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Educational material

Application of IAS 12 – *Income Taxes* – Substantively Enacted Tax Rates (Also applicable to IFRS for SMEs)

Issued March 2021

CONTENTS **Paragraph**

Disclaimer
Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, summarising the requirements of IAS 12 Income Taxes (IAS 12) and Financial Reporting Pronouncement 1 (FRP 1) with regard to when changes in tax rates announced by the Minister of Finance in his/her delivery of the national budget speech are regarded as being substantively enacted. It highlights that a significant degree of uncertainty exists about whether the announcement of the proposed change in the corporate tax rate from 28% to 27%, announced in the 2021 budget speech delivered by the Minister of Finance on 24 February 2021, is substantively enacted at the date of the budget speech.

Entities are reminded to consider the impact of the above when preparing both interim and annual financial statements.

Relevant references to FRP 1 are included below. The full FRP can be accessed here: https://www.saica.co.za/Portals/0/Technical/financial-reporting/FRP%201.pdf

This guidance does not change, remove nor add to, the requirements in IFRS or FRP 1. It is intended to support the sound, consistent and robust application of the requirements in IFRS and FRP 1. While the APC is a technical accounting body, the APC consultation included tax and legal experts to help ensure completeness of the document and the relevant facts and circumstances.

This education material is also applicable to IFRS for SMEs.

2. Background of the educational material

On 24 February 2021, the Minister of Finance stated as follows:

'In this Budget we make the following tax policy proposals. The corporate income tax rate will be lowered to 27 per cent for companies with years of assessment commencing on or after 1 April 2022. This will be done alongside a broadening of the corporate income tax base by limiting interest deductions and assessed losses. We will give consideration to further rate decreases to make our tax system more attractive. We will do this in a revenue-neutral manner. We also intend to leverage the insights of the Davis Tax Committee as we undertake this reform.'

The Minister of Finance may announce changes in tax rates and tax laws during the annual Budget Statement. Such tax rate changes may be in force immediately (subject to ratification by Parliament within 12 months) or will only come into force once enacted. Even once enacted, the tax rate may not come into force immediately as its effective date may be a future date that is more than 12 months after announcement or enactment or alternatively the in force effective date may be subject to a public notice after enactment.

3. Guidance from IAS 12 and FRP 1

In terms of paragraphs 46 and 47 of IAS 12, both current and deferred tax assets and liabilities are to be measured using the tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period.

In order to provide context to the requirements of IAS 12, FRP 1 was issued to address, in a South African environment, when changes in tax rates and tax laws that are announced by the

Minister of Finance during the annual Budget Statement should be regarded as substantively enacted.

In terms of paragraph 6 of FRP 1, changes in tax rates should be regarded as substantively enacted from the time that they are announced in terms of the Minister of Finance's Budget Statement. However, this only applies where the change in tax rates is not inextricably linked to other changes in the tax laws. To be regarded as substantively enacted, there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner.

In terms of paragraph 7 of FRP 1, when changes in the tax rates are inextricably linked to other changes in the tax laws, they should be regarded as being substantively enacted when they have been approved by Parliament and signed by the President.

In terms of paragraph 8 of FRP 1, changes in tax laws other than those covered in paragraphs 6 and 7 of FRP 1, should be regarded as being substantively enacted when they have been approved by Parliament and signed by the President.

4. Application

The Minister of Finance announced the change in the corporate tax rate from 28% to 27% in the Budget speech on 24 February 2021. To be regarded as substantively enacted, there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner.

The APC below, highlights that a significant degree of uncertainty exists around whether this announcement is substantively enacted:

- Paragraph BC8 of FRP 1 states that where an announcement of a change in tax rates is inextricably linked to another change in tax laws, the change in tax rates should be regarded in the same way as a change in tax laws. It further states that this would apply, for example, if a change in tax rates were linked to a change in the basis of taxation (e.g. from a taxable income base to tax being based on a percentage of accounting profit). Therefore, if the adjustments to accounting profit, such as interest and assessed losses to arrive at taxable income were to be changed, these will result in a change in the basis of taxation.

  As announced by the Minister of Finance, the changes to tax rates and tax laws are intended to be done in a [tax] revenue-neutral manner. Thus, any benefit derived from the reduction in the corporate tax rate from 28% to 27% is intended to be offset by limitations placed on interest deductions and the use of assessed income tax losses and other potential proposed changes. Currently the impact of the changes in these tax laws are not known and the effects on taxable income are unclear. Based on the intention of the Minister of Finance that the impact of the reduction in the tax rate should be offset by changes in tax laws, the change to the tax rate could be interpreted as being inextricably linked to intended changes in tax laws, that are not entirely known at the date of the budget speech.

  Further, to be regarded as substantively enacted, the principle in paragraph 6 of FRP 1 is there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner. In this case, substantial changes are expected to the income tax treatment of interest deductions and assessed losses, so that changes brought about by the tax rate change have a revenue-neutral effect.

- The rate change was also already mentioned during 2020, where the link to broadening the base was also mentioned. An extract from the 2020 budget review stated:

  "Corporate income tax
  To promote economic growth, **government intends to restructure the corporate income tax system over the medium term by broadening the base and reducing the rate. Broadening the base will involve minimising tax incentives, and introducing new interest deduction and assessed loss limitations. Rate reductions will be implemented in a revenue-neutral manner.**

  Government has broadened the corporate income tax base since the early 2000s by taxing foreign dividends, imposing capital gains tax and introducing the controlled foreign company regime. In contrast with many other countries, however, South Africa's corporate income tax rate has remained unchanged at 28 per cent for more than a decade. As the gap with our trading and investment partners grows, the country's relative competitiveness declines. India, the United States and the United Kingdom have all recently reduced their corporate income tax rates below 28 per cent.

  Reducing the corporate income tax rate will encourage businesses to invest and expand production, improve the country's competitiveness as an investment destination, and reduce the appeal of base erosion and profit shifting."

  This further indicates that the intention with the rate change is linked to broadening the tax base to ensure a tax revenue-neutral position and cannot be viewed in isolation.

- Even though the tax rate change was mentioned in the Budget Speech itself, the Budget Review document (page 45 of the Budget Review document: http://www.treasury.gov.za/documents/national%20budget/2021/review/FullBR.pdf) is not as specific. This is different to previous rate changes, where the announcement was included in the Budget Review. This further adds to the uncertainty and lack of ultimate clarity.

- The budget speech refers to the effective date of the rate change as for years of assessment commencing on or after 1 April 2022. The previous corporate tax rate changes were effective from 31 March of that same year. It is unusual for a rate change to be announced so long in advance. The general process for tax rate changes is that the rate change is announced in the Budget Review documents, incorporated in a draft Bill issued at the same time as the Budget and that later in that same year is approved by Parliament. This announcement of the reduced corporate income tax rate will not be considered by Parliament during this year and is not incorporated in the 2021 Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill and accordingly will not be legislated in the next 18 months.

- It is also not clear that the mentioned changes will be the only changes to be considered and made to tax laws to ensure that the change in the corporate tax rate has a neutral impact on tax revenue.

- The budget speech makes reference to 'proposals'. In context, this word suggests that this is a proposal and perhaps not yet final and still subject to an approval process by an authorised body. Hence, specific words used in the budget speech such as ‘alongside’ should not necessarily be interpreted as being the final position.

5. Conclusion

The APC above highlights that a significant degree of uncertainty exists as to whether the announcement of the change in the corporate tax rate from 28% to 27% can be considered substantively enacted. Accordingly, entities would need to carefully assess all facts and circumstances in their assessment of whether the rate change is to be considered substantively enacted or whether it is rather inextricably linked to other tax law changes and therefore not substantively enacted at this time, given the uncertainty that exists regarding the announcement.