Grant Thornton

Interpretation 23: Practical Accounting

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Points of reference for preparers of financial reports

What is the issue?

Effective for financial years beginning on or after 1 January 2019, Interpretation 23 (“Int. 23”, “the Interpretation”) *Uncertainty Over Income Tax Treatments* requires that companies consider the potential for adverse tax determinations being made by taxing authorities while under a hypothetical tax review – and record a liability (and expense) where such a finding is considered “probable”. Many entities will not experience a financial impact, but the interpretation is applicable and certain disclosures may be appropriate.

Overview

The Interpretation requires that an entity record a liability where it is considered probable that an uncertain tax treatment would not be resolved in favour of the entity while under review by a taxation authority.

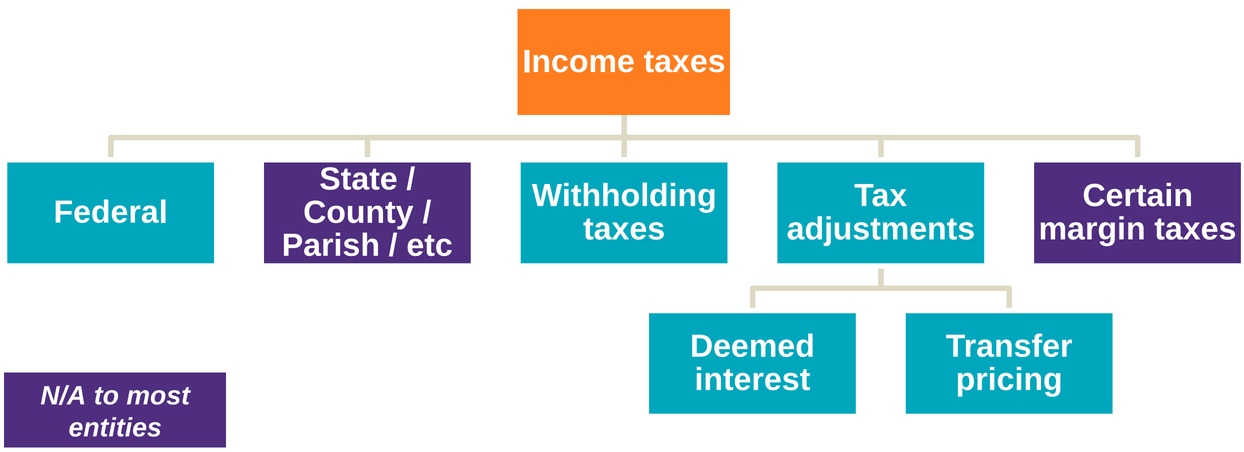
For each individual tax treatment identified, the process is relatively simple, but first we must understand its scope.

- **What “Income Taxes” does Interpretation 23 apply to?**
- **What is a “tax treatment”?**
- **What is meant by “Uncertainty”?**
- **What is a “taxation authority”?**

What “Income Taxes” does Interpretation 23 apply to?

Interpretation 23 applies to any tax that is an “Income Tax” as defined by paragraph 2 of AASB 112 *Income Taxes*: “…income taxes 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 arrangement on distributions to the reporting entity.”

We note that many jurisdictions include multiple taxes which may-or-may not be Income Taxes despite being having a name which implies otherwise. This includes, but may not be limited to, the following.



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What is a “tax treatment”?

A tax treatment is any decision or group of decisions related to income taxes. For example:

- An individual deduction;
- An individual revenue item;
- An individual decision to not declare a transaction as income;
- A class of decisions relating to a similar topic; and
- A series of interlinked transactions.

Other decisions may be tax treatments also – for example, the determination that the entity is not required to pay tax within a jurisdiction.

Tax treatments may also include a group of individual decisions that, in aggregate, comprise a single tax treatment. For example, an entity may make a series of decisions as it relates to a transaction or group of transactions. These decisions may, individually, be acceptable to a taxation authority, but, in aggregate, they may not. Such a series of decisions may comprise multiple tax treatments at the individual decision level and a single tax treatment when considered in aggregate. The level of uncertainty related to the acceptability of each individual tax treatment may not be consistent with the estimation of acceptability of the tax treatment in aggregate.

Tax treatments may relate to current and deferred income taxes.

What is meant by “uncertainty”?

A tax treatment that is “uncertain” in the context of Interpretation 23 is not any tax treatment that is “not certain”, but generally held to be a slightly lower threshold. The purpose of the standard is not to consider those tax treatments that are in accordance with published law and regulation, but instead for the entity to consider those tax treatments that have some probability of error inherent in them – for example, those that require judgement. As an example, there is no question that salaries and wages for most entities are deductible; uncertainty would be introduced if the salaries and wages being deducted relate to services provided to an overseas parent entity by a foreign-based employee.

It is therefore not appropriate to exclude based on ‘class’ of transaction unless each individual transaction within the class is understood to be tax compliant. While the definition is imprecise, this may be deliberate to encourage entities to apply the standard as a principle vs as a rule.

Uncertainty exists in most transactions – the entity must understand which transactions may reasonably be questioned by a taxing authority.

What is meant by “a taxation authority”?

A taxation authority is a body that has authority to review or otherwise make a determination as it relates to income tax of the entity or one of its components. This may include the Australian Tax Office, the United States Internal Revenue Service, HM Revenue & Customers in the United Kingdom, or the courts of a jurisdiction.

Taxing authorities must be those that are able to make determinations as it relates to transactions that are scoped into AASB 112 *Income Taxes* – this can result in disparity in practice between types of taxes.

Measurement

Once a tax treatment has been identified and deemed to be uncertain, a judgement must be made as to whether it is not probable that a taxation authority will uphold the entity's tax treatment. This may require consultation with tax advisors.

If it is determined to be probable that the taxation authority will uphold management's tax treatment, no additional liability is required. The transaction should be tracked for future reference and potential changes in facts and circumstances which will result in a change in the judgement made.

The Most Likely Value

If the expected outcome is binary, or if there is concentration in a single potential outcome, the "most likely" method may result in the most accurate measure of the outcome.

For example, an entity has claimed a deduction for a single transaction of value (after tax) of $1,000 which, upon inspection, is considered probable to not be accepted by a taxation authority. The entity determines that the potential outcome is binary – if the taxation authority determines that the tax treatment will not be upheld, the value of the exposure is $1,000. As a result, a $1,000 liability is recorded.

If it is not determined to be probable that a taxation authority will uphold the entity's tax treatment, the entity must estimate the expected outcome of the inspection. Two methods are prescribed:

- The most likely value; and
- The expected value.

The Appendix to this document includes a decision tree to assist with the above.

The Expected Value

The expected value method calculates exposure by reference to the sum of the probability-weighted outcome of a range of potential outcomes. It is applied where the "Most Likely Value" method is not able to be applied.

Example: Measurement

An entity has entered into a series of transactions with an overseas subsidiary. The overseas subsidiary provides accounting functions and does not generate revenue. It is operated as a break-even operation which is known to not be considered acceptable to the relevant taxation authority. No transfer pricing study has been completed to estimate an appropriate margin for tax purposes. Total costs incurred by the entity (for tax purposes) are $10,000.

Case A:

The entity has considered the potential facts and determined that an outcome in case law is highly consistent:

- 0% margin, occurring 10% of the time; and
- 15% margin, occurring in 90% of cases.

Management determine that 15% margin is the most likely value – a liability of $1,500.

Case B:

The entity determines that a range of potential outcomes exist due to the potential for a taxation authority applying different margin rates. Given the facts of the jurisdiction, the entity has determined that the following outcomes are possible:

Margin Rate	Probability	Weighted Value *
5%	10%	50
10%	25%	250
15%	30%	450
20%	20%	400
25%	15%	375
Liability		1,525

** Calculated as (Tax Cost) * (Margin) *)Probability)*

Subsequent measurement

Changes in facts and circumstances may change an entity's determination as to the acceptability of a tax treatment by a taxation authority. In such an instance, the entity must consider the new facts and circumstances as it relates to its judgements – this new information may increase or decrease the probability of acceptance of a tax treatment by a taxation authority.

Consideration of events that give rise to a change in facts and circumstances after the balance sheet date must be considered in the context of AASB 110 *Events after the Reporting Period* to determine whether an event is an adjusting or non-adjusting event.

Over time, tax treatments will be identified, be included in assessing the potential liability, and then removed as the right to examine or re-examine expires.

Example changes in facts and circumstances

- Completion of a review by a taxation authority;
- Acceptance (or non-acceptance) of a similar tax treatment by the taxation authority for another entity;
- Information regarding the amount paid to settle a similar tax treatment;
- New case law;
- New regulation;
- Expiration of the right to examine or re-examine a tax treatment.

Other recognition, measurement and presentation considerations

Transactions with tax and non-tax characteristics

In certain jurisdictions, certain types of transactions – such as refundable R&D credits – may or may-not be accounted for by applying AASB *112 Income Taxes* based on the facts and circumstances of the individual transaction. Where the underlying transaction is accounted for as an income tax item, it is subject to Interpretation 23; where it is not accounted for as an income tax item, Interpretation 23 does not apply.

Penalties and Interest

Generally, penalties and interest are not included within the scope of AASB 112. As a result, they are not accounted for by applying interpretation 23. We do note, however, that AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* does apply. We would consider it appropriate an entity that records a liability when applying Interpretation 23 consider the need for an additional penalties and interest provision accounted for by applying AASB 137.

Exposure to Benefits and Liabilities

While this paper primarily discusses the risk of payments arising from review by a taxation authority – i.e. additional liabilities to which the entity is exposed – the Interpretation does not differentiate between benefits and liabilities. It thus may be appropriate to account for certain classes of transaction – e.g. cross-border related party transactions ("transfer pricing transactions") by recording a liability in one jurisdiction and, if appropriate and allowed by the second jurisdiction, record an asset for potential tax adjustments. We note that the entity must consider whether a right of offset exists before recording a net liability.

Common sources of Uncertain Tax Treatments

Common sources of an uncertain tax treatment include, but are not limited to:

- Omission of income tax reporting within a taxation jurisdiction;
- Usage of accounting depreciation rates for income tax calculations;
- Inappropriate deferral of revenue recognised over time in accordance with AASB 15 *Revenue from Contracts with Customers*;
- Non-preparation of or reliance on out-of-date transfer pricing studies;
- Accidental breach of withholding tax regulations, especially as it relates to transfers of funds from foreign jurisdictions;
- Non-deeming of interest on related party loans;
- Arithmetic error;
- Untested assumptions, especially regarding the availability of income tax losses in future periods; and
- Usage of a principles-based approach to preparation of foreign-jurisdiction taxes.

Further Ramifications

Historically, the completion of a review by a taxation authority that resulted in an adjustment to income taxes has generally been accounted for as an event within the year of the completion of the review.

Interpretation 23, by requiring that the entity estimate the outcome of such a review, will result in additional consideration for restatement as required by AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* to be made by entities in such a situation.

Generally speaking, where all facts and circumstances were considered at the prior reporting date and it was determined that the outcome of the review was unlikely to be unfavourable to the entity, a change in estimate may reasonably be arguable. Conversely, where certain facts and circumstances were not considered and management can reasonably be expected to have been aware of those facts and circumstances, an error may have occurred.

Practical application

In Australia, it has recently been reported that in more than 70% of reviews undertaken by the Australian Tax Office the entity under review exhibited insufficient tax governance. A common theme in feedback is an over-reliance on external providers and insufficient internal policy and procedure as it relates to taxes.

Policies and procedures comprise a significant component of efficient and effective governance and, due to the interaction with accounting standards and the overarching accounting control environment, will extend beyond the expertise of both tax and accounting specialists; effective policy and procedure development will require coordinated input from experts in both fields.

Generally, the entities that will be most impacted are those that have significant international operations or transact with related parties located in international jurisdictions.

We therefore recommend that the entity develop a documented process and policy for interpretation 23 and include:

- A process for identifying all taxation jurisdictions, including Federal, State and Local jurisdictions. We note that this includes:
  - Countries
  - States
  - Counties / Parishes / Prefectures / Shires
  - Cities / Towns / Villages
- For each jurisdiction, the potential materiality of exposure based on local tax rates, significance of transactions, etc.
- Where jurisdictional exposure may be material, individual uncertain tax treatments impacting that jurisdiction and conclusions as to the ramifications of each uncertain tax treatment.

Disclosure

Disclosure requirements are those defined elsewhere in accounting standards, with certain paragraphs directly referenced by the Interpretation.

The disclosure requirements in the interpretation are open to significant judgement, and should be tailored to the needs of the users and management's assessment of materiality as it relates to potential impacts.

The Interpretation does not change certain pre-existing disclosure requirements but does highlight them – specifically the requirement that entities disclose contingent liabilities that are more than remote in their probability of occurrence, including tax-related liabilities.

Where tax treatments are identified but not considered probable, it is necessary to determine if they are more than remote in probability of a detrimental outcome to the entity – and appropriate disclosure included in the financial statements.

Required Disclosure

- Judgements made in determining taxable profit, tax bases, unused tax losses, unused tax credits and tax rates;
- Information about the assumptions and estimates made in determining taxable profit, tax bases, unused tax losses, unused tax credits and tax rates in disclosing sources of estimation uncertainty;
- If acceptance of an uncertain tax treatment is probable, disclose the potential effect as a tax-related contingency unless contingent event is remote;
- Liabilities arising that are less than probable but more than remote

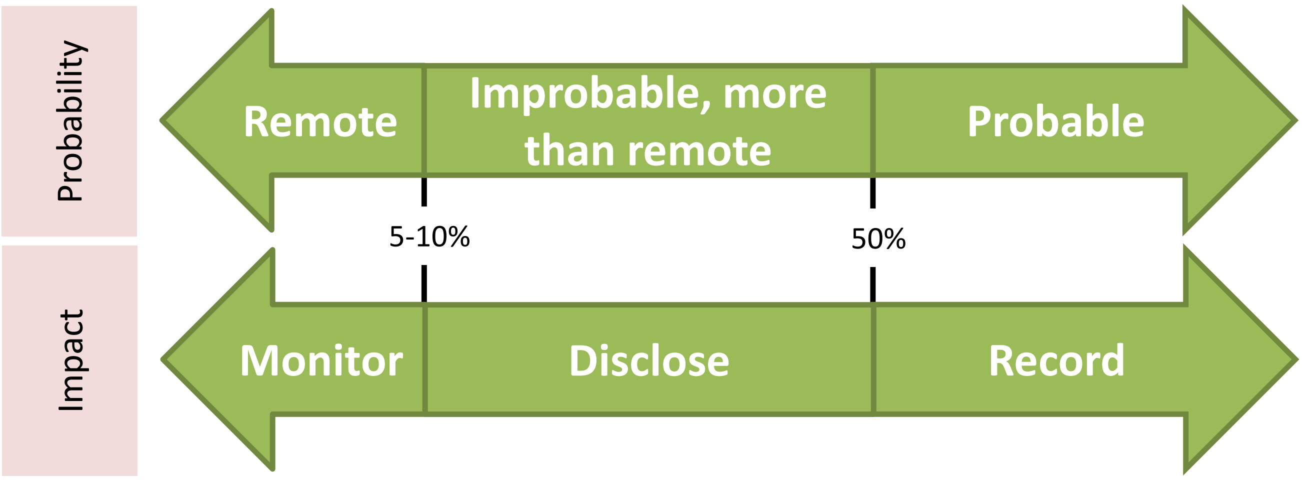
We would recommend preparers of financial statements consider the need to disclose:

- The policies for identifying uncertain tax treatments;
- The policy for measuring uncertain tax treatments;
- Key limitations on exposure to uncertain tax treatments, such as the periods currently under potential inspection by taxation authorities;
- Qualitative and quantitative disclosures related to individually material uncertain tax treatments; and
- Contingent liabilities that are more than remote in nature.

What is meant by "remote"?

"Remote" is not a term defined in accounting standards and is thus open for interpretation. An article released by Chartered Accountants Australia New Zealand[1] indicated that practitioners in Australia considered the definition to be interpreted as anywhere from 3.2% to 12.1%, depending on the practitioner.

Generally, Grant Thornton considers "remote" to be a probability of less than 5%, however this is a matter of judgement.



[1] Lee, E & Ling, E 2016, *Confused with terms such as 'probable', 'reasonably possible' and 'possible? You're not the only one.*, Chartered Accountants Australia New Zealand, accessed 24 July 2020, <https://www.charteredaccountantsanz.com/-/media/4a55e349b970453b830d21d16ede97cc.ashx>

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Appendix: Uncertain Tax Treatments