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South African Perspectives: Its Prospects and Its Income Tax System
Samuel C. Thompson, Jr.*

This article is dedicated to one of my very best friends and former law partners at Schiff Hardin & Waite, the recently deceased Wayne McCoy, who encouraged me to write about my experiences in South Africa.

I. INTRODUCTION

From March 1999 until June 2000, I served on behalf of the United States Treasury Department as the Tax Policy Advisor to the Ministry of Finance and the South African Revenue Service ("SARS") in Pretoria, South Africa. My work with the Ministry and SARS principally focused on issues in business income taxation, including working on (1) the adoption of a capital gains tax; (2) the move from a source basis of taxing foreign income to a residence basis; and (3) the closing of several corporate tax loopholes. In addition to my work with the Ministry and SARS, I briefly assisted the South African Competition Commission on issues related to antitrust merger policy and taught a seminar course at the University of Pretoria School of Law entitled Comparative Merger and Acquisition Law and Regulation: The US, The EU, and South Africa.

As an African American, I was particularly honored to live in South Africa and to work for the Ministry of Finance, under Minister Trevor Manuel, and for SARS, under Commissioner Pravin Gordhan. I thank them for giving me a blessing of a lifetime, which allowed me to put to work for the South African people much of the knowledge and experience I have been so fortunate to gain in my many years of teaching and practicing in the areas of business taxation and mergers and acquisitions.1

* Professor and Director of the Center for the Study of Mergers and Acquisitions, University of Miami School of Law. I thank my wife, Barbara Gothard-Thompson and my research assistant, Byron Stith, for their helpful comments on this article.

1. I thank Bob Klayman, the head of the US Treasury Department’s Office of Tax Assistance, Neal Cohen of the US AID Office in Pretoria, and the many members of the US Embassy in Pretoria,
My enthusiasm for South Africa is shared by my wife Dr. Barbara Gothard-Thompson, who, while we were in South Africa, was the head of Public Affairs for Dow Chemical's South African operations.

This essay briefly presents perspectives on certain structural features of the South African income tax system. Most of the comments are directed at steps that can be taken to enhance South Africa's economic growth and job growth. Given that the unemployment rate among South Africa's non-White population exceeds the unemployment rate in the United States during the Depression, it is crucial that South Africa adopt tax and other policies that will lead it to higher economic growth.

The importance of the tax system in generating growth was recognized by President Thabo Mbeki in a speech he gave on July 17, 2000 at a meeting of the African National Congress ("ANC"), the dominant political party in South Africa. At this meeting, President Mbeki proposed that "foreign companies be offered tax breaks and other incentives to invest in manufacturing plants in South Africa." South Africa currently does not have in its Income Tax Act investment incentives, such as investment tax credits, jobs tax credits, research and development credits, and empowerment zones, each of which is or has been employed in the United States. I believe that South Africa should carefully craft tax incentives to promote both savings and investment, and I set out a broad outline of a set of such incentives in Section II(D) below. These incentives would be consistent with the recent decision by the ANC to "refocus its economic policy priority from strict macroeconomic management to growth targets like jobs and investment."

particularly Ambassador Delano Lewis. I also thank the following short-term Treasury consultants for their assistance in Pretoria: David Rosenbloom of Caplin & Drysdale (international tax issues), Professor Reed Shuldiner of the University of Pennsylvania Law School (capital gains), Tom Petska of the IRS (statistics of income), Selcuk Caner, formerly with the New York State Tax Department and now living in Turkey (revenue estimation), and David Brazell of the US Treasury Department (life insurance taxation). In addition to assistance on the tax policy side, the Treasury has also provided assistance to SARS on tax administration issues. Jim Owens, a former Deputy Commissioner of the IRS, led the team providing this support. While I was in South Africa, several internationally recognized tax experts participated in a weeklong tax policy symposium sponsored by the Ministry of Finance and funded by US AID. See Henry Aaron and Joel Slemrod, The South African Tax System: A Nation in Microcosm, 19 Tax Notes Int'l 2187 (December 6, 1999).

The greatest challenge faced by the South African government is to find ways to stimulate greater economic growth which in turn will stimulate greater employment. South Africa's official unemployment rate rose from 19.3 percent in 1996 to 25.2 percent in 1998. During this period, the expanded definition of unemployment for both rural and non-rural areas rose from 33 percent to 37.5 percent. In 1998, using this expanded definition, the unemployment rates among the various racial groups were as follows: African-47.6 percent, Colored-23.9 percent, Indian-19.5 percent, and White-6.6 percent.

These figures are indicia of South Africa's two different economies: a highly developed economy in which most of its White population enjoy all the benefits of a developed country, and a highly undeveloped economy in which large numbers of Africans and many Coloreds and Indians live in abject poverty. This dichotomy is vividly revealed, for example, on the thirty-minute drive from the world-class Cape Town International Airport to downtown Cape Town, during which you pass squatter camps, which have the worst conditions imaginable, on both sides of a superhighway on your way to beautiful Cape Town with its imposing skyscrapers, spectacular waterfront, and impressive infrastructure.

There has been modest growth in real (noninflationary) gross domestic product ("GDP") over the past five years as indicated by the following statistics: 1994-3.2 percent, 1995-3.1 percent, 1996-4.2 percent, 1997-2.5 percent, 1998-0.6 percent and 1999-1.2 percent. However, the growth in real GDP per capita, which economists

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5. Other important problems facing South Africa are to reduce crime and corruption, and to better combat the AIDS epidemic. South Africa's apparent corruption problem—Transparency International rated South Africa 5.2 out of 10, with 10 as no corruption, and 32nd of 85 countries ranked—and high crime rate deter FDI. Comparative statistics are illustrative: In 1995–1996, the South African murder rate was 61.9/100,000, whereas the US rate, commonly seen as high, was only 7.4/100,000. Similarly, the rape rate was 119.5/100,000 compared to the US 36.1/100,000. South African Institute on Race Relations ("SAIRR"), 1999–2000 South Africa Survey, Millennium Edition 54–55 (SAIRR 2000). These rates are gradually dropping, but, as stated in a recent FDI Confidence Audit for South Africa by AT Kearney, "[i]n almost every industry [surveyed], crime and violence are cited as a major obstacle to investment," and "[o]ver 70 percent of executives [surveyed] share the opinion that crime is a problematic fact of life in South Africa..." AT Kearney, FDI Confidence Audit: South Africa 12 (Global Business Policy Council March 2000).

This is a problem to which South Africa must invest more effort. Perhaps South Africa should consider following the model of Mauritius, a small African nation in the Indian Ocean, which my wife and I visited while we were in South Africa. Mauritius has one of the highest growth rates and lowest unemployment rates in Africa. One glaring difference my wife and I noticed between life in Mauritius and life in South Africa is that Mauritius seemed to have community policing; there were police walking the beat in every community we visited.

7. Id at 8.
8. Id at 11.
claim is the best measure of the standard of living, has been on a downward trend from 1994 through 1999 with negative rates of 1.5 percent and 0.9 percent during 1998 and 1999, respectively. This means that in both 1998 and 1999 the average South African was poorer than in the preceding year. As would be expected, this fall in real GDP per capita was accompanied by the 4.5 percent increase in unemployment from 1996 to 1998. Given the population growth in South Africa, real GDP growth of about 2.1 percent is needed to keep real GDP per capita constant.

The importance of investment for economic and job growth is generally recognized by economists, and it seems clear that one reason for the lack of growth is the relative stagnant level of private capital formation. Gross, and particularly net, private capital formation declined from 1996 through 1998 and had a slight increase in 1999. In addition to the low level of domestic investment, since 1994, in every year except 1997 and 1999, there was more outbound foreign direct investment ("FDI") by South Africans than inbound FDI from abroad. Over the period from 1994 through 1999, outbound FDI exceeded inbound FDI by Rand ("R") 6.7 billion (roughly $1 billion). This means that since 1994, South Africans have invested more in offshore operating businesses than foreigners have invested in South African operating businesses, with most inbound FDI in the form of mergers and acquisitions and not greenfield (new investment) projects.

The heavy outflow of FDI could lead potential foreign investors to ask why they should invest in South Africa when South Africans are not investing in their own country. In this regard, an analysis of investment in South Africa by the Financial Times found that the "sluggish pace of investment by [South African] domestic companies is ... a big disincentive to foreigners exploring opportunities in the country." One executive made the following observation: "[F]oreign investment always follows local investment. A bullish climate in any country is always precipitated by local capital. But the confidence is missing in the local market." Fortunately, the amount of inbound foreign portfolio investment ("FPI") (investments of less than 10 percent) has consistently exceeded the amount of outbound FPI.

It is commonly accepted that the South African government is doing an excellent job in managing fiscal and monetary policy. The budget deficit as a percentage of

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10. Id at S-149.
11. SSA, October Household Survey at Table B (cited in note 6).
12. SARB, Bulletin at S-126 (cited in note 9).
13. FDI is an investment of 10 percent or more in the equity of a foreign business.
16. Id.
17. Id.
18. SARB, Bulletin at S-90 (cited in note 9).
GDP fell from 5.8 percent for fiscal year ("FY") 1996 to 2.3 percent for FY1999, and government debt as a percentage of GDP fell from 49.5 percent of GDP in FY1996 to 47.8 percent in FY1999. The rate of inflation fell from 8.6 percent in 1997 to 5.2 percent in 1999. The government has adopted a policy of inflation targeting, a "new monetary policy framework based on the direct targeting of consumer price inflation . . . [with] an average increase of between 3 and 6 percent [set for] 2002 in the [core] consumer price index. . . ." Although two international rating agencies, Fitch and Standard and Poor's, recently upgraded South Africa's debt rating to investment grade, South African interest rates remain some 6 percent to 7 percent higher than comparable rates in the United States and Europe, meaning that the cost of capital for investing in South Africa is prohibitively high. This higher cost of capital makes it less likely that companies considering investments in South Africa will find the investment attractive. In making investment decisions, companies generally use the discounted cash flow technique under which the expected negative and positive cash flows from an investment are discounted to present value at the applicable cost of capital. Only investments with a positive net present value ("NPV")—the present value of the positive cash flows exceeds the present value of the negative cash flows—are made, and investments with high positive NPV are more likely to be made. The lower the cost of capital and the higher the positive cash flows, the more likely the investment is to produce a positive NPV. Thus, the high cost of capital in South Africa causes an investment in another country with comparable cash flows but a lower cost of capital to have a more positive NPV. This illustrates why it is so important for South Africa to both decrease its interest rates and take measures to enhance the cash flow from investments. In this connection, I suggest that South Africa should adopt targeted tax incentives (which will increase cash flow from investments) as a way of helping to stimulate economic and employment growth.

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19. Id at S-145.
25. Id at 469-475.
II. PERSPECTIVES ON THE SOUTH AFRICAN INCOME TAX SYSTEM

A. Introduction to South African Tax Reform. This section first briefly discusses some of the reasoning behind the adoption of two major changes in the South African income tax system, as set out in Finance Minister Trevor Manuel's Budget Speech of February 2000. These changes will be important in promoting economic growth: the adoption of a capital gains tax and the move from a source basis of taxing foreign income to a residence basis. As Manuel said, these proposals “constitute the most extensive set of tax reforms ever undertaken” in South Africa. Needless to say, I was proud to have had the opportunity to work with the Ministry in developing some of these reforms. Because tax reform is a never-ending process, this section also briefly discusses the following proposed changes to the current system that I believe the Ministry should consider: (1) the adoption of tax incentives to promote investment, including an investment tax credit, a jobs tax credit, and tax credits targeted at increasing business activity in economically disadvantaged communities; (2) a restructuring of the current Secondary Tax on Companies (“STC”) into a dividends tax that would qualify as a creditable withholding tax; and (3) both a limitation on and expansion of contributions to retirement plans. I merely outline the broad contours of these provisions; much work would have to be devoted to carefully crafting the specific provisions, particularly the incentive provisions.

B. The Rationale for Adoption of a Capital Gains Tax. The government's reason for adopting a capital gains tax is that “[t]he absence of a capital gains tax encourages taxpayers to convert income that would ordinarily be taxable into tax-free capital gains.... The result is erosion of both the corporate and individual income tax bases.” A capital gains tax has been adopted in connection with an across-the-board individual rate reduction that includes a decrease in the maximum marginal rate on income from 45 percent to 42 percent.

To give SARS time to draft the necessary legislation and the economy time to adjust to the new regime, the capital gains tax does not become effective until April 1, 2001, and only applies to appreciation after that date. In structuring the tax, provisions were borrowed from the Australian, Canadian, UK, and US capital gains tax rules. The essential terms include an exemption for principal residences, private

27. Id. The potential erosion of the tax base is perhaps best illustrated by the 1999 sale by one of South Africa's leading law firms of its corporate and commercial practice to an investment bank. In this transaction, the partners were able to convert what would otherwise have been income from the practice of law, which would likely have been taxed at the highest individual marginal rates, into wholly tax-free capital gains. See Law Firm's Partners Sell Practice to Match Rivals, Business Day 2 (Nov 1, 1999).
vehicles, and ordinary household goods, a requirement that individuals include only 75 percent of net capital gain in gross income, and a requirement that corporations include 50 percent of net gain in gross income. With a 42 percent maximum marginal rate for individuals and a 30 percent standard corporate rate, this means that the maximum rates on capital gains for individuals is 10.5 percent (25 percent inclusion amount x 42 percent maximum rate), and the maximum rate on corporations is 15 percent (50 percent inclusion amount x 30 percent).

This rate structure is more beneficial to taxpayers than, for example, the Canadian inclusion ratio of 75 percent, the British inclusion rate starting at 100 percent for the first two years, then dropping to 60 percent after 10 years, and the American maximum 20 percent tax rate on net long-term capital gains.

My view is that although the proposed South African rate structure is acceptable for gains realized on sales of capital assets held for a significant period, the 10.5 percent maximum individual rate for capital gains realized over a short period is likely to lead to significant efforts to convert ordinary income into capital gain. This type of conversion activity will undermine the structure of the ordinary income tax. I believe that capital gains realized over a short period, such as a year, should be taxed at regular rates, as is the case in the United States and United Kingdom. Thus, I would urge the South Africans to consider modifying the capital gains provision to tax at full ordinary rates gains realized on sales of capital assets held for no more than one year. In the case of individuals, I would urge the adoption of a 50 percent inclusion rate for gains realized on assets held for between one year and two years and the current 25 percent inclusion rate for gains realized after two years. The adoption of these modifications would significantly increase the efficiency and effectiveness of the capital gains tax.

C. Rationale for Adoption of a Residence-Based System. Minister Manuel explained the government's definition of the difference between a source basis system and a residence-based system as follows: "There are two alternative approaches to the taxation of income flows across international borders. In a source-based system, tax is levied on income earned from a source within a country irrespective of whether it was earned by a resident or a non-resident. In a residence-based system, tax is levied on the residents of a country irrespective of where in the world the income is earned." The South African source system "creates considerable scope for tax structuring as taxpayers find ways to change income that would normally be taxed in South Africa into untaxed 'foreign source' income."

As one illustration of this type of abuse, some South African firms were setting up offshore tax haven subsidiaries ("subs") and making payments to the subs that were deductible in computing the firm's South African income tax. The sub, which would have little or no foreign tax on receipt of the payment in the tax haven jurisdiction,

29. Manuel, Budget Speech at 19 (cited in note 26).
30. Id.
would later repatriate the funds to the South African firm in the form of tax-free dividends. This device effectively converted taxable South African income into completely tax-free foreign source income.

In his Budget Speech, Manuel announced that South Africa would adopt a residence-based income tax system as of January 1, 2000, and would begin immediately taxing most foreign source dividends. One of the guiding principles of the new system is that income a South African firm earns abroad that is subject to taxation in the foreign jurisdiction at a rate comparable to the South African income tax rate is free of South African tax. However, income earned abroad in, for example, tax haven jurisdictions is subject to tax in South Africa with a foreign tax credit being provided for any foreign taxes actually paid. This type of system should eliminate any tax incentive for moving investment capital outside of South Africa.

D. Proposed Tax Incentives for Promotion of Investment—The Case for Tax Incentives.
The risk in adopting any tax incentive is that the incentive may erode the tax base without generating the desired activity. On the other hand, if properly designed, the impact on the revenue may be minimal or possibly neutral or even positive. For example, an analysis of Clinton’s 1993 proposal for an incremental investment tax credit, similar to the one I propose below, reached the following conclusion:

It provides a powerful short-run stimulus to aggregate demand and employment. It has virtually no effect on the deficit over the first two years. It stimulates productive capacity and will therefore raise labor productivity and expand the economy’s productive capacity over the longer-run.

On the other hand, another study of Clinton’s proposal found that “there is substantial uncertainty to the economy’s response to a credit.” This study reports, however, that four different analyses of various investment tax credit proposals indicate that the proposals increased equipment spending, employment, and the deficit.

Prior to implementation, it will be impossible to resolve the debate on the efficacy of the investment incentives proposed here. Still, it is safe to reach the following conclusions. First, the South African economy is desperately in need of an economic push for investment, savings, jobs, and entrepreneurship; the sound macroeconomic policies that are now in place do not seem to be sufficient. Second, there are currently no tax policies in place to actively encourage investment in equipment and increased employment. Third, no one can say with anything close to certainty that tax incentives like those proposed here will not have a positive effect on investment and employment. Fourth, other countries, such as the United Kingdom and the United States, that are in much better economic shape than South Africa, have investment

incentives and jobs credits and provide tax incentives for investing in economically disadvantaged communities. For example, both the United States and the United Kingdom have a credit for research and development and provide tax breaks for small businesses. The United States first enacted an incremental jobs tax credit in 1977. The provision provided that an employer would receive a credit against tax for each net new employee hired. The credit was amended to a credit for hiring members of certain targeted groups that have high unemployment rates. Further, in 1997 the jobs credit was changed to a Work Opportunity Credit, which similarly provides a credit for 40 percent of qualified wages of targeted employees. Thus, the United States, with an unemployment rate of about 4.1 percent, has a credit to help create jobs, while South Africa with a 37 percent unemployment rate has no such device.

As a law professor, I fully understand the arguments in favor of a pure tax system. All things being equal, a pure tax system is preferable. But in South Africa all things are not equal. Indeed with a declining real GDP per capita, the economy is grossly under-performing, and policy-makers must take proactive measures to address the under-performance.

As a way of helping to limit abuse of any tax incentive provisions that may be adopted, I would urge that to qualify for any incentive, a company’s independent auditor and chief financial officer would have to: (1) certify that he or she had determined that all the requirements for qualifying for the incentive are satisfied, and (2) identify any issue that has been resolved in the taxpayer’s favor that is not specifically addressed in the statute or regulations. Also, SARS should adopt an aggressive approach, including an effective audit program, for ensuring that all requirements for qualifying for tax incentives are satisfied.

In addition, it would be appropriate to have each incentive provision expire, or sunset, after a number of years, unless the provision is extended by Parliament. However, to ensure predictability and to allow businesses to invest, the provisions should stay in place for a significant initial period, perhaps five years. It would be appropriate for the Ministry to provide Parliament with periodic reports on the revenue and growth effects of each provision. In this way, the government could meaningfully assess the effectiveness of each incentive provision.

E. A Proposed Investment Tax Credit. As demonstrated above, one reason for the lack of growth in South Africa is the falling level of private capital formation. As indicated by the research of Lawrence Summers, now US Treasury Secretary, "investment in equipment is the single most important factor contributing to economic growth and development." As an illustration of this principle, between 1996 and 1999, the general decline in net private capital formation in South Africa has been accompanied by a decline in employment.

34. SARB, Bulletin at S-126, S-152 (cited in note 9).
As a measure to help stimulate net private capital formation, it is suggested that South Africa consider adopting an investment tax credit, possibly along the lines of the incremental investment tax credit ("IITC") outlined here. An investment tax credit is designed to stimulate investment in plants and equipment by giving the taxpayer a credit (in other words, a reduction) in tax liability, and the IITC discussed here is designed to have the maximum stimulative effect on investment and the minimum adverse revenue effect. Care would have to be given in designing the details of any credit, and it could be particularly difficult to design an effective incremental credit. The United States has never adopted an IITC, apparently because of difficulties in designing such a credit; however, the United States presently has an incremental research and development credit. If it is not possible for the South Africans to design an effective IITC, a non-incremental credit should be developed, but possibly with a lower credit to minimize the adverse revenue effect. The IITC would be available to taxpayers engaged in specified manufacturing activities and would be available for investment in equipment (not buildings) above a specified threshold. The threshold might be 80 percent of the average investment made by the taxpayer during the preceding three years. Taxpayers making an investment in equipment above the threshold would receive a credit against tax liability of, say, 10 percent of the investment.

Thus, for example, if Corporation A has invested an average of R100 million in new equipment over the past three years, its threshold for the current tax year would be R80 million. If during the current tax year Corporation A invested R130 million in equipment, the IITC would be 10 percent of R50 million, which is the amount by which the R130 million investment exceeds the R80 million threshold. Thus, Corporation A would have a credit of R5 million against its current year tax liability.

The credit acts as an incentive for Corporation A to make investment above its threshold. On an aggregate level, the credit could help turn around the steady decline in gross private capital formation that has occurred since 1996.

F. A Proposed Jobs Tax Credit. As indicated above the South African economy has been losing jobs. Fewer people are employed in the formal economy in 2000 than in 1996. The South African labor laws, which are commonly thought to be very protective of labor, may be a contributing factor to this decrease in employment. The incremental jobs tax credit ("IJTC") proposed here would provide a positive incentive for increasing employment of low level employees and, therefore, help offset any negative effect of the labor law.

The IJTC would provide employers with a tax credit of, say, 10 percent for the salaries paid to a specified class of newly hired employees. The purpose of the credit is

35. A non-incremental investment tax credit was adopted in the United States during the Kennedy Administration and was repealed in the 1980s. An incremental credit was proposed by the Clinton Administration in the early 1990s but was not enacted.
to provide a tax incentive for businesses to hire additional employees who are not highly compensated.

The taxpayer would have a threshold that it would have to exceed before the credit would be available. The threshold would be the average over the past three taxable years of the number of employees earning income below a certain level, such as R50,000 per year ("Covered Employees"). The base for computing the credit would be the aggregate salaries paid to "newly hired" Covered Employees, but only to the extent the total number of Covered Employees in the taxable year exceeded the threshold number of Covered Employees. Thus, the base would only include salaries paid to new Covered Employees who were not replacements for departing Covered Employees.

The basic operation of this provision can be illustrated as follows. Assume that for the last four years, Corporation B employed ten employees who made less than R50,000 per year. Corporation B's threshold is, therefore, ten. In the current year, Corporation B retains each of these ten employees and adds an additional five permanent employees each of whom makes R50,000. Thus, the number of Covered Employees in the current year, fifteen, exceeds the threshold by five. Therefore, the salaries of the five newly hired Covered Employees are included in the base for calculating the credit. This means that the base is R250,000 (5 x R50,000), and the credit is 10 percent of this amount, R25,000.

G. A Proposal for a Package of Tax Incentives to Promote Investment in Economically Disadvantaged Communities. The South African Income Tax law does not contain special tax incentives designed to increase business activity in economically disadvantaged communities. In contrast, the United States has a variety of such tax incentives, and the US Congress is currently considering others.6 The empowerment zones provisions of the US Internal Revenue Code provide tax incentives for businesses that locate within certain economically disadvantaged areas. The tax incentives available include a 20 percent wage credit for the first $15,000 of wages paid to residents of certain zones who work in the empowerment zone and an additional expensing deduction for certain equipment.7 In addition, the Code contains provisions to encourage economic development in the city of Washington, DC.8 The Code also contains special tax incentives to promote business development on Indian reservations.9 In addition, President Clinton has proposed in his FY2001 Budget

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7. Id at 2.
8. Id.
9. Id at 3.
additional incentives for economically distressed areas, including a tax credit for investments in stock in certain community development entities.  

I strongly urge South Africa to follow the lead of the United States in developing a package of tax incentives to encourage business development in economically disadvantaged areas.

H. A Proposed Revision of the Secondary Tax on Companies. Currently the standard corporate tax rate in South Africa is 30 percent. Dividends are not subject to tax, but corporations pay a Secondary Tax on Companies ("STC") in the amount of 12.5 percent on dividends. Thus, for example, if a corporation has R1,000,000 in taxable income, the corporation pays a corporate level tax of 30 percent or R300,000. This leaves R700,000 in after-corporate tax income. If, after taking account of the STC, the corporation wanted to pay out all of this R700,000, the corporation would distribute a dividend of R622,222. The corporation would have to pay a STC of 12.5 percent of this dividend, or R77,777.70. Thus, the total of the corporate tax and the STC is R377,777, which is a combined rate of tax of 37.7 percent. This combined rate is less than the top marginal individual rate of 42 percent. This means that for many South Africans it is more advantageous to earn money through a corporation than directly.

It is instructive to compare the South African system with the classical system of taxing corporate income that exists in the United States and a fully integrated system, which many economists claim is the theoretical ideal. Under the US classical system, regular corporations are subject to a maximum rate of 35 percent and dividends are taxed in the hands of individual shareholders at a maximum rate of 39.6 percent, which produces a combined corporate and shareholder rate of 55.74 percent. Under a fully integrated system, corporate earnings, whether distributed or not, would be taxed in the hands of the shareholders at rates applicable to shareholders. Thus, if a fully integrated system were to apply in the United States, and a shareholder were in the maximum rate bracket, his or her applicable share of the corporation’s income would be taxed at a 39.9 percent rate. In South Africa, the rate in such case would be 42 percent.

In the end, the South African system produces a tax result on distributed corporate income that is less than the result that would apply under the theoretical ideal. I am aware of no other country in the world that offers a similar benefit for distributed corporate earnings, and I can think of no policy justification for this structure. In addition, the structure has a deterrent effect on attracting foreign portfolio investment, because the STC is generally not creditable as a withholding tax. For example, if an American individual investor purchases shares of a South African corporation, the dividends received will be taxed at the 37.7 percent rate and the shareholder will not receive a credit against his or her US tax liability for the STC.

40. Id at 4.
On the other hand, if the STC were restructured as a withholding tax, the US investor would receive a credit against his or her US tax liability in the amount of the STC, subject to certain limitations. By converting the STC into a withholding tax, South Africa could significantly increase the attractiveness of South African equities for foreign investors.

South Africa should eliminate this unjustifiable tax break for distributed corporate earnings and make its equities more attractive to foreign investors by making the following changes in the structure of its corporate tax. First, the corporate rate should stay at 30 percent or possibly even be decreased, because it is important to encourage the retention of corporate earnings, which is the principal source of savings in South Africa. Second, the STC should be converted into a withholding tax in the amount of the present 12.5 percent. Third, the 12.5 percent withholding tax would be a final tax for foreign shareholders and low bracket South African shareholders who presently do not have to file returns because their tax liability is satisfied under the current wage withholding system. All other shareholders, which in the case of individuals would include principally South Africans in the 42 percent maximum tax bracket, would have to include a percentage of the dividend (grossed-up for the withholding tax) in income and would receive a credit against their tax liability for the withholding tax. The inclusion percentage should be set at 60 percent so that the combined corporate and shareholder tax rates for the 42 percent bracket taxpayer is about 47 percent. The higher combined rate could be viewed as the price the shareholder pays for being able to retain income in the corporation at the lower 30 percent corporate rate; it is analogous to a tax on the deferral benefit associated with retained earnings.

The suggested system is a partially integrated system and is similar to the systems employed in many countries, including Britain. It is not perfect, but it has the following virtues. First, it eliminates the perverse effect under the current system which allows high bracket taxpayers to earn income through corporations at lower rates than if they earn the income directly. Second, it collects more tax from high bracket taxpayers who receive distributions of corporate earnings, and so it should act as an incentive for corporations to retain earnings, which is the largest source of savings in South Africa. Indeed the increased taxes on distributed earnings could be used to lower the standard corporate rate, which could have a beneficial effect on investment. Third, at zero cost to the South African fisc, investments in South African equities become more attractive because the 12.5 percent withholding tax, which is at the same rate as the STC, is now creditable as a foreign withholding tax for foreign portfolio investors. This means that in the case of a US portfolio investor who can take advantage of the full credit under the US foreign tax credit provisions, the tax on distributed earnings of a South African corporation is reduced from 37.7 percent under the current system to 30 percent. This type of change could make South Africa significantly more attractive as an investment destination.
I. A Proposal for Both a Limit on and Expansion of Pension Fund Contributions—The Case for a Limit on Deductions by High Income Taxpayers. South Africa does not have a Social Security system. It does, however, have a means-tested old age pension, which is funded out of general revenues. Under this pension system, the maximum pension is approximately R550 per month (roughly US $90).

The current South African tax system has a variety of provisions designed to increase retirement savings. These include a deduction for employer and employee contributions to pension plans, and an employee deduction for contributions to retirement annuity funds. Under Section 11(k) of the Income Tax Act, an employee is allowed an annual deduction from gross income for contributions to a pension fund in an amount not to exceed the greater of (1) R1,750 or (2) 7.5 percent of remuneration from retirement-funding employment (for example, salaries and other compensation). This is on top of the employer’s maximum deductible contribution of 20 percent.41

There is no monetary limit on the deductible amounts an employer and employee can contribute to a pension plan as is the case in the United States and most other countries. Thus, for example, a South African executive making the equivalent of $1 million a year could personally deduct up to $75,000 in pension contributions and his employer could deduct up to $200,000, for total tax deductible contributions of $275,000 per year. The combined limit for employee and employer contributions to defined contribution plans in the United States is $30,000.42 In addition, under current South African law, a person participating in a pension fund may also make a tax-deductible contribution of at least R1,750 to a Retirement Annuity Fund.

These deduction rules provide extremely generous tax benefits for wealthy South Africans. I believe that it is very important for the government to cap the amount of contributions to pension plans and also to use the additional taxes collected as a result of the cap to expand the availability of retirement savings to a broader base of South Africans. The expansion of coverage is particularly important given the fact that South Africa does not have a Social Security System.

J. The Case for an Expansion of Pension Benefits for Poor South Africans. To help low-income South Africans prepare for their retirement years, it is suggested that the additional taxes collected from the cap on retirement plan contributions suggested above (and other resources if necessary) be devoted to developing a mandatory retirement savings program (“MRSP”) for low-income South Africans. Such a system would be similar to the systems in Chile and Mexico and be based in part on


42. US Internal Revenue Code of 1996, sec 415(c) as amended 735 (West 1996).
principles similar to those governing individual retirement accounts in the United States.43

Under this MRSP proposal, all taxpayers earning gross income below a certain level, say R50,000 (roughly $8,000), would be required to make an annual contribution to a personal MRSP account in the amount of, for example, 1.5 percent of gross income. The government would make a matching contribution of 0.5 percent of such gross income. Each covered taxpayer would then have an annual investment in an MRSP account equal to 2 percent of gross income, and the government would have contributed 25 percent of the contribution.

South Africans not in the tax system, including domestic workers, street vendors, and the unemployed, should also be able to voluntarily participate at a certain basic level, with the government making a matching contribution. Thus, every adult in South Africa could participate in this retirement savings plan if he or she desired.

The contributed funds would be invested in South African equities and debt, and no tax would be imposed on the income earned on the funds held in a MRSP account. Participants could not draw down on their accounts until retirement.

The economic effects of long-term participation in the MRSP could be dramatic. Based on computations by the Joint Committee Report on Private Individual Accounts, under an assumption of an average 5.5 percent annual return after inflation, the funds available for a taxpayer with an annual taxable income of R40,000 who participated at that level for thirty-five years would be approximately R85,000 in real terms. This would support an annual joint and survivor life annuity of around R6,235, which is about the level of the annual old age pension.

Of course, the details of the administration of the MRSP would have to be worked out carefully, but in view of the absence of a Social Security system in South Africa, the MRSP or a similar system of private retirement accounts could permit the South African government, without significant costs, to help large numbers of its citizens prepare for their retirement years.

III. Conclusion

From my experience living and working in South Africa, I have a personal appreciation for the greatness and uniqueness of this wonderful country. I am confident that in time South Africa will create the sustainable growth that will permit all of its people to enjoy economic prosperity. I hope that the suggestions I have set out here regarding such matters as the need for (1) a fresh and creative look at the efficacy of tax incentives; (2) structural improvements in its capital gains and

corporate taxes; and (3) a redirection of some of the current retirement tax benefits from the wealthy to the poor, will be of assistance in helping South Africa attain economic prosperity. I close by again thanking the South African government for giving me the privilege of working for the Ministry of Finance and SARS.