

Unused STC credits: is AC 501 bullet proof?

In his budget speech of 21 February 2007 the Minister of Finance announced that government proposes to phase out Secondary Tax on Companies (STC) and to replace it with a new tax on dividends. It is proposed that this process will take place in two phases. The first phase will see a decrease in the rate of STC from 12.5% to 10%, with effect from 1 October 2007, and a redefinition of the base to apply to all distributions. It is proposed that phase two will commence during 2008 and that it will introduce a dividend tax at the shareholder level. The administrative enforcement of this dividend tax will be by way of a withholding tax that the company deducts from the dividend and pay over to SARS on behalf of the shareholders. It is expected that the introduction of the withholding tax should be complete by the end of 2008.

The future abolishment of STC will be viewed as a relief to accountants, as the accounting treatment of STC has always been contentious. Generally speaking the accounting for a withholding tax is much easier and internationally more common. Until STC is however abandoned the accounting considerations remain relevant and in order to be in compliance with International Financial Reporting Standards (IFRSs) due consideration should be given to the accounting treatment in terms of these standards.

STC is a tax that a company is liable for when the company declares dividends to its shareholders. The calculation of STC is regulated by sections 64B and 64C of the Income Tax Act (the Act), and is payable on the net amount. The net amount is calculated as the amount of dividends declared, reduced by the amount of certain dividends received. In terms of the Act, if an entity has an excess of dividends accrued over dividends declared during a given dividend cycle, that excess is carried forward to the next dividend cycle and is then deemed to be a dividend that accrued to the entity during the next dividend cycle. This "excess" is generally referred to as unused STC credits. Since 1999, South African accountants have considered the accounting treatment of unused STC credits. Are they contingent assets (as previously argued by AC 303, which has been withdrawn)? Are they assets? Or, more specifically, are they deferred tax assets?

The Accounting Practices Board's decision to align South African Statements of Generally Accepted Accounting Practice (SA GAAP) with IFRSs and to issue new IFRSs without amendment in South Africa in future has been coupled with a decision to interpret IFRSs for uniquely South African issues. These interpretations are issued as the AC 500-series; and their application is compulsory for both SA GAAP and IFRS

reporters. The first of these interpretations, AC 501, *Accounting for "secondary tax on companies"*, addresses (amongst other things) the accounting treatment of unused STC credits. The consensus in AC 501 is that an entity should recognise a deferred tax asset for unused STC credits to the extent that it is probable that the entity will declare a dividend of its own against which these unused credits can be used. The accuracy of this consensus appears to be important, as potentially large figures are involved. Based on a study conducted by the authors during 2004, 7 per cent of the top 200 JSE listed companies had unused STC credits in excess of R1 billion, while 25 per cent had unused STC credits between R100 million and R1 billion.

The requirements of IFRS

AC 501 argues that STC meets the definition of an income tax, in IAS 12, *Income taxes*. The current article does not consider whether this assumption in AC 501 is correct. For the purposes of the article, the authors assume that STC is, in fact, an income tax, and thus the authors focus on determining whether the consensus in AC 501, namely that an entity should recognise a deferred tax asset for unused STC credits, is beyond all doubt an accurate interpretation of IFRSs. According to IAS 12, income taxes include all domestic and foreign taxes that are based on **taxable profits**. Taxable profit is in turn defined by IAS 12 as the profit for a given period (determined in accordance with the rules established by the taxation authorities) on which income taxes are payable. Based on the assumption that STC is an income tax, the net amount as defined in terms of section 64B of the Act is considered to be "taxable profit" for the purposes of IAS 12.

IAS 12 determines that a deferred tax asset for unused tax losses and unused tax credits should be recognised if the following criteria are met:

- There must be an unused tax loss (Criterion 1.1) or an unused tax credit (Criterion 1.2).
- It must be probable that the unused tax loss or unused tax credit will realise in the future when it is set off against taxable profits (Criterion 2).
- If, based on the criteria above, there is indeed a deferred tax asset, the related deferred tax asset must be measured at the rate applicable to undistributed profits (Criterion 3).

These criteria are considered in more detail below.

Criterion 1.1: Are unused STC credits "unused tax losses" for the purposes of IAS 12?

IAS 12 defines a "tax loss" as the loss for the period (determined in accordance with the rules established by the taxation authorities) against which income taxes are recoverable. In South Africa, an example of an "unused tax loss", for the purposes of IAS 12, is the balance of an assessed loss. The following two opposing opinions exist with regard to unused STC credits:

- Unused STC credits are similar in nature to unused assessed losses (Opinion 1).
- Unused STC credits can never create a tax loss (Opinion 2).

Opinion 1: Unused STC credits are similar in nature to unused assessed losses

The following table illustrates some of the similarities between unused assessed losses and unused STC credits:

Unused assessed loss	Unused STC credits
The unused balance is carried forward to the next year of assessment (section 20(1)(a) of the Act).	Unused STC credits are carried forward to the next dividend cycle (section 64B(3)(a) of the Act).
The unused balance is used as an offset (deduction) against "income" (section 20(1) of the Act).	The unused balance is deducted in the calculation of the net amount (section 64B(3)(a) of the Act).

The following example illustrates the similarities between unused assessed losses and unused STC credits from an accounting perspective:

Example 1

Scenario A: An entity earned taxable income of R100 000 and incurred deductible expenses of R120 000 during Year 1. During Year 2, the entity earned an income of R100 000 and incurred expenses of R80 000.

Scenario B: An entity earned a dividend income of R100 000 during Year 1. The dividend income is exempt from normal income tax in terms of section 10(1)(k) of the Act. During Year 2, the entity earned no dividend income, but declared a dividend of R100 000.

	Unused assessed loss Scenario A R	Unused STC credits Scenario B R
Year 1		
Income	100 000	100 000
Expenses	(120 000)	-
(Loss) / profit before tax	(20 000)	100 000
Income tax income / (expense)	5 800	12 500
- current tax	-	-
- deferred tax	5 800	12 500
Profit after tax	(14 200)	112 500
Effective tax rate	29%	(12.5%)
Year 2		
Income	100 000	-
Expenses	(80 000)	-
(Loss) / profit before tax	20 000	-
Income tax income / (expense)	(5 800)	(12 500)
- current tax	- ¹	- ³
- deferred tax	(5 800) ²	(12 500)
Profit after tax	14 200	(12 500)
Unused assessed loss Scenario A R		Unused STC credits Scenario B R
Effective tax rate	29% ⁴	- ⁵

1. $[100\ 000\ (\text{income}) - 80\ 000\ (\text{expenses}) - 20\ 000\ (\text{unused assessed loss})] \times 29\% = \text{nil}$.
2. Reversal of the deferred tax asset recognised in the previous period.
3. $100\ 000\ (\text{dividends declared}) - 100\ 000\ (\text{unused STC credits}) = \text{nil}$.
4. $5\ 800 / 20\ 000 \times 100 = 29\%$
5. $(12\ 500) / 0 \times 100 = \text{error}$.

It is therefore evident that the recognition of a deferred tax asset in respect of an unused assessed loss results in matching between the losses incurred by an entity during a particular period and the related tax benefit of these losses (which will only materialise in future periods). By contrast, the recognition of a deferred tax asset in respect of an unused STC credit results in matching between the dividends received during a particular period and their related STC benefit (which will only materialise in future periods).

Opinion 2: Unused STC credits can never create a tax loss

From an accounting perspective, STC is considered an income tax. It is therefore necessary to draw an analogy between normal company tax and STC. Consider the following table, which illustrates the relevant tax computations:

Normal company tax		STC	
Gross income	XXX	Dividends declared	XXX
Less: Exempt income	(XXX)	Less: Unused STC credits	(XXX)
Plus: Specific inclusions	XXX	Plus: Specific inclusions	XXX
Income	XXX	Income	XXX
Less: Allowable deductions	(XXX)	Less: Allowable deductions	-
Taxable income	XXX	Net amount	XXX

The normal income tax base is determined, in broad terms, by commencing with gross receipts and accruals, then including special inclusions and excluding exempt income, and then reducing the resultant sum (defined as "income") by allowable expenditure deductions (irrespective of whether these are general or special deductions). Since exempt income is an exclusion rather than a deduction, it does not form part of the tax base under any circumstances. Because STC is considered to be an income tax, one could argue that the STC tax base is analogous to the normal income tax base. In terms of section 20(2) of the Act, an assessed loss arises in the case of normal income tax when the admissible deductions exceed "income", in other words, the remaining gross income after deducting the exempt income (see the definition of "income" in terms of section 1 of the Act). One could argue that (certain) dividend income is the equivalent of exempt income in the STC tax base, rather than a tax expenditure deduction. The contention is thus that unused STC credits are deducted from the dividends that are declared (which could be considered "gross income" in the STC tax base), because they represent amounts distributed that are not subject to STC, in other words, "exempt income". De Koker (2001:\$13.10) states that, in general, "incoming dividends" (that is, dividends earned by a company) would already have borne STC when they were distributed, and that they are therefore effectively offset against outgoing dividends in the computation of the liability of the distributing company, and so take the form of a tax shelter. This argument might support the view that dividend income is "exempt income" in the STC tax base.

From Example 1, above, one can see that, in Scenario A, the assessed loss is used as a deduction against income that has been earned in Year 2. Consequently, the assessed loss reduces the current tax expense of Year 2. In Scenario B, however, the R100 000 dividend income earned in the previous year will never be subject to STC. Therefore, even though a dividend of R100 000 is declared during Year 2, it does not represent taxable profit (income) for the purposes of STC, as it is considered exempt income. One can therefore not argue that the unused STC credit is used to reduce the current tax expense for STC, as a current tax expense could only be reduced if the entity had "taxable profits" for the purposes of STC. As the dividend of R100 000 is declared out of profits that are exempt for the purposes of STC, no

taxable profit or income exists in Year 2, and therefore no reduction of a current tax expense could take place.

Criterion 1.2: Are unused STC credits "unused tax credits" for the purposes of IAS 12?

AC 501 uses the following wording: "[W]here an entity received a dividend without utilising the related tax credit in that period...". AC 501 therefore seems to take the view that unused STC credits are "unused tax credits" as envisaged by paragraph 34 of IAS 12. Although IAS 12 does not define "unused tax credits", it prescribes a similar treatment for unused tax credits as that for unused tax losses. This suggests that, for the purposes of IAS 12, an "unused tax credit" is a credit that is determined in accordance with the rules established by the local taxation authority.

The Act does not contain a definition of a tax credit. In its 2005 guide, *Information on Income Tax*, the SARS has included a section on income tax credits. The credits mentioned in this section are Pay As You Earn, Standard Income Tax on Employees and foreign tax credits (SARS 2005:5). In the same guide, a template is provided for the calculation of the tax liability. In this template, the credits referred to are deducted from the total tax payable to calculate the tax liability (SARS 2005:36). It therefore appears that a critical characteristic of a tax credit is that it is offset against the tax payable. In order to determine whether unused STC credits are "unused tax credits" for the purposes of IAS 12, it is necessary to establish whether unused STC credits are offset against the STC payable.

The following table illustrates the difference between foreign tax credits and unused STC credits:

Foreign tax credits		STC credits	
Gross income	XXX	Dividends declared	XXX
Less: Exempt income	(XXX)	Less: STC credits	(XXX)
Plus: Specific inclusions	XXX	Plus: Specific inclusions	XXX
Income	XXX	Income	XXX
Less: Allowable deductions	(XXX)	Less: Allowable deductions	-
Taxable income	XXX	Net amount	XXX
Tax @ 29%	XXX	Tax @ 12.5%	XXX
Foreign tax credits	(XXX)	Credits	-
Tax payable	XXX	Tax payable	XXX

This analysis is also confirmed by IT 56 (SARS 2006:2), which is the return for the payment of STC. In this return, it is clear that STC credits are deducted in the calculation of the net amount and are not offset against the STC payable. It therefore appears that unused STC credits are not unused tax credits for the purposes of paragraph 34 of IAS 12.

Conclusion on Criteria 1.1 and 1.2

Unused STC credits might not be "unused tax credits" for the purposes of IAS 12. Two opposing opinions exist as to whether unused STC credits are "unused tax losses" for the purposes of IAS 12. These opposing arguments indicate that there is some uncertainty as to whether unused STC credits are "unused tax losses". The first opinion focuses on the fact that the Act provides for a "benefit" by allowing unused STC credits to be carried forward to the next dividend cycle, and that such a "benefit" represents an asset of the entity. The second opinion, however, contends that the carryforward of unused STC credits does not provide for any benefit. The Act has merely been constructed in such a manner to prevent the double taxation of dividends in the STC tax base. As such, unused STC credits are considered to be exempt income.

Criterion 2: It must be probable that the unused tax loss or unused tax credit will realise in the future through a set-off against taxable profits

"Taxable profit" is defined in IAS 12 as the profit for the period (determined in accordance with the rules established by the taxation authorities) upon which income taxes are payable. It appears that STC is

levied on "taxable profits" (that is, the distributed profits included in the "net amount" as determined by section 64B(2) of the Act), as defined by IAS 12. Unused STC credits are deducted in the calculation of the net amount (section 64B(2) of the Act), and that therefore reduces the amount that is ultimately subject to STC. It is not entirely clear whether a reduction and a set-off is the same for the purposes of IAS 12. If one considers dividend income to be exempt income for the purposes of STC, the deduction of unused STC credits in the calculation of the net amount is more akin to a reduction of gross income as opposed to a set-off against taxable profits.

Criterion 3: Any resulting deferred tax asset must be measured at the rate applicable to undistributed profits

IAS 12 provides the following example to illustrate paragraph 52A (IASB 2000:552B):

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 enterprise 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 IAS 1252A is very similar to the situation in South Africa. The only difference is that, in the example, the distributed tax rate of 35 per cent is lower than the undistributed tax rate of 50 per cent, while in South Africa the distributed tax rate is higher than the undistributed tax rate, because STC is levied when profits are distributed.

The table below indicates the difference between the undistributed and the distributed rates in South Africa:

	Undistributed	Distributed
Normal income tax	29%	29% ¹
STC	0% ²	11.11% ³
Total (normal income tax and STC)	29%	36.89% ⁴

1. The calculation of normal income tax is not affected by the distribution of profits.
2. STC is only triggered once a dividend is declared (section 64B(2) of the Act).
3. $12.5 / 112.5 \times 100 = 11.11\%$.
4. $29 + (100 \times 0.71 \times 12.5 / 112.5) = 36.89\%$, based on the assumption that profits are fully distributed. With a more conventional distribution of 50% of total profit the effective rate is reduced to 33.44% [$29 + (100 \times 0.71 \times 0.5 \times 12.5 / 100)$].

It is clear that STC is only triggered once profits are distributed. The contention is therefore that even if one concludes that unused STC credits are "unused tax losses" for the purposes of IAS 12 (in other words, they are not "exempt income"), the asset should have a value of Nil in the balance sheet.

Concluding remarks

The authors contend that it might be necessary to revisit the consensus in AC 501 with regard to the recognition of a deferred tax asset for unused STC credits. If one reads the Income Tax Act superficially, one could conclude that unused STC credits represent a benefit to an entity, and that a deferred tax asset should be recognised for this benefit. A more detailed analysis of the Income Tax Act, however, reveals that the

wording in the Act has been constructed in such a manner to ensure that dividend income that is distributed to shareholders is exempt from STC in order to avoid double taxation. If STC is considered to be an income tax, then it should follow that dividend income is not subject to STC. In any event, even if a deferred tax asset exists, such an asset might not have a value in terms of IAS 12, as all deferred tax assets must be measured at the rate applicable to undistributed profits. Paragraph 52B of IAS 12 specifically states that the income tax consequences of dividends should be recognised when a liability to pay the dividend is recognised (i.e. when a dividend is declared). The authors contend that there might be some grounds to argue that unused STC credits are also "income tax consequences of dividends" and should consequently only be accounted for once a dividend has been declared. If this is true, an entity could never recognise an asset for STC, and the liability to pay STC on the net amount should only be recognised once a dividend has been declared. Until AC 501 is revised, however, entities will not be allowed to follow the approach suggested by the authors. Whether it is, in fact, conceptually correct to record the liability for STC only once a dividend has been declared is another unresolved debate.

Perhaps accountants should consider whether they have not complicated the accounting treatment of STC altogether. Many of the Accounting issues regarding STC are as a consequence of the fact that STC is considered to be an income tax. It is interesting to note that with effect from 1 October 2007 the reduction in the STC rate from 12.5% to 10% will also be coupled with a name change. STC will in future be referred to as a "dividend tax", even though it will still be levied at the company level (until the implementation of the tax at the shareholder level by the end of 2008). This raises the question whether STC is in fact an income tax?

The Accounting issues surrounding STC may well disappear with the expected abolishment of the tax at the end of 2008. The question however remains: have we been accounting correctly for STC all these years, and if not, how significant is the impact of this on financial statements that have been published in the past? And, if the current treatment prescribed by AC 501 is not correct, do we continue with this until STC is abolished? ~~asa~~

NOTES

The authors welcome any comments on this article. Comments should be directed to ms@up.ac.za.

The authors would like to acknowledge the arguments of Mr Marius van Blerck, used in Opinion 2 in Criterion 1.1.

REFERENCES:

1. De Koker, A. 2001. *Silke on South African Income Tax*. Memorial Edition. Durban: Butterworths.
2. South African Revenue Service (SARS). 2005. Information on Income Tax.
3. South African Revenue Services (SARS). 2006. [www-document. www.sars.gov.za](http://www.sars.gov.za). IT 56 Return for payment of secondary tax on companies. Accessed 23 May 2006.

Elmar Venter, MCom (Taxation), CA(SA), is a former Senior Lecturer in the Department of Accounting at the University of Pretoria. Madeleine Stiglingh, MCom (Taxation), CA(SA), is an Associate Professor in the Department of Taxation at the University of Pretoria.