

An analysis of the accounting treatment of a tax on company distributions in South Africa

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ABSTRACT

South Africa adopted a dual corporate income tax system in 1993 by reducing the normal company tax rate and introducing a second-stage tax on distributions known as secondary tax on companies (STC) that was imposed on the company and not on the shareholder. The local consensus was that STC must be recognised as an expense as part of the company tax charge. This consensus appeared to contradict the definition of an expense in the Conceptual Framework for Financial Reporting. STC was subsequently replaced with dividends tax which, in the case of cash distributions, is a withholding tax imposed on the shareholder while it remains a tax on the company in the case of non-cash distributions. The objective of this study is to evaluate the accounting treatment of taxes on distributions, both formerly and currently imposed in South Africa, to determine which treatment approach is appropriate. The appropriateness of the different accounting treatment approaches to a tax imposed on company treatments is assessed based on the relevant fundamental principles of accounting practices (standards) and the decision-usefulness theory. The study includes a reflection on the differences and similarities, both legal and in substance, between STC and dividends tax in order to determine whether a differential accounting treatment approach is warranted. The study observed that there are significant legal and administrative differences between STC and dividends tax but that the economic substance of the two taxes is similar in that both taxes diminish the ultimate return derived by shareholders. It was further observed that the differentiator applied by accounting standards in determining the treatment approach, favours the legal form rather than the economic effect (substance) of the taxes. The study found that a country-specific pronouncement on whether dividends tax is an income tax would be useful. Preparers of financial statements would also benefit from specific guidance on determining whether dividends tax is linked to past transactions or events that generated distributable profits.

KEYWORDS: Tax accounting, tax on company distributions, dividends tax, secondary tax on companies, corporate income tax, IAS 12

ACRONYMS

APA	American Psychological Association
APB	Accounting Practices Board
CTC	Contributed tax capital
FRP	Financial Reporting Pronouncement
FRSC	Financial Reporting Standards Council
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IFRS for SMEs	International Financial Reporting Standard for Small and Medium Enterprises
SAICA	South African Institute of Chartered Accountants
SA GAAP	South African Statements on Generally Accepted Accounting Practice
SARS	South African Revenue Service
STC	Secondary tax on companies

FORMAT AND REFERENCE STYLE

This mini-dissertation is presented in article format, in accordance with the policies of the North-West University's Faculty of Economic and Management Sciences and consists of one research article.

Therefore, referencing in this mini-dissertation complies with the writing style requirements of the American Psychological Association (APA).

CHAPTER 1 INTRODUCTION

1.1 INTRODUCTION

1.1.1 Background to the research study

South Africa replaced secondary tax on companies (STC) with dividends tax on 1 April 2012 (Income Tax Act 58 of 1962). While both STC and dividends tax are imposed on distributions made by companies to its shareholders, the operational mechanism of these two taxes differs. STC was imposed on the company (company-level tax) whereas dividends tax is imposed on the shareholder¹ (shareholder-level tax) with the company merely having an obligation to withhold the tax on the shareholder's behalf. The two taxes also have different methods to ensure that the same distribution is not taxed more than once should it flow through multiple companies in a tiered structure².

The accounting treatment of STC was contentious (Hemus, 1996). The Accounting Issues Task Force of the South African Institute of Chartered Accountants (SAICA) issued guidance in *AC 303 Accounting for the dual corporate tax system* shortly after STC was enacted in which it suggested that STC be treated as an expense in the distributing company's financial statements (SAICA, 1993). However, the definition of an expense as contained in the *Conceptual Framework for Financial Reporting* excludes transactions "relating to distributions to holders of equity claims" (International Accounting Standards Board [IASB], 2021a). According to Hattingh (2013), who served on the Accounting Issues Task Force at the time of the issue of the guidance, the rationale

¹ STC was imposed in terms of part VII of chapter 2 of the Income Tax Act (1962). Dividends tax is imposed in terms of Part VII of Chapter 2 of the Income Tax Act (1962). In the case of non-cash distributions by companies, referred to as distributions of an asset *in specie*, dividends tax is imposed on the company and not the shareholder (company-level tax).

² STC achieved this by allowing a deduction for dividends received from dividends declared and levying the tax only on the net amount (section 64B(2) of the Income Tax Act, 1962). Dividends tax achieve this by exempting dividends paid to another South African company (section 64F(2) of the Income Tax Act 58 of 1962).

for the accounting treatment as an expense was that STC was perceived as an elective tax (it could be avoided by not making distributions to shareholders) and that the users of financial statements generally expect taxes to be treated as expenses.

Treating STC as an expense for accounting purposes resulted in various problems. The effective South African corporate income tax rate³ was substantially increased as a result of STC, which resulted in a lack of competitiveness when compared to other jurisdictions (South African Revenue Service [SARS], 2017). It also contributed to the classical agency problem⁴ when company directors deferred distributions to avoid the tax charge against reported earnings that could affect their incentives, which was arguably to the detriment of shareholders. Such treatment could also lead to an accounting mismatch between earnings and the STC expense where distributions were made out of past profits resulting in the associated tax being reported as an expense in a different accounting period leading to distorted financial reporting (Hattingh, 2013). SARS (2019) cites the “adverse accounting profit reduction” (p. 3) created by STC as one of the reasons for transitioning from STC to dividends tax. Venter and Stiglingh (2007) question whether STC was in fact an income tax and whether the ensuing accounting treatment thereof was correct.

Since dividends tax is imposed on the shareholder and no longer on the company as was the case with STC, it is arguably no longer disputatious as to its treatment as an expense from the company’s perspective, as the tax is not borne by the company and is, therefore, not treated as a company expense (section 64EA of the Income Tax Act 58 of 1962). However, the tax on non-cash distributions is still borne by the company and it is questionable whether the mere fact that the tax on cash distributions is now legally imposed on the shareholder, justifies the change in accounting treatment.

³ The high corporate income tax rate is an issue currently being deliberated in South Africa with proposals to reduce the rate by broadening the corporate income tax base (National Treasury, 2021).

⁴ Refer to Jensen and Meckling (1976).

One of the fundamental qualitative characteristics of financial reporting is faithful representation, which favours reporting on the economic substance of an economic phenomenon rather than solely on its legal form (IASB, 2021a).

The impact of the difference in approaches to the accounting treatment of a tax on distributions on certain key line items reported in financial statements, is illustrated in Table 1. The illustration assumes that the reporting entity derived a pre-tax profit of R100 million and wishes to distribute all post-tax profits as a dividend to its shareholders and that a corporate income tax rate of 28% applies to the pre-tax profit and that distributions are subject to a tax at 20%. In Column A, the tax on distributions is treated as an expense at company-level, which is similar to the approach previously advocated by SAICA for reporting STC. In Column B, the tax on distributions is not treated as an expense at company level but included in the value of the distribution reported as a reduction in equity in the statement of changes in equity (appropriation approach), which is in line with the treatment of the extant dividends tax that is imposed on shareholders. In both instances, the net post-tax dividend ultimately received by shareholders is R57.6 million. However, there are vast differences in the reported net earnings and effective tax rates between the two approaches, as indicated in Columns C and D. There is a variance of 33.96% in the tax expense and effective tax rates and a variance of 25% in the reported post-tax earnings between the two approaches.

Table 1: Impact of different treatment approaches of a tax on distributions on information reported in the financial statements

Information reported in financial statements	A Expense approach	B Appropriation approach	C Absolute difference	D Variance (%)
Profit before tax	R100 million	R100 million	-	-
Tax expense	R42.4 million ⁵	R28 million ⁶	R14.4 million	33.96%
Profit for the year (after tax)	R57.6 million	R72 million	R14.4 million	25.00%

⁵ (R100 million x 28%) + (R72 million x 20%)

⁶ R100 million x 28%

Effective tax rate reported in financial statements	42.4%	28%	14.40%	33.96%
Net post-tax dividend derived by shareholders	R57.6 million	R57.6 million	-	-

1.1.2. Theoretical framework

The ultimate goal of accounting is to provide decision makers, such as investors, with information that is useful in deciding whether or not to provide resources to the reporting entity (IASB, 2021a).

The approach adopted in respect of the treatment of a tax on distributions, will arguably be relevant to such decision makers.

In order to consider which of the accounting treatment approaches to the treatment of a tax on distributions is appropriate, one must consider a framework of basic accounting assumptions. Buys (2010) distinguishes between assumptions based on principles and assumptions based on practices and argues that prevailing accounting standards are likely premised on practices.

When considering basic assumptions based on *practices* as contained in current accounting standards, the *Conceptual Framework for Financial Reporting* as issued by the IASB (2021a) is likely an appropriate framework to use. While the *Conceptual Framework for Financial Reporting* is not an accounting standard and it does not override any requirement in any accounting standard, it does assist standard setters in the development of accounting standards based on consistent concepts. It also assists preparers of financial statements to develop consistent accounting policies for transactions to which no specific accounting standard applies (IASB, 2021a).

Buys (2010) warns that merely considering practices as sound accounting theory would be detrimental to the accounting discipline. The *Conceptual Framework for Financial Reporting* does not always serve as the ideal basis for developing accounting policies and contains a number of internal inconsistencies (Demski, 2008; Sundem, 2007).

In order to consider basic assumptions based on *principles*, it is therefore also necessary to consider the fundamental theoretical assumptions of accounting theory. Kerlinger (1964) defines

a theory as “a set of interrelated constructs, definitions and propositions that present a systematic view of the phenomenon by specifying relationships among variables with the purpose of explaining and predicting the phenomena” (p.9). Riahi-Belkaoui (2012) states that there is no single comprehensive accounting theory in existence, but that various attempts have been made to develop a general accounting theory. Norris (1980) describes the process of comparing existing usage in accountancy to a theoretical ideal that consists of a co-ordinated logical scheme of principles that is derived by a process of abstract reasoning. Chambers (1955) discusses the *decision-usefulness/decision-model paradigm* of accounting by reasoning that rational management requires an information providing system as a footing for both decisions and for reviewing the outcomes of decisions. A formal information providing system would need to comply with two propositions, the first being a condition of logical discourse requiring the system to be logically consistent and not permitting rules or processes that are contrary to other rules and processes. The second proposition stems from the use of accounting information as a basis for making decisions that have practical consequences and that such information should be relevant to the type of decision-making, which it is expected to enable (Chambers, 1955).

This study considers the appropriateness of the treatment approaches to a tax on company distributions by considering sound accounting practices in specific accounting standards and the *Conceptual Framework* and by considering the foundational principles of accounting theory such as the *decision-usefulness/decision-model paradigm*.

1.2 PROBLEM STATEMENT AND RESEARCH QUESTION

The different approaches to the accounting treatment of a tax imposed on company distributions will have a significant impact on the information conveyed about the reporting entity's earnings, effective tax rate and dividend yield and could consequently affect the decision-making of the users of financial statements.

From this problem, the following research question is formulated to be addressed by this study:
Which of the treatment approaches to accounting for a tax on distributions is appropriate to facilitate rational decision-making by users of financial statements?

1.3 RESEARCH OBJECTIVES

This study attempted to address the research question with the following theoretical objectives:

1.3.1 Primary objective

The primary objective of this study was to analyse the accounting treatment of a tax on distributions to determine which treatment approach is appropriate in terms of both prevailing accounting practices and in terms of foundational accounting theory.

1.3.2. Secondary objective

The secondary objective of this study was to perform a comparative analysis of dividends tax and STC to determine the fundamental differences and similarities, both legal and in substance, between the two taxes in order to conclude on whether a differential accounting treatment approach is justified.

1.4 RESEARCH DESIGN AND METHODOLOGY

Tomkins and Groves (1983) state that the selection of the most suitable research methodology depends on the nature of the phenomenon that is the subject of the research. Specifically, the assumptions that the researcher holds about the reality of the phenomenon (ontology), will affect the manner in which knowledge can be gained about such phenomenon (epistemology), which subsequently determines the process through which the research must be conducted (methodology).

1.4.1 Paradigmatic assumptions

Ontology is the study of reality or existence (Mouton & Marais, 1988). Ryan *et al.* (2002) describe ontological assumptions as alternative ways of viewing the world. Morgan and Smircich (1980)

identified six ontological assumptions that may each be associated with different schools of thought in the social sciences, such as accounting. They placed the six ontological assumptions on a continuum ranging from most objective (reality as a concrete structure or naïve realism) to most subjective (reality as a projection of human imagination or idealism). The fourth ontological assumption on the continuum is transcendental idealism, which views reality as a symbolic discourse. This assumption views the world as human actors who make sense of their reality through social interaction and mediation, which is facilitated through shared meanings and norms (Ryan *et al.*, 2002).

The discipline of accounting is concerned with economic events that have social consequences and that affect social relationships and it provides information that is useful and meaningful to members of society that are engaged in activities that have social implications (Mautz, 1963). As such, this study is premised on the interpretivist view that reality is derived from social processes and is actualised through human interaction.

1.4.2 Research method

Interpretative accounting research as described by Chua (1986) was employed to conduct this study. This qualitative research method uses theory to provide explanations of human intentions and assesses its adequacy through logical consistency and subjective interpretation. The appropriateness of the different accounting treatment approaches to a tax imposed on company treatments was assessed based on the relevant fundamental principles of accounting practices and of foundational accounting theory. This includes a reflection on the differences and similarities, both legal and in substance, between dividends tax and STC in order to determine whether a differential accounting treatment approach is warranted.

1.4.3 Literature study

The study identified the principles of accounting practices by consulting the *Conceptual Framework for Financial Reporting* (IASB, 2021a) and specific accounting standards such as *International Accounting Standard 12 Income Taxes* as issued by the IASB (2021b). In order to

determine the relevant principles of foundational accounting theory, the study consulted commentary and views on accounting philosophy and theory such as Ryan *et al.* (2002), Riahi-Belkaoui (2012), Norris (1980), Bloom and Elgers (1981) and Schroeder *et al.* (2009). The study also compared STC and dividends tax by performing a conceptual analysis of the two taxes.

1.5 CHAPTER OVERVIEW

Chapter 1	Research proposal including problem statement, objectives and research design.
Chapter 2	Standalone research article in which the accounting treatment of a tax on distributions is analysed in terms of accounting practices and foundational accounting theory, a comparison is performed between dividends tax and STC to determine the fundamental differences and similarities between the two taxes and a demonstration of the impact of different accounting treatment approaches to a tax on distributions on key information reported on or derived from the financial statements.
Chapter 3	Conclusion

CHAPTER 2 RESEARCH ARTICLE

An analysis of the accounting treatment of a tax on company distributions in South Africa

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Abstract

South Africa adopted a dual corporate income tax system in 1993 by reducing the normal company tax rate and introducing a second-stage tax on distributions known as secondary tax on companies (STC) that was imposed on the company and not on the shareholder. The local consensus was that STC must be recognised as an expense as part of the company tax charge. This consensus appeared to contradict the definition of an expense in the *Conceptual Framework for Financial Reporting*. STC was subsequently replaced with dividends tax which, in the case of cash distributions, is a withholding tax imposed on the shareholder while it remains a tax on the company in the case of non-cash distributions. The objective of this study is to evaluate the accounting treatment of taxes on distributions, both formerly and currently imposed in South Africa, to determine which treatment approach is appropriate. The appropriateness of the different accounting treatment approaches to a tax imposed on company treatments is assessed based on the relevant fundamental principles of accounting practices (standards) and the decision-usefulness theory. The study includes a reflection on the differences and similarities, both legal and in substance, between STC dividends tax in order to determine whether a differential accounting treatment approach is warranted. The study observed that there are significant legal and administrative differences between STC and dividends tax but that the economic substance of the two taxes is similar in that both taxes diminish the ultimate return derived by shareholders. It was further observed that the differentiator applied by accounting standards in determining the treatment approach, favours the legal form rather than the economic effect (substance) of the taxes. The study found that a country-specific pronouncement on whether dividends tax is an income tax would be useful. Preparers of financial statements would also benefit from specific guidance on determining whether dividends tax is linked to past transactions or events that generated distributable profits.

Keywords:

Tax accounting, tax on company distributions, dividends tax, secondary tax on companies, corporate income tax, IAS 12

1. Introduction

South Africa adopted a dual corporate income tax system in 1993 in response to a perception that the company tax rate of 48% was too high when compared internationally (McAllister, 2010). This entailed a reduction of the company tax rate to 40% and the imposition of a second-stage tax on the distribution of after-tax profits at a rate of 15%, called secondary tax on companies (STC). STC was only levied when a company distributed profits as dividends and therefore encouraged retention and reinvestment of profits to stimulate growth through self-financing (McAllister, 2010).

The accounting treatment of STC was contentious (Hemus *et al.*, 1996; Venter & Stiglingh, 2007). The Accounting Issues Task Force of the South African Institute of Chartered Accountants (SAICA) issued guidance in *AC 303 Accounting for the dual corporate tax system* shortly after STC was enacted in which it suggested that STC be treated as an expense in the paying company's financial statements (SAICA, 1993). However, this treatment is ostensibly in contrast with the definition of an expense as contained in the *Conceptual Framework for Financial Reporting* that excludes transactions "relating to distributions to holders of equity claims" (IASB, 2021a). According to Hattingh (2013), who served on the Accounting Issues Task Force at the time of issue of the guidance, the rationale for the accounting treatment as an expense (hereafter referred to as the "expense approach") was that STC was perceived to be an elective tax since it could be avoided by not making distributions to shareholders and that the users of financial statements generally expected taxes to be treated as expenses. AC 303 was replaced with *AC 501 Accounting for Secondary Tax on Companies*⁷, a local accounting interpretation, that still called for STC to be treated as an expense (SAICA, 2003).

Various problems ensued from the expense approach. Reporting STC as an expense exaggerated the effective South African company tax rate when compared to other jurisdictions where distributions were taxed at shareholder level, making South Africa appear less competitive (South African Revenue Service [SARS], 2017). The expense approach also results in lower reported earnings per share, since *International Accounting Standard (IAS) 33 Earnings Per Share* requires the use of the after-tax profit or loss when calculating the numerator (IASB, 2021d).

The impact of the difference in approaches to the accounting treatment of a tax on distributions on certain key line items reported in financial statements, is illustrated in Table 1. The illustration assumes that the reporting entity derived a pre-tax profit of R100 million and will distribute all post-tax profits as a dividend to its shareholders. It also assumes that a corporate income tax rate of 27% applies to the pre-tax profit and that distributions are subject to a further tax of 20%. In Column A, the expense approach is followed. In Column B, the tax on the distribution is not treated as an expense at company level but rather charged to equity as part of the dividend (hereafter referred to as the "appropriation approach"), which is in line with the treatment of a withholding tax on dividends as prescribed by *IAS 12 Income Taxes* (IASB, 2021b). In both instances, the net post-tax dividend ultimately received by shareholders is R58.6 million. However, there are vast differences in the reported net earnings, effective tax rates and earnings per share between the two approaches, as demonstrated in Columns C and D.

⁷ South African Statements of Generally Accepted Accounting Practice (SA GAAP) have been substantially aligned with International Financial Reporting Standards (IFRS) since 1993 and have been exact replicas of IFRS since 2004 through a dual numbering system (SAICA, 2004). The erstwhile Accounting Practices Board (APB) was still charged with issuing statements and interpretations to address South African specific matters not addressed in the IFRS, one such interpretation being AC 501 (SAICA, 2003). SA GAAP was withdrawn with effect from financial years commencing on or after 1 December 2012 and replaced with the IFRS or International Financial Reporting Standards for Small and Medium Enterprises (IFRS for SMEs), the latter being available to companies that are not listed on a public exchange (Companies Regulations, 2011). In 2011, the APB was replaced with the Financial Reporting Standards Council (FRSC), a legally mandated standard setter, through the enactment of section 203 of the Companies Act, 71 of 2008. The FRSC has the power to issue financial reporting pronouncements (FRPs) to address circumstances that are specific to South Africa and not specifically addressed by the IFRS, provided that they are not in conflict with the IFRS (FRSC, 2022).

Table 1: Impact of different treatment approaches of a tax on distributions on information reported in the financial statements

Information reported in financial statements	A Expense approach	B Appropriation approach	C Absolute difference	D Variance (%)
Profit before tax	R100 million	R100 million	-	-
Tax expense	R41.6 million	R27 million	R14.6 million	35.01%
Profit for the year (after tax)	R58.4 million	R73 million	R14.6 million	25.00%
Effective tax rate reported in financial statements	41.60%	27.00%	14.60%	35.01%
Net post-tax dividend derived by shareholders	R58.4 million	R58.4 million	-	-
Basic earnings per share	R5.84	R7.30	R1.46	25.00%

Adopting the expense approach could also exacerbate the classical agency problem, which is the conflict between the divergent interests of shareholders (principals) and directors (agents) (Jensen & Meckling, 1976). Directors would be incentivised to rather defer distributions to avoid the tax charge against reported earnings, on which their incentives are based, arguably to the detriment of shareholders. Such treatment also led to an accounting mismatch between earnings and the STC expense where distributions were made from past profits resulting in the associated tax being reported as an expense in a different accounting period thereby distorting financial reporting (Hattingh, 2013).

With effect from 1 April 2012, STC was replaced with dividends tax by the enactment of section⁸ 64E of the Income Tax Act, 58 of 1962. STC was a tax imposed on the company (section 64B(2)) whereas dividends tax is imposed on the shareholder⁹ with the company merely having an obligation to withhold and pay the tax to the South African Revenue Service (SARS) on behalf of shareholders (section 64EA and section 64G). The two taxes also have different methods to ensure that the same distribution is not taxed more than once should it flow through multiple companies in a tiered structure.

Since dividends tax on cash dividends is legally imposed on the shareholder and no longer on the company as was the case with STC, it is arguably no longer disputatious as to its treatment as an expense from the company's perspective. This is because the tax is not borne by the company and is, therefore, not treated as a company expense (IASB, 2021b: para. 65A).

However, while the workings and legal form dividends tax are different from STC, one could argue that in substance, they are both taxes on distributions ultimately borne by the shareholder and are therefore similar in substance. One of the fundamental qualitative characteristics of financial reporting is faithful representation, which favours reporting on the economic substance of an economic phenomenon rather than solely on its legal form (IASB, 2021a).

It is, therefore, questionable whether the mere fact that the tax on distributions is now legally imposed on the shareholder, justifies a change in accounting treatment from the expense approach to the appropriation approach, or alternatively, whether the expense approach was the correct way to account for STC in the first place. In addition, dividends tax on non-cash dividends is still imposed on the company.

The ultimate goal of accounting is to provide decision makers, such as investors and financiers with information that is useful in deciding whether or not to provide resources to the reporting entity (IASB, 2021a). The approach adopted in respect of the treatment of a tax on distributions, will arguably be relevant to such decision makers.

⁸ All references to "section" in this article refer to sections of the Income Tax Act (1962) unless indicated otherwise.

⁹ Referred to as the "beneficial owner" which is defined as "the person entitled to the benefit of a dividend attaching to a share" (section 64D). In the case of non-cash distributions, referred to as distributions of an asset *in specie*, dividends tax is imposed on the company (section 64EA).

In order to consider which of the accounting treatment approaches to the treatment of a tax on distributions is appropriate, one must consider a framework of basic accounting assumptions. Buys (2010) distinguishes between assumptions based on *principles* and assumptions based on *practices* and argues that prevailing accounting standards are likely premised on practices.

IAS 12 *Income Taxes* is a specific accounting standard that prescribes the accounting treatment for income taxes (IASB, 2021b). In addition, when considering basic assumptions based on practices as contained in current accounting standards, the *Conceptual Framework for Financial Reporting* is likely an appropriate framework to use. While the *Conceptual Framework for Financial Reporting* is not an accounting standard and it does not override any requirement in any accounting standard, it does assist standard setters in the development of accounting standards based on consistent concepts. It also assists preparers of financial statements to develop consistent accounting policies for transactions to which no specific accounting standard applies (IASB, 2021a).

Buys (2010) warns that merely considering practices as sound accounting theory would be detrimental to the accounting discipline. The *Conceptual Framework for Financial Reporting* does not always serve as the ideal basis for developing accounting policies and contains a number of internal inconsistencies (Demski, 2008; Sundem, 2007). In order to consider basic assumptions based on principles, it is therefore also necessary to consider the fundamental theoretical assumptions of accounting theory.

2. Objective

The objective of this study is to evaluate the accounting treatment of taxes on distributions, both formerly and currently imposed in South Africa, to determine which treatment approach is appropriate.

3. Research method

Interpretative accounting research as described by Chua (1986) was applied to conduct this study. This qualitative research method uses theory to provide explanations of human intentions and assessing its adequacy through logical consistency and subjective interpretation.

The appropriateness of the different accounting treatment approaches to a tax imposed on company treatments is assessed based on the relevant fundamental principles of accounting practices (standards) and the decision-usefulness theory.

The study includes a reflection on the differences and similarities, both legal and in substance, between STC and dividends tax in order to determine whether a differential accounting treatment approach is warranted.

4. Conceptual analysis of STC and dividends tax

4.1 STC

4.1.1 Background to the introduction of STC and effective tax rates

Prior to March 1993, the South African corporate income tax system consisted of a solitary tax, referred to in tax legislation as “normal tax”, which was imposed on the taxable income of a company at a rate of 48%. Consistent with the principle of averting economic double taxation, dividends were tax neutral, at both the corporate and shareholder level (McAllister, 2010).

However, this rate was considered too high when compared to other jurisdictions (Department of Finance, 1993). In response, the South African government opted to introduce a dual corporate income tax system and with effect from 17 March 1993 with the introduction of STC at a rate of 15% through the enactment

of section 34(1) of the Income Tax Act (1993). STC was essentially a second-stage tax imposed on after-tax profits distributed by a South African company and it was imposed at the corporate level.

The introduction of STC allowed a reduction in the company income tax rate from 48% to 40% and was again decreased to 35% in 1994 when the STC rate was increased from 15% to 25%. Refer to Table 2 for historical company tax rates and STC for the period between 1 April 1991 (approximately one year before the introduction of STC) and 31 March 2012 (the date when STC was repealed). The table also shows the total effective tax rate if all after-tax profits of the company are distributed as dividends.

Table 2: Corporate income tax rates in South Africa between 1991 and 2012

Period	Company income tax (“normal tax”) rate imposed on taxable income	Secondary tax on companies (STC) rate imposed on net dividends declared	Total effective tax rate if all company profits are distributed as a dividend
1 April 1991 to 16 March 1993	48%	-	48%
17 March 1993 to 31 March 1993	48%	15%	56%
1 April 1993 to 31 March 1994	40%	15%	49%
1 April 1994 to 21 June 1994	35%	15%	45%
22 June 1994 to 13 March 1996	35%	25%	51%
14 March 1996 to 31 March 1999	35%	12.5%	43%
1 April 1999 to 31 March 2005	30%	12.5%	39%
1 April 2005 to 30 September 2007	29%	12.5%	38%
1 October 2007 to 31 March 2008	29%	10%	36%
1 April 2008 to 31 March 2012	28%	10%	35%

Compiled by authors with data obtained from McAllister (2010) and South African Reserve Bank (SARB, 2020)

4.1.2. Imposition of STC

STC was imposed on the “net amount” of dividends declared by a company that was a South African resident for income tax purposes. The “net amount” was the amount of dividends declared by the company less any incoming dividends during a dividend cycle (section 64B). The reason for deducting incoming dividends was to avoid economic double taxation, as the incoming dividend would have been subject to STC when it was declared by the paying company. If incoming dividends exceeded outgoing dividends during a dividend cycle (negative net dividend), then no STC was payable and the excess was carried forward and deemed to be an incoming dividend in the next dividend cycle. A dividend cycle was effectively the period between two outgoing dividend declarations by a company.

An exemption from STC was available for intra group dividends between two companies that were both residents of South Africa for tax purposes (section 64B(5)(f)). The declaring company had to elect that the exemption be applied. Such dividends were not regarded as incoming dividends when calculating the “net amount” of the recipient company. Under the subsequent dividends tax system, the exemption method would be applied for all dividends between South African resident companies as the mechanism to prevent double taxation instead of the “net amount” system employed under STC (refer to 4.2).

4.1.3. Definition of a “dividend”

The tax base for the imposition of STC was a “dividend” as defined in section 1, a highly complex definition that consisted of over 2 300 words. The definition started by describing a dividend as an amount distributed by a company to its shareholders. It is an established principle in South African tax law that the word “amount” is wider than money and includes other forms of property, both corporeal and incorporeal, which have a money value (*WH Lategan v. Commissioner for Inland Revenue*, 1926). Therefore, both distributions in cash and distributions *in specie* (non-cash distributions) could potentially qualify as a dividend.

The definition then listed a number of amounts that are specifically included in the definition such as profits distributed by a company that is in the course of being terminated, profits distributed by a company that is

not in the course of being terminated, the nominal value of capitalisation shares awarded to shareholders and bonus debentures or securities awarded to shareholders and any reduction of the profits of the company due to a reduction of its capital or a share buy-back.

The definition centred around the word “profits”, which was not defined in tax legislation but derived its meaning from accounting principles and company law. This obfuscated the tax system and opened the door for tax avoidance (SARS, 2022).

The definition also listed a number of amounts that are specifically excluded from the definition such as the nominal value of capitalisation shares issued out of the share premium account and the repayment of share capital or share premium.

Lastly, the definition contained three provisos. The first two provisos addressed the consequences when reserves have been capitalised. The underlying principle of these provisos was that reserves retain their character as either profits (subject to STC when distributed) or capital (not subject to STC when distributed). The third proviso deemed unrealised profits to be profits irrespective of whether such amounts are recognised for financial reporting purposes.

The definition of a dividend was based on the concept of capital maintenance. If a company made a distribution from share capital or share premium, it was not considered to be a dividend whereas if a company made a distribution from accumulated profits, it was considered to be a dividend (SARS, 2022).

4.1.4. *Deemed dividends under STC*

Section 64C was an anti-avoidance provision that deemed certain amounts to be dividends for purposes of STC, even if the amounts were not actual dividends consisting of profit distributions. An obvious method that shareholders could employ to avoid STC, particularly in closely held companies, is by withdrawing amounts from the company on a loan account to either the shareholder or a connected person. Since there is an obligation to repay the amount to the company, it could not be a distribution of profits. Section 64C(2)(g) read together with section 64C(4)(d) deemed such loans to be dividends for purposes of STC where the interest charged on the loan was less than the “official rate of interest¹⁰”. Loan repayments on such loans were deemed to be incoming dividends for purposes of determining the “net dividend”.

Examples of other deemed dividends include companies ceasing to be a tax resident of South Africa, settlement or payment of the debt of a shareholder or a connected person, amounts applied or used by the company for the benefit of a shareholder and transfer pricing adjustments.

4.2. Dividends tax

4.2.1 *Background to the introduction of dividends tax*

STC was repealed with effect from 31 March 2012 and replaced with dividends tax through the enactment of section 56(1) of the Revenue Laws Amendment Act (2008). Dividends tax was initially imposed at a rate of 15% and the rate was increased to 20% for dividends paid on or after 22 February 2017.

Dividends tax on cash dividends is levied on the beneficial owner and operates as a withholding tax. Dividends tax on non-cash dividends (distributions of an asset *in specie*) is levied as an additional tax on the company (section 64EA).

The reasons for transitioning from STC (a company-level tax) to dividends tax (mostly a shareholder-level tax) include the adverse accounting profit reduction and higher reported effective tax rate under STC, the

¹⁰At the time, defined in paragraph 1 of the Seventh Schedule to the Income Tax Act, the official rate of interest was a rate fixed by the Minister of Finance from time to time by notice in the Government Gazette (McAllister, 2010).

international norm¹¹ is to impose a withholding tax at shareholder level and the lack of access to treaty relief from STC since treaty relief generally only applies to withholding taxes (SARS, 2022).

4.2.2. *Imposition of dividends tax*

Dividends tax is imposed on dividends paid by South African resident companies and on cash dividends paid by non-resident companies that are listed¹² on a South African exchange (section 64D). Unlike STC that was levied upon declaration of the dividend, dividends tax is levied when a dividend is paid, which is deemed to be the earlier of the date that it is paid or that it becomes due and payable (for listed companies, cash dividends are deemed to be paid on the date that it is actually paid).

An exemption system is used to prevent double taxation. Most notably, dividends paid by a resident company to another resident company is exempt from dividends tax (section 64F(1)(a)).

4.2.3. *Revised definition of a “dividend”*

The definition of a “dividend” in section 1 was substantially revised with effect from 1 January 2011, even before the transition from STC to dividends tax. The revised definition departs from accounting principles, company law and the common law in that it is no longer premised on the distribution of profits. SARS (2022) describes the revised definition as “an artificial tax concept”.

A dividend is essentially an amount transferred or applied by a company for the benefit or on behalf of any person in respect of a share in that company. The definition implies that there must be a *nexus* between the amount transferred or applied and the share in the company. The revised definition is significantly wider than the former definition that was based on capital maintenance principles, which dictated that an amount was only a dividend if it was a distribution of profits. The revised definition does not distinguish between the distribution of profits and the return of capital unless the distribution is elected to be a distribution of the company’s “contributed tax capital” (CTC).

The definition of a dividend specifically excludes a distribution that results in a reduction in the company’s CTC (see discussion below), a distribution of capitalisation or bonus shares¹³ and amounts transferred on certain share buy-backs by listed companies by way of a general repurchase of its shares.

The revised definition introduced the concept of CTC, another artificial tax concept. CTC is essentially the capital contributed by the shareholders of the company. If the company wishes to return such capital to shareholders by way of a distribution, it must deliberately and unilaterally elect that the distribution is a reduction of CTC. If the election is not made, the amount will be a dividend despite the fact that it may be a return of capital from an accounting or company law perspective.

It is, therefore, possible for a company redeeming its own shares in a share buy-back transaction, to have the entire amount transferred to the shareholder classified as a dividend if it does not elect the utilisation of CTC. Equally, it is possible for a company to distribute profits to a shareholder that is entirely classified as a return of capital for tax purposes if the election is made that the distribution is a reduction in CTC.

¹¹ Estonia levies corporate income tax on distributed profits rather than on taxable income at a rate of 20% of the gross amount (Deloitte, 2022). India introduced a dividend distribution tax (DDT) on 1 June 1997, but after much criticism, DDT was repealed and replaced with a withholding tax on dividends with effect from 1 April 2020 (Raguwanshi, 2021).

¹² In terms of section 9 of the Financial Markets Act (2012), the exchanges currently licensed are the Johannesburg Stock Exchange (JSE), A2X Markets, Cape Town Stock Exchange (previously 4 Africa Exchange) and Equity Express Securities Exchange.

¹³ The rationale for this exclusion is that capitalisation or bonus shares transferred to shareholders do not have any real effect since the underlying assets of the company and interests therein remain intact. Refer to *Commissioner for Inland Revenue v. Collins* (1923) where this principle was well-established.

If a company makes a distribution to a shareholder and elects that such a distribution is a reduction in CTC, the distribution would not be a dividend and would not be subject to dividends tax. Such distribution would generally have capital gains tax consequences for the shareholder.

The wide ambit of the revised definition and the artificial concept of CTC, giving discretion to the company to decide when an amount is a return of capital for tax purposes, has arguably made the definition significantly less complex and there is also less need for provisions that deem amounts to be dividends.

4.2.4. *Deemed dividends under dividends tax*

The dividends tax legislation in part VIII of chapter II of the Income Tax Act (1962) contains only one deemed dividend, the granting of a low or interest free loan to a connected person (such as a shareholder or a person connected to a shareholder) in respect of a share (there is a causality requirement between shareholding and the granting of the loan). Similar to the comparable STC provision, the benchmark interest to avoid the application of the deeming rule is the "official rate of interest"¹⁴. Unlike STC, where the entire loan was deemed to be a dividend, it is now only the interest not charged on the loan that is deemed to be a dividend. Loans granted to South African resident companies are also excluded from the deeming provision due to the exemption method applied in the dividends tax system to avoid taxing the same distribution twice. This deemed dividend is regarded as a distribution of an asset *in specie* and the resultant dividends tax is, therefore, imposed on the company.

The Income Tax Act contains other provisions that deem amounts to be dividends for dividends tax purposes such as a company ceasing to be a tax resident in South Africa (section 9H(3)(c)) and the secondary transfer pricing adjustment (section 31(3)).

4.3. **Summary**

STC was an additional tax imposed on a company when it declared dividends. Under the STC system, a dividend was essentially defined as a distribution of the accumulated profits of the company. This narrow definition required several legislative inclusions to deem certain amounts to be dividends which did not fall under the definition.

Dividends tax on cash distributions is a tax on dividends imposed on the beneficial owner of the shares with the paying company being required to withhold the tax and pay it to SARS on the beneficial owner's behalf. Dividends tax on non-cash distributions is an additional tax imposed on the company. The definition of a dividend under the dividends tax system has done away with the concept of capital maintenance and has been divorced from the accounting and company law principles that regard a dividend to be the distribution of profits. Instead, a dividend is now an artificial tax concept and essentially entails that a company distributes an amount and the cause of the distribution is a share in the company.

It is evident that there are vast differences between STC and dividends tax, particularly on cash dividends. In *Volkswagen of South Africa (Pty) Ltd v. Commissioner for the South African Revenue Service* (2008), the High Court (Transvaal Provincial Division) had to rule on whether STC qualified for a reduced rate of tax under the withholding tax on dividends relief provisions of the tax treaty between South Africa and Germany. It was held that since STC was a tax on the company and not on the shareholder, it was not substantially similar to a withholding tax on dividends and accordingly did not qualify for treaty relief. However, the differences between STC and dividends tax are mostly legal and administrative in nature. The economic effect of both an additional company tax on dividends and a withholding tax on dividends is similar as each tax affects the ultimate return derived by the shareholder.

¹⁴ Now defined in section 1 as the rate of interest equal to the South African repurchase rate plus 1% (in case of loans denominated in South African currency).

5. Accounting treatment of a tax on company distributions

5.1. IAS 12 *Income Taxes*

IAS 12 *Income Taxes* was originally issued by the International Accounting Standards Committee (IASC)¹⁵ in October 1996 and replaced *IAS 12 Accounting for Income Taxes* that was originally issued in July 1979 (IASB, 2021b).

The objective of IAS 12 is to prescribe the accounting treatment for income taxes. The Standard is premised on the notion that the tax consequences of transactions or other events must be accounted for in the same way that the reporting entity accounts for the transactions or other events themselves (tax accounting follows the accounting of the underlying transaction) (IASB, 2021b).

This section considers whether taxes on distributions, particularly STC and dividends tax imposed in South Africa, are income taxes and therefore within the ambit of IAS 12. It also deliberates the appropriate accounting treatment of STC and dividends tax by applying the principle that tax accounting follows the accounting of the underlying transaction.

5.1.1. *Scope of IAS 12: Is a tax on distributions an ‘income tax’?*

The Standard is applied in accounting for income taxes (IASB, 2021b: para. 1). Income taxes are defined to include all domestic and foreign taxes that are based on taxable profits (IASB, 2021b: para. 2). Taxable profit is defined as the profit for the period, determined by applying the relevant tax law, upon which income taxes are payable (IASB, 2021b: para. 5). Beyond these definitions, the Standard does not provide any further guidance as to what constitutes an income tax. Ernst & Young (2018) remarks that the definition is circular (income tax is a tax based on taxable profit which, in turn, is the profit on which income tax is payable) and that it is not always clear if a tax is an income tax for purposes of the Standard.

In March 2006, the International Financial Reporting Interpretations Committee (IFRIC) deliberated on whether to give guidance on which taxes are in the scope of IAS 12 (IASB, 2006). The IFRIC noted that the definition of income taxes infers that not all taxes are within the scope of the Standard and because taxable profit is not the same as accounting profit, taxes do not have to be based on a number that precisely matches accounting profit in order to be in the scope of IAS 12. The IFRIC further remarked that the term “taxable profit” suggests a concept of a net amount rather than a gross amount. The IFRIC concluded its deliberation by observing that there is a wide array of different taxes imposed globally and that professional judgement is required in determining which of those taxes are income taxes. Since it was not feasible for the IFRIC to develop further guidance on what is an income tax within a reasonable time frame, it was decided not to take a project on guidance of the scope of IAS 12 onto its agenda (IASB, 2006). Ernst & Young (2018) view the result of the IFRIC’s deliberations as confirmation of the complexity of drawing consensus as to what constitutes an income tax.

Since the definition of a “dividend” under the majority of the STC regime essentially entailed the distribution of profits, STC on actual dividends levied in terms of section 64B, is arguably an income tax as contemplated in IAS 12. The events leading up to the enactment of STC also enhance this viewpoint. Prior to the imposition of STC, there was a single company tax imposed on the taxable income of a company (normal tax). The introduction of STC was accompanied by a reduction in the normal tax rate. A subsequent increase in the STC rate was again accompanied by a comparable reduction in the normal tax rate. For that reason, the introduction of STC was fittingly described as a dual corporate income tax system. The question arises whether STC imposed on deemed dividends was an income tax. The fact that the deemed dividend provisions in section 64C is primarily aimed at combatting the avoidance of STC imposed on actual dividends, suggests that STC on deemed dividends was also an income tax. Venter and Stiglingh (2017)

¹⁵ The IASB, the successor of the IASC, adopted IAS 12 upon its formation in April 2001.

remark that the entire debate around the accounting treatment of STC is dependent on whether STC is in fact an income tax.

Conversely, the definition of a dividend under the dividends tax regime is not based on the concept of profit distribution, but rather on the cause of the distribution. If the distribution is made in respect of a share, it is generally considered to be a dividend, irrespective of the origin of the distribution. The artificial nature of the revised definition, particularly the unilateral election of when a distribution is a return of capital through the utilisation of the company's CTC, makes it less apparent if and when dividends tax is a tax on taxable profits.

According to the IASB (2006), any taxes that are not in the scope of IAS 12, will fall under the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

5.1.2. Tax accounting follows accounting of underlying transaction

The principle that the tax consequences of a transaction must be accounted for in the same way as the underlying transaction itself, is stated in the objective paragraph of IAS 12 and then repeated in the specific guidance in paragraphs 58 and 61A. This principle entails that for transactions and other events recognised in profit or loss, the related tax effects are also recognised in profit or loss. For transactions or other events recognised outside profit or loss (either in other comprehensive income or directly in equity), the related tax effects are also recognised in outside profit or loss (either in other comprehensive income or directly in equity, respectively) (IASB, 2021b).

IAS 32 *Financial Instruments: Presentation* requires that distributions to holders of an equity instrument be recognised directly in equity (IASB, 2021c: para. 35). Any tax levied on distributions must, therefore, ostensibly be recognised directly in equity. However, this inference is not always correct when one considers the limited revisions to IAS 12 that were published by the IASB in October 2000. These revisions provide specific pronouncements for the accounting treatment of the income tax consequences of dividends and became operative for financial statements covering periods beginning on or after 1 January 2001 (Muthupandian, 2008).

The specific pronouncements address both taxes on dividends levied on the reporting entity (para. 57A) and withholding taxes on dividends paid to tax authorities on behalf of shareholders (para. 65A).

5.1.2.1. Accounting for a tax on dividends levied on the reporting entity

It should be observed that the specific pronouncements refer to *dividends* rather than to *distributions to holders of an equity instrument* that is used in IAS 32. International Financial Reporting Standard (IFRS) 9 *Financial Instruments* define dividends as "[d]istributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital"¹⁶. The former concept is, therefore, narrower since it is restricted to the distribution of profits whereas the latter is wider as it conceivably refers to any distribution to holders of equity instruments.

According to the IASB (2021b: para. 57B), the income tax consequences of a dividend are linked more directly to past transactions or events that generated distributable profits than to the distribution of the dividend itself. The reporting entity must, therefore, first establish the cause (past transactions or events) that generated the distributable profits and then apply paragraph 58 to determine where to recognise those tax consequences (IASB 2021b: para. BC64). The IASB (2021b: para BC64) observes that the reason for income tax consequences of dividends (such as different rates of tax for distributed and undistributed profits) should not affect where those tax consequences arise because the income tax consequences arise

¹⁶ The IASB's definition of a dividend is consistent with the definition of a dividend pronounced by Knight-Bruce LJ in *Henry v Great Northern Railway Co (1857) 27 LJ Ch 1 18*: "a share of profits".

from a distribution of profits. It is emphasised that “[w]hat matters is the resulting tax effect, not the mechanism” (IASB, 2021b: para. BC64).

STC was a tax on dividends levied on the company (reporting entity) and therefore fell under the ambit of paragraph 57A. The definition of a dividend under the STC regime was premised on the distribution of accumulated profits. As such, the expense approach is arguably the appropriate accounting treatment for STC.

Dividends tax on non-cash dividends is also a tax levied on the company. However, the artificial nature of the definition of a dividend under the dividends tax regime, requires further interrogation to determine what appropriate treatment of the ensuing dividends tax is.

For example, if a company distributes profits by transferring an asset to shareholder in lieu of a cash dividend, the resultant dividends tax, which is imposed on the company, is linked more directly to past transactions or events that generated distributable profits and the expense approach is the suitable accounting treatment for the dividends tax.

Conversely, if an unlisted¹⁷ company buys back its own shares from a shareholder and does not elect that the repurchase is a reduction in CTC, the amount transferred to the shareholder as consideration for the buy-back would constitute a “dividend” and would be subject to dividends tax. If such amount transferred is a non-cash amount, the dividends tax would be imposed on the company. In this case, the tax is evidently linked more directly to the distribution itself and not to past profits and the appropriation approach would be the more suitable accounting treatment of the dividends tax.

The existence of company-level taxes on dividends is not pervasive and the only notable current example is Estonia that levies a 20% tax on distributed profits rather than imposing a tax on taxable income. In 2004, the IFRIC was requested to consider whether the expense approach or appropriation approach was the correct treatment of the Estonian tax. The IFRIC ultimately decided not to add this deliberation to its agenda as it expressed reservations about interpreting a specific tax system (Deloitte, 2004).

5.1.2.2. Accounting for a withholding tax on dividends

Paragraph 65A of IAS 12 states that a withholding tax deducted from the dividend and paid or payable to tax authorities on behalf of the shareholder, must be charged to equity as part of the dividend. Ernst & Young (2018) notes that there is little economic difference between a requirement to pay a withholding tax (such as the dividends tax on cash dividends levied in South Africa) and a requirement to pay an additional tax on distributed profit (such as STC that was levied in South Africa before being substituted with dividends tax). However, the accounting treatment is substantially different. The withholding tax is treated as a charge directly to equity whereas the additional tax is charged to profit or loss. The former has no impact on the entity’s reported earnings, effective tax rate and earnings per share, whereas the latter adversely affects all of those items.

Accounting should favour reporting on the economic substance of an economic phenomenon rather than solely on its legal form. If one takes the stance that the economic effect of both an additional company tax on dividends and a withholding tax on dividends is similar on the shareholder and the only differences are legal and administrative in nature, it is questionable whether the specific pronouncements in IAS 12 on the accounting treatment of the income tax consequences conform to the substance over form principle.

In its basis for conclusions on the specific pronouncements, the IASB states that “[w]hat matters is the resulting tax effect, not the mechanism” (IASB, 2021b: para. BC64). However, the main differences between an additional company tax on dividends and a withholding tax on dividends imposed on the

¹⁷ Certain share buy-back transactions concluded by listed companies are specifically excluded from the definition of a “dividend”. Refer to 4.2.3.

shareholder, a primary user of the information conveyed in the financial statements, appear to relate more to the mechanism than to the tax effect.

5.2. Specific guidance issued in South Africa

Following the enactment of STC in 1993, the Accounting Issues Task Force of SAICA issued *AC 303 Accounting for secondary tax on companies*, an opinion that recommended that STC be treated as part of the company tax charge in the income statement and therefore the expense approach (SAICA, 1993). The rationale for the opinion was that STC is not a tax on shareholders, but a company tax. The opinion does recognise that dividend levels may vary, which could result in tax charges in the income statement being disproportionate to pre-tax earnings (SAICA, 1993). *AC 303* was subsequently replaced with *AC 501 Accounting for secondary tax on companies* that similarly also reached the consensus that STC should be treated as part of the income tax charge in the income statement. The adoption of a dual corporate income tax system and the resultant reduction in the normal tax rate on companies was cited as further rationale for the consensus (SAICA, 2003).

Since the definition of a dividend under the STC regime was based on the concept of profit distribution, the specific guidance issued in South Africa on the accounting treatment was consistent with the pronouncements in IAS 12, although the treatment is not entirely consistent with the definition of an “expense” as contained in the *Conceptual Framework for Financial Reporting*.

There has, however, been no specific guidance issued in South Africa on the accounting treatment of dividends tax and there are two areas of contention that could benefit from specific guidance to ensure consistent treatment, particularly where dividends tax is imposed on non-cash distributions. The first is whether dividends tax is an income tax and therefore within the scope of IAS 12. The second emanates from the artificial nature of the revised definition of a dividend that could result in the imposition of dividends tax on transactions where there was no distribution of profits such as a share buy-back where the company has not elected that the consideration transferred to the shareholder is a reduction in CTC.

5.3. Conceptual Framework for Financial Reporting

As noted in the introduction to this study, the *Conceptual Framework for Financial Reporting* is not an accounting standard and it does not override any accounting standard or any requirement of an accounting standard. The purpose of the *Conceptual Framework for Financial Reporting* is to assist the IASB in developing accounting standards based on consistent concepts, assist preparers of financial statements to develop consistent accounting policies in cases where no specific accounting standard applies or when a standard allows a choice in accounting policy and to assist with the understanding and interpretation of accounting standards (IASB, 2021a: para SP1.1 & SP1.2).

The *Conceptual Framework for Financial Reporting* defines expenses as “decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims” (IASB, 2021a: para. 4.69).

If an accounting standard departs from aspects of the *Conceptual Framework for Financial Reporting*, it must explain the departure in the basis for conclusions on that standard. In the *Basis for Conclusions on IAS 12 Income Taxes*, the IASB (2021b: para BC64) does justify its stance that income tax consequences of dividends originate from the distribution of profits. However, the revised definition of a “dividend” that forms the tax base for dividends tax in South Africa, is no longer premised on the distribution of profits.

5.4. Fundamental accounting theory: decision-usefulness

Riahi-Belkaoui (2012) states that there is no single comprehensive accounting theory in existence, but that various attempts have been made to develop a general accounting theory. Norris (1980) describes the process of comparing existing usage in accountancy to a theoretical ideal that consists of a co-ordinated logical scheme of principles that is derived by a process of abstract reasoning.

However, Scott (2003) advocates the adoption of a decision-usefulness approach in response to the impossibility of theoretically correct financial reporting, a stance that is supported by some of the observations in this study.

Chambers (1955) discusses the decision-usefulness paradigm of accounting by reasoning that rational management requires an information providing system as a footing for both decisions and for reviewing the outcomes of decisions. A formal information providing system would need to comply with two propositions, the first being a condition of logical discourse requiring the system to be logically consistent and not permitting rules or processes that are contrary to other rules and processes. The second proposition stems from the use of accounting information as a basis for making decisions that have practical consequences and that such information should be relevant to the sort of decision making that it is expected to enable (Chambers, 1955).

The specific pronouncements in IAS 12 on the accounting treatment of an income tax on dividends imposed on the reporting entity infers that the expense approach must be adopted. This inference is not entirely consistent with the definition of an expense in the *Conceptual Framework for Financial Reporting* that excludes costs in relation to distributions to holders of equity claims. This contradiction is explained by surmising that the income tax consequences of a dividend are linked more directly to past transactions or events that generated distributable profits than to the distribution of the dividend itself, but it remains an inconsistency nonetheless.

Accounting information about a tax on dividends would certainly be relevant to the decision-making of an investor, because it affects the ultimate return on the investment. Although the economic effect on an investor of an additional company tax on dividends is similar to the economic effect of a withholding tax, extant accounting standards prescribe the expense approach for the former and the appropriation approach for the latter. This has the potential to obfuscate decision-making, particularly when considering different investment options in jurisdictions with dissimilar tax regimes.

Before being repealed at the end of March 2012, the STC rate of tax was 10%. Its successor, dividends tax, was introduced at 15%. Despite an effective 50% increase in the tax imposed on dividends, the transition from STC to dividends tax resulted in a decrease in the effective tax rate reported in company financial statements merely because legally, dividends tax is imposed on the shareholder. The information reported in financial statements after the transition therefore reflected the opposite of the reality¹⁸.

Conceptually, rational decision-making would be enhanced if the accounting treatment of both taxes are based on the economic substance of the tax instead of its legal form or its administrative or operational mechanism. An alternative remedy could be additional disclosures about the tax effects of dividends, which could be useful to users of financial statements. However, Efreteui *et al.* (2021) caution that additional disclosures could potentially increase narrative complexity and have the opposite effect of clouding decision-making

¹⁸ Several listed companies did explain the transition from STC to dividends tax in their financial statements, notably MTN Group Ltd (2011), Naspers Limited (2012), Sasol Limited (2012), Shoprite Holdings Ltd (2012) and Firstrand Limited (2012).

6. Conclusion

There are significant differences between the STC regime and its successor, dividends tax. STC was an additional tax on dividends imposed on the company, whereas dividends tax on cash dividends is a withholding tax imposed on the shareholder, while dividends tax on non-cash distributions remains an additional tax on the company. The tax base under STC, that is, the definition of a dividend, was premised on the concept of the distribution of profits and was consistent with accounting, common law and company law principles. Conversely, the revised dividend definition that applies under the dividends tax system, is an artificial tax concept. In order to avoid the imposition of STC more than once on the same dividend (economic double taxation), STC was imposed on the net dividend declared after deducting incoming dividends from other South African tax resident companies. The dividends tax system prevents economic double taxation by exempting dividends paid between South African tax resident companies.

However, the differences between STC and dividends tax are mostly related to the legal form and operational mechanism of the two taxes. The economic effect of the two taxes is similar as both diminish the ultimate returns derived by shareholders.

The differentiator applied by IAS 12 between applying the expense approach or appropriation approach is premised on the legal form rather than the economic substance of the different taxes. If the tax is imposed on the company, IAS 12 prescribes the expense approach. If the tax is a withholding tax imposed on the shareholder, the appropriation approach must be followed. In addition, the prescriptions of IAS 12 to follow the expense approach for company-level taxes on dividends are not entirely consistent with the *Conceptual Framework for Financial Reporting*.

It is not always evident whether dividends tax, particularly on non-cash distributions, is an income tax and therefore within the scope of IAS 12. Given the artificial nature of the revised dividend definition and the unilateral discretion of the company to decide on the use of CTC, it is not readily apparent if dividends tax is linked to past transactions or events that generated distributable profits. Both uncertainties could benefit from local guidance such as country-specific pronouncements issued by the FRSC in the form of FRPs.

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CHAPTER 3 CONCLUSION

3.1 PURPOSE OF THIS CHAPTER

The purpose of this chapter is to provide a summary of key findings of the study (research article) and how these findings address the research objectives formulated in Chapter 1.

3.2 RESEARCH FINDINGS

3.2.1 Primary objective

The primary objective of this study was to analyse the accounting treatment of a tax on distributions to determine which treatment approach is appropriate.

The shareholder is a key user of financial statements, particularly in respect of dividends. The extent of taxes on dividends would arguably be relevant to the shareholder and accurate, unambiguous and consistent financial reporting on taxes on dividends would enhance rational decision-making by the shareholder.

The differentiator applied by IAS 12 between applying the expense approach or appropriation approach is premised on the legal form rather than the economic substance of the different taxes. If the tax is imposed on the company, IAS 12 prescribes the expense approach. If the tax is a withholding tax imposed on the shareholder, the appropriation approach must be followed, that is, charging the withholding tax against equity as part of the dividend. It is questionable whether these divergent treatment approaches are justified by a mere difference in legal form. Since the shareholder is a key user of financial statements, it is suggested that the economic substance from the shareholder's perspective be a greater consideration when determining the financial reporting treatment approach to taxes on dividends. In addition, the prescriptions of IAS 12 to follow the expense approach for company-level taxes on dividends are not entirely consistent with the *Conceptual Framework for Financial Reporting*.

It is not always evident whether dividends tax, particularly on non-cash distributions, is an income tax and therefore within the scope of IAS 12. Given the artificial nature of the revised dividend definition and the unilateral discretion of the company to decide on the use of CTC, it is not always apparent if dividends tax is linked to past transactions or events that generated distributable profits. Both of these uncertainties could benefit from local guidance such as country-specific pronouncements issued by the FSRC.

3.2.2 Secondary objective

The secondary objective of this study was to perform a comparative analysis of dividends tax and STC to determine the fundamental differences and similarities, both legal and in substance, between the two taxes in order to conclude on whether a differential accounting treatment approach is justified.

There are significant differences between the STC regime and its successor, dividends tax. STC was an additional tax on dividends imposed on the company, whereas dividends tax on cash dividends is a withholding tax imposed on the shareholder, while dividends tax on non-cash distributions remains an additional tax on the company. The tax base under STC, that is, the definition of a dividend, was premised on the concept of the distribution of profits and was consistent with accounting, common law and company law principles.

Conversely, the revised dividend definition that applies under the STC system, is an artificial tax concept. In order to avoid the imposition of STC more than once on the same dividend (economic double taxation), STC was imposed on the net dividend declared after deducting incoming dividends from other South African tax resident companies. The dividends tax system prevents economic double taxation by exempting dividends paid between South African tax resident companies.

However, the differences between STC and dividends tax are mostly related to the legal form or the operational mechanism of the two taxes. The economic effect of the two taxes is similar as both diminish the ultimate returns derived by shareholders. It is an established and generally accepted principle that financial reporting must favour reporting on the economic substance of a phenomenon rather than solely on its legal form.

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