US vs the WORLD, a taxing issue
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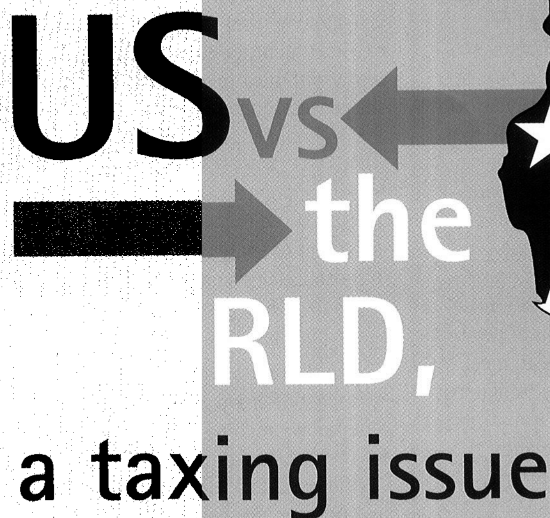

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), the standard-setting authority in the United States, have jointly undertaken a short-term convergence project to eliminate a variety of differences between International Financial Reporting Standards (IFRSs) and US GAAP. This "convergence project" arose from an arrangement reached by the two boards in September 2002. The objective of the short-term convergence project, more specifically related to income taxes, is to significantly reduce the number of differences between Statement 109, the US standard on Income Taxes, and IAS 12, the IFRS standard on Income Taxes, without replacing or reconsidering the fundamental principles of either standard.

As part of the short-term convergence project on income taxes, the IASB and FASB will consider the appropriate tax rate at which deferred tax assets and liabilities should be recognised, i.e. the distributed or undistributed tax rate. IAS 12 (paragraphs 52A and 52B) requires an entity to recognise its deferred tax assets and liabilities at the undistributed tax rate, while US GAAP generally requires an entity to recognise deferred tax assets and liabilities at the distributed tax rate. This anomaly and the possible convergence thereof could have a profound impact on South African companies, should IAS 12 be amended to require entities to recognise deferred tax assets and liabilities at the distributed tax rate. The imposition of Secondary Tax on Companies (STC), together with the corporate income tax, imposes a dual corporate tax system in South Africa, with a liability for both STC at a rate of 12.5% and normal income tax at a rate of 30%. South African companies are therefore taxed at an undistributed rate of 30% and a distributed rate of 37.78%.

This article will consider the various arguments for and against the use of the distributed tax rate and, more specifically, as it relates in the South African context to STC.

> IAS 12 requires an entity to recognise its deferred tax assets and liabilities at the undistributed tax rate, while US GAAP generally requires the distributed tax rate.

The IASB Framework

The IASB Framework states that the Board will use the Framework to assist them in their review of existing IFRS and, as a result, the number of cases of conflict between the Framework and IFRS will diminish through time. What will therefore be considered in this article is whether the recognition of a deferred tax liability for STC is consistent with the IASB Framework, and when such liability should be recognised in terms of the IASB Framework.

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). 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).

IAS 37 - Provisions, Contingent Liabilities and Contingent Assets, describes a past event (first element) 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 not have any realistic alternative to settling the obligation created by this event. The **first element**, the *obligating* event, poses a problem, as there could be two potential

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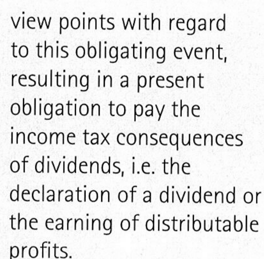

view points with regard to this obligating event, resulting in a present obligation to pay the income tax consequences of dividends, i.e. the declaration of a dividend or the earning of distributable profits.

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 the company involved.

The **third element**, i.e. 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 actually occur. Whether it is possible to estimate the future dividend policy of a company accurately is also a questionable matter.

The **fourth element**, namely the *reliability* of the amount, also proves to be an issue. There are a number of issues that would need to be taken into account in deciding on the appropriate corporate tax rate:

- Whether the rate should be based on the maximum rate payable if all profits were distributed; or
- Should it only take the expected dividend cover into account; and
- The effect of dividends received on the effective tax rate.

From the above, the following elements of the definition of a liability, and the recognition criteria for a liability, are problematic, and as such, require further scrutiny:

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

(b) Can the probability of future dividend declarations be determined? (third element)

(c) Can the liability relating to STC be measured reliably? (fourth element)

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

Arguments supporting the obligating event being the declaration of a dividend

Arguments held in support of the view that the obligating event is the declaration of a dividend, are the following:

- The necessary obligating event to justify the recording of the deferred tax liability is the declaration of the payment of dividends and at 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 and, as long as the dividend is not approved by the enterprise's bodies, the enterprise has no obligation to pay the additional tax.

- Deferred tax is meant to reflect the expected tax consequences of the recovery and settlement of assets and liabilities. Since STC is only calculated and payable on distribution of profits, it does not represent a tax consequence of the manner of recovery and settlement of assets and liabilities. It could also be argued that since temporary differences arise only in respect of assets and liabilities, and not retained earnings, there is no temporary difference for undistributed profits.

- AC 303 - Accounting for secondary tax on companies, which has been withdrawn with the issue of AC 501 - Accounting for Secondary Tax on Companies (STC), required that the potential liability for STC on undistributed profits be treated as a contingent liability. It could therefore be argued that if the liability to pay STC is contingent until the dividend declaration, it could be appropriate to use the undistributed rate to measure deferred tax liabilities.

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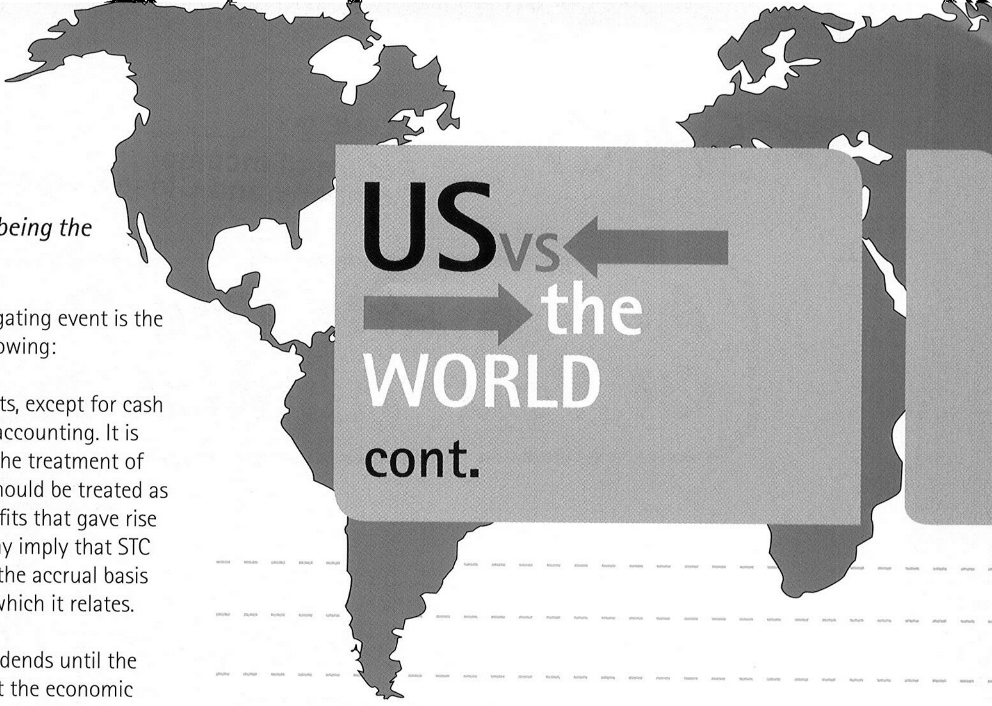

Arguments supporting the obligating event being the recognition of distributable profits

Arguments held to support the view that the obligating event is the recognition of distributable profit include the following:

- An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. It is considered that the conceptual difficulty of the treatment of IAS 12§52A and IAS 12§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 and if STC is an expense the accrual basis requires that it be recognised in the year to which it relates.

- Not recognising the tax consequences of dividends until the dividend declaration does not properly reflect the economic substance and consequences of tax systems where different rates apply to undistributed and distributed profits. Under such tax systems all profits during the lifetime of an enterprise will ultimately be taxed at the rate applicable to distributed profits, as all components of equity (including undistributed profits), sooner or later, are "automatically" paid out to shareholders (at latest, when the enterprise is liquidated).

- IAS 12 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 income tax consequences of dividends is the past transactions, i.e. the earning of distributable profits, as opposed to the declaration of a dividend.

> Since temporary differences arise only in respect of assets and liabilities, and not retained earnings, there is no temporary difference for undistributed profits.

Can the probability of future dividend declarations be determined?

The "probability" (third) element of the recognition criteria links in very closely 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 considered to be the declaration of a dividend, the "probability" element of the recognition criteria will be met, since once a dividend has been declared, it could be said that it is virtually certain that STC will be paid. However, if the obligating event is considered to be the earning of distributable profits, the "probability" element proves to be more problematic, since it would necessitate determining whether future dividend declarations are probable.

Definition of probability

The Framework determines that 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.

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 such time it is certain. Various legal and other aspects influence the declaration of a dividend, which will need to be considered in a probability assessment of future dividend declarations. This includes:

- Companies Act requirements for dividend declarations;
- Common Law requirements for dividend declarations;
- The effect of future dividend declarations on the sustainable growth of the company;
- The dividend policy of the company;
- The information content of dividends;
- The nature of the company's shareholders; and
- The availability of sufficient cash reserves to fund the dividend payment.

Can the liability relating to STC be measured reliably?

In this paragraph the considerations regarding the final element, namely the reliable measurement, will be analysed. The "reliable measurement" (fourth element) of the recognition criteria once again links in very closely 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 considered to be the declaration of a dividend, the "reliable measurement" element of the recognition criteria will be met, as the amount of the dividend will be known and therefore the amount of the STC liability can be measured reliably. However, if the obligating event is considered to be the earning of distributable profits, the "reliable measurement" element proves to be more problematic, since it would necessitate an estimate of the amount of future dividend declarations.

Investigation of the issue

In general the total rate of tax a company would pay under the dual tax system would depend on its dividend declaration policy. Assuming a 100% dividend-declaration policy, total tax as a percentage of pre-tax income and accounting profits would be 37.78%. At a more conventional distribution of one-third, the percentage reduces to 32.59%.

It is held that if a company has a standard dividend cover, or if the dividend has been declared prior to the finalisation of the financial statements, the recognition criteria have been satisfied and

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the STC liability should be recognised. As an enterprise is generally in a position to control the dividends declared, tax should only be recognised for STC that will probably be payable from the profits recognised.

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

The IASB Framework 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. Where it is possible to make an estimate, for example based on the dividend cover of a company, this recognition criteria is satisfied, even though subsequent events may prove that the amount is not exact.

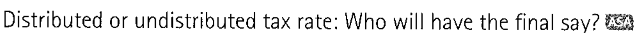
CONCLUSION: *distributed or undistributed rate?*

In the previous paragraphs it was considered whether it is conceptually appropriate to recognise deferred tax at the undistributed rate. Some believe that since potential tax consequences are disclosed in the notes, the approach to recognise current and deferred tax assets at the undistributed rate is the most transparent one.

On the other hand, the American Institute of Certified Public Accountants (AICPA) released a document which supported the use of the distributed rate in measuring deferred tax liabilities. The AICPA considered the rate that should be used to record deferred income taxes in South Africa under US GAAP. The Task Force discussed two views, i.e. a distributed rate of 37.78% or an undistributed rate of 30%. The Task Force expressed a preference for the distributed rate. However, the Task Force noted that the current literature was not entirely clear and agreed that the issue be referred to the Emerging Issues Task Force (EITF) for further consideration.

As part of the short-term convergence project the IASB has already tentatively decided that the tax rate applicable to undistributed profits is generally appropriate. The FASB will be considering the issue in the upcoming months and should they disagree with the IASB's tentative conclusions, the IASB will then reconsider the issue. The FASB has indicated that any conclusions reached in the convergence project will be published as an exposure draft to obtain public comment before the FASB adopts final changes to Statement 109. The FASB expects to issue an exposure draft in late 2004 or early 2005.

Distributed or undistributed tax rate: Who will have the final say? ASA



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