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New income tax accounting standard

The International Accounting Standards Board (IASB) has released Exposure Draft ED/2009/2 *Income Tax* (the ED), which proposes a new International Financial Reporting Standard (IFRS) to replace IAS 12 *Income Taxes*. The Australian Accounting Standards Board (AASB) is expected to release an equivalent ED in due course to propose to replace AASB 112 *Income Taxes*.

The IASB has invited submissions on the ED by 31 July 2009. A standard arising from the ED is expected to be issued in the first half of calendar 2010 and is likely to apply to reporting periods commencing during 2011. It is likely that this standard will apply to superannuation entities currently preparing general purpose financial reports, although the exact requirements will depend on the AASB's current review of superannuation fund accounting and its interaction with revised differential reporting regimes that are likely to be implemented for publicly and non-publicly accountable entities' in Australia.

The ED proposes to retain the 'temporary difference' approach to accounting for income taxes and harmonise with the equivalent United States standard in a number of areas. Major changes include:

- the treatment of 'uncertain tax positions' (which is a high risk area with commercial implications for many entities)
- a new calculation methodology for deferred taxes
- elimination of various exceptions to the recognition of deferred tax
- changes to the allocation of income taxes between financial statement components.

Further details of the ED are in our joint accounting and tax alert '[IASB's income tax proposals - taxing times ahead]'.

What does it mean for superannuation funds?

From the perspective of superannuation funds, the ED is more interesting for what it doesn't say, rather then what it does. A number of long-running issues in deferred tax accounting for superannuation funds are not addressed in the ED. In this alert, we explore the issue of the recognition of deferred tax assets arising from tax losses.

Superannuation funds should also be aware of the proposed weighted-probability basis for the recognition of uncertain tax positions. Superannuation funds will need to carefully consider what 'uncertain tax positions' they have, the requirements of the new standard and what additional disclosures will need to be made.

Recognition of tax losses

One of the issues that the ED seeks to clarify is the treatment of tax losses and how these losses should be recognised and measured for financial statement purposes. In the current market, the recognition and measurement of a deferred tax asset (DTA) for a superannuation fund's realised and unrealised tax losses is a critical issue given the ramifications this has on the superannuation fund's stakeholders, particularly members.

AASB 112 provides limited guidance on the measurement of DTAs in situations where tax losses can be carried forward indefinitely and this has lead to a number of interpretational difficulties in practice as most losses can, at least notionally, be carried forward indefinitely under Australian tax law. These issues are exacerbated in the superannuation sector by the nature of the assets held and the way in which taxable gains and losses arise.

In light of these difficulties, a number of 'rules of thumb' are sometimes suggested as the basis for the recognition of DTAs, even though these are not explicitly derived from the guidance in AASB 112 and have various levels of support amongst accounting professionals. For instance, there is no mention of a 'cap' (such as a percentage of a superannuation fund's net assets) on the maximum amount of the tax losses that should be recognised by superannuation funds under the guidance in the Standard.

Under the ED, DTAs will be recognised in full, less, if applicable, a 'valuation allowance' to reduce the net carrying amount of the DTA to the highest amount that is ***more likely than not*** to be realisable against taxable profit. That is, all tax losses should be recognised as a DTA and then reduced by a 'valuation allowance' if it is 'more likely than not' that there will not be sufficient taxable profit/gains in the future to realise the tax loss. As a result, the net DTA recognised should be the highest amount that is more likely than not to be realised (i.e. there is a 50.01% chance that the tax loss will be utilised in the future).

This proposed approach will replace the current recognition requirement in AASB 112 which is based on whether the realisation of the deferred tax asset is ***probable***. AASB 112 does not define what is meant by 'probable' and varied practice exists, although in the Australian context 'probable' has generally been taken to mean 'more likely than not'. Accordingly, in many respects, the ED is not expected to change the net amount of DTAs recognised by Australian entities, although it would result in a 'gross' less 'valuation allowance' approach.

The ED provides more guidance than the existing income tax standard in relation to the recognition of DTAs, largely incorporating equivalent US guidance. This additional guidance is commonly already referred to in applying the existing AASB 112 through the operation of the so-called 'hierarchy' in AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* and so should already be considered good guidance when applying the 'probable' test under the existing standard. Accordingly, the ED does little to assist in the difficult interpretation issues that superannuation funds face in determining the appropriate amount of DTAs to recognise in their financial statements.

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The 'more likely than not' and 'probability' tests need to be considered on a case by case basis. The ED indicates that the following should be considered under the 'more likely than not' test:

Positive factors	Negative factors
• Existing investments that will generate sufficient gains to use the losses in the future • Any unrealised gains which have not been reflected in the net asset value of the entity • Strong earnings history coupled with identifiable causes for the losses which are unlikely to recur • Changes in investment strategies based on market data of increased return or hedging of investment risk	• History of unused losses • Expectation of further losses • Uncertain circumstances that if resolved unfavourably would adversely affect future operations and gains on a continuing basis • A recoupment period that is so brief that it would limit the realisation of the DTA in a single year or traditional cyclical business

Other factors to consider under the 'more likely than not/probability' tests include:

- the nature of the losses and whether they are realised or unrealised losses
- the quantum of the losses
- the nature of the investments held by the superannuation fund and whether gains will be generated by those assets which will offset the losses
- whether the superannuation fund holds any trust or other flow-through investments and whether gains are expected to flow through which will offset the losses
- income projections and other analysis relating to the future income of the superannuation fund
- the period of time over which the superannuation fund believes that it will recover the losses
- an expectation of the receipt of exempt income or other transactions that may reduce available losses, or otherwise make them unavailable to the fund
- the business plans of the superannuation fund and whether it is likely to continue operations into the future
- the availability of any income tax rollover relief which may transfer the value of the losses from one fund to another (for example, the current proposed superannuation fund capital gains tax (CGT) losses rollover relief).

While there is concern that DTAs due to losses could be overstated in the current environment, equally DTAs should not be understated on the basis of 'conservatism' or 'prudence'. Any understatement may also create equity issues for the stakeholders, particularly departing members.

The real issue for superannuation funds is that there is limited guidance in the existing standard and the ED dealing with the recognition of losses that can be carried forward indefinitely given the unique position of superannuation funds. What is really needed is more guidance regarding the recognition of these losses.

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Action required

The recognition of DTAs for superannuation funds is a significant issue. Trustees need to determine an appropriate policy which is fair and equitable to all stakeholders including new, existing and exiting members while complying with the accounting standards and industry practice.

Key questions to ask include:

- whether there is a DTA tax loss recognition policy and how often this policy is reviewed
- whether the DTA tax loss recognition policy has been reviewed given the current economic climate
- what factors are to be taken into consideration to determine the probability of the tax losses being recovered
- whether the DTA loss recognition factors have been appropriately considered
- whether the DTA tax loss recognition policy reconciles with the crediting rate/unit pricing DTA tax loss recognition policy
- whether the use of a DTA cap is appropriate
- what equity issues are likely to arise from the recognition/non-recognition of DTA tax losses
- if CGT rollover relief will apply to the losses, what DTA tax loss amount should be recognised by the transferring fund based on the value of those losses/DTA tax loss recognition policies in the receiving fund
- the impact of the ED including the impact (if any) on the current DTA tax loss recognition policies
- the impact the ED will have on the fund's underlying investments
- whether you should make a submission or advise us of your concerns so that we can take them into account in our submission.

If you are an employer, you should consider the potential impact of the income tax ED on your fund and how these changes may affect your funding obligations particularly in relation to your defined benefit obligations and any defined benefit underpins that you may have.

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