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Video Transcription: Introduction to Dividends Tax

Hi, I'm Shaun Parsons, and in this video we're going to look at the basics of dividends and dividends tax.

To start with, what happens prior to a company deciding whether or not to pay a dividend? The company determines its net profit before tax for financial reporting purposes. At the same time, the company calculates its taxable income for income tax purposes. The net profit before tax minus the tax on the taxable income is the company's net profit after tax. This is the amount that is available either for reinvestment in the company or for distribution to its shareholders as a dividend.

As a dividend is paid out of the company's after-tax income, the dividend is usually exempt from income tax in the hands of the recipient shareholder. If it wasn't, the same income would effectively be taxed twice; once in the hands of the company and once in the hands of the shareholder.

This does not however mean that there are no tax consequences to declaring and paying a dividend. When a company pays a dividend, that dividend is subject to dividends tax at 15%, unless it is paid to a South African resident company or another exemption from dividends tax applies.

Let's look at this in more detail. Firstly, how is a dividend defined for tax purposes?

A dividend is any distribution by a South African resident company linked to any share in that company, including a distribution in respect of the repurchase of its own shares, unless it is a general repurchase of shares by a JSE-listed company.

A dividend does not include the return of amounts originally paid to the company for the purchase of shares, or the issuing of new shares.

Dividends may be paid in cash, or in the form of a distribution of other assets, such as trading stock. The payment of a dividend in a form other than in cash is called a dividend *in specie*. The value of a dividend *in specie* is based on the market value of the asset or assets distributed.

Dividends paid are subject to a 15% dividends tax if those dividends are from a South African company, or from a foreign company listed on the JSE.

The liability for the dividends tax on a cash dividend rests with the recipient of the dividend. However, it is the company that must withhold this amount from the dividend declared and pay it to SARS. The recipient therefore receives a net dividend of 85% of what was declared, and the recipient's liability for the dividends tax is discharged.

In contrast, the liability for the dividends tax on a dividend *in specie* rests with the company declaring the dividend. The company must therefore pay a tax of 15% over and above the value of the dividend declared. In this case the company is not withholding an amount to satisfy the liability of the recipient; the company is actually settling its own liability. The recipient receives the asset or assets, and has no dividends tax obligations.

In certain cases a dividend is exempt from dividends tax. The most frequently arising instance is when the dividend is paid to another South African resident company. A dividend paid by one South African company to another is exempt from dividends tax. This exemption is quite logical – since the dividend that is eventually paid to someone other than a resident company will be subject to dividends tax, this prevents the same income from being taxed multiple times along the way.

A dividend is also exempt from dividends tax if the dividend will be included in the income of the recipient. Remember that income is a defined term, meaning gross income minus exempt income. If the dividend is not exempt, then it remains in the income of the recipient and will increase their taxable income. This happens in the case of a dividend from a real estate investment trust (or REIT). The dividend is not exempt because it is deductible for the REIT, which means the dividend is paid out of pre-tax income.

If the dividend in not exempt from normal tax, then it is exempt from dividends tax.

So, a dividend from a South African company or a cash dividend from a foreign company listed on the JSE is subject to dividends tax, unless it qualifies for one of the exemptions.

What happens to foreign dividends? South Africa does not have the right to charge dividends tax on dividends received by South African residents from foreign companies (unless of course they are listed on the JSE). This could potentially make foreign investments more attractive than local ones, which would not be a good outcome.

For this reason, foreign dividends are usually not fully exempt from income tax. They are only partially exempt – 13/28 is exempt where the recipient is a company, and 26/41 where the recipient is an individual or trust. Why?

Let's look at when the recipient is an individual. If 26/41 is exempt, then 15/41 remains in taxable income. If the individual is in the maximum tax bracket of 41%, when their taxable income is multiplied by 41%, the effective tax rate on the original dividend is 15%. This is the same amount as the dividends tax that would have been charged if the dividend were a local dividend.

The same principle is true in respect of companies. If 13/28 is exempt, 15/28 is taxable. When multiplied by the corporate tax rate of 28%, the result is income tax of 15% of the amount of the full dividend.

There are however situations in which foreign dividends are fully exempt from income tax. This is normally to cater for specific situations where the income of the foreign company will potentially be included in the taxable income of the recipient, and removing the dividend prevents double taxation.

So, when a South African company makes a distribution to its shareholders it will give rise to a 15% dividends tax, unless it is paid to a South African resident company or another exemption applies. Is there any way of the company getting money to its shareholders without giving rise to dividends tax?

One way might be to loan money to the shareholders without charging interest. At some distant date in the future the company could then declare a dividend equal to the value of the loan, offset it against the outstanding loan, and the problem of the dividends tax would have been pushed far into the future.

To prevent this kind of tax avoidance, where any debt is owed to a company by a natural person who is a resident and who is a connected person to that company, the amount of the interest benefit is deemed to be a dividend for the purposes of dividends tax. The amount of interest that the shareholder didn't have to pay will be subject to dividends tax.

Furthermore, the amount is treated as a dividend *in specie* rather than a cash dividend. This means that it is the company that is liable for the dividends tax, and the company must find the money to settle the amount owing.

Let's recap:

- A dividend from a South African company will be subject to dividends tax of 15%, unless it is paid to another resident company or qualifies for one of the other available exemptions.

- The full amount of the dividend declared is included in the gross income of the recipient, not the amount net of dividends tax.

- However, a dividend from a South African company is normally exempt from income tax. This means that the only tax consequence of the dividend is the 15% dividends tax.

- Foreign dividends are not subject to dividends tax. They are however usually only partially exempt from income tax, resulting in an effective tax rate of 15% on foreign dividends.

That's it – thanks for watching.