

Staff Issues Paper

Accounting for income tax of public sector entities

Introduction

- 1 In December 2014, AASB staff ('staff') received a letter (see Agenda Paper 15.3) from a constituent raising an issue in relation to the imposition of income tax accounting on government-owned for-profit public sector entities. In essence, the constituent questioned whether it is appropriate to include such entities within the scope of AASB 112 *Income Taxes*.
- 2 Following subsequent discussions¹ with staff during the period May – August 2015, the constituent made a formal submission for the AASB's consideration.

Objective and structure of the paper

- 3 This Issues Paper analyses the issues raised by the constituent. The paper concludes with options for addressing the issues, staff recommendation and a question to the Board.
- 4 The paper is structured as follows:
 - (a) Background information on issues raised (paragraphs 5 – 8);
 - (b) Overview of issues (paragraph 9);
 - (c) Staff analysis (paragraphs 10 – 22);
 - (d) Options for addressing the issues (paragraphs 23 – 24);
 - (e) AASB staff recommendation (paragraph 25); and
 - (f) Question for the Board

Background information on issues raised

- 5 The introduction of the Tax Equivalent Regime (TER) in Australia was initiated by the National Competition Policy (NCP), a set of policy reforms adopted by governments to attain a higher standard of living through increasing competition². One of the intergovernmental agreements that established the NCP was the *Competition Principles Agreement*, which promoted the principle of "competitive neutrality" in circumstances where there is competition between Government businesses and the private sector.

1 Via electronic mails and teleconference

2 See [Part 1 Introduction](#) in *Local Government Tax Equivalents Manual* issued by the Queensland Treasury.

- 6 State (or Territory) owned enterprises are exempt from paying Federal income tax³. Thus, the purpose of the TER is to remove any net competitive advantage public sector entities would otherwise hold over their private sector competitors by notionally subjecting them to relevant taxation laws as if they were subject to those laws. Accordingly, these entities are required to pay ‘income tax equivalents’ to their respective owners.
- 7 From 1 July 2001, the National Tax Equivalent Regime (NTER) was introduced to ensure consistency in the income tax treatment of Government businesses across Australian jurisdictions⁴. As a result, Government businesses that are sufficiently commercial to operate under the Income Tax Assessment Act (ITAA) based income tax regime are nominated by their respective owners to be included in the NTER, whilst those that are not nominated yet required to pay income tax equivalents are governed by the relevant TER of the jurisdiction in which they operate.
- 8 Paragraph Aus2.1 in AASB 112 makes specific reference to public sector entities and income tax equivalents as follows:

Aus2.1 For public sector entities and for the purposes of this Standard, income taxes also include forms of income tax that may be payable by a public sector entity under their own enabling legislation or other authority. These forms of income tax are often referred to as “income tax equivalents”.

Accordingly, public sector entities subject to the NTER currently apply AASB 112 for the purpose of income tax accounting.

Overview of issues raised⁵

- 9 The constituent raised the issue in the context of government-owned water entities subject to the NTER. The constituent provided and subsequently confirmed the following arguments in drawing the conclusion that it is **not** appropriate for those entities to be within the scope of AASB 112.
 - (a) The Consolidated Revenue Fund (CRF) is the main working fund of the Commonwealth into which “all revenues or moneys raised or received by the Executive Government of the Commonwealth”⁶ are pooled. All income and company tax receipts are initially credited to the CRF after which the receipts are required to be appropriated by law⁷. However, the NTER is an administrative arrangement that requires a direct transfer to a State/Territory government via the Australian Taxation Office (ATO). Since this arrangement

3 Income Tax Assessment Act 1936 (Cth) Division 1AB section 24AO states that an entity limited solely by shares which are beneficially owned by one or more government entities is a State/Territory body (STB). Division 1AB section 24AM exempts STBs from income tax.

4 See [section 2.3](#) of *Commercial Policy Framework – Tax Equivalent Regime for Government Businesses* (New South Wales Treasury 2003)

5 In subsequent communications, the constituent explained that large amounts of deferred tax liabilities are contributing to a negative public perception. Staff looked at a number of public water entities’ annual financial reports and confirmed that large portions of deferred tax liabilities were attributable to revaluations of infrastructure assets. However, this is not addressed in this paper as a separate issue as it is a consequence of the application of AASB 112.

6 The Australian Constitution section 81

7 The Australian Constitution section 83

effectively bypasses the federal collection and appropriation process, it is merely a collection by the ATO for and on behalf of the owner (i.e., the State/Territory government), and as it is not an income tax at law it should not be treated as income tax under AASB 112;

- (b) The relationship of a State/Territory government and the entity it owns cannot be described as a relationship between an income tax taxing authority and an income tax payer. This is because to describe the State/Territory government as an income taxing authority would be in contravention of the Australian Constitution that allows only the Commonwealth to charge such taxes; and
- (c) NTER payments are in the nature of a distribution to owners:
 - (i) a payment to the owner in accordance with terms determined by the owner and that is not a payment for a good or service provided by the owner to the entity is a return to that owner and therefore should be viewed as dividends or return of equity. AASB 112 does not apply to dividends or return of equity; and
 - (ii) as a payment to an owner that is not for a good or service provided by the owner to the entity is in the nature of capital, hence deferred tax liabilities cannot arise given the non-reciprocal nature of the transaction.

Staff analysis

Issue 1: Are income tax equivalent payments under the NTER an income tax for the purposes of AASB 112?

- 10 AASB 112 Paragraph Aus2.1 describes income tax equivalents as ‘forms of income tax that may be payable by a public sector entity under their own enabling legislation or other authority’⁸. As such, staff think it is necessary to first determine whether, in substance, a payment under the NTER (the enabling legislation) satisfies the definition of ‘income tax’. In the staff’s opinion, the substance of an income tax payment or transfer should be given more weight than its form. Staff note that the arguments from the constituent outlined in paragraphs 9(a) and 9(b) above place greater emphasis on the latter.
- 11 Income taxes are defined in AASB 112 to include ‘all domestic and foreign taxes which are based on *taxable profits*. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity’. Taxable profit is defined in AASB 112 as ‘...the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).’
- 12 In March 2006 the International Financial Reporting Interpretations Committee (IFRIC) considered the scope of IAS 12 *Income Taxes*. The IFRIC decided not to

8 Staff conducted research with the aim of determining the basis for the AASB’s decision to include accounting for income tax equivalents within the scope of AASB 112. The details are provided in Appendix A of this paper.

provide guidance on which taxes are within the scope of IAS 12 *Income Taxes*. The IFRIC agenda decision noted, *inter alia*, that:

- (a) the term ‘taxable profit’ implies a notion of a net rather than gross amount; and
 - (b) because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope.
- 13 NTER payments are made in instalments to the agent of the State or Territory government on a Pay As You Go (PAYG) basis. The amount of each NTER instalment to be paid by an entity is calculated as the product of multiplying two factors – the entity’s instalment income multiplied by an instalment rate.⁹ Instalment income is calculated as the net of assessable income and deductible expenses in accordance with the federal income tax laws listed at Attachment 4 of the NTER Manual.¹⁰ The instalment rate is the rate specified by the Commissioner of Taxation or a self-selected rate.
- 14 Paragraph 17 of the NTER Manual states that NTER entities are not entitled to use an accounting profits model to determine their (equivalent) taxable income or instalment income for the purposes of the NTER. Staff therefore expect there to be differences between an entity’s instalment income and its accounting profit. Notwithstanding the likelihood of such differences, staff concur with the IFRIC’s view repeated in paragraph 12(b) that taxes do not have to be based on the same figure as accounting profit to be within the scope of AASB 112.

Staff view

- 15 Based on the above arguments, staff are of the view that, given the method of computing the amount of NTER instalment to be paid by an entity, the entity’s instalment income has the attribute of a taxable profit described in paragraph 12(a), i.e., a net amount, and therefore is within the scope of AASB 112.

Issue 2: Including income tax equivalents within the scope of AASB 112 is a breach of the Australian Constitution

- 16 The constituent argued that it is unconstitutional for a State/Territory government to be acting as an income taxing authority because the Australian Constitution delegates such powers only to the Commonwealth. The subject matter is beyond the scope of this paper and for this reason staff gave limited consideration to this issue. Nevertheless, staff formed the tentative view that, from the perspective of AASB 112, taxing authorities need not be the Commonwealth as the Standard does not define the term ‘taxing authority’ or provide a description other than to state that taxable profit (loss) for a period is determined in accordance with the rules established by the taxation authorities.

9 The instalment rate is not a corporate tax rate but a rate that is required to adjust the instalment income to match the expected income tax liability for the tax year.

10 See [Part 1](#) of the *Manual for the National Tax Equivalent Regime* available at the ATO website.

Issue 3: Are income tax equivalents a distribution to owners?

- 17 The constituent provided two arguments regarding this issue. First, payments to the owner in accordance with terms determined by the owner and that is not a payment for a good or service provided by the owner to the entity are returns to that owner and are therefore dividends or a return of equity. Second, any payment to an owner that is a non-reciprocal transaction is in the nature of capital.
- 18 In relation to the first argument, staff considered two interrelated questions as to whether, (1) the nature of the relationship between a State/Territory government and the entity it owns and (2) the discretion of the government over the receipts from the entity, are affected as a result of the owned entity being the subject of NTER (or any other Tax Equivalent Regime).
- 19 Staff think that the NTER changes the nature of the relationship between the entity and its owner because its operation deprives the owner of the ability to determine the amount and timing of profits it wishes to receive¹¹. A counter argument might be that the NTER was put in place at the discretion of the owner, but the fact that the owner is no longer able to effect the payment terms and the payment takes on the substance of an income tax due to the mechanics of the arrangement (as analysed under Issue 1) suggests that the owner is not, when receiving payments under the NTER, acting in the capacity of an owner. Viewed in this light, staff consider the assertion that NTER payments are distributions to owners as owners is not supportable.
- 20 In relation to the second argument, staff are of the view that any income tax would be considered a non-reciprocal transfer. The view is consistent with paragraph 24 of AASB 1004 *Contributions* wherein it is stated:

24 *...governments are not obliged to provide commensurate benefits, in the form of goods or services, to particular taxpayers in return for their taxes. For this reason, involuntary transfers are non-reciprocal transfers.*
- 21 The constituent argued that for a payment to be in the nature of a liability, commensurate benefits should be provided by the owner to the entity in return for the payment received. Staff note that notwithstanding that income tax is a non-reciprocal transaction, the occurrence of the taxable event results in an entity recognising a liability for income tax.
- 22 On balance, staff tentatively formed the view that in substance, the NTER payment is an income tax for the purposes of AASB 112.

Options for addressing the issues

- 23 Since the issues are not considered to be not-for-profit entity specific, the AASB Interpretations and Improvements Model¹² provides two options for addressing the issue:

11 Detailed discussion on income tax of public sector entities can be found on p.17-19 of the Australian Accounting Research Foundation's (AARF) Discussion Paper No.22 *Accounting for Income Tax* (Keys 1995)

12 The version as modified in February 2012 is [available](#).

- (a) take no action and give reasons; or
 - (b) refer the issue to the IFRS Interpretations Committee for consideration.
- 24 However, as the issue is limited to public sector entities, staff recommend not to refer the IFRS Interpretations Committee. Staff have instead identified the following options:
- (a) issue a tentative Agenda Decision;
 - (b) direct staff to undertake further research and outreach on the issues; or
 - (c) add the issue to the AASB work program.

AASB staff recommendation

- 25 Staff recommend option (a) on the basis that public sector entities that pay income tax equivalents under their enabling legislation or other authority including NTER instalment payments should not be relieved from the application of AASB 112 to the extent that income tax equivalents reflects the substance of an income tax as defined in AASB 112.
- 26 If the Board agrees with the staff recommendation in paragraph 25, staff propose to bring draft wording of the tentative Agenda Decision to the October AASB meeting.

Question for Board members:

Do Board members agree with the staff recommendation to issue a tentative Agenda Decision?

Appendix A

Preliminary staff research

Basis for paragraph Aus2.1

- 27 Staff conducted research to find the basis for the AASB's decision to incorporate income tax equivalents within the scope of AASB 112.
- 28 The relevant paragraph first appeared in the 1989 version of AAS 3 *Accounting for Income Tax (Tax-effect Accounting)*. This Standard was issued concurrently with AASB 1020 *Accounting for Income Tax (Tax-Effect Accounting)* for the not-for-profit and for-profit sector, respectively. Based on this finding, staff subsequently searched through Public Sector Accounting Standards Board (PSASB) papers from the 1988-1989 period.
- 29 In the memorandum for Agenda Item 4(e) dated 5 September 1989, PSASB staff made a recommendation to the Board to consider extending the scope of AAS 3 to accounting for any form of income tax by all reporting entities. The minutes of the PSASB meeting held on 12 and 13 October 1989 document the PSASB's decision to adopt the proposal, however without providing the basis.
- 30 The minutes for Agenda Item 7 of the June 1997 AASB meeting document the Board's decision to add reference to tax equivalents applicable to public sector entities. The basis for this decision was also unavailable.
- 31 In Agenda Paper 6.3 of the October 2003 AASB meeting, it was recommended by staff that the AASB extend the scope of AASB 112 to include accounting for income tax equivalents. The minutes of the same meeting mention the Board's decision without providing the underlying rationale.

Preliminary staff outreach

- 32 Staff sought views from two Board members in regard to the following questions:
 - (a) Have you, in your experience, come across the issue raised by the constituent and if so, is it an issue raised more generally by government businesses or limited to water entities?
 - (b) What would be the views as held by your organisation regarding this issue? Specifically, could income tax equivalents considered to be in the nature of a distribution to owners? Why or why not?
- 33 Both board members said that this issue was not raised by public sector entities generally. One board member noted, however, that a similar view (as that of the constituent) was expressed by the chair of one of the Victorian water entities.
- 34 Both board members acknowledged that the NTER is a tax equivalent regime that was put in place to achieve competitive neutrality and that payments under the NTER are clearly not in the nature of a distribution to owners. One board member pointed to the fact that the owner does not have discretion with regard to the timing and amount of transfer and the NTER is an externally imposed regime.

35 Other comments are noted as follows:

- (a) the industries in which public sector entities operate are often monopolistic;
- (b) as part of the National Competition Policy (NCP), government businesses were required to pay and distinguish between:
 - (i) loan guarantee fees;
 - (ii) tax equivalents; and
 - (iii) dividends.