ACCOUNTING FOR "SECONDARY TAX ON COMPANIES (STC)"

Paragraph .12 of the Statement of Generally Accepted Accounting Practice (GAAP) on Presentation of Financial Statements requires that financial statements should not be described as complying with Statements of GAAP unless they comply with all the requirements of each applicable statement and each applicable approved interpretation. Interpretations are not intended to apply to immaterial items.

References:

The statement on income taxes,

the statement on events after the balance sheet date,

the statement on provisions, contingent liabilities and contingent assets,

the interpretation on share capital – reacquired own equity instruments,

the interpretation on equity – cost of an equity transaction,

the statement on earnings per share, and

the statement on interim financial reporting.

Issues

1. Issue 1: An enterprise incurs Secondary Tax on Companies (STC) charges on the distribution of dividends to its shareholders. The primary issue is how STC should be presented in the financial statements of an enterprise.
2. Issue 2: In terms of paragraph .12 of the statement on events after the balance sheet date, if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an enterprise should not recognise a liability for those dividends as at the balance sheet date. This raises the issue of when the STC on proposed or declared dividends should be recognised.

3. Issue 3: Certain equity instruments are classified as liabilities and the dividends on such instruments are accrued as a present obligation, in terms of the statement on provisions, contingent liabilities and contingent assets whether or not the dividends have been declared at the balance sheet date. The question arises as to the accounting treatment of the STC related to such dividends.

4. Issue 4: In terms of paragraph .06 of the interpretation on equity – cost of an equity transaction, the transaction costs of an equity transaction should be accounted for as a deduction from equity, net of related taxes. The issue is whether STC on the reacquisition of an enterprise's own equity instruments should be accounted for as a charge to income for the period or as a deduction directly from equity.

5. Issue 5: In terms of paragraph .12 of the statement on earnings per share, the net profit or loss for the period attributable to ordinary shareholders for the purpose of calculating basic earnings per share should be the net profit or loss for the period after deducting any undeclared cumulative preference dividends. The question arises whether the STC relating to the preference dividend should also be deducted for the purpose of calculating basic earnings per share.

6. Issue 6: In terms of paragraph .10 of the statement on interim financial reporting, the form and content of the interim financial report should conform to the requirements of the statement on presentation of financial statements for a complete set of financial statements. The question arises as to the interim period in which the STC expense is to be recognised, i.e. whether STC is recognised on a discrete basis for dividends declared during each interim period or whether the expected STC charge for the year as a whole is treated on an integral basis and is spread over all interim periods (by being included in the effective tax rate used in determining the tax charge for each interim period).

7. Issue 7: In instances where an entity received dividends and has not utilised the related STC credits on such dividends received, the question arises as to whether the entity should recognise a deferred tax asset for the unused STC credits.

Consensus

8. Issue 1: STC should be treated as part of the income tax charge in the income statement for the period. In requiring this treatment, it is recognised that the level of dividends, whether ordinary or preference, may vary, and the resulting tax charge in the income statement may be disproportionate to pre-tax earnings.

9. Issue 2: STC is a charge against income, and should be recognised as an expense in the same period as the related dividend is accrued as a liability.

10. Issue 3: In instances where an equity instrument is classified as a liability and a dividend related to that equity instrument has been accrued as a liability at balance sheet date, the related STC should also be accrued as a liability at the same time.

11. Issue 4: STC arising on the reacquisition by an enterprise of its own equity instruments should be accounted for as part of the tax charge in the income statement and not as a deduction directly from equity.

12. Issue 5: In instances where cumulative preference dividends have not yet been declared at the balance sheet date, both the preference dividends and the STC related to the preference dividends should be deducted from the net profit or loss for the period for the purpose of calculating basic earnings per share.

13. Issue 6: The STC expense should be recognised in each interim period based on the dividend accrued as a liability during that interim period.

14. Issue 7: To the extent that it is probable that the entity with the STC credit will declare dividends of its own against which unused STC credits can be utilised, a deferred tax asset should be recognised for such STC credits.

Basis for conclusions

15. Issue 1: The Minister of Finance announced in his 1993 budget a reduction in the rate of normal tax on companies and close corporations, and a new tax called Secondary Tax on Companies (STC) on distributed income. Accordingly, a dual corporate tax system applie**s** to all companies and close corporations, one part of

the tax being levied on the taxable income and the other, a secondary tax, on distributed income. The dual corporate tax system was incorporated in the amendments effected by the Income Tax Act, 1993 (the Act). STC is not a withholding tax on shareholders but a tax on companies. In terms of paragraph .56B of the statement on income taxes, the income tax consequence of dividends is more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequence of dividends is recognised in net profit or loss for the period. STC is thus an expense of the company and is charged to income.

16. Issue 2: As noted above, paragraph .56B of the statement on income taxes, states that the income tax consequence of dividends is recognised when a liability to pay the dividend is recognised. The STC is thus not recognised until such time as the liability for the dividends has been recognised.

17. Issue 3: For the reason provided in issue 2, the STC relating to the dividend on equity instruments classified as liabilities is recognised at the same time that the liability for the dividend is recognised.

18. Issue 4: Paragraph .06 of the interpretation on equity – costs of an equity transaction, states that the transaction costs of an equity transaction should be accounted for as a deduction from equity, net of related taxes. For the same reason that STC on dividends is included in the income tax charge for the period, even though dividends are charged directly to equity, STC on the reacquisition by an enterprise of its own shares is included in the income tax charge for the period, even though the reacquisition by an enterprise of its own shares constitutes an equity transaction. STC is a tax on the enterprise and is not a transaction cost of reacquiring own shares. It is therefore not accounted for as a deduction from equity.

19. Issue 5: Paragraph .12 of the statement on earnings per share, states that the preference dividends should be deducted from net profit or loss for the period attributable to ordinary shareholders for the purpose of calculating basic earnings per share. As the preference dividend is not available for distribution to ordinary

shareholders, and thus deducted to determine earnings attributable to ordinary shareholders, similarly the STC on the preference dividend is also not available for distribution to ordinary shareholders, and should thus also be deducted when determining earnings attributable to ordinary shareholders.

20. Issue 6: In terms of paragraph .40 of the statement on interim financial reporting, costs that are incurred unevenly during a financial year should only be anticipated or deferred for interim reporting purposes if it is also appropriate to anticipate or defer that type of cost at the end of the financial year. Paragraph 19 of Appendix II of the statement on interim financial reporting (revised), states "…. tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate". Therefore, the STC expense arising on a dividend is recognised when it is incurred, i.e. in the same interim period as the related dividend is accrued as a liability, and it is not anticipated or deferred.

21. Issue 7: In terms of paragraph .38 of the statement on income taxes a deferred tax asset should be recognised for the carryforward of unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax credits can be utilised. Where an entity received a dividend without utilising the related tax credit in that period and it is probable that such STC credits will be utilised in future, the criteria have been met for recognising a deferred tax asset.

Disclosures

22. The following STC disclosures should be made in the financial statements - certain of these disclosures are also required by the statement on income taxes:

    (a) The amount provided for STC (paragraph .84 of the statement on income taxes).

    (b) The amount of the STC on dividends to shareholders that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the

financial statements (paragraph .85(j) of the statement on income taxes).

(c) In addition, the enterprise should disclose the nature and amounts of the potential STC consequence practicably determinable and whether there are any potential income tax consequences not practicably determinable (paragraph .86A of the statement on income taxes).

(d) An explanation that will assist in an understanding of factors affecting the charge for STC. Such an explanation would be relevant where the STC charge is a significant component of the total tax charge or where the effective rate of STC varies substantially from the standard rate.

(e) The amount of unutilised STC credits that arise where dividend income exceeds dividends declared, to the extent that it has not been raised as a deferred tax asset.

(f) The reconciliation required by the statement on income taxes between the standard and effective rates of normal tax on pre-tax earnings should commence with the standard rate of normal tax and should include STC as a reconciling item.

Effective date

23. This Interpretation becomes effective for annual financial periods beginning on or after 1 January 2004. Earlier application is encouraged.

24. Changes in accounting policies should be accounted for according to the transition requirements of the statement on net profit or loss for the period, fundamental errors and changes in accounting policies.