Grappling with NZ IFRIC 23 Uncertainty over Income Tax Treatments

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NZ IFRIC 23 brings uniformity in accounting for uncertain tax positions

With the ever-increasing complexity of applying tax laws and heightened environments of tax transparency, there have been different historic approaches taken to uncertain tax positions. For example, 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 methodology;
- Setting thresholds for assessing tax uncertainties; and
- Eliminating the consideration of detection risk.

1. Applicable accounting standard

NZ IFRIC 23 *Uncertainties Over IncomeTax Treatments* clarifies, when accounting for uncertain tax positions, that NZ IAS 12 *Income Taxes* is the appropriate accounting standard, instead of NZ IAS 37 *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.

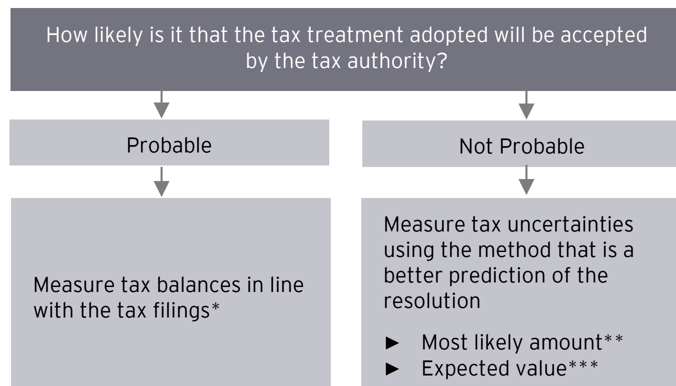
Consequently, there can be a change to the way tax uncertainties are dealt with, depending on previous accounting policies applied. NZ IFRIC 23 does not require additional disclosures to those already outlined in NZ IAS 12.

Recording a tax provision?

Some entities may 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

The below diagram summarises the new approach taken to uncertain tax treatments:



* Under New Zealand's self-assessment regime, taxpayers must correctly determine their tax liability and pay their taxes on time. In addition, they must disclose all information that the Commissioner requires in a timely and useful way.

** 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 New Zealand applied NZ IAS 37'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 NZ IAS 37 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 need to assess the likelihood of acceptance of their claim, and if probable then recognise an asset at that time.

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.

To be granted the right to appeal the decision through the courts, ABC must prepay half of the amount arising from the disallowed deduction. 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, levies or export duties are not income taxes, and therefore NZ IAS 37'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 relevant 'authority'. In many cases, it would be reasonable to conclude the Inland Revenue Department (IRD) is the relevant authority. However, there may be some circumstances whereby the relevant foreign courts may be considered the appropriate 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:

- Historic filing positions taken
- 'Informal' steps taken by IRD (for example, Inland Revenue Alerts or a Risk Review notification)
- Domestic announcements to change approach or law by the Government or IRD with retrospective application
- Legal and/or tax advice or case law developments

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 (considering 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 NZ IFRIC 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 28%

	Prior to NZ IFRIC 23	
	Virtual certainty (Applying NZ IAS 37)	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 $1.4m	Weighted average based on possibilities. ABC may have recorded a tax amount of $2.2m

	NZ IFRIC 23
	Probable threshold
Deductible Amount	**$10 million**
Basis	ABC determines that $10 million will probably be accepted as a deduction. A tax amount of $2.8m is recorded; no further amounts recognised. However, if management had considered the amount would probably be disallowed, then a tax liability is recorded for $2.8m (being the "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. Consequently, some may need to release historic provisions held, which are now no longer supportable within methodology of NZ IFRIC 23.

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, in accordance with NZ IFRIC 23, 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 uncertain position, 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 one or more revenue authorities over complex tax matters, for example multinational transfer pricing. On transition, management will need to consider the point in time it determines a position taken is probable of being (or not being) accepted by the relevant tax authority(ies).

Example 3 Transition considerations

ABC Limited has a 30 June year end. NZ IFRIC 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 IRD requested further information. Applying NZ IAS 37, ABC disclosed the tax matter as a contingent liability in its 30 June 2019 financial report and described the possibility (not probability) of the deduction being denied.

Upon adoption of NZ IFRIC 23, ABC measures its tax balances on 1 July 2019 consistent with its tax filings and the disclosures it made in its 30 June 2019 financial statements. Because ABC anticipates the uncertainty would be resolved by either allowing (or disallowing) the deduction outright, and the deduction is probable to be accepted, an uncertain tax liability is not recorded on transition.

Example 4 Illustrative Disclosure on Transition

NZ IFRIC 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. NZ IFRIC 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 New Zealand 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 NZ IAS 1 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 is 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.

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