Tax Accounting Issues for June year ends

1 June 2014

The approaching year end has brought with it the usual challenges around tax accounting, but with some additional issues by virtue of impending legislative changes. We also discuss the impact of the tax rate change proposed in the recent Federal Budget.

Reduction in the company tax rate

The Government has confirmed its intention of lowering the company tax rate to 28.5% from 1 July 2015. However, for many companies this will be offset by the proposed Paid Parental Leave (PPL) levy of 1.5% of taxable income over $5,000,000.

From the point of view of tax accounting, we expect the PPL levy will be an 'income tax' for the purposes of AASB 112, which would need to be shown as a tax expense in your accounts. In addition, as it is applied to the same taxable income as income tax, it will impact the rate at which deferred taxes are measured.

The first question to consider is: when do you need to account for these changes? Under AASB 112, changes in tax law are not accounted for until they have been 'substantively enacted'. In Australia, the concept of 'substantively enacted' means the measure has been passed by the Senate – it does not need to wait for the relevant law to be given for Royal Assent.

Expectations are that these measures will not be introduced, let alone pass, both Houses of Parliament by 30 June 2014. Therefore the current focus is more about understanding the potential impact and informing stakeholders rather than considering the impact in the 30 June 2014 financial accounts.

Understanding this potential impact will require a closer consideration of your deferred tax balances.

The combination of the 28.5 per cent income tax rate and the 1.5 per cent PPL levy effectively creates a set of marginal tax rates for companies – 28.5 per cent on the first $5,000,000 of taxable income, and 30 per cent thereafter. This means that deferred tax balances and profit forecasts will need to be scheduled out to estimate how much of the deferred taxes (including losses) will reverse in years where the taxable income will be less than $5,000,000 (pre-recoupment of losses). According to AASB 112, this part will need to be measured using the 28.5 per cent rate, with the balance remaining at 30 per cent.

Practically, this means that any company with expectations of taxable income well over $5,000,000 in the years in which deferred taxes are expected to reverse will not show a material impact. Other companies may find that there is a need to write down all, or a portion of, their deferred tax balances to 28.5 per cent.

We expect any changes to deferred tax will be through the P&L, i.e. booked to income tax expense.

Change in the treatment of outbound instruments

This is a proposal to align the treatment of dividends from foreign companies to the debt-equity rules elsewhere in the tax law.

There are specific provisions which determine the classification of an instrument as debt or equity for tax purposes, with the classification affecting many aspects of their treatment such as deductibility and franking of returns. However, the exemption for dividends from foreign associates has historically not been affected by this classification, remaining instead based on the legal form of the investment.

This is particularly relevant for certain hybrid instruments (such as types of redeemable preference shares) that may be treated as debt for tax purposes, yet the return received is currently exempt in Australia as it is a dividend at law.

The key change proposed by the Government is to remove the exemption for foreign dividends where the shares are otherwise treated as debt for tax purposes.

The Government has confirmed its intention of passing these changes, possibly by 30 June 2014!

At present, most companies do not show any deferred tax in respect of such investments, for one or both of the following reasons:

1. There is no tax payable on the return. This means no Australian tax due to the exemption for foreign dividends, and no (material) foreign withholding tax on payment of the dividends.
2. As an investment in a subsidiary, any deferred tax liability is eligible for the recognition exception in AASB 112, on the grounds that the company can control the timing of the reversal of the temporary difference, and it is not likely that it will reverse for the foreseeable future.

The proposed change to the law will effectively remove the first point for certain instruments, as the return will become subject to Australian income tax.

Significantly, where an instrument becomes tax debt, and therefore returns are assessable, any foreign exchange gains and losses on FX denominated investments may also become taxable or deductible (in whole or in part).

The question which needs to be resolved is the extent to which unrealised FX positions as at 1 July 2014 will be assessable or deductible in the future. There are also consequential implications, such as in relation to related hedges or borrowings in connection with making the foreign investment. These considerations are not the focus of this article. Suffice to say these are complex questions!

Beyond the tax considerations, these issues give rise to tax accounting considerations, as FX can give rise to significant temporary differences.

Further, for any deferred tax liabilities, companies will need to consider whether the recognition exception can apply to such instruments (which may be classified as debt for accounting purposes).

Practically, for these kinds of instruments, it may be difficult to show that the deferred tax liability will not reverse in the foreseeable future, as many of the terms of issue that result in the shares being debt for tax purposes (length of term, compulsory redemption, cumulative dividends, etc) will mean that the reversal of the temporary difference is foreseeable or even inevitable.

As such, many companies will not be able to access this recognition exception, and will need to raise deferred tax liabilities in respect of these investments.

It is clear that there are many uncertainties in terms of the tax issues to consider as well as the associated tax accounting issues.

The challenge is that there may not be much time to obtain clarity.

Given the Government's current intentions and the Parliamentary sitting schedule, it is quite possible that this law will be substantively enacted sometime between mid-June and mid-July 2014!

Accordingly, it is simply not clear whether the impact of any changes will need to be reflected (ie booked) in 30 June 2014 accounts or possibly merely disclosed as subsequent event note disclosures. Either way, it is likely that companies will need to do the work required to be in a position to reflect any adjustment in these accounts as required.

There is also the need to keep relevant stakeholders informed well in advance given the potentially material impact of any changes.

Accordingly, we strongly recommend that companies take stock of their outbound instruments to identify those potentially impacted, and if required, formulate a plan to understand and quantify the impact in the given time frame.

For completeness, we note that while this article is focused on outbound instruments with returns currently not taxable, where those returns may become assessable, the issues are also relevant to those instruments with currently assessable returns which will become non-taxable under the new law.

Tax consolidations and future deductible liabilities

A key change that was announced in the 2013 Budget, but will be pursued by this Government, is to amend the law to 'effectively' deny deductions for 'future deductible liabilities' - broadly those expenses incurred after acquiring a subsidiary, to the extent the expenses were accrued or provided at the time of the acquisition. The proposed date of effect is 13 May 2013, so it will affect any acquisitions after that date, including any in the year ending 30 June 2014.

As the law currently stands, when a company is acquired by a consolidated group, any expenses of the subsidiary that are incurred after consolidation are deductible to the group (under the 'single entity rule').

The proposed change to the law will include an amount in assessable income over a 12 month period (for current liabilities) or a 48 month period (for non-current liabilities) following the joining time equal to the deductible liability that was accrued or provided at the joining time (while the liability will continue to be fully deductible as incurred). As a consequential amendment, it is expected that there will also be an adjustment to the process under which tax bases are reset upon acquisition (the 'allocable cost amount').

From a deferred tax point of view, this change means that a deferred tax liability should be booked for provisions and accruals in purchase price accounting for acquisitions after the law has been substantively enacted.

However, it is significant that the retrospective effect of the change presents an unexpected result for acquisitions in the period from 13 May 2013 to the date that the law is substantively enacted.

The purchase price accounting for an acquisition takes into account the tax law at the time of the acquisition. Therefore, any acquisitions between 13 May 2013 and the date of substantive enactment need to be accounted for on the basis of the existing law – that is, no deferred tax liabilities for future assessable amounts.

Unfortunately, this means that when the law does become substantively enacted, its retrospective effect results in a deferred tax liabilities arising. This will not be a change to the purchase price accounting – as it results from a law change after the acquisition date – and the impact will be to increase tax expense and not adjust goodwill.

In some cases, there will be an offsetting change to deferred tax balances in respect of assets, as the retrospective change to the allocable cost amount may increase the tax costs of assets. However, in many cases, this increase will be absorbed by assets that either have no deferred tax (e.g. goodwill, shares in foreign subsidiaries) or the tax base is not determined with reference to the tax cost (e.g. non-tax depreciable intangibles).

There is a remote possibility that these provisions will be substantively enacted prior to 30 June 2014, and therefore companies will need to be prepared to reflect any impact in the 30 June 2014 accounts. For those expecting a material impact, relevant stakeholders need to be appropriately managed.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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