Impact of the Dividends Tax on deferred tax assets arising from unutilised Secondary Tax on Companies (STC) credits

Introduction

.01 In February 2007, the Minister of Finance announced a two-phase approach to Secondary Tax on Companies (STC) reform.

- The first phase entailed the reduction of the STC tax rate to 10 per cent, as well as a revision of the tax base (i.e. the definition of “dividend”) on which the STC relies. The initial elements of this phase were brought into being by the Revenue Laws Amendment Act, 2007.
- The second phase entailed the replacement of STC with a new shareholder tax (“Dividends Tax”) on company dividends.

.02 Dividends Tax will result in a tax being levied on shareholders, and not on the company that declares the dividend. The company that pays the dividend will collect the tax on behalf of the shareholders and make payment directly to the South African Revenue Service (SARS).

.03 It is expected that companies with unutilised STC credits will be able to reduce the Dividends Tax payable by shareholders on dividends received during a transitional period of five years. Any unutilised STC credits will expire on the fifth anniversary of the effective date of Dividends Tax. The declaration of dividends by a company will be deemed by SARS to be a distribution of unutilised STC credits. These unutilised STC credits will be allocated pro rata amongst all shareholders within the same class that are entitled to the dividend, irrespective of whether or not those shareholders are exempt from Dividends Tax.

Scope

.04 This circular addresses:

- The impact that Dividends Tax will have on deferred tax assets previously recognised in respect of STC credits held; and
- The accounting treatment of any deferred tax remeasurement required as a consequence of considering the impact of Dividends Tax.
Accounting references

.05 Paragraph 34 of IAS 12 – Income Taxes states “A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.”

.06 Paragraph 37 of IAS 12 states “At the end of each reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria set out in paragraph 24 or 34. Another example is when an entity reassesses deferred tax assets at the date of a business combination or subsequently (see paragraphs 67 and 68).”

.07 Paragraph 47 of IAS 12 states “Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.”

.08 Paragraph 52B of IAS 12 states “The income tax consequences of dividends are more directly linked to past transactions or events than to distributions to owners. Therefore, the income tax consequences of dividends are recognised in profit or loss for the period as required by paragraph 58 except to the extent that the income tax consequences of dividends arise from the circumstances described in paragraph 58(a) and (b).”

.09 Paragraph 56 of IAS 12 states “The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.”
.10 Paragraph 14 of AC 501 – Accounting for “Secondary Tax on Companies (STC)” states “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.”

.11 Paragraph 4 of SIC 25 – Income Taxes – Changes in the Tax Status of an Entity or its Shareholders states “A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised outside profit or loss. The current and deferred tax consequences of a change in tax status shall be included in profit or loss for the period, unless those consequences relate to transactions and events that result, in the same or a different period, in a direct credit or charge to the recognised amount of equity or in amounts recognised in other comprehensive income. Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in profit or loss), shall be charged or credited directly to equity. Those tax consequences that relate to amounts recognised in other comprehensive income shall be recognised in other comprehensive income.”

.12 Paragraph 8 in the “Basis for Conclusions” of SIC 25 states “Because tax consequences recognised outside profit or loss, whether in other comprehensive income or directly in equity, must relate to a transaction or event recognised outside profit or loss in the same or a different period, the cumulative amount of tax recognised outside profit or loss can be expected to be the same amount that would have been recognised outside profit or loss if the new tax status had applied previously.”

Accounting treatment

.13 The recoverability of a deferred tax asset is required to be assessed at the end of each reporting period. The carrying amount of the deferred tax asset is reduced to the extent that it is no longer considered probable that the economic benefits inherent in the deferred tax asset will be utilised.

.14 Dividends Tax will have the effect that STC credits no longer serve to reduce a company’s tax obligation and therefore will be held solely for the benefit of the company’s shareholders. Deferred tax assets recognised in respect of the carryforward of STC credits will cease to reflect future tax
benefits available to be realised by the company. This should be considered in assessing the recoverability of deferred tax assets recognised in respect of these STC credits.

.15 Where an adjustment to the deferred tax asset is required in order to reflect a change in the expected future economic benefits from holding STC credits, this adjustment should be recognised in profit or loss. The remeasurement is a consequence of a change in tax legislation and is not related to the future distribution of dividends. SIC 25 states that a change in tax status must be recognised in profit or loss except if the tax (or deferred tax) consequences of the change in tax status relate to transactions and events that created a direct credit or charge to the recognised amount of equity or in amounts recognised in other comprehensive income. The change in tax status of South African companies in respect of tax on dividends does not bring about transactions or events that create adjustments to the amounts recognised in equity. It does, however, reflect the reduction in the carrying value of a deferred tax asset, in respect of STC credits held, that was previously recognised in profit or loss.

.16 Companies should consider Circular 03/2009 – *Headline Earnings* and refer to the detailed table in paragraph 21 of that Circular, when determining the impact that any adjustment to a deferred tax asset balance will have on headline earnings.

**Responsibility**

.17 Members should determine the necessary action required in the context of their responsibilities.