Grappling with Australian Interpretation 23 Uncertainty over Income Tax Treatments

Building a better working world

Australian Interpretation 23 brings uniformity in accounting for uncertain tax positions

With the ever-increasing complexity of applying tax laws and heightened environments tax transparency, there have been different approaches taken to uncertain tax positions. Uncertainties can exist over whether income is taxable, deductibility of costs, transfer pricing, tax amortisation, and utilisation of tax credits.

The interpretation combats this inconsistency through clarifying the accounting, setting thresholds for assessing uncertainties, and assuming 100% detection risk.

1. Applicable accounting standard

Australian Interpretation 23 clarifies, when accounting for uncertain tax positions, that AASB 112 Income Taxes is the appropriate accounting standard, instead of AASB 137 Provisions, Contingent Liabilities and Contingent Assets. Uncertain tax positions are now to be presented as part of the (current or deferred) tax balances, instead of as a separate provision.

Consequently, there can be a change to the way tax uncertainties are dealt with, depending on previous accounting policies applied. Interpretation 23 does not add disclosures to those already required.

Recording a tax provision?

Some entities will no longer carry a provision where policies were previously overly cautious, and others may now record a liability where they previously had taken an aggressive tax position.

2. The "probable" threshold

This diagram summarises the approach taken to uncertain tax treatments:

How likely is it that the tax treatment adopted will be accepted by the tax authority?

- **Probable** → Measure tax balances in line with the tax filings
- **Not Probable** → Measure tax uncertainties using the method that is a better prediction of the resolution
  - ► Most likely amount*
  - ► Expected value**

* Use if the possible outcomes are binary, or are concentrated on one value
** Use if there is a range of possible outcomes

The first assessment to be made is whether the tax position taken is probable or not probable of being accepted by the relevant tax authority. If it is assessed as probable, then nothing further is considered and the entity's tax balances in its financial statements should be consistent with its tax filing. However, if it is assessed as not probable, then a liability for an uncertain tax position should be recognised and measured by predicting how the matter would be resolved.

In assessing the likelihood of acceptance by the tax authority, the 'probable' threshold is understood to be above 50%.

Some practises regarding liabilities

Previously, many in Australia applied AASB 137's criterion of a 'probable' outflow of resources before recognising a provision for a tax uncertainty. To compound this, some also incorporated the risk of detection by a tax authority. For some, this meant not recognising a liability, and for others, it meant recognising one.

Some practises regarding assets

Previously, some entities applied the virtually certain threshold under AASB 137 when accounting for potential tax refunds arising from disputes with the tax authority, meaning they previously did not record an asset for the refund until it was granted. Now, entities will assess the likelihood of acceptance of their claim, and if probable then recognise an asset.

Example 1 Virtually certain vs probable

ABC Limited has operating subsidiaries in foreign jurisdictions. In one jurisdiction, $10m of income tax deductions were disallowed by the tax authority.

ABC assesses they have a 70% chance of success (for being allowed the deduction), on appeal, for the full amount. Previously, the contingent asset may not have been recognised if collection was not virtually certain. However, now ABC will recognise a tax receivable as it is considered probable of being accepted by the courts.

Note the threshold for recognising assets can differ depending on the nature of the matter. Matters related to GST/VAT, levies or export duties are not income taxes, and therefore AASB 137's virtually certain threshold for contingent assets continues to apply.

2.1 Identifying the authority

In assessing the probability of acceptance, management will need to consider the identity of the 'authority'. In many cases, it would be reasonable to conclude the ATO is the relevant authority. However, there may be some circumstances whereby the courts may be considered the authority. For those operating in multiple jurisdictions, separate assessments for each jurisdiction is needed.

Assessing the probabilities

Management should consider various sources of evidence when exercising judgement on the probability of an uncertain tax treatment being accepted. They might consider, for example:

- Past experiences
- Practice guidelines published by the ATO
- Announcements by the ATO
- Legal advice or case laws

3. Measuring an uncertainty: when acceptance is not probable

If it is not probable that a tax authority will accept an entity's tax positions according to its tax filings, and therefore uncertain tax assets and/or liabilities need to be recognised, then the next assessment to be made is how to measure them. This is not a free choice, but rather based on considering the method (in context of facts and circumstances) that better predicts how each uncertainty will be resolved.

Previously, some may have had a policy of measuring uncertainties by applying one consistent approach, e.g., most likely outcome, or expected value, or another method. Now, the method will rely on how an uncertainty is predicted to be resolved – for a binary resolution (allowed/disallowed for a specified amount), using the most likely amount; or for a range of possibilities (some, partial or all allowed/disallowed), using an expected value approach.

Example 2 Pre and Post Australian Interpretation 23

ABC Limited incurs $10m of costs. The deductibility of the costs is evaluated as follows:

- ABC is virtually certain that at least a $5m deduction will be accepted.
- ABC considers it a 60% chance that an additional $5m deduction will be accepted.

Assume a tax rate of 30%

	Prior to Australian Interpretation 23	
	Virtual certainty (AASB 137)	Weighted average
Deductible Amount	$5 million	$5m + $5m*60% = $8 million
Basis	ABC is virtually certain $5m is deductible. ABC may have recorded a tax amount of $1.5m	Weighted average based on possibilities. ABC may have recorded a tax amount of $2.4m

	Australian Interpretation 23
	Probable threshold
Deductible Amount	$10 million
Basis	ABC determines that $10 million will probably be accepted as a deduction. A tax amount of $3m is recorded; no further amounts recognised. However, if management had considered the amount would probably be disallowed, then a tax liability is recorded for $3m ('most likely' amount predicted for resolution).

3.1 Conservatism

Some have previously applied conservative judgement when accounting for tax uncertainties. Those that had taken conservative positions will need to change to take a balanced perspective to whether tax positions filed will be accepted by the tax authority. Also, those that also considered a general risk of a sovereign tax authority acting on matters will also need to exercise judgement on their positions being accepted. Consequently, some may need to release provisions no longer supportable.

4. Detection risk

In assessing probability of acceptance, management are to hypothetically assume a taxation authority can and will examine (or audit) all positions. It is also further assumed that an authority has full knowledge of all related information when making examinations. In other words, the risk of detection is always to be 100%.

Previously, some built different levels of risk into their probability assessments, which affected whether assets and/or liabilities were recognised, and the quantum of those amounts. For example, entities that conduct business in multiple jurisdictions might have prepared a risk matrix to incorporate the risk of detection and tax authority involvement in its tax matters.

Those that have previously taken aggressive approaches to their tax uncertainties, based on a low expectation of detection, will need to reassess their positions in a risk agnostic manner. Consequently, some may need to record uncertain tax liabilities, highlighting the importance of documenting assessments.

5. Unit of account

Management will need to determine the level for assessing how uncertain tax positions are expected to be resolved by a tax authority. One approach to resolution may be for each matter to be considered separately due to having unique characteristics. Another approach to resolution may be as a basket of matters together, such as a lump sum settlement of multiple transfer pricing matters.

In assessing which approach better predicts the resolution of an uncertainty, management will need to exercise judgement by considering:

- The entity's own past practice and experience in preparing and supporting its tax treatments
- How the authority has considered and settled similar matters in the past
- Communications and guidelines of the authority
- Recent court decisions and other case law
- The extent to which outcomes are mutually dependent
- The significance of individual matters and the level of resources required to resolve them separately versus together.

6. Other challenges

6.1 Transition

An entity may currently find itself in an ongoing dialogue and negotiation with the ATO over complex tax matters, for example multinational transfer pricing. On transition, management may need to consider the point in time it determines a position taken is probable of being (or not being) accepted by the tax authority.

Example 3 Transition considerations

ABC Limited has a 30 June year end. Interpretation 23 is applied for the first time in its 30 June 2020 financial statements.

Prior to transition, ABC's 30 June 2018 tax return included deductions for complex cross border transactions, and in February 2019, the ATO requested further information. Applying AASB 137, ABC disclosed the tax matter as a contingent liability in its 30 June 2019 financial report and described it as a slight possibility (not probability) of the deduction being denied.

Upon adoption of Interpretation 23, ABC measures its tax balances on 1 July 2019 consistent with the facts available. Because ABC anticipates the uncertainty would be resolved by either allowing (or disallowing) the deduction outright, and the deduction is considered probable of being accepted (consistent with its disclosure in its 30 June 2019 financial report), an uncertain tax liability is not recorded on transition at 1 July 2019.

Example 4 Disclosure on Transition

The following is an example disclosure.

Australian Interpretation 23 is applicable for financial years beginning on or after 1 July 2019. In the past, the Group has only recognised claims against tax authorities when considered virtually certain. Following transition, claims are recognised when probable. Australian Interpretation 23 was applied using the modified retrospective approach without adjusting comparative periods. The transition resulted in a $10m increase in income tax receivables and retained earnings.

6.2 Highly complex transactions and judgement

When assessing tax positions, management need to consider involving experts qualified to advise on tax implications in the jurisdictions in which they operate. This is especially important for highly complex transactions, and for multinationals having a presence outside of Australia operating in multiple jurisdictions involving several tax authorities. In exercising judgements about assumptions and estimates made in determining tax positions, entities should also consider disclosing its significant judgements in accordance with AASB 101 Presentation of Financial Statements.

Next steps

Management of more complex businesses should implement robust processes to gather the information for their judgments. This may involve a multi-disciplinary team from finance, accounting, tax, legal and external advisors and specialists. It's also important to assess the sensitivity and magnitude of uncertain tax positions. Processes should be designed to capture completeness of existing uncertain tax positions, to capture new positions as new transactions/products are approved, and for assessments to be reviewed at each reporting date by senior management.

To discuss further, please contact your local EY adviser.