consider STC equitable, as it is not necessarily levied on an ability to pay. A company, which has made no profit but declares a dividend, will be liable to pay STC. This will even apply in certain circumstances in a liquidation situation. This negative aspect is further compounded in that it certainly does not minimise, in the writer's submission, the disincentive effect on levels of effort and enterprise. This has been discussed in some detail above and it is clear that the existence of STC may very well discourage investors from investing and discourage certain entrepreneurs from starting businesses at all, as discussed previously. The distorting effect on the allocation of capital by STC merely adds weight to this conclusion.

The writer therefore concludes, using the above economic criteria, that STC can not be considered a good tax, despite the fact that it has proved an extremely lucrative tax for treasury and is expected to contribute almost R9 billion to the national treasury in the 2005 / 2006 tax year, which no doubt assists the state in providing certain social and other services to the average citizen and imposes a social cost on corporate entities in favour of society in general.[57] What is not clear is what the opportunity cost of the tax has been, in other words how much extra tax would have been collected if there had not been STC and how much extra employment would have been created if

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[57] SARS. (2005) Estimate of National Revenue, 2005.
Available from: http://www.treasury.gov.za

STC had not been instituted? And quantifiably what further investment opportunities have been lost due to the introduction of this tax?

The writer further wishes to critically analyse the Katz Commission's two approaches in dealing with the problems of STC. It is important to emphasise that even the Katz Commission recognises that there are problems with STC and that it is not as successful a tax as the Minister of Finance maintains. The writer in some detail above discussed this in previous chapters.

The commission set out the following approaches to deal with STC problems; firstly to mitigate some of the problems or secondly to introduce an imputation system in South Africa.

The commission favours an introduction of an imputation system, possibly recognising that any mitigation of problems will be partially successful at best, but concluded that it would not be practical for South Africa for the foreseeable future and could only be implemented once South African tax payers became more sophisticated.

Mitigation of the problems consisted of inter alia reducing the rate that STC is levied at as well as educating foreign governments and potential investors about STC. The rate of STC has been reduced substantially from a high of 25% and the government has been very active on the negotiation front, but despite this the writer submits that at best the problems of STC have been reduced but not dissipated. This is clear from the comments of the authors cited by the writer throughout this thesis.

This negative attitude to STC has been compounded, in the writer's submission, by the Minister of Finance making such comments, as STC will remain as long as the ANC is in power and that STC is a tax on the rich.[58] As discussed previously this gives the distinct impression that it is a punitive tax levied for political reasons and that no amount of evidence brought forth to show its negative aspects will be taken into consideration. This conclusion may not necessarily be accurate but the impression, in the writer's submission, exists.

All writers are in agreement that in any event STC could not be abolished immediately but at best would have to be phased out gradually and no doubt replaced by some other form of taxation. Even the Katz commission prefers an imputation system in principle but believes that it is too sophisticated for South Africa at this stage. The writer submits that the Katz Commission is correct in this regard. There is obviously some conflict in philosophy between the Katz Commission on the one hand and the government's political adherence, come what may to STC. In any event the government has a policy of economically empowering and uplifting the poor and disadvantaged and it may be difficult to justify doing away with STC if it is considered effective in this regard. Alternatively if STC actually hampers the upliftment of the poor and disadvantaged STC would be unjustifiable.

Politically the government is wedded to the concept of STC with the Minister of Finance stating publicly that as long as the African National Congress remains the ruling party STC will remain. This the writer's submits is in conflict with another

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[58] Ensor, L. (2005) Secondary Tax here to Stay-Manuel.
Available from: http://www.businessday.co.za/Articles/TarkArticle.aspx?ID=1401046

programme close to the government's collective heart as discussed earlier, namely that of Black Economic Empowerment. As discussed above STC is in effect a 12.5% empowerment premium. This in the writer's submission is one of the strongest criticisms of STC as it is hindering implementation of a major policy of the present government.

As regards other issues STC has generated remarkably little litigation for such a contentious tax and the writer therefore concludes that by and large it is clear and understandable and is a relatively simple tax to implement as far as the state is concerned. A positive factor of STC, in the writer's submission, is that it helps prevent certain unsavoury situations where the directors and shareholders could abuse the separate legal personality of a company. This was discussed in some detail in the literature review. A further positive factor, at least prima facie, is the fairly significant amount of revenue generated by this tax, which inter alia could be used for social upliftment of the population. These positive factors must be weighed against the negative factors before coming to a final conclusion as to the desirability and efficacy of STC.

The tax policy of the government is stated to be "creating a more competitive direct tax regime capable of supporting investment and economic growth".[59]

If the above is the tax policy of the government, which they say that it is, and bearing in mind the hypothesis of the writer as well as the argument specified in this chapter,

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[59] Business Day. (2005) Never Mind the Technicalities of Tax Let's Hear the Philosophy. Available from: http://allafrica.com/stories/printable/200504120276.html

the writer submits that STC is probably a hindrance and not an asset to the government's overall tax policy. In any event if STC is hindering investment and the creation of employment then it is certainly a tax that is harming the people it is supposed to help the most that is the poor and the unemployed. Added to this STC impacts negatively on other important government programmes and policies such as BEE. A further factor to possibly weigh up is that STC might cause certain political problems for the South African government. STC remains to this day a quite unfamiliar tax internationally, in the writer's submission. Therefore despite the fact that the government is actively involved in negotiating the new double taxation agreements to include STC many of the older ones do not and STC remains an exotic an unfamiliar system in the international tax sphere. The writer submits that business may influence foreign governments negatively towards South Africa, due to the overwhelmingly negative attitude to STC, and this may result in political fallout. This is added to the negative financial and economic impact of STC in the view of most writers and leads the writer to the conclusion below.

8. Conclusion

The writer submits that STC should be phased out, but not in one fell swoop, due to the amount retrieved and its economic impact, but should be reduced over a period of time until it is ultimately phased out. The conclusion reached by the writer, taking into account the hypothesis postulated in Chapter one, and the literature on the topic, is that STC is not a desirable and efficacious tax.

CHAPTER 4

1. Introduction

1.1. Shortcomings Of The Thesis And Recommendations Made

The writer posed the question in an earlier chapter as to whether STC suffers from the defects of its supposed virtues? In other words is it fulfilling the functions it is supposed to or is it doing the very opposite?

The tax policy of government was held to be the "creating a more competitive direct tax regime capable of supporting investment and economic growth". [60] It is clear from most of the writers on the subject that not only is STC not doing this it is probably inhibiting the achievement of this and is incompatible with other government programmes. This conclusion has been reached by analysing the comments and attitudes of writers on this topic and not by conducting primary research, which is outside the scope of this thesis. The recommendations are therefore made on the results of the secondary research conducted.

2. Shortcomings Of The Thesis

As mentioned above the writer submits that the major shortcoming of this thesis relates to the lack of primary research into the topic. The secondary research conducted is wide ranging but the suggestion is made that primary research is conducted into the consequences of maintaining STC and the consequences of phasing it out. This should overwhelmingly consist of quantitative research so that

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[60] Business Day. (2005) Never Mind the Technicalities of Tax Let's Hear the Philosophy. Available from: http://allafrica.com/stories/printable/200504120276.html

statistical conclusions can be drawn. Should the results of the primary research support that of the secondary research, which already exists, then the writer submits that the recommendations below would be beneficial.

The writer does not accept totally the Katz Commission solutions as being the only way of dealing with the shortcomings of STC but agrees that for the foreseeable future the introduction of an imputation system is not practical for South Africa and partially agrees that at the very least the problems associated with STC must be mitigated, but submits that this is acceptable only in the short to medium terms, as the very concept of STC may be questionable. It is emphasised that the below recommendations would be subject to primary research supporting the conclusions reached by the writer based on the secondary sources.

3. Recommendations

3.1. Primary Research To Be Conducted

The writer would recommend that quantitative primary research be conducted as to the impact of STC. Once this has been done then it should be clearer whether STC has an overwhelmingly negative or positive impact. Statistical and verifiable conclusions will then be able to be drawn. Although quantitative research should be the main focus of the research some qualitative research should also be conducted to test issues such as perception of investors and attitudes to STC. Should the research confirm the outcomes reached from the secondary research conducted by the writer then the following recommendations are also made.

3.2. Gradual Phasing Out Of STC

As was indicated previously, although STC is garnering a fairly large amount of revenue for government, in the long term it is incompatible with government tax philosophy and incompatible with other important government programmes.

The inevitable conclusion reached therefore is that STC should be phased out. This should be done in a gradual manner to minimise the negative impact on other government programmes and the budget. This can be done by progressively lowering the rate of STC over several years until the rate is zero.

A slight variation of this theme could be to allow companies to claim dividends declared as a deduction and do away with the debt / equity distinction in the financing of companies.

This will further help in reducing the corporate tax rate which most interested parties and commentators have declared must be reduced to ensure that South Africa is competitive.

3.3. Close Corporations To Be Free Of STC And Possible Introduction Of An 'S' Type Corporation

Due to the negative impact STC has on small business it is suggested that while STC is being phased out CCs should not be subject to STC. Whether in general STC is phased out or not, it is submitted that as far as CCs are concerned STC should be done away with due to the negative impact on small business and the attendant negative impact on the economy as a whole.

This can be done by either simply making them free of STC obligations or introducing a business entity equivalent to the American S Corporation, which enjoys the benefits of corporate personality but pays tax as if it were a partnership.[61] This should help encourage entrepreneurs to utilise a corporate entity and encourage the growth of employment.

Should STC not be permanently phased out the writer submits that CCs, or their equivalents, be made free of STC due to the advantages discussed previously.

3.4. Split Rate System

The writer suggests that this system only be introduced once primary research has been done to ensure that the benefits outweigh the costs. The secondary research conducted by the writer seems to suggest that such a system would have a positive impact. In the split rate system distributed profits in the form of dividends are subject to a lower tax rate than retained profits, which is the very opposite to the STC system.
It is submitted by the writer that if the phasing out of STC is done over a reasonable period of time, which would allow adjustment by all parties concerned and enable adequate primary research to be done, there should be no long term loss of tax revenue as revenue will be raised from the effects of greater investment and the creation of employment. This will ultimately not only benefit the fiscus but all the people of South Africa.

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[61] Snyman, E., Henning, J. (2003) 'The Limited Liability Company in the USA: An Innovative Organisational Option With Lessons for South Africa', South African Law Journal, vol. 120, pp153 – 171.

In conclusion, should primary research support the findings made from the secondary research conducted by the writer, then STC should be phased out in stages and the payment of dividends be encouraged.

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