The timing of the recognition of a liability. for secondary tax on companies in accordance with international financial reporting standards

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United States Generally Accepted Accounting Practice ("US GAAP") generally requires taxes to be measured at the rate applicable to distributed profits, while International Financia1Reporting Standards ("IFRS") requires the undistributed rate to be used. This current conflict between US GAAP and IFRS has particular relevance in South Africa, which has a dual tax' system as a result of Secondary Tax on Companies ("STC") being levied when a company distributes its profits. Currently, under US GAAP, South African companies would be required to raise a liability for the tax that would become payable' on the future distribution of profits, while under IFRS, this is only recognised when the profits are distributed.

The objective of the study is, therefore, to consider the timing of the recognition of a liability for STC.

The literature study has indicated strong arguments for both the recognition of a inability for STC prior to the declaration of a dividend and the non-recognition of a liability for STC prior to the dec1aration of a dividend. The empirical study, however, concluded that the recognition of ability prior to the declaration of a dividend is not appropriate, as a majority of the respondents believe that no "past event" has occurred and therefore the definition of a liability in terms of the IASB Framework is not satisfied. The results of the empirical study, however, also indicate that if the "past event" hurdle could be overcome, uncertainty exists as to whether the recognition of a liability for STC prior to the declaration is appropriate. This is as a result of mixed opinions among the respondents as to whether the "probability" and "measurability" criteria, in terms of the IASB Framework, could be satisfied prior to the declaration of a dividend.

KEY WORDS
Distributed rate, F AS 109, IAS 12, IFRS, Income tax consequences of dividends, Secondary Tax on Companies, South Africa, Undistributed rate, US GAAP,

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BACKGROUND AND FORMULATION OF THE STUDY

Background

"The move to global standards is unstoppable. The world is demanding it – not just standard-setters but investors, users, regulators" (Barth, 2003:8).

It has long been recognised that, in order for international capital markets'. to function properly, a "single set of high quality, international accounting standards" must exist (Campbell, Hermanson. & McAllister, 2002:20). Recent developments in the accounting sphere suggest that two significant accounting reporting frameworks remain globally, namely United States Generally Accepted Accounting Practice ("US GAAP") and the International Financial Reporting Standards ("IFRS").

Several countries have already incorporated IFRS into their local accounting frameworks, for example, the Russian Federation (Deloitte, 2004:4). In 2001 the European Commission also took a positive step towards creating a high quality European capital market by requiring the use of IFRS for all entities listed on European stock exchanges for financial periods commencing on or after 1 January 2005 (Tyrrall, 2004:1). In July 2002, the Australian FRC endorsed a requirement that Australian reporting entities use IFRS by 1 January 2005. In December 2002, Estonia decided to permit Estonian companies to use IFRS instead of national standards - the Estonian standards have been largely rewritten in Line with IFRS (Tyrrall, 2004:1). In South Africa, the Johannesburg Securities Exchange ("JSE")- listing requirements have also been revised, requiring all JSE-listed companies to comply with IFRS for annual periods beginning on or after 1 January 2005 (SAICA, 2003a:§03).

A study performed by Tarca (2004) on the use of US GAAP and IFRS from 1999 to 2000, however, indicated that, overall, US GAAP was used more widely than IFRS. This shows the influence of US GAAP in the international business environment, and demonstrates the importance of US capital markets (Tarca, 2004:86).

Therefore, many believe that a precondition for a "single set of high quality international accounting standards" is convergence between US GAAP and IFRS (Campbell *et al,* 2002). Convergence of accounting standards around the world is one of the main objectives of the International Accounting Standards Board ("IASB"), the standard setting authority for IFRS (Tyrall, 2004:1). In pursuit of this objective, the IASB and the Financial Accounting Standards Board ("FASB"), the standard setting authority in the United States, have launched a short-term convergence project to reduce the differences between IFRS and US GAAP (Tyrall, 2004:1).

The convergence of FASB Statement no 109, *Accounting for Income Taxes* ("FAS 109"), and International Accounting Standard *12, Income Taxes* ("IAS 12"), forms part of this short-term convergence project (FASB, 2004:1). One issue under consideration is the appropriate tax rate at which deferred tax assets and liabilities should be measured (FASB, 2004:2). FAS 109 generally requires deferred taxes to be measured at the rate applicable to distributed profits (FASB, 2004:2), while IAS 12 (2000:§52A) requires the undistributed rate to be used.

• **Defining the problem**

The convergence between IFRS and US GAAP on the tax rate at which tax assets and liabilities should be measured could have a profound impact, especially on South African and Estonian companies. South African companies pay a Secondary Tax on Companies ("STC") on dividends paid to shareholders, while the Estonian tax system is an extreme example of a dual- income tax rate system, with a zero tax rate on undistributed taxable income and a higher rate on distributed income (KPMG, 2004b:319). Currently companies in Estonia and South Africa recognise tax assets .and. liabilities at the rate applicable to undistributed profits under IFRS, while they would-be required to use a higher rate for measurement under current US GAAP. The decision on the appropriate tax rate at which tax assets and liabilities should be measured could also influence some type of entities, for example, real estate investment trusts, registered investment companies and cooperative enterprises in the United States (IASB & FASB, 2005:1). These entities receive special treatment under the United States tax law, as they do not pay income taxes to the extent that a minimum percentage of earnings are distributed to shareholders and certain other requirements are met (IASB & FASB. 2005:3). The FASB is of the opinion that a decision to use the undistributed rate will significantly change the financial reporting, for these types of entities, as currently under US GAAP the distributed rate is used (IASB & FASB, 2005:1). Therefore, even though this study only considers the appropriate tax rate for the measurement of tax assets and liabilities in the context of South African companies, companies in Estonia and certain companies in the United States might be similarly affected.

Objective of the study

The objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an enterprise that is useful to a wide range of users in making economic decisions (IASB Framework, /989:§12). The current conflict between IFRS and US GAAP as to the timing of the recognition of the income tax consequences of dividends might negatively impact the usefulness of the information provided to the users of the financial statements on the income tax consequences of dividends.

The objective of the study is, therefore, to consider the timing of the recognition of d liability for STC. The conclusion reached by this study might assist in the convergence of FAS 109 and TAS 12.

Scope of the study

This study focuses on the timing of the recognition of a liability for STC in an entity's separate financial statements.

While the concept of "dividends" is very wide and includes arty amount envisaged by the dividend definition contained in section 1 of the South African. Income Tax Act 58 of 1962 ("the Act"), as well as certain deemed dividend provisions contained in section 64C of the Act, this study focuses only on cash dividends distributed by a company to its 'shareholders while the company is a going concern.

It is further assumed that the criteria for the recognition of dividends as contained in LAS 10, *Events after the Balance Sheet Date,* are conceptually sound.

Research methodology

A literature study and an empirical study were performed.

First, a background to STC and the financial reporting framework in South Africa is provided. The accounting treatment relating to the initial recognition of STC is then considered with reference to the accounting framework. Concerns regarding the accounting treatment, as identified in the literature study, were tested by means of a questionnaire sent to the accounting-technical and tax partners of the eight largest auditing firms in South Africa and the accounting lecturers who teach students at the honours level of the various universities in South Africa. Finally, the findings of the study are provided.

BACKGROUND: THE SOUTH AFRICAN SITUATION Background to

STC

The introduction of a dual tax system for companies in South Africa in order to encourage growth in new and fast-growing companies without at the same time prejudicing the fiscus to any great extent, has been described as one of the more interesting developments of the 1993 budget (Old Mutual, 1993:3). The announcement of a dual tax system for companies and close corporations in South Africa resulted in a reduction of the corporate tax rate, at that stage from 48% to 40%, and introduced a new STC at a rate of 15% on net dividends declared by a company on or after 17 March 1993 (Business Day, 1993:2). The STC rate was reduced to 12.5%, with effect from 13 March 1996 (Department of Finance, 1996:5.6). The corporate tax rate for years of assessment ending on or after 1 April 2005 is 29% (National Treasury, 2005:26).

In accordance with the Act, the amount of STC is based on the "net amount" (section 64B(2) of the Act). The net amount is the amount by which the amount of dividends declared (which is not exempt from STC in terms of section 64B(5) of the Act) exceeds the sum of certain dividends that accrued to the company during the dividend cycle (section 648(3) of the Act). 1,,There the sum of dividends accrued exceeds the dividend declared, the excess shall be carried forward and deemed to be a dividend which accrued to the company during the succeeding dividend cycle of the company (section 64B(3)(a) of the Act). From an accounting perspective, the recognition of STC is considered on a gross basis (AC 501, 2003:§07). In other words, the "net amount" is divided into its two composite components, namely a possible liability on the amount of dividends to be declared and a possible asset on the amount of dividends accrued. This study only considers the timing of the recognition of a liability for the amount of future dividend declarations.

STC is payable on actual dividends declared as well as certain deemed dividend declarations as envisaged by section 64C of the Act. According to De Koker (2003:§13.11), the purpose of section 64C of the Act is to provide anti-avoidance provisions, which are designed to prevent the avoidance of the liability for STC levied by section 64B of the Act.

The dual tax system results in the following distributed and undistributed tax rates (based on the assumption that taxable income is fully distributed):

Taxable income	100
South African normal taxation @ 29%	(29)
Gross distributable income (before STC)	71
STC @ 11,11% (12,5/112.5)	(7,89)
Net distributable amount	63;11

The dual tax system therefore results in a distributed tax rate of 36.89% (MB) for companies in South Africa, consisting of an undistributed rate of 29% (A) and an additional tax of 7.89% (B) that is levied on pre-taxed profits upon distribution.

Background to the financial reporting framework in South Africa

The ISE Securities Exchange's revised Listing Requirements require listed companies to comply with IFRS for financial periods commencing on or after 1 January 2005 (SAICA, 2003a:§03). Previously, listed companies in South Africa could choose to comply either with FRS or with South African Statements of Generally Accepted Accounting Practice ("SA GAAP") (SSE Listing Requirements, 2004:§8.62(b))

Since 1993, South Africa has been harmonising SA G_AAP with international standards (SAICA, 2004a:§01) and, .in the last several years, SA GAAP has been substantially harmonised with IFRS (SAICA, 2003b:1). During December 2003, the IASB issued Improvements to TRS ("the Improvements Project"). Thirteen existing standards were improved in this batch (SAICA, 2004a:§03). The process to further align SA GAAP with IFRS thus commenced when these thirteen improved standards were issued in South Africa as a result of the IASB's Improvements Project (SAICA, 2003:§04). In addition to the IASB's Improvements Project, several other standards were revised by the IASB (SAICA, 2004a:§04). These have also been revised in South Africa (SAICA, 2004a: §04). The remaining Statements of SA GAAP, which will not be revised within the near future, have been re-issued to align the text thereof with the equivalent IFRSs (SAICA, 2003b:§05). This process has been completed (SAICA, 2004c:37). SA GAAP is, after all these convergence projects, an exact replica of the relevant 1FRS. To indicate this, a dual numbering system is used to refer both to the IFRS and SA GAAP number (SAICA, 2004b:§06). The Accounting Practices Board ("APB") in South Africa took a decision, in future, to issue the international text of 1FRS in South Africa, without any amendments (SAICA, 2003b:1).

The AC 500-series is utilised in South Africa for Statements of SA GAAP and Interpretations of Statements of SA GAAP to address matters specific to South Africa, not addressed in FRS (SAICA, 2003a:§07). With SA GAAP fully aligned with IFRS, the only difference between SA GAAP and IFRS will be the AC 500-series, for which there is no IFRS equivalent. Compliance with 1FRS will result in compliance with SA GAAP, insofar as an entity is also in compliance with the specific local Statements and Interpretations issued as part of the AC 500-series (SAICA, 2004b:§21). The first AC 500 statement in South Africa is AC 501, *Accounting for "Secondary Tax on Companies (STC)"("AC* 501").

Background to the accounting literature on STC

During 2003 the South African Institute of Chartered Accountants ("SAICA") released AC 501, Accounting *for "Secondary Tax on Companies (STC)"*. AC 501 was initially released for public comment by ED 153, *Accounting for Secondary Tax on Companies* ("ED 153"), which requested comments on six issues. Based on the responses received, a seventh issue was identified, and ED 159, *Accounting for Secondary Tax on Companies* ("ED 159") was released for public comment, requesting comments only on the seventh issue identified. AC 501 was released without any major amendments to ED 159.

The structure of AC 501 consists of three sections, namely "issues", "consensus" and "basis for conclusions". The "issues" section sets out the seven issues relating to the accounting for STC, the "consensus" section provides the accounting treatment for the seven issues, while the "basis for conclusion" section discusses the rationale for the conclusions reached in the "consensus" section.

AC 501 became effective for financial periods beginning on or after 1 January 2004, but earlier application was encouraged (AC 501, 2003:§23). In support of the use of the undistributed rate, AC 501 (2003:§09) concludes that STC should only be recognised once the dividend to which it relates has been recognised.

The Framework for the Preparation and Presentation of Financial Statements

As SA GAAP has been aligned with IFRS and JSE listed companies are required to prepare financial statements in accordance with IFRS, the Framework for the Preparation and Presentation of Financial Statements of the IASB ("the LASB Framework") also has relevance in South Africa.

The LASB Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users-(IASB Framework, 1989: §01).

Amongst other things, the purpose of the IASB Framework is to assist those who prepare financial statements in applying IFRS and in dealing with topics that have yet to form the subject of IFRS (IASB Framework, 1989: § 01(d)). Although the accounting for STC has been addressed locally, it has not yet formed the subject of an IFRS, and consequently the IASB Framework should also be used in the evaluation of issues relating to the recognition of STC.

The purpose of the LASB Framework is further to assist the Board of the International Accounting Standards Committee ("the Board") in the development of future IFRS and in its review of existing IFRS, such as LAS 12 referred to in this paper (IASB Framework, 1989: §01(a)). As AC 501 is an interpretation of IFRS, ultimately AC 501 should also conform to the IASB Framework.

The Board recognises that in a limited number of cases there may be a conflict between the LASB Framework and an IFRS, and that in these cases the requirements of the IFRS prevail over those of the IASB Framework (IASB Framework, 1989:§03). However, the Board is guided by the IASB Framework in the development of future Standards and in its review of existing Standards. Therefore, the number of conflicting cases between the

IASB Framework and IFRS will diminish over time (IASB Framework, 1989:§03). From this one may concluded that the Board intends that all IFRS ultimately conform to the IASB Framework.

Both the IASB Framework and the FASB Framework identify and similarly define assets and liabilities as balance sheet elements (Campbell *et al.,* 2002:20). They also approach tile areas of recognition and Measurement in a similar-way (Campbell *et* 2002:20). This suggests that a conclusion under the IASB Framework might result in a similar conclusion under the FASB Framework.

Conclusion

In this paragraph a background to STC has been provided and a financial reporting framework against which the conceptual soundness of the principles for the recognition of SIC in the annual financial statements of companies listed on the JSE could be measured, has been identified, namely DRS (including the IASB Framework). IFRS is an appropriate financial reporting framework, as SA GAAP has been aligned with IFRS, and as JSE-listed companies are required to prepare financial statements in accordance with IFRS for financial periods commencing on or after 1 January 2005.

In the next paragraph the issues pertaining to the timing of the recognition of a liability for STC in the annual financial statements of companies listed on the JSE are measured against *this* framework.

CONCEPTUAL SOUNDNESS OF AC 501 WITH REGARDS TO THE TIMING OF THE RECOGNITION OF STC

Background to the issue

AC 501 (2003:§09) states that

(a) STC is a charge against income; and

(b) STC should be recognised as an expense in the same period as the related dividend is accrued as a liability.

In its "basis for conclusions", AC 501 (2003:§16) relies on AC 102 (2001:§56B) or TAS 12 (2000:§52B), which is the IFRS equivalent to AC 102. LAS 12 (2000:§52B) states that the income tax consequences **of dividends are** recognised when the liability to pay the dividend is recognised.

The liability to pay the dividend is recognised when the dividends are appropriately authorised and no longer at the discretion of the entity (1AS 10, 2003:§13), Because the income tax consequences of a dividend are recognised when the dividend is authorised, current and deferred tax assets and liabilities are measured at the tax rate applicable to undistributed profits (LAS 12, 2000:§52A). The requirement by 1AS 12 (2000:§52A) that an enterprise should measure its current and deferred tax assets and liabilities at the rate applicable to undistributed profits was considered highly controversial when the paragraphs were exposed for public comment during 2000 (AcSEC, 2000:2; FASB,

2000:2; Institut der Wirtsthaftsprafer, 2000:3).

Therefore, in order to assess the conceptual soundness of the consensus reached in AC 501 with regard to the timing of the recognition of STC, the following requires investigation:

Whether AC 501 has correctly classified STC as an "income tax consequence of dividends" which would make LAS 12§52B applicable.

Whether the principle that STC (provided that it is in fact an income tax consequence of dividends) should be recognised when the dividend is recognised is conceptually sound.

is STC an "income tax consequence of dividends"?

Introduction

LAS 12§52B reads as follows:

> *"In the circumstances described in paragraph 52A, the income tax consequences of dividends are recognised when a liability to pay the dividend is recognised The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners.'-* (1AS 12, 2000:§52B)

"The circumstances described in paragraph 52A" relate to the fact that, in some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to the shareholders of the enterprise (lAS 12, 2000:§52A). In other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend to the shareholders of the enterprise (LAS 12, 2000:§52A).

In order to determine whether STC falls within the ambit of IAS 12 (2000:§52A and §52B), it should first be determined whether STC is an "income tax", and second, if STC is in fact an "income tax", whether STC is an income tax "consequence of dividends".

Is STC an "income tax"?

For the purposes of 1AS 12, income taxes include all domestic and foreign taxes which are based on taxable profits (LAS 12, 2000:§02). Taxable profit is defined as the profit for the period (determined in accordance with the rules established by the taxation authorities) upon which income taxes are payable (LAS 12, 2000:§05). If STC is, therefore, considered to be an "income tax", the "period" will be the dividend cycle and the "profit" will be the net amount as defined in section 64B(5) of the Act. It should, however, be considered whether STC is an "income tax" as defined by IAS 12.

STC 'is a tax payable and borne by 'the company (De Koker, 2003:.§13.10) and is consequently a cost to the company. With the introduction of STC, the normal company tax rate was reduced from 48% to 40% (Old Mutual, 1993:3) and it therefore appears as though the introduction of STC was to compensate the government for the loss in revenue from the decrease in the normal company tax rate. The 1993 budget referred to a dual tax on ail companies: one part was levied on the declared profits forming taxable

income, and the other on distributed profits (Department of Finance, 1993:6.5). It therefore follows that STC is a tax on the profits of a company. These profits only trigger STC once they are distributed. In the 1999 budget review, it was also confirmed that double tax treaties, which had been recently concluded, treated STC as a tax on company profits and not as a tax on dividends received in the bands of shareholders (Department of Finance, 1999:155). De Koker (2003:§13.10) states that the approach that STC is a tax imposed on the distributing company is reinforced by the fact that *no* provision is made for the deduction of the tax from outgoing dividends.

As STC is levied on taxable profits (the "net amount" as envisaged by section 64B(3) of the Act), it might be seen as an "income tax" as envisaged by LAS 12.

Is STC an income tax "consequence of dividends"?

LAS 12 provides the following example to illustrate paragraph 52B (1AS 12, 2000:§52B):

> *The following example deals with the measurement of current and deferred tax assets and liabilities for an enterprise in a jurisdiction where income taxes are payable at a higher rate on undistributed profits (50%) with an amount being refundable when profits are distributed. The tax rate on distributed profits is 35%. At the balance sheet date, 31 December 20x1, the .enterFise does not recognise a liability for dividends .proposed or declared after balance sheet date. As a result, no dividends are recognised in the year 20x1. Taxable income for 20x1 is 100,000. The enterprise recognises a current tax liability -and a current tax expense of 50,000. Subsequently, on 15 March 20x2 the enterprise recognises dividends of 10,000 from previous operating profits as a liability. On 15 March 20x2 the enterprise recognises the recovery of income taxes of 1,500 (15% of dividends recognised as a liability) as a current tax asset and as a reduction of current income tax expense for 20x2.*

The example provided in 1AS 12 is very similar to the situation in South Africa. The only difference is that, in the example, the distributed tax rate of 35% is lower than the undistributed tax rate of 50%, while in South Africa the distributed tax rate of 36.89% is higher than the undistributed tax rate of 29%. However, it should be noted that IAS 12 (2000:§52A) clarifies that, in some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to the shareholders of the enterprise.

From the example it appears as though the term "income tax consequences of dividends" is interpreted as the difference in the tax levied on distributed and undistributed profits. In the example, a refund of 15% is receivable when profits, previously taxed at 50%, are distributed, whereas in South Africa additional tax of 7.89% is payable when profits, previously taxed at 29%, are distributed. STC is therefore considered to be an income tax consequence of dividends.

Conclusion

As STC is considered to be an income tax and moreover an income tax consequence of .dividends, it could be stated that the consensus reached in AC 501 (2003:§09) is sound, based • on the application of LAS 12 -(2000:§52A and §52B). The, next paragraph considers whether the principles contained in LAS 12 (2000:§52A and §52B), namely that the income tax consequences of dividends should only be recognised once the dividend has been declared, are conceptually sound, thus whether it is appropriate that the current and deferred tax assets and liabilities should be measured at the undistributed rate.

Distributed or undistributed rate — the various arguments Introduction

IAS 12 (2000:§52A) states that current and deferred tax assets **and** liabilities should be measured at the undistributed tax rate. The following represents an example ("example 1"), in a hypothetical situation, of the difference between measuring current **and** deferred tax assets and liabilities at the undistributed rate compared to the distributed rate:

Example 1

Assume a company has a profit before tax of R100 000 and a movement in temporary differences of R20 000 (taxable). The taxable profit of the company is therefore R80 000 (R100 000 – R20 000). The company has not distributed any of its profits. The income tax expense included in the income statement can be calculated as follows:

	Undistributed rate	**Distributed rate**
	R	R
Current tax	23 200[1]	29 512[2]
Deferred tax	5 800[3]	7 378[4]
Income tax expense	29 000 (A)	36 890 (B)
Profit before tax	100 000	100 000
Income tax expense	(29 000)	(36 890)
Profit after tax	*71 000* (C)	63 110
Effective tax rate	29%	36,89%

1. R80 000 x 29% = R23 200
2. R80 000 x 36,89% =R29 512
3. R20 000 x 29% = R5 S00
4. R20 000 x 36,89% = R7 378

It is clear that the difference between the undistributed and the distributed rate amounts to R7 890 (D) (R36 890 A – R29 000 B) for this hypothetical situation. If a liability for STC is to be recognised on the undistributed profits (R100 000), this will also amount to R7 890 D (R71 000 C x 12.5 / 112.5), From this one could argue, that

by measuring current and deferred tax at the undistributed rate (R29 000 A) and by also recognising a liability for STC on undistributed profits (R7 890 0), one is achieving the same total tax (normal tax and STC) result as would be the case if the distributed rate is used to measure current and deferred tax (R36 890 B). In South Africa, the issue is whether a liability should be raised for the - STC: that -would become :payable on the future declarations of dividends (in the example above R7 890 D (R36 890 B - 129 000 A)).

The conclusion that the measurement of current and deferred tax at the undistributed rate together with a separate liability for STC on undistributed profits gives the same result as using the distributed rate to measure current and deferred tax assets and liabilities is, however, not valid for all cases. Consider the followin^g hypothetical example:

Example 2

Assume a company has a profit before tax of R100 000, which includes non-taxable income of R30 000 (donation received), and a movement in temporary differences of R20 000 (taxable). The taxable profit of the company is therefore R50 000 (R100 000 - R30 000 - R20 000). The company has not distributed any of its profits. The income tax expense included in the income statement can be calculated as follows:

	Undistributed rate	**Distributed rate**
	R	**R**
Current tax	14 500[1]	18 445[2]
Deferred tax	5 800[3]	7 378[4]
Income tax expense	20 300 (F)	25 823 (G)
Profit before tax	100 000	100 000
Income tax expense	(20 300)	(25 823)
Profit after tax	79 799(**H**)	74 177
Effective tax rate	20.30%	25.823%
Reconciliation of tax rates		
Undistributed I distributed tax rate	29%	36.89%
Non-taxable income	(8.7%)[5]	(I1.067%)[6]
Effective tax rate	20,30%	25,823%

1. R50 000 x 29% = RI4 500
2. R50 000 x 36.89% - R18 445
3. R20 000 x 29% = R5 800
4. R20 000 x 36.89% = R7 378
5. (R30 000 x 29%) / RI00 000 x 100 = 8,7%
6. (R30 000 x 36.89%)1 R100 000 x 100 = 11,067%

It is clear that the difference between the undistributed and the distributed rate amounts to R5 523 (1) (R25 823 G -1220 300 F). If a liability for STC is to be recognised on the undistributed profits (R100 000) this will, however, amount to R8 856 (J) (R79 700 H x 12.5 / 112.5). By measurin^g current and deferred tax at the undistributed rate and by

also recognising a liability for STC on undistributed profits the total tax will amount to R29 156 (K) (R8 856 J ± R20 300 F). Tithe distributed rate is used to measure current and deferred tax assets and liabilities the total tax will amount to R25 823 G. The difference between the two approaches amount to R3 333 (L) (R29 156 K – R25 823 G), which represents the STC on the non-taxable profits of R30 009 (R30 000 x 12.5 / 112.5). Therefore, by merely measuring current and deferred tax assets and liabilities at the distributed rate, one would not account for the full tax effect of the future distribution of undistributed profits, as non-taxable ·or non-tax deductible amounts do not form part of the tax base. In South Africa, the issue is, therefore, whether a liability should be raised for the STC that would become payable on the future declarations of dividends. This liability constitutes a total amount of R8 856 J, which includes both the component that does form part of the tax base (in other words the R5 523 I in example 2 above) and the component that does not forth part of the normal income tax base (in other words R3 333 L in example 2 above)

In this study the "undistributed rate" is therefore defined as the accounting consequences that follow from reconising tax assets and, liabilities without taking into account the STC effect of future dividend declarations. The "distributed rate" is defined as the accounting consequences that follow from recognising current and deferred tax assets and liabilities at the undistributed rate, together with the STC that will become payable on the future declaration of undistributed profits (either partially as part of the current-and deferred tax assets and liabilities or totally as a separately liability for STC).

IAS 12 (2000:05) defines "current tax" as the amount that is payable (recoverable) **in** respect of the taxable profit or loss for the period. In South Africa, STC only becomes **payable** upon the declaration of a dividend. In example 1 above, if current and deferred tax assets and liabilities are measured at the distributed rate, the total difference between the distributed and undistributed rate in the income tax expense of R7 890 D consists of two components, namely an amount of R6 312 (R29 512 – R23 200) relating to STC that is included as part of current tax and an amount of R1 578 (R7 378 – R5 800) that is included as part Of deferred tax. The amount of R6 312;-included as part of current tax, will not meet the definition of "current tax" in IAS 12, as the amount is not payable at year-end. Uncertainty also exists as to whether this amount (R6 312) would meet the definition of "deferred tax liabilities" in IAS 12, as it might not be calculated on a temporary difference. However, irrespective of the classification of the tax as either a current or a deferred tax, the issue to be considered remains whether the entity should raise a liability for the additional tax (R7 890 in example 1 above) that would become payable when the profits (R100 000 in example I above) are distributed.

The arguments for and against using the undistributed tax rate in measuring tax assets and liabilities were investigated by means of a literature study of the comment letters to E68, the exposure draft which released IAS 12 (2000:§52A and §52B) for public comment, and other applicable accounting literature. The IASB Framework states that-the Board will use the Framework to assist the Board in its review of existing IFRS (IASB Framework, 1989:§01(a)). As a result, the number of cases of conflict between the LA.SB Framework and TFRS will diminish through time (IASB Framework, 1989:§03). Therefore, a twofold approach was followed in assessing the arguments for and against the use of -the undistributed rate in measuring the liability for tax. Firstly, the principles contained in IAS 12 (2000:§52A and 52B) were evaluated against the IASB Framework, for, if these principles are in conflict with the Framework, such conflict should diminish through time as part of the review process of the IASB.

econdly, the specific principles contained in IAS 12 (2000:§52A and 52B) were evaluated against the general principles contained in LAS 12, in order to determine whether the Standard is in conflict with itself.

The IASB Framework Introduction

A liability is defined as a present obligation of the enterprise arising from *past events* ("first element"), the settlement of which is expected to result in an *outflow* from the enterprise of resources embodying *economic benefits* ("second element") (IASB Framework, 1989: §49(b)). A liability should be recognised if it is *probable* that any future economic benefits associated with the item will flow from the enterprise ("third element") and the item has a cost or value that can be *measured* with *reliability* ("fourth element") (IASB Framework, 1989:§83).

LAS 37 (1999:§17) describes a past event that leads to a present obligation as an obligating event. For a past event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by this event (IAS 37, 1999:§17). The **first element,** namely an *obligating event,* poses a problem as there could be two potential points of view with regard to the obligating event that results in a present obligation to pay the income tax consequences of dividends, namely the earning of distributable profits or the declaration of a dividend (Everingham & Watson, 2000:16-35).

The second element, an *outflow* from the enterprise of resources embodying *economic benefits,* will be met, as the payment of STC will result in a cash outflow, thereby depleting the asset base of a company.

The third **element,** that is, the *probability* of the outflow of future economic benefits, may also be problematic, as a liability for STC will only qualify for recognition if it is probable that an outflow of future economic benefits will occur.

The **fourth** element, namely the *reliability* of the *measurement* of the amount, can also be difficult to determine. Everingham and Watson (2002:16-36) state that there are a number of issues that need to be taken into account in deciding on the appropriate corporate rate, namely whether the rate should be based on the maximum rate payable if all profits were distributed, or whether it should only take into account the expected dividend cover. The effect of dividend income on the appropriate corporate tax rate also needs to be considered (Everingham Watson, 2002:16-35).

It is clear that the following elements of the definition of a liability and the recognition criteria for a liability are problematic:

- What is the obligating (past) event that causes a present obligation to pay STC? (first element)
- Can the probability of future dividend declarations be determined? (third element)
- Can the liability relating to STC be measured reliably? (fourth element)

These elements are investigated further below.

What is the obligating (past) event that causes a present obligation to pay STC?

Arguments supporting the notion that the obligating event is the declaration of a dividend

- Bugg (2004:1) believes that the necessary obligating event required to justify the recording of either the tax asset or the liability is the declaration of the payment of dividends and that on the balance sheet date the payment of dividends is a future transaction, **not** directly related to **the past earnings.** The obligating event is the ultimate shareholders' approval of the payment of dividends (Bugg, 2004:1) and, as long as the dividend is not approved by the enterprise's bodies, the enterprise has no right to receive a tax refund (or in the South African context, has no obligation to pay the additional tax) (Nestle S.A., 2000:2). In particular, the measurement of taxes cannot be based on a transaction that does not yet meet the criteria for recognition in the financial statements (KPMG, 2000:3). The IASB (2005:4) is of the view that prior to the declaration of a distribution, the difference between the undistributed and distributed tax rates is a consequence of an action, namely distribution of profits that has not yet been taken. Consequently the IASB (2005:4) believes that the differences in tax rates do not meet the definition of a liability, as the obligation to pay the tax authorities does not exist unless and until the entity is obligated to distribute its income.

  (Comment: IAS 12 (2000:§52A) specifically states that the income tax consequence of dividends are more directly linked to past transactions or events than to distributions to owners. Bugg (2004:1), however, believes that the payment of dividends is a future transaction, and is not directly related to past earnings.)

- Prior to the declaration of a dividend, an entity may not have the ability to pay dividends to its shareholders, as a result of, for example, a solvency problem that would prevent a distribution to shareholders or restrictions on dividend distributions contained in debt covenants (1ASB, 2005:4).

Arguments supporting the notion that the obligating event is the recognition of distributable, profits

- An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting (IAS 1, 2003: §25). When the accrual basis of accounting is used, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definition and recognition criteria for those elements in the LA.SB Framework (IAS 1, 2003:§.26).

  Everingham and Watson (2000:16-37) state that the conceptual difficulty of the treatment of IAS 12§52A and §52B is that the tax should be treated as an expense, but not matched against the profits that gave rise to an expense. Recognition as an expense- may-imply that STC relates to' the -profit as opposed to the (Everingharn & Watson, 2000:16-35). Conceptually, if it does relate to profits, it should be accrued in the same financial year as the profits (Everingham & Watson,

2000:16-37). Delaying the recognition criteria of the STC until declared as a dividend would have the effect of overstating the reported profit (Watson 2002:2).

If STC is an expense, the accrual basis requires that it is recognised in the year to which it relates (Everingham & Watson, 2000:16-35; Watson, 2002:1).

A tax paid on dividends represents *an* additional tax an income if the shareholders do not receive - a corresponding tax Credit for the tax on the dividend paid by the enterprise, i.e. the tax is not a withholding tax on the shareholders (AcSEC, 2000:2; FASB, 2000:2). Accordingly, that tax should be recognised when the income is earned and the measurement of the tax assets and liabilities should include that additional tax (AcSEC, 2000:2; FASB, 2000:2).

• If the tax consequences of dividends are not recognised until the dividend is declared, it is artificial and does not properly reflect the economic substance and consequences of tax systems where different rates apply to undistributed and distributed profits (Institut der Wirtschaftspriifer, 2000:2). Under such tax systems, all profits during the lifetime of an enterprise will ultimately be taxed at the rate applicable to distributed profits, simply because shareholders have an interest in the net assets of the enterprise and all components of equity (including undistributed profits) are "automatically" paid out to shareholders sooner or later (at the latest, when the enterprise is liquidated) (Institut der Wirtschaftspriifer, 2000:2). Consequently, in substance, shareholders have no discretion to decide whether or not Profits are distributed but only a discretion to decide **when** they are distributed (Institut der Wirtschaftsprffer, 2000:3). In fact, the obligating event that should trigger the recognition of a future tax refund or an obligation to pay additional tax is not the proposal, declaration or resolution of dividends, but the earning of taxable income that is available for distribution to shareholders (Institut der Wirtschaftsprafer, 2000:3).

(Comment: The above argument ignores the going concern assumption. Even though all profits might eventually be taxed at the distributed rate, the financial statements of a company that is a going concern may not reflect the situation that would arise if a company were to be liquidated. The financial statements are normally prepared on the assumption that the enterprise is a 'going concern and will continue to be in operation for the foreseeable future (IASB Framework, 1989:§23). It should, however, be noted that the going concern assumption does not preclude the recognition of the liability for STC as distributable profits are earned, but might limit the amount that must be recognised.)

IAS 12 (2000:§52A) states that the income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. This statement in itself might indicate that the obligating event that results in a liability for the income tax consequences of dividends is past transactions (the earning of distributable profits), as opposed to the declaration of a dividend.

AC 303, *Accounting for secondary tax on companies* (1999:07) (an accounting opinion issued by the Accounting Issues Task Force of SA1CA, which has been withdrawn with the issue of AC 501) required that the STC on undistributed profits be treated as a contingent liability.

The definition of a contingent liability consists of two components. *First,* a contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise ("first definition") (LAS 37, 1999:§10). *Second,* a contingent liability could also be a present obligation that arises from past events, but that is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation;-or because- the amount of the obligation cannot be measured with sufficient reliability ("second definition") (LAS 37, 1999:§10).

The difference between the first definition and the second definition is that, in terms of the first definition, there is no present obligation (the obligation is only "possible"), and therefore the definition of a liability is not met, while in terms of the second definition, there is a present obligation, and the definition of a liability is met. However, in terms of the second definition, the item is not recognised in the balance sheet, as the recognition criteria (of probability and measurability) are not met.

The first definition of a contingent liability requires the "future events" not to be wholly within the control of the enterprise. Everingham and Watson (2000:16-36) believe that an enterprise is generally in a position to control the dividends declared. It therefore appears that the STC on undistributed profits would not satisfy the first definition of a contingent liability.

From this, the conclusion may be drawn that AC 303 Viewed the SIC or undistributed profits as a contingent liability in terms of the second definition of a contingent liability. This might indicate that a present obligation exists as a result of a past event (as profits are earned).

- The FASB is of the opinion that the use of the distributed rate provides more reliable information to the users of the financial statements: They believe that from an investor's perspective, when there is a mismatch between the dividends and earnings of an entity, that financial statements that captures the expense (or benefit) of that mismatch are a better representation of the true state of the financial position of the entity (IASB, 2005:3). They believe that although the timing between an entity earning distributable profits and the distribution of those profits to its shareholders can be quite long, the time difference is not a justifiable reason under the accounting model for income taxes to defer the recognition of *the* ultimate effects (IASB, 2005:4).

Conclusion

From the various arguments above it is clear that there are contradictory opinions as to what constitutes the obligating event for the liability for SIC (that is the declaration of -the dividend or the earning of distributable profits). In order to arrive at a solution which would - as required by the IASB Framework (1989:§33) - represent the transaction of STC faithfully, it should be considered which of the arguments is more closely associated with the principles contained in the IASB Framework.

Can the probability of future dividend declarations be determined?

Introduction

In the previous paragraph the "obligating event" element (the first element) of the definition of a liability has been analysed. In this paragraph the "probability" element (the third element) of the recognition criteria for a liability will be investigated. The "probability" element of the recognition criteria ties in very closely with what is considered to be the obligating event that causes an entity to recognise a liability to pay STC. If the obligating event is the declaration of a dividend, then the "probability" element of the recognition criteria is met, because, once a dividend has been declared, it could be stated that it is virtually certain that STC will be paid. However, if the obligating event is the earning of distributable profits, the "probability" element is more problematic to determine, as doing so necessitates determining whether future dividend declarations are probable (Basson, 2002:1).

In this paragraph, the various factors that establish whether the probability that future dividend declarations can be estimated reliably are investigated through a literature study of the legal and other requirements applicable to a dividend declaration. This is done in order to determine whether it would be practically possible to assess the probability of future dividend declarations at the stage at which the distributable profits are earned.

Definition *of probability*

"Probability" is explained in the IASB Framework (1989:§85) as follows:

> *"The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise.. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared."*

It, therefore, follows that if there is an insufficient degree of certainty that future dividend declarations will be made, the recognition of a liability to pay STC will not be appropriate until a sufficient degree of certainty has been obtained.

Companies Act (61 of 1973) requirements for dividend declarations

A company may make payments to its shareholders if the company is able or would be able after the payment to pay its debts as they become due in the ordinary course of business ("liquidity criteria"), if the consolidated assets of the company, fairly valued, Would, after the payment, be more than the consolidated liabilities of the company ("solvency criteria") and if it is authorised to make such payments by its articles (section 90 of the Companies Act).

In an annual general meeting, the company may declare dividends, but no dividend may exceed the amount recommended by the directors (Schedule 1 to the Companies Act par 84).

Common law rules may also determine the amount that may be distributed as dividends (Correia, Flynn, Uliana & Wormald, 2000:591). This amount is known as the distributable profit and may differ from the accounting definition of profit (Correia *et al.,* 2000:591). The rules for the determination of distributable profit can be summarised as follows:

- Dividends may not be paid from contributed share capital (Cilliers, Benade, Henning, Du Plessis, Delport, De Koker & Pretorius, 2000: 345).

- The company's annual financial statements as a whole must be taken into account in determining whether profits are distributable (Cilliers *et al.,* 2000:346),

- Dividends may be distributed out of revenue profits without first providing for losses or the depreciation of fixed assets; losses and depreciation of "circulating or floating" assets must, however, be taken into account in the determination of distributable profit (Cilliers *et al.,* 2000:347).

- Losses incurred it previous years may be disregarded in the computation of distributable profits (Cilliers *et al.,* 2000:348).

- A realised profit on the sale of fixed assets is available for distribution by way of a dividend (Cilliers *et al.,* 2000:349).

- Unrealised profits may also be available for distribution in appropriate circumstances (Cilliers *et al.,* 2000:349).

Other factors

Correia *et al.* (2000:590) hold that various other factors also influence the decision -to declare a dividend. The 'dividend decision is one of three distinct yet connected decisions, the other two being the investment and the financing decisions (Correia *et al.,* 2000:585). A decision about any one of these may affect the others and will affect the sustainable growth rate of the farm (Correia *et al.,* 2000:585). Another factor that influences the dividend decision is the information content of dividends, the fact that a dividend is seen as a signal of management's confidence that the earnings generated can be sustained (CIMA, 1999:271). The nature of shareholders could also influence the dividend decision, as shareholders tend to be attracted to companies that satisfy their needs with regard to the balance between cash income and -capital growth (CIMA; 1999:269). It should also be considered that dividends are mainly cash payments, and a company must have sufficient cash to pay the dividends it declares (CIMA, 1999:271).

Conclusion

In assessing the probability of future dividend declarations, it follows from the above that a company must determine whether all the following criteria are met:

- liquidity criteria;
- solvency criteria;

- sufficient distributable profit in teens of Common Law; and
- sufficient cash reserves to fund the dividend payment.

In assessing the probability of future dividend declarations, the following also needs to be considered:

- the effect of future dividend declarations on the sustainable growth of the company;
- the information content of dividends; and
- the nature of the company's shareholders.

The combination of these factors and the amount of judgement involved in assessing their probability prior to the declaration of any dividends might mean that the "probability" criteria in terms of the LASB Framework are not always met prior to the declaration of a dividend.

Can the liability relating to STC be measured reliably?

Introduction

In the previous two paragraphs, the element of the definition of a liability; that is, the obligating event (the first element) and the element of the recognition criteria for a liability, namely the probability of the outflow of economic resources (the third element), have been investigated. In this paragraph the considerations with regard to the final element, namely "reliable measurement" (the fourth element), are analysed. The "reliable measurement" element of the recognition criteria is once again very closely linked to what is considered to be the obligating event that causes an entity to recognise a liability to pay STC. If the obligating event is the declaration of a dividend, the "reliable measurement" element of the recognition criteria is met, because the amount of the dividend is known and, therefore, the amount of the STC liability can be measured reliably. However, if the obligating event is the earning of distributable profits, the "reliable measurement" element is more difficult to establish, as it necessitates an estimation of the amounts of future dividends to be declared.

Investigation of the issue

Based on the assumptions that a company derives its profits from trade (which excludes dividends) and that its taxable income for normal tax purposes is the same as its accounting profits, the total tax rate a company pays under the dual tax system depends on its dividend declaration policy (Everingham & Watson, 2000:16-34). Assuming that the company has a 100% dividend declaration policy, the total tax as a percentage of the pre-tax income and accounting profits would be 36.89%. With a more conventional distribution of one third, the percentage drops to 31.63%.

Everingham and Watson (2000:16-39) note that the cash position of most enterprises is such that the possibility of a distribution of all or a significant part of retained earnings is remote. Everingham and Watson (2000:16-34) also argue that STC should not be assumed for the tax implications of distributing all profits as they are earned, as the

normal recognition criteria of probability and measurability of the SIC liability would not be satisfied. As an enterprise is generally in a position to control the dividends declared, tax should only be recognised for STC that is probably going to be payable from the profits recognised (Everingliam & Watson, 2000:16-36). Watson (2002:2) believes that if a company has a standard dividend -cover, 6f if the dividend has been declared prior to the finalisation of the financial statements, the recognition criteria have been satisfied, and the STC liability should be recognised. Hattingh (2000:2) shares this view, as he believes that the declaration of the dividend after the year-end is an event after the balance sheet date that confirms that the company had .a liability for STC at the year-end on the part of the profit declared as a dividend.

From the above, one can conclude that it might not always be appropriate to recognise a liability for STC on all distributable profits, as they are earned.

The IASB Framework (1989:§86) emphasises that, in many cases, cost or value must be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. However, when a reasonable estimate cannot be made, the item is not recognised in the balance sheet or income statement (IASB Framework, 1989:§86). An item that, at a particular point and time, fails to meet the recognition criteria of reliable measurement may qualify for recognition at a later date ac a result of subsequent circumstances or events (1ASB Framework; I989: §87).

Conclusion

From the above it follows that it might not be appropriate in all circumstances to recognise tax assets and liabilities at the distributed rate, as it might not be possible to make a reliable estimate of the amount of future dividend declarations. However, if an entity has a standard dividend cover or a dividend has been declared subsequent to year-:- end, but prior to the finalisation of the financial statements, it could be argued that the amount of future dividend declarations can be measured reliably (and therefore the SIC consequences can also be measured reliably) at the balance sheet dates.

!AS 12, Income Taxes

Introduction

In the previous paragraphs, the various arguments for and against using the undistributed rate in measuring tax liabilities have been analysed in terms of the' principles contained in the IASB Framework. In this paragraph the use of the undistributed rate is evaluated in terms of the principles contained in IAS 12, ignoring IAS 12 (2000) §52A and §52B.

KPMG (2004a:3) argues that it is possible, using IAS 12 (ignoring IAS 12 (2000) §52A and §52B)), to conclude that the undistributed rate should be used in measuring deferred tax' liabilities. This is only the case if there is no taxable temporary difference with regard to STC (IAS 12, 2000:§15).'

There are various views on whether there is a temporary difference (ignoring IAS 12 (2000: §52A and 52B) relating to STC. The two main opinions are these:

- There is no temporary difference for STC (KPMG, 2004a:3) (“Opinion 1”);

- There could potentially be a temporary difference relating to STC (ignoring IA.S 12 (2000) §52A and 523) (Everingham & Watson, 2000:16-36) ("Opinion 2").

These two opinions were investigated further, as it appears that there is some uncertainty as to whether a temporary difference exists for STC.

A temporary difference does not exist for STC (Opinion 1)

KPMG (2004a:3) maintains that the tax rate applicable to undistributed profits should be used to measure current and deferred tax assets and liabilities. The rationale behind using the undistributed rate when measuring current and deferred tax assets and liabilities is that deferred tax is meant to reflect the expected tax consequences of the recovery and settlement of assets and liabilities (KPMG, 2004a:3). Since STC is only calculated and payable upon distribution, of the profits, it does not represent a tax consequence of the manner of recovery and the settlement of assets and liabilities (KPMG, 2004a:3). It is also argued that since temporary differences arise only on assets and liabilities. and not on retained earnings, there is no temporary difference on undistributed profits (KPMG, 2004a:3). AC 303 (1999:§11) stated that the rate that is expected to apply when the asset in realised or the liability is settled excludes STC. Therefore, no deferred tax liability is recognised for STC that might/would become payable on the future distribution of those retained earnings (KPMG, 2004a:3).

It should, however, be considered that paragraphs 52A and 523 (stating that current and deferred tax assets and liabilities should be measured based on the undistributed rate) were included in IAS 12 (2000) only in 2000. It could, therefore, be argued that the inclusion of paragraphs 52A and 52B is excessive, if it **is,** in fact, possible to determine from LAS 12 (2000) - ignoring paragraphs 52A and 52B - that the undistributed rate should be used in measuring current and deferred tax assets and liabilities.

A temporary difference relating to STC could potentially exist (Opinion 2)

Everingham and Watson (2000:16-36) claim that the tax consequences of STC are similar in concept to those of the subsidiary in group financials. IAS 12 specifically deals with the implications of taxes payable by a subsidiary on distributions to the reporting entity (IAS 12, 2000:§39). Everingham and Watson (2000:16-36) believe that the tax consequences of STC are similar in concept to those of the subsidiary in group financials, as the issue is that profits are recognised that may give rise to taxes payable in the future if those profits are distributed in the form of a dividend. This gives rise to a temporary difference for which deferred tax should be recognised (Everingham & Watson, 2000:16-36). IAS 12 (2000:§39) determines that an enterprise should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference, and it is probable that the temporary difference will not reverse in the foreseeable future. Although this section relates only to temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, Everingham and Watson (2000:16-36) are of the opinion that the conclusion reached would be a "good compromise" for the treatment of deferred tax on STC.

The fact that a temporary difference relating to STC could potentially exist is further supported by an analysis of the inclusion of the definition of temporary differences in IAS 12 (2000). Deferred tax liabilities are defined as the amounts of income taxes payable in **future periods** in respect of taxable temporary differences (IAS 12, 2000: §05). Taxable temporary differences are defined **temporary differences** that will result in taxable amounts in determining the taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled (IAS 12, 2000: §05).

The recognition of profits which will probably be declared to shareholders in future periods will result in taxable amounts in determining taxable profit in future periods (the "net amount" on which STC is calculated), but the difference between the timing of the inclusion of profits for accounting and tax purposes does not arise from the recovery of an asset or the settlement of a liability; but from retained earnings (the declaration of a dividend) (KPMG, 2004a:3). This might indicate that there is no temporary difference on which a deferred tax liability for STC could be calculated. In order to evaluate this further, cognisance should be taken of the process followed by the IASB to determine the definition of temporary differences, as set out in IAS 12 (2000:§05).

IAS 12 (2000) replaced the original IAS 12, *Accounting for Taxes on Income.* The original IAS 12 required an enterprise to account for deferred tax on **timing** differences, while IAS 12 (2000) focuses on temporary differences (IASB, 2000:12-2). Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods (IASB, 2000:12-2). Temporary differences are differences between the tax base of an asset or liability and its carrying amount in the balance sheet (IAS 12, 2000:§05). All **timing differences are temporary** differences, while the inverse is not always true (IASB, 2000:12-2).

In the case of STC it could be considered that a possible timing difference arises when distributable profits are earned and included in accounting profit, while those profits are not included in taxable profit (the "net amount") until a dividend is declared. As all timing differences are considered to be temporary differences, it follows that a possible temporary difference for STC could exist.

Conclusion

From the above, it follows that one could argue that there may be a temporary difference with regard to STC.

Concluding remarks: distributed or undistributed rate?

In the previous paragraphs, it has been considered whether it is conceptually appropriate to recognise deferred tax at the undistributed rate.

Some believe that, because the potential tax consequences of dividends are disclosed in the notes to the financial statements, the approach of recognising current and deferred tax assets at the undistributed rate is the most transparent (UBS; 2000:1;- Treuhand Kammer, 2000:1).

On the other hand, the American Institute of Certified Public Accountants ("AICPA") has released a document which supported the use of the distributed rate in measuring

deferred tax liabilities. AICPA has considered the rate that should be used to record deferred income taxes in South Africa under US GAAP (AICPA, 2002:7). The Task Force discussed two options, namely a distributed rate or an undistributed rate (AICPA, 2002:7). The Task Force expressed a preference for the distributed rate (AICPA, 2002:7). However, the Task Force noted that the current was not entirely clear and agreed that the issue be referred to the Emerging Issues Task Force ("EITF") for further consideration (AICPA, 2002:7).

In the next paragraph, the results obtained from the literature study will be tested empirically.

RESULTS OF THE EMPIRICAL STUDY

Background to the questionnaire

The empirical questionnaire was distributed to accounting lecturers teaching students on the honours level at universities in South Africa, the accounting technical partners at the eight largest auditing firms in South Africa and the lead tax partners at the eight largest auditing firms in South Africa ("defined population"). The questionnaires have been sent to this focussed target group in order to try and increase the quality of the answers. Accounting lecturers ,and accounting technical partners were chosen as they are currently actively involved with accounting standards on a day-to-day basis and should, therefore, have an in depth knowledge of the accounting provisions. The lead tax partners were chosen as they should have an in depth knowledge of STC. All three the target groups should be aware of STC and the accounting for STC and should be competent to answer the questionnaire, although the tax partners might find difficulty in answering detailed accounting questions. The limitation associated with qualitative questionnaires should however be borne in mind, namely that they are mainly based on the opinions and perceptions of the respondents and also that the opinions and perceptions of the respondents might be influenced by literature or opinions that are currently available on an issue.

The honours level accounting lecturers at universities in South Africa were identified either from information contained on the website of the university or from a telephone call made directly to the university concerned to obtain the information and contact details.

The eight largest auditing firms in South Africa were selected based on fee income, as contained in a survey done by the *International Accounting Bulletin* (Dayasena, 2003:12). A questionnaire was sent to the lead corporate tax partner of each firm and all the technical accounting partners of each film. These individuals were identified by means of a telephone call to each of the firms to obtain the name(s) and e-mail address(es) of the relevant parties. Where a firm did not have a specialist accounting and/or tax department, the questionnaire was sent to the contact partner, as listed in the *International Accounting Bulletin* (Dayasena, 2003:15), with an instruction to forward it to the most appropriate individual in the firm. The questionnaires were distributed to the 'parties via e-mail.

Part I of the questionnaire contained a general background on the topic and the questionnaire, while part 2 consisted of general questions about the profile of the respondent. The questionnaire also contained an extract of all the paragraphs in AC 501,

IAS 12 and the IASB Framework that are relevant to the study and the questions that were posed. Even though some of the respondents have indicated that their knowledge on AC 501 and IAS 12 is poor, all the necessary information was included in the questionnaire for the respondent to provide an informed answer. In order to answer the questionnaire; respondents were not required to have detailed STC knowledge. Therefore, although some respondents indicated that their STC knowledge is poor, this should not have a significant impact on the results. Part 3 contained one question relating to the status of the IASE Framework. Part 4 dealt with the income tax consequences of dividends (two questions), while Part 5 contained seven questions on the application of the IASB Framework to the recognition of a liability for STC. Part 6 (three questions) related to the application of IAS 12 to STC.

The questionnaire was also forwarded to SAICA with a request to send it to all the APB and the Accounting Practices Committee ("APC) members. An additional two responses were obtained via this process. For analysis purposes the responses received via this process were grouped with the responses of the technical accounting partners, as these responses all relate• to accounting specialists. The responses from the APB and APC members are not included in the analyses of the response rate below, as their responses are considered to be in addition to the defined population.

Response rate

In total, 64 questionnaires were distributed: 33 to accounting honours level lecturers, 24 to accounting technical partners at the eight largest auditing firms in South Africa and seven to lead tax partners at the eight largest auditing firms in South Africa.

The response rate in the various categories was as follows:

Response rate	
Accounting lecturers	48
Technical accounting partners	58.
Tax partners	29
Total response	50

Questionnaires that had not been returned by the deadline date were followed up with additional e-mails and/or telephone calls.

Profile of respondents

The profile of the persons that responded to the questionnaire ("respondents") was as follows:

- 38% of the respondents had less than five years experience in their particular field, 38% had between five and ten years experience and 24% had more than ten years .experience.

- 29% of the respondents considered their knowledge of section 64B of the Act (STC legislation) to be "good", 50% considered it to be "fair", while 21% considered their knowledge to be "poor".

- 76% of the respondents considered their knowledge of AC 501 to be "good", 18% considered it to be "fair", and 6% considered their knowledge to be "poor".

- 79% of the respondents considered their knowledge of IAS 12 to be "good", 15% considered to be "fair", and 6% considefeCltheirknowledge to be "poor".

- Only 18% of the respondents provided SAICA with comments to ED 153. Only 24% of the respondents commented on ED 159.

Statistical summary of results

The following tables set out the results of the responses received to the empirical questionnaire:

Do you agree that the recognition of an asset or liability for STC as either normal or deferred tax should be consistent with the principles contained in the IASB Framework for the Preparation and Presentation of Financial Statements?

	Lecturers	Technical	Tax partners	Total
Totally disagree	0	0	0	0
Disagree	0 -	0	0	o
Neutral	0	0	50	3
Agree	44	25	50	35
Totally agree	56	7	0	62
Total	100	100	100	100

The results of the questionnaire confirmed the conclusion drawn from the literature study that the principles contained in accounting standards should be in conformity with the Framework. A high percentage (97%) of respondents agreed or totally agreed that the recognition of an asset or liability for STC should be consistent with the principles contained in the Framework.

For the purposes of IAS 12, Income Taxes, income taxes .include ail domestic and foreign taxes which are based on taxable profits. With the introduction of STC, the normal company tax rate was reduced and the 1993 Budget referred to STC as being levied on distributed profits. Do you consider STC an "income tax" as defined by IAS 12?

	Lecturers	**Technical**	**Tax partners**	**Total**
			%	%
Totally disagree	6	12	0	9
Disagree .	25	0	0	12
Neutral	0	25	0	12
Agree	50	25	100	41
Totally agree	19	38	0	26
Total	100	100	100	100

The results of the empirical questionnaire supported the conclusion reached by the literature study that STC is an "income tax" as defined by IAS 12 — 67% of the respondents agreed or totally agreed with this conclusion.

IAS 12§52A states, amongst other things, that in some jurisdictions income taxes are payable at a hi^g^her or lower rate if part or all of the net profit or retained earnings is paid out as a dividend to shareholders of the enterprise. This is referred to by IAS 12 as the income tax "consequence of dividends". Based on the assumption that STC is an income tax,-do-you. consider STC income tax "consequence of dividends", i.e. resulting in income taxes being payable at a higher rate upon distribution of the retained earnings?

	Lecturers	**Technical**	**Tax partners**	**Total**
				%
Totally disagree	0	0	0	0
Disagree	6	13	0	9
Neutral	0	0	0	0
Agree	63	31	100	50
Totally agree	31	56	0	41
Total	**100**	**100**	**100**	**100**

Of the respondents, 91% agreed or totally agreed with the conclusion reached in the literature study that STC is an income tax "consequence of dividends".

What do you consider to be the "past event" that results in a "present obligation" for SIC?

	Lecturers	**Technical**	**Tax partners**	**Total**
			°,^1^0	%
The declaration of dividend	82	81	100	82
The recognition of distributable profits	12	13	0	12
Other	6	6	0	6
Total	**100**	**100**	**100**	**100**

The results of the empirical questionnaire did not confirm the same degree of uncertainty obtained from the literature study as to what is regarded as the obligating event that results in a present obligation for STC. Of the respondents, 82% believed that the declaration of a dividend is the appropriate past event that results in a present obligation for STC.

If you consider the "past event" which results in a "present obligation" for STC to be the declaration of a dividend, what is your main reason for this conclusion?

	Lecturers	Technical	Tax	Total partners
	%	**%**	**%**	**%**
As long as the dividend is not approved by the enterprise's bodies, the enterprise has no obligation to pay the additional	100	100	100	100
Other	0	0	0	0
Total	**100**	**100**	**100**	**100**

All of the 32% of respondents that considered the past event that results in the present obligation for STC to be the declaration of a dividend concurred with Bugg (2004:1) that the entity has no obligation to pay the additional taxes until a declaration has occurred.

If you consider the "past event", which results in a "present obligation" for STC to be the recognition of distributable profits, what is your main reason for this conclusion? (Rank the following in terms of importance, 1 being "most important" and 3 being "the least important". You may use the same ranking more than once.)

	Lecturers	**Technical**	**Tax partners**	**Total**
	Aver a ze	**Average**	**Average**	**Average**
STC is classified as an expense and should be matched with the income it relates to. The recognition of STC as profits are earned is therefore in accordance with the accrual principle		2.5	N/A	2.25
Over the lifetime of an enterprise all profits will ultimately be taxed at the rate applicable to distributable profits (at latest, when the enterprise is liquidated)	2.5	2	N/A	2.25
The income tax consequences of dividends are more directly linked to past transactions, i.e. the earning of distributable profits, than to distributions to owners	1.5		N/A	1.5

The 12% of respondents that considered the past event that results in a present obligation for STC to be the recognition of distributable profits placed a high premium on the fact that the income tax consequences of dividends relate more to the past earnings of a company than to the distribution itself.

A dividend declaration is influenced by various factors, namely legal requirements (for example section 90 of the Companies Act and Common Law principles), as well as various other considerations (for example the sustainable growth of a company, the information content of dividends, the nature .of shareholders and the availability of sufficient cash). Considering all of these factors, do you believe it is possible that the probability of future dividend declarations could be determined prior to the declaration of a dividend?

	Lecturers	**Technical**	**Tax partners**	**Total**
Totally disagree	12	6	0 '	9
Disagree	31	38	0	32
Neutral	13	6	0	9
Agree	38	50	100	47
Totally agree	6	0	0	3
Total	100	100	100	100

The respondents were not in agreement as to whether the probability of future dividend declarations could be determined prior to the declaration of a dividend. Of the respondents, 50% agreed or totally agreed that the probability could be determined prior to the declaration of a dividend, while 41% of the respondents disagreed or totally disagreed with the statement. The empirical results confirm the uncertainty with regard to this issue, as was also suggested by the literature study.

If the recognition of the STC liability is appropriate prior to the declaration of the dividend, do you believe that the liability should be provided for the tax implications of distributing all profits as they are earned or only for the STC that is probably going to be payable from the profits recognised (for example, based on dividend cover or dividend history)?

	Lecturers	Technical	Tax partners	Total
Recognise STC liability for distribution of all profits	0	25	50	15
Recognise STC liability for STC that is probably going to be payable from profits recognised (for example, based on dividend cover or dividend history)	81	44	50	62
Question not answered by respondent	19	31	0	23
Total	100	100	100	100

Most of the respondents (62%) agreed with the conclusion reached in the literature study that, where it is considered appropriate to recognise STC prior to the declaration of a dividend, STC should only be recognised on the profits that are probably going to be distributed.

If a company .has a standard dividend cover, do you believe that the measurability criterion (as contained in the Framework) has been satisfied for the recognition of a liability for STC prior to the declaration of a dividend?

	Lecturers	Technical	Tax partners	Total
Totally disagree	13	18	0	15
Disagree	44	63	0	50
Neutral	13	0	50	9
Agree	19	19	50	21
Totally agree	6	0	0	3
Question not answered by respondent	5	0	0	2
Total	100	100	100	100

The results of the empirical study are in conflict with the results obtained from the literature study. The literature study indicated that where a company has a standard dividend cover the "measurability" criterion in terms of the TASB Framework has been complied with. A high percentage (65%) of respondents disagreed or totally disagreed with this view. The unexpected results of the empirical study might be as a result of respondents not considering the measurability criterion in isolation. The mere fact that an entity has a standard dividend cover does not mean that all the other elements of the definition. of a liability and the recognition criteria are satisfied, and this might therefore also impact on the measurability.

If a company declares a dividend after the balance sheet date but prior to the finalisation of the financial statements, do you agree that the measurability criterion (as contained in the Framework) has been satisfied for the recognition of a liability for STC on the balance sheet date?

	Lecturers	Technical	Tax partners	Total
Totally disagree	5	25	0	15
Disagree	44	19	0	29
Neutral	13	0	50	9
Agree	' 25	50	50	38
Totally agree	13	6	0	9
Total	100	100	100	100

The literature study indicated that where a company declares a dividend after the balance sheet date but prior to the finalisation of the financial statements the "measurability" criterion in terms of the IASB Framework has been satisfied Respondents were fairly evenly divided on this issue, as 47% of the respondents agreed or totally agreed with this statement, while 44% of the respondents disagreed or totally disagreed with this statement. Of particular interest is the contrast between the results obtained from accounting lecturers and those from technical partners. Of the technical partners, 56% felt that the measurability criterion is satisfied in this case, while a much lower percentage of lecturers (38%) concurred with this view. The respondents that rated their knowledge on IAS 12 to be "poor" (6% of the respondents), were all neutral to this question.

Since temporary differences arise only an assets and liabilities, and not on retained earnings, there is no temporary difference on undistributed profits. Do you agree with this statement?

	Lecturers	**Technical**	**Tax -partners**	**Total**
Totally disagree	0	5	0	2
Disagree	12	19	0	15
Neutral	19	6	0	12
Agree	56	38	100	50
Totally agree	13	31	0	21
Total	**100**	**100**	**100**	**100**

Respondents were in general (71%) in agreement with "Opinion 1" in the literature study with regard to the non-existence of a temporary difference for undistributed profits.

lAS12§39 determines that an enterprise should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interest in joint ventures, except to the extent that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. The tax co insequences of STC are similar in concept, as the issue is that profits are recognised that may give rise to taxes payable in future if those profits are distributed in the form of a dividend. Do you agree with this statement?

	Lecturers ,	**Technical**	**Tax partners**	**Total**
Totally Disagree	12	2.5	0	18
Disagree	38	25	0	29
Neutral	2•5	0	5,0	15
Agree	19	50	50	35
Totally Agree	6	0	0	3
Total	**100•**	**100**	**100**	**100**

The results of the empirical study indicate that 47% of the respondents believe that the analogy of temporary differences relating to investments in subsidiaries, associates and joint ventures could not be applied to undistributed earnings relating to STC, while 38% believe that this could well be done. A high percentage (15%) of the respondents was "neutral" to the question. Of particular interest is that 50% of the technical respondents and tax partners agreed that a temporary difference could well exist, while by comparison 51% of the accounting lecturers disagreed or totally disagreed with the statement. This indicates some uncertainty in this regard. Of the 6% of respondents that indicated that their knowledge of IAS 12 is "poor" 50% (i.e. 3% of the total respondents) were neutral to the question, while 50% (i.e. 3% of the total respondents) '

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The original IAS 12 required an enterprise to account for deferred tax on timing differences. Timing differences are differences between taxable profit and accounting profit that originate in one period and reverse in one or more subsequent periods. In the case of SIC it could be argued that a timing difference arises as distributable profits are earned and 'included in accounting profit, while it is not included in taxable profit (i.e. the "net amount" for STC purposes). Do you agree with this statement?

	Lecturers	Technical	Tax partners	- Total
	%	%	%	%
Totally disagree	12	25	0	18
Disagree	63	38	100	53
Neutral	13	12	0	11
Agree	6	25	0	15
Totally agree	6	0	0	3
Total	**100**	**100**	**100**	**100**

Only 18% of the respondents agreed or totally agreed with the statement that a timing difference relating to STC could exist. This contradicts the results obtained from the literature study. All 6% of the respondents who rated their knowledge of LAS 12 as "poor", disagreed with the question.

Overall conclusion on empirical study

Respondents in general agreed that the recognition of a liability for STC prior to the declaration of a dividend is inappropriate, as-they believed that the past event that results in a present obligation for STC is the declaration of the dividend.

The respondents did not agree with the results obtained from the literature study with regard to the following:

- Respondents did not agree that where a company has a standard dividend cover that the "measurability" criterion has been complied with.
- Respondents did not agree with the findings that a timing difference relating to STC could exist.

The empirical study indicated uncertainty amongst respondents with regard to -the following:

- Respondents are divided as to whether the probability criteria for the recognition of a liability for SIC could be satisfied prior to the declaration of a dividend;
- Respondents are divided as to whether the measurability criterion for the recognition of a liability for STC could be satisfied prior to the declaration of a dividend in the case where a dividend is declared after the balance sheet date but prior to the finalisation of the financial statements;
- Respondents are divided as to whether the analogy for temporary differences in group accounts could be applied to undistributed earnings.

CONCLUSION ON THE STUDY

The literature study revealed that there are several .conflicting views with regard to the timing of the recognition of the liability for STC. Those who argue for the recognition of the liability as distributable profits are earned, argue that the accrual principle warrants sufficient support for recognition, as profits are earned. Those opposing recognition of the liability as profits are earned argue that the tax consequences of a transaction cannot be recognised until the underlying transaction has been recognised and, that, as such, the liability for STC can only arise one the Underlying dividend has become a liability.

The majority of the respondents in the empirical study agreed with the second view, namely that the liability for SIC can only be recognised once the dividend has been recognised, and the majority of the respondents, therefore, believe that the conclusion of AC 501 on issue 2 is conceptually sound. The "past event" criterion of the definition of a liability appears to be the most problematic hurdle to overcome in the recognition of a liability prior to the declaration of a dividend. However, the results of the empirical study indicate that if the "past event" hurdle- could be overcome, uncertainty also exists as to whether the recognition of a liability for SIC prior to the declaration is appropriate. The respondents are divided as to whether the "probability" and "measurability" criteria could be satisfied. Respondents were also divided as to whether, a temporary difference, similar to those applied for investments in subsidiaries, joint ventures and associates, could exist. An independent empirical study on the dividend practices of companies in South Africa has, however, indicated that a large percentage of companies in South Africa have a dividend policy with which shareholders are familiar and the majority of these companies declare a dividend on an annual basis. The majority of companies that have a dividend policy indicated that such a policy provides for a fixed percentage of profits to be distributed. The findings from this independent empirical study might, however, indicate, contrary to the results of the empirical research performed in this study that the "probability" and "measurability" criteria could be satisfied prior to the declaration of a dividend.

The short-term convergence project between the IASB and the FASB might once again highlight the question whether STC' should be accrued as profits are earned, and therefore whether tax assets -and liabilities should be measured at the undistributed or distributed rate.

As part of the short-term convergence project, the FASB has already tentatively decided that the tax rate applicable to undistributed profits is generally appropriate (IASB, 2004:10). The FASB has, however, decided at a meeting held on 19 January 2005 that, if corporate income is taxed at different rates, depending on whether that income is distributed to shareholders, the measurement of tax assets and liabilities should be based on the distributed rate (FASB, 2005a:2).

At a FASB Board meeting held on 23 March 2005, the FASB agreed to concur with the IASB, namely that tax assets and liabilities should be measured at the undistributed rate (FASB, 2005b:2). It was noted from the agenda to this meeting that a majority of the FASB Board members gave preference to the use of the distributed rate over the undistributed rate (FASB, 2005b:4). Although it was felt that the distributed rate is, "conceptually superior", to the undistributed rate, the FASB Board members felt that this issue revisited as part of the conceptual Framework Project (FASB,

2005b:2). The FASB Board members believe that the principal issue relates to defining the obligating event (FASB, 2005b:2), and as such this matter fits better with the Conceptual Framework Project. The decision of the IASB and the FASB to measure tax assets and liabilities at the undistributed rate will now be exposed for public comment, before the necessary amendments are made to US GAAP (FASB, 2005b:4). While it, therefore, appears as though short-term convergence may be reached on this matter, the final word on what constitutes the obligating event has not yet been said; this will be reassessed as part of the Conceptual Framework Project of both Boards.

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