AASB Staff Issues Paper
Employee Benefits: Estimating tax payable by the plan on contributions where franking credits are available

Purpose

1 The purpose of this paper is to explore an issue raised by HoTARAC in a July 2015 letter to the Board and to inform the Board of an enquiry, related to the same issue, received from a public-sector constituent. The issue relates to the amount that should be estimated for tax payable by a plan on contributions if the plan expects to have sufficient franking credits from return on plan assets to offset the tax payable on contributions. This paper also informs the Board of AASB staff activities to date on the issue and seeks direction from the Board for future actions, if any.

Background on Franking Credits

2 In Australia, in certain circumstances, recipients of dividends are able to benefit from the tax that the dividend-paying entity has paid on income that is distributed as dividends. This is accomplished by way of the dividend imputation system set out in the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997* (collectively referred to hereinafter as "tax law"). Entities that elect to pass on the benefit of tax already paid on income distributed as dividend may do so by attaching, or imputing, a tax credit (known as a "franking credit") to the dividend. The recipient of the dividend is then able to utilise that franking credit against their tax liability and obtain a cash refund of any excess franking credits available after the tax liability is settled.

3 As an example, assume an entity distributed a $70 dividend and attached a $30 franking credit to that dividend. The recipient of the dividend would receive $70 in cash but report $100 in taxable income. The recipient would then utilise the $30 franking credit imputed in the dividend to offset their tax liability or obtain a cash refund to the extent that the recipient had no tax liability.

4 Below are relevant extracts from the Australian Master Tax Guide:

(a) As a general rule, taxpayers are entitled to a refund if their tax offsets for franked distributions exceed their tax liability, ignoring those offsets (ITAA97 s 67-25). Once franking credits have been used to offset any income tax liability, any excess credits will be refunded. [¶4-820 Refund of excess franking credits]

(b) A complying superannuation fund that receives franked distributions will have its assessable income grossed up to include the amount of franking credits attached (ie reflecting the company tax paid attributable to the distributions) in the same manner as other recipients of franked distributions… [¶13-160 Tax offsets, losses and other concessions]

(c) A complying superannuation fund is entitled to a franking tax offset of the full amount of franking credits, even though its primary tax rate as a complying fund is 15% or its income is exempt… The offsets may be set off against tax on other fund income. [¶13-160 Tax offsets, losses and other concessions]

(d) A superannuation fund must therefore include the total franked and unfranked amount of distributions received, as well as the franking credits attached, to determine its net income or loss. [¶13-160 Tax offsets, losses and other concessions]

5 Australian defined benefit plans often invest in plan assets that distribute dividends with attached franking credits. Such plans are able to utilise those franking credits to offset their tax liability arising from other sources of income, including tax levied on contributions to fund a defined benefit deficit. Such contributions are taxed at a flat rate of 15% in Australia, but as indicated above, this tax can be offset with franking credits received from plan assets as plans are generally required to pay one aggregate tax amount, being the net of the tax payable on contributions and investment income, less any allowable deductions or credits.

Background on Issue

6 AASB staff note that this issue was raised in the July 2015 HoTARAC letter to the AASB, however, this issues paper considers specifically an enquiry received from a public-sector constituent because the issue is explored in greater detail in the enquiry received.

7 The enquiry received requested clarification on whether franking credits can be taken into consideration in estimating the tax payable by a defined benefit plan on contributions expected to be made to reduce the net defined benefit plan liability. The defined benefit plan referred to by the constituent is a plan that is closed to new members and a large proportion of the income/return on the plan assets is tax exempt due to the fact that many of the existing plan members are in 'pension phase'. As a consequence, a greater amount of franking credits attached to the income is expected to be available to reduce the plan's overall tax liability, including tax payable on contributions. Projections for the constituent's defined benefit plan, based on expected future contributions, indicate that the net tax liability of the plan would be zero (or close thereto) for the next 20 years on the assumption that there will be sufficient future franking credits available to offset the tax payable on contributions.

8 The constituent is concerned that the guidance in AASB 119 *Employee Benefits* appears to require the estimation of taxes payable by the plan on contributions (which would be a financial actuarial assumption in measuring the defined benefit obligation of the plan) to be treated separately from the franking credits available on return on plan assets (which would be incorporated in the measurement of the fair value of plan assets when they arise). This gross accounting approach is not how the plan's overall tax liability would be determined by the Australian Tax Office as indicated in paragraphs 4-5 above.

9 The constituent noted that:

- in calculating the present value of the defined benefit obligation using the projected unit credit method, AASB 119.76(b)(iv) requires that actuarial assumptions used to estimate the ultimate cost of providing post-employment benefits should include *"…taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service*";

- AASB 119.130 explicitly distinguishes between taxes payable on contributions and other taxes payable by stating that "*In determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation (paragraph 76)…"; and*

- AASB 119.BC130 states that" …*the fact that a fund has chosen to invest in particular kinds of asset does not affect the nature or amount of the obligation. …..Consequently, the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan.*"

10 The constituent viewed that applying the gross accounting approach would create an accounting mismatch and overstate the defined benefit liability because franking credits would be recognised within the return on plan assets only as they arise whereas the tax payable on future contributions would be incorporated as a financial assumption in determining the present value of the defined benefit obligation at reporting date. The constituent noted that the issue is further exacerbated by the fact that the majority of members of the defined benefit plan are in "pension mode" resulting in the return on plan assets attributable to these members being exempt from income tax, therefore providing no source of investment income tax to offset with franking credits in the calculation of the return on plan assets as per AASB 119.130.

11 The constituent requested that the AASB consider the issue, with a view to providing some guidance in AASB 119 to align the tax treatment with the accounting treatment.

Structure of Issues Paper

12 The remainder of this paper is structured as follows:

(a) AASB staff informal discussion with IASB staff;

(b) AASB staff analysis of AASB 119 requirements;

(c) AASB staff view and alternative view;

(d) assessment of the significance of the issue; and

(e) AASB staff recommendation on next steps.

AASB staff informal discussion with IASB staff

13 AASB staff had an informal discussion with IASB staff to gain an understanding of the intent of the amendments made to IAS 19 in 2011.

14 The IASB staff noted that the measurement of the defined benefit obligation of a plan should not be affected by the funding of the plan. This is consistent with the discussion in AASB 119.BC130 as stated in paragraph 9 above and Agenda Paper 11C of the December 2010 IASB meeting (AP11C)[1] that clarifies the intent of the amendments. Specifically, paragraph 5 of AP11C stated that funded and unfunded plans would measure the defined benefit obligation at the same amount.

[1] AP11C can be found at: http://www.ifrs.org/Meetings/Pages/IASB-Board-Meeting-13-December-2010.aspx

15 The IASB staff further noted that whilst the measurement of the defined benefit obligation, including the estimation of taxes payable on contributions, is based on obligations arising from the occurrence of past events, being the provision of service, the expectation that there would be sufficient franking credits to offset the taxes payable on contributions is based on uncertain future events.

16 Thus based on the above, the IASB staff are of the view that the estimation of taxes payable by the plan on contributions should be determined separately from the franking credits that are expected to arise on return on plan assets.

AASB staff analysis of AASB 119 requirements

Dichotomy of taxes payable in relation to the DBO and plan assets

17 AASB staff consider that AASB 119 creates a divide in the accounting treatment for taxes payable by the plan in relation to service before the reporting date or on benefits resulting from that service, and all other taxes payable by the plan. Paragraphs 76(b)(iv) and 130 of AASB 119 create this dichotomy as noted in paragraph 8 above.

18 Accordingly, if an entity is required to pay tax on contributions relating to past service, or on benefits resulting from that service, the plan should include those taxes payable as a financial assumption in determining the present value of the defined benefit obligation (without taking into account the availability of franking credits) as those taxes are an element of the ultimate cost of providing the related long-term employee benefits. Other taxes payable by the plan, such as investment income tax, would be offset with any franking credits receivable or included in the return on plan assets as they arise, which would form part of the measurement of plan assets. AASB staff note that this is consistent with:

- the clarification provided in paragraph BC121 of IAS 19 that states "… *(a) the estimate of the defined benefit obligation includes the present value of taxes payable by the plan if they relate to service before the reporting date or are imposed on benefits resulting from that service, and (b) other taxes should be included as a reduction to the return on plan assets.*";
- the observation in paragraph BC122 that "… *IAS 19 requires an entity to estimate the ultimate cost of providing long-term employee benefits. Thus, if the plan is required to pay taxes when it ultimately provides benefits, the taxes payable will be part of the ultimate cost. Similarly, the ultimate cost would include any taxes payable by the plan when the contribution relates to service before the period (such as in the case of contributions to reduce a deficit).*"; and
- paragraph BC130 that states "…*the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan.*"

19 AASB staff acknowledge that the AASB 119 requirements discussed above would lead to the recognition of the present value of estimated tax payable on contributions within the plan's defined benefit obligation, which in turn may overstate the defined benefit liability. This is because the entity expects to pay no tax on contributions since

it expects to have sufficient future franking credits to fully offset any tax payable that would arise on contributions.

AASB staff view (separate treatment of contributions tax and franking credits)

20 AASB staff think that the requirements of IAS 19 are clear that the tax payable on contributions should be treated separately from franking credits arising on income from plan assets. This is consistent with the observations in paragraphs 17 and 18 above and also with the view under tax law that franking credits are taxable income of the entity. As such, it would seem appropriate to include franking credits within the return on plan assets as they arise rather than incorporate them in the assumption of taxes payable by the plan on contributions.

21 An extension of the above view is that if an entity were to estimate that it had no taxes payable on contributions due to the expectation of future franking credits, such an estimate would implicitly involve the estimation of future income that has not yet been earned, to offset taxes payable on contributions expected to be made to reduce a net defined benefit liability at reporting date relating to employee services rendered to that date.

22 Furthermore, AASB staff note that based on discussions held with IASB staff (refer to paragraphs 13-16 above), the intentions of the IASB for the revised requirements of IAS 19 are consistent with the separate treatment of contributions tax and franking credits. This is because the requirements of IAS 19 are based on the view that the measurement of the defined benefit obligation should not be affected by the funding status of the plan (i.e. funded or unfunded) and an entity should only offset taxes, and other administration costs, with the return on plan assets if those costs and taxes are related to the management of plan assets. Therefore, the existence of franking credits would not change the measurement of the defined benefit obligation.

23 AASB staff also note that the application of IAS 19 results in an estimation of the defined benefit obligation that is a known and measurable obligation of the entity arising from past events. The need to make contributions to the plan is based on the period-end net defined benefit liability, and accordingly the entity is obligated to fund the shortfall via contributions, on which the entity is required to pay tax. On the other hand, the rights to franking credits only arise when the entity that makes a distribution declares a franked dividend.

Alternative view (combined treatment of contributions tax and franking credits)

24 AASB staff are aware, based on limited outreach done, that there are those that consider a combined approach could be taken to deal with the taxes payable by a plan. Those of this view highlight that the requirement in AASB 119.76 is to ensure that an entity includes the appropriate actuarial assumptions to determine the ultimate cost of a defined benefit plan. This would involve using the entity's best estimates of the variables that would determine that ultimate cost. Where the entity's best estimate is that no tax would be payable on contributions, an entity should not be required to recognise any such obligation in the measurement of the defined benefit obligation.

25 Furthermore, if the plan foresees no probable outflow of economic resources because it expects that sufficient future franking credits will be available to offset the taxes

payable on contributions, then it would seem that no taxes payable by the plan should be incorporated in determining the defined benefit obligation, consistent with the general guidance in the *Conceptual Framework* on the recognition of liabilities.[2] In fact, providing for taxes payable on contributions when such an outflow is not expected would seem excessively conservative and contradictory to the guidance in AASB 119.76.[3]

26 Furthermore, including taxes payable by the plan in the actuarial assumptions to estimate the defined benefit obligation where the plan is not expecting to pay that tax is not representative of the economics of the plan.

27 AASB 119 defines 'defined benefit obligation' as "… *the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods*". Where franking credits fully offset the taxes payable on contributions, no tax payments by the plan on contributions would be required, and therefore, such an assumption need not be included as part of the actuarial assumptions of the defined benefit obligation.

<u>AASB staff view on combined treatment</u>

28 AASB staff acknowledge that some of the arguments discussed in the combined treatment appear to make sense from a practical point of view. However, AASB staff note that the IAS 19 requirements in this regard are clear that taxes payable on contributions must be treated separately from the availability of franking credits on return on plan assets. This is further supported by the rationale provided in the Basis of Conclusions of IAS 19 (as outlined in paragraph 18 above), and the informal discussion to IASB staff. Furthermore, conceptually, it would seem inappropriate to offset taxes payable by the plan on contributions related to service before reporting date with franking credits that may arise in future reporting periods.

29 Another issue arising with the combined treatment is that an entity would need to "track" the amount of franking credits it receives in a period and how much of those franking credits were previously incorporated in estimating taxes payable on contributions.

Assessment of the significance of the issue

30 While this issue was raised by HoTARAC and by a public-sector constituent, AASB staff note that it could arise in any defined benefit plan in Australia where contributions must be made.

31 However, AASB staff note that there are very few defined benefit plans remaining in Australia that would have material numbers of pensioners and most of them are in the public sector.

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2 CF.91: A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably…

3 AASB 119.76: Actuarial assumptions are an entity's **best estimate** of the variables that will determine the ultimate cost of providing post-employment benefits… [emphasis added]

32 AASB staff also note that from an international perspective this issue would only arise in jurisdictions that have a similar tax system as Australia (i.e where taxes are payable on contributions and franking credits are available on income, which can be used to offset taxes payable by the plan or received as a cash refund from tax authorities). AASB staff are not aware of another jurisdiction that has Australia's particular combination of taxes and tax credits and that have this potentially material impact on defined benefit obligation measurement. Therefore, if this issue were to be raised with the IFRS Interpretation Committee (the Committee), it would be unlikely to be considered sufficiently widespread to warrant consideration by the Committee.

AASB staff recommendation on next steps

33 Staff consider there are four possible actions that the Board could take:

(i) submit the issue to the Committee,

(ii) issue an Australian-specific interpretation;

(iii) modify AASB 119 for an NFP-specific issue; or

(iv) reject the issue.

Each of these options is discussed below.

<u>(i) Submit the issue to the Committee</u>

34 Paragraphs 5.14 to 5.22 of the IASB and IFRS Interpretations Committee *Due Process Handbook—February 2013* outlines the Committee's considerations for items submitted for discussion.

35 In summary, issues should be evaluated against the following criteria:

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

(c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow scope that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs?

(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.

36 Although AASB staff consider that the issue could give rise to diverse accounting approaches (i.e. as in criterion (b) above) where entities could apply the separate or combined accounting approaches (as discussed in paragraph 20 – 29 above) and criteria (c) – (e) above would be met for the issue, AASB staff do not expect the issue to be added to the agenda of the Committee because criterion (a) above would most likely not be met as noted in paragraph 32 above.

<u>(ii) Issue an Australian-specific interpretation</u>

37 The AASB's *Interpretations and Improvements Model—February 2012* documents the due process to follow when considering an issue for addition to the AASB's agenda.

38 The criteria for consideration are aligned with those of the Committee, and where the issue proposal relates to an IFRS adopted in Australia, the Board may either:

(a) take no action and give reasons; or

(b) refer the issue to the Committee for consideration.

39 Where the AASB refers an issue to the Committee:

(a) if the Committee adds the issue to its work program or refers the matter to the IASB as the subject of an improvement, the AASB includes the issue on its work program in the same manner; and

(b) if the Committee rejects the issue, the AASB assesses the reasons for its rejection and, depending on the significance of the issue in Australia and before publishing an agenda rejection statement on the AASB website, decide whether further action, if any, should be taken by the AASB. The AASB may decide to add the issue to its work program and establish an Advisory Panel. However, the AASB considers that a unique domestic interpretation of an IFRS adopted in Australia would be required only in rare and exceptional circumstances.

40 Accordingly, if the Board wishes to issue a unique domestic interpretation of an IFRS the Board will be required to first submit the issue to the Committee and wait for the Committee to reject the issue. Subsequent to such a rejection the AASB would ordinarily also reject the issue, however, in rare and exceptional circumstances the Board may decide to issue a domestic interpretation.

41 As noted in the *Interpretations and Improvements Model*, in the event that the AASB does issue a domestic interpretation the Committee will provide no assurances that such an interpretation is consistent with IFRSs.

<u>(iii) Modify AASB 119 for an Australian-specific NFP issue</u>

42 The AASB's *Process for Modifying IFRSs for PBE/NFP* policy outlines the circumstances under which the AASB would consider modifying an IFRS for Australian NFP entities and if so, what considerations the Board will need to make.

43 Paragraph 3 of this policy states: "the purpose of modifying IFRSs for PBE/NFP is to reflect differences between the PBE/NFP and for-profit sectors, including differences in user information needs, that warrant a different accounting treatment or guidance for public benefit and not-for-profit entities."

44 In the application of the above, the policy notes that there are two questions that would generally be considered before modifying an IFRS for PBE/NFP:

(a) Are there issues that might warrant modifying an IFRS for PBE/NFP?

(b) Are the identified issues sufficiently significant to warrant a departure from an IFRS?

45 The policy notes, however, that there are many technical issues on which individuals and Boards hold a range of views as to the appropriate treatment. Disagreement with the IASB's treatment is unlikely to provide good reason, in and of itself, for changing the requirement in an IFRS – modifications should arise from differences between sectors, user needs and cost-benefit considerations.

<u>(iv) Reject the issue</u>

46 As permitted by the *Interpretations and Improvements Model—February 2012* the Board may decide to reject the issue and provide reasons for such a rejection, similar to Committee rejection decisions.

Staff recommendation

47 As explained in paragraph 36 above, AASB staff do not expect the Committee to add the issue to its agenda. AASB staff also do not consider that the issue is rare and exceptional only to the Australian public sector to warrant an Australian-specific interpretation. There are a small number of entities in the Australian private sector that have defined benefit plans although the plans in the private sector may not be in 'pension mode' i.e. where majority of its members are retired.

48 Thus based on the above, AASB staff recommend that the Board reject the issue and provide reasons for its rejection in an Agenda Decision.

49 AASB staff propose the following wording for the reasons why the Board has not added the issue to its agenda:

Reasons for not adding the issue to the AASB's agenda

The AASB considered an enquiry on the amount that should be estimated for tax payable by a plan on contributions to a defined benefit plan if the plan expects to have sufficient franking credits from return on plan assets to offset the tax payable on contributions. The AASB noted that tax payable by a plan on contributions is an element of the ultimate cost of providing a post-employment benefit and should be incorporated in the measurement of a defined benefit obligation. The AASB also noted that the funding status of a plan should not impact the measurement of the defined benefit obligation.

Accordingly, the AASB decided not to add the issue to the AASB's agenda because the guidance in AASB 119 was sufficiently clear and would not give rise to significantly divergent interpretations.

Questions to the Board

Does the Board agree with the AASB staff recommendation in paragraph 48 above? If yes, does the Board agree with the proposed wording in paragraph 49 above for the agenda decision?