

Accounting Alert

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Accounting for tax consolidation under A-IFRS

At its meeting held on 22 March 2005, the Urgent Issues Group reached consensus on how the impacts of tax consolidation should be accounted for under Australian equivalents to International Financial Reporting Standards (A-IFRS).

Whilst the final Interpretation is subject to finalisation by the UIG out-of-session and subsequent approval by the AASB, this Accounting Alert seeks to provide an early warning on some of the impacts of these developments.

Overview

The effect of Interpretation 1052 *Tax Consolidation Accounting* is as follows:

- each entity in the tax-consolidated group recognises its own deferred tax balances and income tax expense
- the head entity recognises the group's aggregate current tax liability and the benefit of any tax losses arising in the tax-consolidated group
- where amounts payable under any tax funding agreement that is in place does not mirror these requirements, the net difference is treated as an equity transaction.

This approach is radically different from that currently required by UIG Abstract 52 'Income Tax Accounting under the Tax Consolidation System'. Unfortunately, the pragmatic approach adopted under UIG Abstract 52 must be sacrificed in the quest for IFRS convergence, potentially resulting in more compliance costs for businesses in their transition to A-IFRS.

As a result, it may also undermine some of the benefits of tax consolidation for Australian entities. There may be a need to revisit the nature and wording of tax funding arrangements and to consider flow on impacts in areas such as systems, resources and dividend planning.

However, there will be no direct impact on consolidated financial reports from the application of the Interpretation, i.e. it will not affect tax accounting in the consolidated financial report which will be calculated in accordance with the 'normal' requirements of AASB 112.

Methods of accounting in each entity

The Interpretation would require each member of a tax-consolidated group to recognise current and deferred tax balances in accordance with the broad principles of AASB 112 *Income Taxes*.

No single method of measuring current and deferred tax amounts is dictated by the Interpretation, however the method adopted must be systematic, rational and consistent with the broad principles of AASB 112. The Interpretation is expected to include the following examples of 'acceptable' methods:

- a 'stand alone' approach as if each entity remained taxable in its own right
- a 'separate taxpayer' approach calculated on the basis that each entity remains taxable as part of the tax-consolidated group
- a 'group allocation' approach whereby tax consolidated amounts are allocated to each entity in the tax-consolidated group.

Whilst this may appear to offer a free choice of method and a great deal of flexibility when tax accounting within tax-consolidated groups, a word of caution is advised. Only methods that are consistent with the broad principles of AASB 112 will be acceptable, meaning that the following approaches would **not** be acceptable:

- methods that allocate tax amounts on an arbitrary basis, e.g. based on sales revenue, the effective tax rate for the group, unadjusted accounting profits, etc

Each entity in a tax-consolidated group to do its own tax accounting

This Interpretation may impose some unexpected and last minute changes to A IFRS transition plans

Three alternatives are provided as examples of methods of tax accounting in each entity

The method chosen must be broadly consistent with AASB 112

- methods that have a discriminatory allocation approach, e.g. only allocating amounts to profit-making members of the group, with no allocation to loss making members
- methods that do not result in deferred tax assets and liabilities being recognised in each entity, or those which only recognise some balances in each entity.

Each tax-consolidated group will need to carefully consider and appropriately balance the potential benefits and costs of the methods available.

Equity transactions

Where the current tax amounts (including current period tax losses and other tax offsets/credits) calculated in each entity are different from any amounts payable under a tax funding arrangement, the net difference is treated as an equity transaction by the subsidiary and a change in the cost of the investment in the subsidiary by the head entity.

This treatment is justified on the basis that the net difference effectively represents an additional contribution by equity participants or a distribution between the subsidiary and its parent.

If entities wish to avoid the equity treatment, tax funding arrangements can be implemented or modified to mirror the requirements of Interpretation 1052, i.e. require a payment to or from the head entity for the amount of any current tax liability or current year tax loss. This would also mean that current tax amounts could be allocated by reference to the tax funding arrangement.

The 'contribution by equity participants' concept under Interpretation 1052 may be seen to be inconsistent with the definition of 'contributions by owners' in AASB 3 *Business Combinations*. Due to this potential inconsistency the AASB has issued an invitation to comment on the AASB 3 treatment, with a recommendation that the existing definition of 'contributions by owners' be deleted.

Comparison with UIG Abstract 52

The approach currently adopted in UIG Abstract 52 is considered inconsistent with IFRS, meaning that a new approach to accounting for tax consolidation was required.

Major differences include:

- deferred taxes will need to be recognised for all temporary differences arising using the 'balance sheet approach' under AASB 112, rather than only for a limited number of timing differences (where AASB 1020 'Accounting for Income Taxes (Tax-effect Accounting)' was previously applied)
- current and deferred taxes are recognised by each entity in the tax-consolidated group, rather than only in the head entity
- deferred taxes recognised in each entity will be measured by reference to the carrying amounts in that entity, rather than the consolidated carrying amounts at the level of the tax-consolidated group, with further deferred tax amounts then recognised on consolidation as appropriate
- the net impacts of tax funding arrangements being treated as equity transactions rather than being recognised as part of income tax expense

Whilst the new approach to accounting for tax consolidation may result in additional compliance and other costs as part of the transition to A-IFRS, the approach adopted by Interpretation 1052 will address some of the issues arising under UIG Abstract 52. These include:

- the potential for deferred tax liabilities of group members to result in substantial accounting losses in the head entity is removed, eliminating issues with dividend planning, solvency declarations, etc
- business combinations that occur after a tax-consolidated group is formed will no longer result in the recognition of tax expense/income in the head entity in relation to 'assumed' deferred tax balances, again positively impacting profit and net assets of the head entity when compared to the UIG Abstract 52 approach
- entities leaving tax-consolidated groups will already have historical financial information with full tax accounting – particularly important in relation to floats, divestments and similar transactions.

Transitional requirements

To ensure full compliance with IFRS, no special transitional provisions are included in Interpretation 1052. Therefore, the general requirements of AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* will apply, i.e. full retrospective application of Interpretation 1052 will be required.

This will involve the following:

- recognising deferred tax balances in the opening balance sheets of members of the tax-consolidated group at the date of transition using the balance sheet method under AASB 112, i.e. based on reset tax values and the carrying amounts in each subsidiary
- recognising deferred taxes on consolidation related to fair value adjustments and other adjustments made outside the books of the members of the tax-consolidated group

Net difference between entity specific current tax and TFA recognised in equity

Equity adjustments may be able to be avoided by revising tax funding arrangements

Significant changes to the approach under UIG Abstract 52

There are some positive aspects to the new proposals

Full retrospective application will be required

- restating comparative information to be consistent with the new requirements, i.e. restating the income tax expense to exclude the impact of any tax funding arrangements and take into account current and deferred tax consequences in each entity
- determining whether there are any initial amounts that should be recognised as a contribution by equity participants or a distribution between the subsidiary and its parent, i.e. where there has been no tax funding arrangement in the past or the arrangement is not consistent with amounts recognised under Interpretation 1052.

Fortunately, there have only been a small number of accounting periods since the introduction of tax consolidation, providing an upper limit on the effort required to determine the adjustments arising from the initial application of the Interpretation.

Issues not addressed by the Interpretation

Whilst the certainty in approach that will come with the finalisation of Interpretation 1052 is welcomed, there are a number of issues that remain unresolved when accounting for tax consolidation.

These issues include:

- when and how tax consolidation should be taken into account when tax accounting, i.e. should the impacts be recognised in the period for which tax consolidation is adopted (as a change in tax status once a decision is made), or should the implementation of tax consolidation be anticipated (as a change in accounting estimate based on management expectations of implementation)?
- whether and how temporary differences in relation to investments within tax-consolidated groups should be calculated and either recognised as deferred taxes or only disclosed in the financial report (depending on the application of the recognition exceptions under AASB 112). Commentators have suggested many alternatives including:
 - basing calculations on a management expectation that all entities will eventually leave the tax-consolidated group, requiring an annual calculation of a notional CGT cost base for each investment under the so-called 'reverse ACA' rules
 - treating an entity leaving the group as a voluntary change in tax status and only recognising the impacts in the financial period that an entity leaves the group
 - only considering management's expectation as at each reporting date and only performing a deferred tax calculation where an entity is expected to leave the tax-consolidated group in the foreseeable future.

None of the alternatives in relation to these issues is completely satisfactory from a conceptual or pragmatic perspective and unlike the matters dealt with in Interpretation 1052, they do have an impact on consolidated financial statements. The UIG may need to revisit these aspects (and others) as accounting issues arise in relation to accounting for tax consolidation. In the meantime, we expect that a diverse range of practices may develop on these types of issues.

Furthermore, tax consolidation is also only a part of the wider A-IFRS impact area of tax accounting. The transitional adjustments associated with AASB 112 are often dealt with late in A-IFRS implementation plans. The AASB is also considering Australian specific implementation guidance on AASB 112 which may impact many entities and transactions.

Therefore, tax accounting remains a significant A-IFRS transition area where entities need to understand the issues and consider alternative views and approaches.

Interaction with IASB/FASB convergence

The primary reason that Interpretation 1052 is necessary in the Australian context is a lack of guidance under AASB 112 on how tax consolidation should be treated in the separate financial statements of members of a tax consolidated group.

Tax consolidation is not unique to Australia and a number of countries around the world permit a 'consolidated tax return' approach to determining tax liabilities.

The United States has a tax consolidation regime that is conceptually similar to Australia and SFAS 109 *Accounting for Income Taxes* has specific requirements in relation to accounting for its impacts. Indeed, much of the wording of Interpretation 1052 has been based on these equivalent requirements of SFAS 109.

The IASB and FASB are currently working on a joint project to bring the requirements for income tax accounting closer together. The IASB has recently agreed to include the guidance from SFAS 109 on tax consolidated groups in the proposed revised IAS 12, and this may ultimately lead to the withdrawal or amendment of Interpretation 1052.

The requirements of SFAS 109 (and so the revised IAS 12) are not exactly the same as Interpretation 1052. It is unclear which methods of measuring current and deferred taxes within tax-consolidated groups may prove to be acceptable under any revised IAS 12/AASB 112. This therefore has the potential to result in further adjustments to tax consolidation accounting in the future.

There may be more guidance issued in due course on other tax consolidation issues

Tax consolidation accounting is being considered as part of FASB/IASB convergence project

The IASB amendments to IAS 12 might again result in transitional adjustments

Action points

The following questions should be considered by entities affected by tax consolidation accounting:

Choosing an accounting method

- which method of tax accounting will be adopted within the tax-consolidated group and how has this approach been justified?
- which approach is easiest to implement and which gives the best accounting outcome?

Transitional adjustments

- what transitional adjustments are required in relation to tax consolidation at the date of transition to A-IFRS? What areas are affected and are the adjustments material?
- is the necessary information available to determine the opening balance adjustments in each entity with sufficient accuracy?
- what impacts might adjustments have on the reported solvency of individual entities in the tax-consolidated group, subsidiary level banking arrangements or bonus plans, taxation arrangements (e.g. tainting), etc?
- what impacts will the new requirements have on comparative information in our first A-IFRS financial report?

Tax funding arrangements

- what tax funding arrangements are currently in place within the tax-consolidated group?
- what has been the key determinant(s) of the terms of the tax funding arrangements?
- it is commercially acceptable to implement or revise tax funding arrangements to take into account the requirements of Interpretation 1052?
- can any amendments to tax funding arrangements be implemented before the beginning of our first A-IFRS reporting period to minimise one-off adjustments in the first year?

Impacts on the wider A-IFRS transition project

- what adjustments to our systems and processes will be necessary to accommodate the accounting methodology in Interpretation 1052? Have these aspects been budgeted for and costed?
- what impacts will Interpretation 1052 have on our overall A-IFRS implementation project? Does our timetable allow adequate time to consider the impacts and issues?
- are there flow on impacts to other areas, such as dividend planning, banking covenants, bonus plans and other factors at the subsidiary level, etc?

Feedback and assistance

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