DEPARTMENT OF TRADE AND INDUSTRY

NO. 1446 **18 DECEMBER 2017**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS AND INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR SMALL AND MEDIUM ENTERPRISES

I Dr Rob Davies, Minister of Trade and Industry in consultation with the Financial Reporting Standards Council, under section 204 of the Companies Act, 2008 (Act 71 of 2008), hereby publish the draft Financial Reporting Pronouncement (FRP) as a guide in terms of section 29(3) of the Act.

Interested persons may submit written comments on the proposed Amendment Regulations not later than thirty (30) days from the date of publication of this notice to:

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Dr Rob Davies, MP
Minister of Trade and Industry
24 November 2017

FINANCIAL REPORTING PRONOUNCEMENT 1

SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

Issued xxx 2017

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PREFACE

Financial Reporting Pronouncement 1 (FRP 1) has been issued by the Financial Reporting Standards Council (FRSC). It is applicable to companies within the ambit of the Companies Act 71 of 2008 applying either International Financial Reporting Standards (IFRS) or IFRS for SMEs. It is applicable to both the 2009 and 2015 version of IFRS for SMEs.

FRP 1 addresses the issue of when changes in tax rates and tax laws that are announced by the Minister of Finance during the annual Budget Statement are regarded as substantively enacted, in a South African context, under IFRS and IFRS for SMEs.

With reference to the Preface to Documents Issued by the FRSC (Preface), the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardisation of financial reporting.

This FRP has the same authority as IFRS and IFRS for SMEs.

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SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS

References

IFRS:
- IAS 8 – *Accounting Policies, changes in Accounting Estimates and Errors*
- IAS 10 *Events after the Reporting Period*
- IAS 12 *Income Taxes*

IFRS for SMEs:
- Section 10 – *Accounting Policies, Estimates and Errors*
- Section 29 *Income Taxes*
- Section 32 *Events after the End of the Reporting Period*

Background

1. The Accounting Practices Board (APB) issued AC 502 – *Substantively Enacted Tax Rates and Tax Laws* in 2006 as a local interpretation. Following the proposed withdrawal of Statements of Generally Accepted Accounting Practice (GAAP) in 2012, SAICA issued this local interpretation as Financial Reporting Guide 1. The Financial Reporting Standards Council (FRSC) has considered the content of this Guide and has decided to issue it as a Financial Reporting Pronouncement (FRP). Although AC 502 and the SAICA Financial Reporting Guide 1 were local interpretations of IFRS, they address a concept that is equally relevant under IFRS for SMEs. Hence, this FRP applies to both IFRS and IFRS for SMEs. The only changes of substance relate to incorporating the relevant references from IFRS for SMEs as well as revising the illustrative examples to reflect both a change in corporate tax rate and a change to the inclusion rate for capital gains.

2. The Minister of Finance may announce changes in tax rates and tax laws during the annual Budget Statement.

3. In terms of paragraphs 46 and 47 of IAS 12, paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version[1]), 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.

[1] IFRS for SMEs 2015 version has a mandatory effective date of annual periods commencing on or after 1 January 2017.

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4. Paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version) state that tax rates and tax laws are regarded as substantively enacted when the remaining steps in the enactment process have not affected the outcome in the past and are unlikely to do so.

Issue

5. In a South African context, the issue is: when should changes in tax rates and tax laws that are announced by the Minister of Finance during the annual Budget Statement be regarded as substantively enacted?

Consensus

6. 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.

7. 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.

8. Changes in tax laws other than those covered in paragraphs 6 and 7 above, should be regarded as being substantively enacted when they have been approved by Parliament and signed by the President.

9. The changes in tax rates and tax laws should be applied to the period to which they relate. For example, a change in tax rates could be announced during a tax year as being applicable to the following year, in which case the current tax balances in the balance sheet would be based on the previous tax rate, whereas the deferred tax balance in the balance sheet would be based on the new tax rate.

Effective date

10. An entity shall apply this FRP for annual periods beginning on or after xxx[2]. Earlier application is permitted and is encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

[2] Proposed effective date is annual periods beginning on or after 1 January 2018.

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11. This FRP shall be applied retrospectively subject to the provisions of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (for entities applying IFRS) and Section 10 *Accounting Policies, Estimates and Errors* (for entities applying IFRS for SMEs).

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Illustrative examples and disclosure guidance

These examples accompany, but are not part of this FRP. The examples are merely illustrative and do not purport to reflect the tax laws and tax rates applicable in South Africa.

IE1 Capital gains are included in taxable income on a proportionate basis. On 23 February 20X5 the Minister of Finance in the Budget Statement announces the following changes:

- a change in the corporate tax rate from 30% to 29%. This change is effective for entities with a year of assessment ending on or after 1 April 20X5; and
- a change in the inclusion rate of capital gains from 66.6% to 80%. This change is effective from years of assessment begininng on or after 1 March 20X5.

IE2 On the basis of this FRP, the date of substantive enactment for both the corporate tax rate, and the capital gains tax rate, change is 23 February 20X5, this being the date of the Budget Statement. However, for entities with a year end prior to 1 April 20X5, the rate of tax to be used for current tax is 30%, since the corporate tax rate change applies to entities with years ending on or after 1 April 20X5. For capital gains arising in years of assessment beginning before 1 March 20X5, 66.6% of such gains should be included in the calculation of current tax; whereas an inclusion rate of 80% should be used for capital gains arising in years of assessment beginning on or after 1 March 20X5.

IE3 In terms of paragraph 28 of IAS 34 – *Interim Financial Reporting*[3], an entity is to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, which means that current and deferred tax balances in interim financial statements are to be measured using tax rates and tax laws that have been enacted or substantively enacted by the date of the interim balance sheet.

IE4 In keeping with the previous paragraphs, the current and deferred tax amounts in the balance sheet should be dealt with as outlined below.

<u>Entity's year end is before 23 February 20X5</u>

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98%[4] should be used).

[3] IFRS for SMEs does not address interim financial reporting.

[4] 66.6% x 30% = 19.98%

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- The deferred tax balance disclosed on the balance sheet at year end should be based on a tax rate of 30% and an inclusion rate for capital gains of 66.6%. Where these financial statements are approved for issue after 23 February 20X5, the entity should include a subsequent event note in the financial statements to the effect that the deferred tax balance will change in the future as a result of the change in corporate tax rate from 30% to 29% and the change in CGT rate from 19.98% to 23.2%[5]. For these entities the change in tax rates will be reflected in the following year's financial statements.

Entity's year end is between 23 February and 31 March 20X5

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98% should be used).
- The deferred tax balance shown on the balance sheet at year end should be measured using a tax rate of 29% and an inclusion rate for capital gains of 80% for gains (i.e. an effective CGT rate of 23.2%).

Entity's year end is after 31 March 20X5, but before 28 February 20X6

- Current tax balances should be measured at 29% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.31%[6] should be used).
- The deferred tax balance shown on the balance sheet at year end should be measured using a tax rate of 29% and an inclusion rate for capital gains of 80% (i.e. an effective CGT rate of 23.2%).

[5] 80% x 29% = 23.2%
[6] 66.6% x 29% = 19.31%

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Entity's interim results are for a period ending before 23 February 20X5 for an entity with a year ending after 31 March 20X5 (but before 28 February 20X6), with the results being published after 23 February 20X5

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98% should be used).
- The deferred tax balance disclosed on the balance sheet at interim should be based on a tax rate of 30% and an inclusion rate for capital gains of 66.6%.
- A subsequent event note should be included commenting that the results for the full year will measure current and deferred tax balances at 29%. And that for deferred tax, the inclusion rate for capital gains expected to arise after the end of the current annual financial reporting period will increase to 80% resulting in an effective CGT rate of 23.2%.

Entity's interim results are for a period ending on or after 23 February 20X5 for an entity with a year ending after 31 March 20X5, but before 28 February 20X6

- The current and deferred tax balances should be measured using a 29% tax rate.
- For current tax, the inclusion rate for capital gains should be 66.6%.

  For deferred tax, the inclusion rate for capital gains should be 66.6% for capital gains expected to be included in taxable income by the end of the current annual financial reporting period and 80% for capital gains expected to be included in taxable income after the end of the current annual period.

IE5 In terms of IAS 12, paragraphs 80 and 81, the following, amongst other things, should be disclosed:

5.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

5.2 A reconciliation between the effective tax rate and the applicable tax rate.

5.3 An explanation of the change in the applicable tax rate compared to the previous accounting period.

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IE6 In terms of paragraphs 29.31 and 29.32 of IFRS for SMEs (2009 version), the following, amongst other things, should be disclosed:

6.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

6.2 An explanation of the change in the applicable tax rate compared to the previous accounting period.

IE7 In terms of paragraphs 29.39 and 29.40 of IFRS for SMEs (2015 version), the following, amongst other things, should be disclosed:

7.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

7.2 An explanation of any significant differences between the tax expense (income) an accounting profit multiplied by the applicable tax rate.

7.3 An explanation of the change in the applicable tax rate compared to the previous accounting period.

IE8 In terms of IAS 10 paragraph 21, paragraph 32.10 of IFRS for SMEs (both 2009 and 2015 versions) an entity shall disclose the following for each material category of non-adjusting events after the reporting period:

8.1 the nature of the event, and

8.2 an estimate of its financial effect, or a statement that such an estimate cannot be made.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 IAS 12 states the following:

1.1 "*Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.*" (paragraph 12.46[7])

1.2 "*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 the rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.*" (paragraph 12.47[8])

1.3 "*Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).*" (paragraph 12.48)

BC2 IFRS for SMEs provides the following additional guidance:

2.1 "*An entity shall regard tax rates and tax laws as substantively enacted when the remaining steps in the enactment process have not effected the outcome in the past and are unlikely to do so.*" (paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version))

BC3 In order to interpret the meaning of substantive enactment and the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner, it would be appropriate to regard a tax rate or tax law as substantively enacted where there is persuasive evidence that:

3.1 the government is able to enact and is committed to enacting the proposed change in the foreseeable future; and

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[7] The equivalent reference in IFRS for SMEs is paragraph 29.6 (both 2009 and 2015 versions).

[8] The equivalent reference in IFRS for SMEs is paragraph 29.18 (2009 version) and paragraph 29.27 (2015 version).

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3.2 the entity expects to be assessed on the basis of the announced rates/ laws, where the change relates to the current year.

In addition, the requirements of this paragraph would usually exist only when the proposed change is specified in sufficient detail to be understood and applied in practice, and once the change has been tabled in Parliament.

BC4 In South Africa, the change in tax rates is only actually enacted when the necessary legislation is passed by Parliament, which occurs some months after the Budget Statement. However, the Income Tax Act provides, in paragraph 17(4) of the Fourth Schedule, that provisional tax should be based on the rate *"in respect of that year foreshadowed by the Minister of Finance in his budget statement"* if the rate for that year has not been fixed by Parliament. Accordingly, the rate as announced by the Minister of Finance is given legal standing in the Income Tax Act and is to be used for tax payment purposes.

BC5 Furthermore, the budget is presented in Parliament by a member of the ruling party, which has a substantial majority, meaning that the ruling party is able to ensure that the revised tax rate will be passed by Parliament.

BC6 The factor in BC4, supplemented by that in BC5, is regarded as meeting the requirement in IAS 12, paragraph 48, that the announcement of the new rates has the substantive effect of actual enactment. BC4 and BC5 also provide a basis for meeting the requirement in paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version).

BC7 A change in tax rate, however, needs to be distinguished from other changes in tax legislation. Paragraphs 46 to 48 of IAS 12 and Section 29 of IFRS for SMEs not only refer to tax rates, but also to tax laws. Whilst the Minister of Finance might announce changes in tax laws in the Budget Statement, these changes are generally only drafted at a later stage. This means that the detail of the changes is only decided upon at this later stage, and could incorporate amendments made subsequent to the proposals announced in the Budget Statement. In addition, changes to the proposed legislation can be made as a result of debates in Parliament and in committees as well as in response to comments received when draft legislation is released for public comment. In this case, because the detail of the changes is generally only decided upon at a later date, substantive enactment would be regarded as occurring when the legislation is approved, seeing that prior to this date there is not sufficient certainty as to the details to be applied in practice when the changes are actually enacted. This is distinguished from a change in tax rates that only requires one amount to be changed and is therefore a change that can be made without interpretation issues arising, which are only resolved when the legislation is finally approved.

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BC8 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. 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). The same would apply if a new tax were introduced because the details of the legislation would only be enacted at a later date. Normally changes to tax laws, such as changes made to close perceived tax loopholes, are made independently of any changes in tax rates.

BC9 As noted above, the current and deferred tax balances are to be measured on the basis of the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. This means that, if the tax rates and tax laws are regarded as being enacted or substantively enacted after the balance sheet date, they are regarded as non-adjusting events after the balance sheet date, even when the changes to the tax rates and tax laws are applied retrospectively. In this case, the required disclosures in terms of IAS 10 (under IFRS) and Section 32 (under IFRS for SMEs) are to be provided.

BC10 This FRP only addresses issues related to the selection of the tax rate to be used to calculate the deferred tax balance and the current tax expense. It does not address the subsequent implications relating to the recognition of any related income or expense, and therefore does not address the issue of whether the tax effect of the current year's temporary differences should be calculated using the current or prior rate, and further whether the tax rate change should be made to the opening or closing balance of deferred tax. As these issues are not addressed in IAS 12 or IFRS for SMEs, it is not appropriate for this FRP to address these issues.