



Institute of Actuaries of Australia

**LIFE INSURANCE AND WEALTH MANAGEMENT PRACTICE COMMITTEE
AND
SUPERANNUATION AND EMPLOYEE BENEFITS PRACTICE COMMITTEE**

**Information Note: Deferred Tax Assets – Issues and Considerations
for Life Insurance Companies and Superannuation Funds**

June 2010

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1. Status of Information Note

This Information Note was prepared by the Life Insurance and Wealth Management Practice Committee (“LIWMPC”) and the Superannuation and Employee Benefits Practice Committee (“SEBPC”) of the Institute of Actuaries of Australia (“Institute”). It does not represent a Professional Standard or Practice Guideline of the Institute and has been prepared for the purpose of informing members of issues in valuing and monitoring deferred tax assets (“DTAs”) for unit pricing and crediting rates. Note that references in this Information Note to unit pricing should be read to include crediting rate methodologies for superannuation funds and other non-discretionary non-participating life insurance business.

Feedback from Institute members is encouraged and should be forwarded to the LIWMPC / SEBPC as follows:

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This is the first version of this Information Note, although it is noted that [Guidance Note 150 \(Treatment of Deferred Tax Liability for Unrealised Capital Gains\)](#) discussed provisioning for deferred tax for unit pricing. It was withdrawn in 2006 as some of the guidance it contained had become out of date and/or was superseded by guidance provided by the Australian Prudential Regulation Authority (“APRA”) and the Australian Securities and Investments Commission (“ASIC”) in their joint document entitled “[Unit Pricing: Guide to Good Practice](#)”.

It is also noted that [Guidance Note 150](#) contained limited discussion of loss recoverability and monitoring analysis for determining appropriate DTA values for unit pricing which are the focus of this Information Note. It also considered disclosure and unit price adjustments relating to non-taxed unlisted unit trusts which are not considered in this Information Note.

2. Background

2.1 Deferred tax assets

For taxed funds, the unit price calculation may include an allowance for expected future tax payments/receipts in order to support equitable unit pricing across generations of unitholders.

Tax provisioning in unit pricing is complex and members may be requested to assist in the development of methodologies and approaches. In particular, members may be asked to provide advice on valuations where losses exceed income/gains and the company/fund/trust has a DTA.



This Information Note sets out issues that might be considered when assessing the value of losses, including the likelihood and timing of their application against future positive tax obligations, as well as issues involved where there is more than one unitised investment option in the tax pool.

2.2 Tax principles applying to unitised funds

The largest class of taxed unitised funds is regulated superannuation business which includes:

- ▶ superannuation funds, including corporate funds and industry funds;
- ▶ Pooled Superannuation Trusts (“PSTs”); and
- ▶ life insurance superannuation business, where unitholders invest in unit-linked life insurance policies.

Superannuation funds and PSTs are entities separate from the managers and companies that administer them. This is different to life insurance business where the unitised fund assets are owned by the life insurance company through the statutory funds. Nonetheless, in order to preserve consistency with superannuation fund and PST taxation, the assets backing life superannuation products are effectively ring-fenced within what is defined as a virtual Pooled Superannuation Trust (“VPST”) for tax purposes.

The VPST identifies assets which are entitled to the same tax treatment as superannuation funds. Capital and revenue losses are also quarantined within the VPST. Each life office has only one VPST (which may include investment linked and non-linked business, as well as including business in multiple statutory funds).

Unitised annuity business may be maintained within a superannuation fund or within a life office statutory fund. For tax purposes, assets supporting annuity business in a life company are referred to as segregated exempt assets (“SEA”). Although a zero rate of tax applies to investment earnings on annuity business, annuities can be considered taxed funds as they provide tax-free benefits to unitholders. For unit pricing purposes, an allowance may need to be made for refundable tax credits, even though no tax is paid on income and gains.

The other main class of taxed unitised business is ordinary class business sold as life policies. First home saver account business (“FHSA”) is quite small, but is also taxed as superannuation business.

2.3 Tax principles relevant to DTA valuations for superannuation business

A superannuation fund, VPST or PST often provides various investment products and/or investment choices (hereafter referred to as “investment options”). In order to unit price and



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maintain these investment options, separate asset pools are established using internal accounting structures.

However, such divisions are generally not referred to in tax legislation and the calculation of tax on investment earnings is typically framed at the tax entity level, which is the overall superannuation fund, VPST or PST.

The following is the Committees' understanding of the basic principles relevant to determining DTAs for superannuation business. However, tax legislation is complex to interpret and is subject to change.

Therefore, the level of input from experts in tax law should be appropriate taking into account the actuary's own knowledge, the circumstances of the VPST/superannuation fund/PST and the nature of the engagement/advice:

- ▶ the tax rate for investment earnings is 15%, although tax is assessed separately for income and net capital gains. In addition, the amount of capital gains is discounted by 33 1/3rd% for assets held for more than 12 months. It is noted that gains and losses on certain types of assets, for example bonds, derivatives and certain foreign assets, may be taxed as income rather than capital gains;
- ▶ realised capital losses can be offset against realised capital gains (they cannot be used as a deduction against income). The 33 1/3rd% discount for assets held for more than 12 months applies only to the net gain (that is, the discount is applied after setting off losses against the full undiscounted capital gain). As a result, losses provide a greater tax shield (15%) when offset against "short" gains compared with "long" gains where the tax relief is 10% of the loss;
- ▶ unused realised capital losses (which occur where realised losses exceed realised capital gains) may be carried forward and applied against future capital gains;
- ▶ for assets purchased prior to 21 September 1999, the manager may choose to have capital gains calculated using an indexed cost base with indexation frozen at 30 September 1999 (where the manager chooses this method, the 33 1/3rd% discount does not apply, so managers choose the indexation method only if it provides a more favourable outcome than discounting). Indexing the cost base is not permitted where a capital loss has been made; and
- ▶ business from one life insurance company may be transferred into another life insurance company under Part IX of the Life Insurance Act 1995 (Cth). It is also possible to combine superannuation funds/PSTs or undertake a successor fund transfer. An area where the tax rules are currently developing relates to whether unused losses in the transferor company/fund/PST should receive "roll-over relief". Due to the likelihood of



further changes in this area, this issue is not considered further in this Information Note. Nonetheless, the rules may be a consideration for members where such a transfer is likely or imminent.

For unit pricing purposes, tax provisions are required for each investment option within the tax entity.

However, interactions between the separate asset pools supporting each investment option may have implications for the assessment of DTAs. This is discussed further in this Information Note.

2.4 Tax principles relevant to DTA valuations for life insurance ordinary business

Compared with superannuation, the high-level features of the tax basis for ordinary investment life insurance business are less complicated.

Ordinary investment business is taxed as part of the overall ordinary business tax class of the life company which is all of the life business (including shareholder capital and retained earnings) other than that written in the VPST and SEA.

The tax rate used for the business is 30% with capital gains and losses being treated on revenue account.

This also means that capital gains provisions specific to superannuation, such as discounting and indexing of cost bases for certain assets, do not apply.

2.5 Regulatory involvement

For the past several years, APRA and ASIC have been key stakeholders in the development and monitoring of industry unit pricing practice.

In particular, their "[Unit Pricing: Guide to Good Practice](#)" (initially published in November 2005 and subsequently updated in a version published in August 2008) ("Guide") clarifies their expectations and provides a benchmark for managers to measure their practices against (APRA and ASIC, 2008).

It contains guidance relating to specific tax issues in unit pricing and these are referred to throughout this Information Note.

Just as importantly, the [Guide](#) also provides a set of broad principles to which all aspects of the unit pricing methodology should adhere. These principles are often relevant when addressing some of the complex issues related to taxed unitised funds.



For example, the Guide indicates that where estimates included in unit prices need adjustment, the change should be made as soon as possible and not implemented gradually over time (APRA and ASIC, 2008, pp15-16).

2.6 Industry association involvement

The Investment and Financial Services Association Limited (“IFSA”) is a national not-for-profit organisation representing the retail and wholesale funds management and life insurance industries. IFSA has a role in developing industry consensus, standardising practices and procedures and ensuring proper disclosure with respect to unitised funds management.

IFSA has published standards and guidance notes relating to unit pricing which are referred to throughout this Information Note (IFSA, 2006a, 2006b and 2006c).

IFSA believes that the regulators’ [Guide](#) reinforces IFSA’s existing standards.

3. Issues to consider when valuing a deferred tax asset

Since the introduction of tax on superannuation investment earnings in July 1988, and with the exception of some short periods where investment losses were made (for example, in September 2001 and early in 2003), investment markets have overall trended upwards. Consequently, realised/unrealised gains have generally exceeded losses and funds have typically had deferred tax liabilities (“DTLs”).

However, a consequence of the global financial crisis and its breadth (across asset classes) was that many funds accumulated significant realised/unrealised capital losses. As a result, many managers had to implement and/or review their DTA valuation and monitoring techniques to ensure they appropriately took into account likely DTA recoverability and volatility.

It is also noted that the issue of DTA valuations is likely to be ongoing and will arise in future because of the nature of markets and market cycles leading to circumstances where losses exceed gains.

This section sets out the issues to consider when determining DTA values for the unit pricing tax calculation.

3.1 Equity and unit pricing principles

The unit pricing mechanism is designed to return to unitholders the actual performance of their share of fund assets, net of an appropriate allowance for tax and expenses.



While issues of practicality, simplicity and efficiency are considerations in selecting the DTA valuation and monitoring approach, the primary objective is that it produces equitable outcomes.

A common understanding of equity in relation to unit pricing is that asset/liability values are determined such that they do not favour buyers, sellers or continuing unitholders.

3.2 APRA and ASIC guidance

The key high-level principles and considerations for valuing and managing DTAs set out in the [Guide](#) are as follows:

1. based on the fund's circumstances, DTAs should be included in unit prices to the extent they have value for present or future unitholders;
2. this valuation should take into account the circumstances of the fund, the governing documentation, the likelihood and timing of possible events and the approach taken to discounting for the time value of money;
3. the value of DTAs included in unit prices should be systematically reviewed to help achieve equity between investors and to minimise price discontinuities in unit prices;
4. the regulators would not expect to see a tax policy that always, or never, recognises DTAs; and
5. it is reasonable to consider capping the amount of DTAs included in unit prices.

While the [Guide](#) also sets out factors to consider in determining the DTA value (for example, size of losses, tax rate, ability to use losses elsewhere in entity, expected growth, etc), limited detailed interpretive guidance on suitable methods or assumptions to use for the valuation is provided (APRA and ASIC, 2008, pp68-69).

3.3 IFSA guidance

[IFSA Standard 9.00 "Valuation of Scheme Assets and Liabilities" \(October 2006\)](#) also sets out principles for valuing DTAs. It notes that:

- "11.4.4 ... the value of realised and unrealised tax losses and the like must be determined so as to favour neither a seller nor a buyer of Scheme interests.
- 11.4.5 The value of such losses is dependent on future events including the amount of taxable income or gains generated by the fund, any



increase or decrease in the size of the fund and the extent to which future capital gains may be entitled to the discount allowed for assets held for more than 12 months.

- 11.4.6 Given these uncertainties a valuation process is likely to conclude that there is a range of acceptable values rather than a single number. Nevertheless unit pricing requires the use of a single number. The Scheme Operator must choose the number within that range of values that in their judgment has the least bias in favour of either a seller or buyer of Scheme interests." (IFSA, 2006b, p9)

3.4 Accounting standards

In the case of DTA valuations, the current accounting requirements appear reasonably general. [AASB 112 \(Income Taxes\) \(30 October 2009\)](#) published by the Australian Accounting Standards Board ("AASB") requires that a deferred tax asset be recognised if it is considered probable that there will be sufficient future taxable profits against which the loss can be utilised. It also requires that they not be discounted for time value of money (AASB, 2009, pp29-31).

However, there is limited detailed guidance on appropriate methods or assumptions to use for the "probable" test.

As a result, many fund managers have considered the value they have adopted for unit pricing as also being suitable for accounting purposes.

However, the [Guide](#) acknowledges that managers may choose to discount DTAs (and/or DTLs) for time value of money effects and that the DTA/DTL for unit pricing may be different to that for accounting purposes.

It is noted that there may be implications for capital adequacy for life insurers under APRA regulatory prudential standards and solvency for superannuation funds if different values are adopted. There may also be cases where governing documents require the two values to be the same or similar.

3.5 Overall valuation / capping approach and issues

A common industry approach for superannuation business involves capping or considering capping when the DTA reaches a threshold level. The threshold level is typically expressed as a proportion of net asset value ("NAV") or NAV assets on capital account.



This approach effectively involves 100% recognition of the DTA up to the threshold level. Where the threshold level is a cap, there is effectively zero recognition for the tax value of additional capital losses.

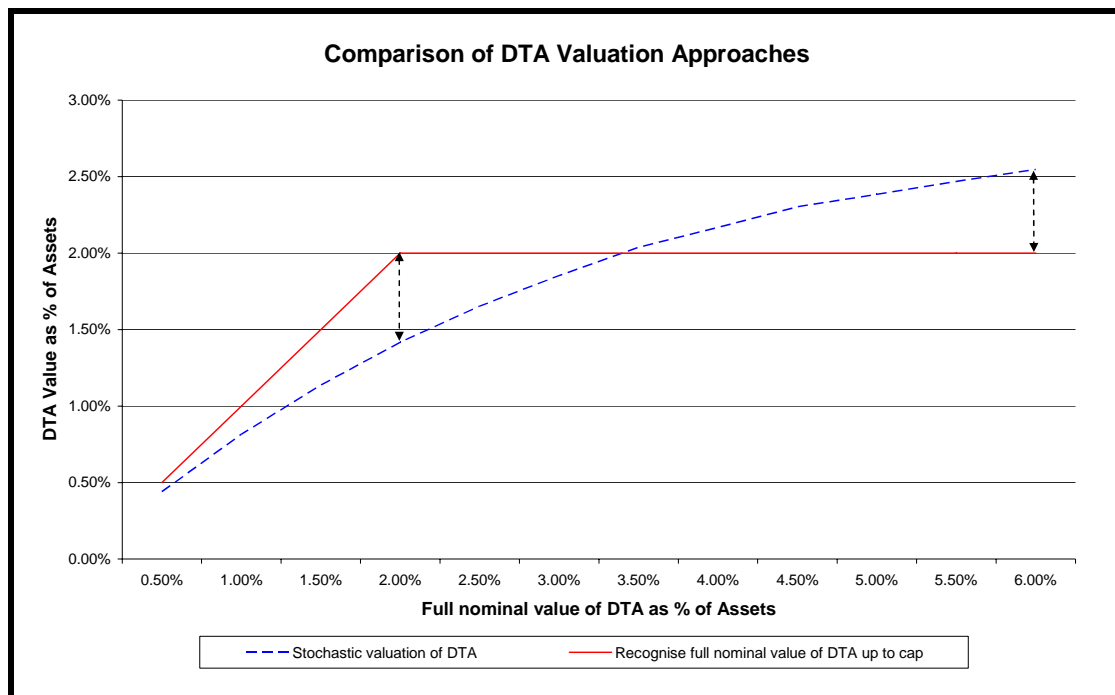
For managers that treat the threshold as a trigger for review, management may undertake further analysis and apply judgment to set the DTA level.

Whether the threshold level is applied as a cap or a trigger, it is calculated using a simple deterministic approach based on the expected level of recovery using the expected growth rate of the assets for a fixed recovery period – that is, it is calculated as:

$$\text{Expected growth rate} \times \text{years} \times \text{tax rate}$$

While such deterministic analysis is widely performed, it may not fully capture the DTA's valuation characteristics. For example, the marginal value of tax losses diminishes gradually as the amount of tax losses increases. This is because the likelihood of earning sufficient capital gains in future to recover the tax value of each additional capital loss progressively reduces. As the DTA is a non-income producing asset, the marginal value also falls because the expected length of time before it is realised increases.

The chart below shows an indicative high-level analysis of the relationship between DTA valuation and fund losses under a standard 2% cap approach compared with an approach that recognises that the marginal value diminishes as losses increase. It is noted that the chart should be considered indicative only. The DTA valuations are not intended to be realistic or appropriate for any particular fund:



The chart highlights that, for losses below the cap, the deterministic approach is likely to exceed a stochastic-based valuation and this difference is likely to reach a maximum for losses at or around the cap.

Members could consider the implications particularly where a large cap is adopted and incoming unitholders are effectively paying the full nominal value of tax losses that may be subject to significant risk of non-recovery and/or time value of money effects.

Conversely, the values produced by the fixed cap method may be significantly lower than the stochastic valuation approach where capital losses are large. Such a point may be worth considering particularly where the cap has been set at a relatively low level and to ensure that exiting unitholders are not treated unreasonably by receiving a low value for large tax losses while providing incoming unitholders the opportunity for considerable, say 30%, tax free market gains.

Where the cap is small and the DTA is not large, the differences between the two valuation approaches may seem small and within the overall materiality given the uncertainty and subjectivity involved in the DTA valuation. However, for funds with a larger cap – or where the DTA is large for a particular investment option – these issues may be more material.



3.7 Stochastic valuation approaches

The DTA shares similarities with a call option as its ultimate value is highly dependent on future scenarios of cashflows and market performance (not to mention changes to tax rules).

Therefore, an at least theoretical case could be mounted that an analysis linked to projected ranges of outcomes, such as a stochastic approach, best captures its valuation characteristics.

A stochastic approach also automatically captures the diminishing value of marginal losses as the amount of losses increase.

Nonetheless, it is noted that, while historic information and/or future market implied estimates may be used to assist with setting volatility, dividend and discount rate assumptions, judgment is also required to set certain other key assumptions which are not market observable. For example, the length of the projection, future cashflows, the risk/benefits of changes to tax law and correlations between these. The subjectivity involved in setting these assumptions may limit the appeal of stochastic/scenario-based approaches which are also complex to implement.

Therefore, managers may find it easier to consider the appropriate DTA against a measure of the expected growth rate of the assets and a reasonable recovery period, rather than adopting a complex stochastic valuation.

Nonetheless, the stochastic analysis may provide one alternative view to further support the DTA adopted and, when used in tandem with the simplified approach, assist decision making on cap revisions and addressing updates to a cap following changes to fund circumstances.

It may also provide an alternative valuation view which further supports the results from the deterministic approach. In addition, where the deterministic approach is used as a trigger rather than a hard cap, it may provide another useful piece of evidence to consider when making judgments and setting the DTA.

In this way, the alternative analysis may provide additional comfort that important valuation decisions involving this complex contingent asset are made with sound judgment and using available information.

3.8 Interactions between investment options within a tax pool

In order to strike unit prices, DTA values are required for each investment option. However, the tax law does not recognise distinctions between investment options within the tax entity



and, as such, DTA recoverability depends on the future gains of the VPST/superannuation fund/PST in total.

Therefore, an approach too heavily focused on investment option analysis may fail to appropriately recognise opportunities to realise the tax value of losses in one investment option by setting those losses off against gains in others.

On the other hand, overall tax entity level approaches fail to appreciate that within an overall tax entity level cap of, say, 2%, individual investment options may have much higher levels of DTA (expressed as a proportion of the NAV or NAV on capital account). Various issues may be involved when setting high DTA levels at the individual investment option level, even when the DTA does not seem unreasonable based on high-level analysis at the overall tax entity level, including:

- (a) *discounting for time value of money* – as noted above, the DTA is a non-income producing asset. There may be circumstances where an undiscounted DTA provision is considered reasonable at the overall fund level, but where time value of money impacts are significant for investment options where the DTA is large;
- (b) *asset mix* – where holding a DTA results in reduced exposure to investments, it can dilute the earnings of an investment option. Where such impacts are considered likely to be material, management may consider taking action (for example, through the use of other funds available within the VPST/superannuation fund/PST, or by investing in derivatives). However, such actions must take into account the interests of all unitholders and be permitted under law;
- (c) *other constraints* – some funds may specify in their product disclosure statement that the level of cash and other assets not exceed a certain level. This may represent an additional constraint for the manager to consider when setting the DTA. Managers that do not monitor/automatically cap on a daily basis may decide to cap the DTA at a lower level to avoid temporary increases in the DTA between formal reviews which result in investment guideline breaches;
- (d) *exposure to risk* – as the DTA is a contingent asset dependent upon future experience, any point-in-time assessment of the DTA cap/value used for unit pricing may need updating as future experience emerges.

Where an individual investment option has a large DTA, the unitholders' exposure to significant write-downs may represent a risk that they were not expecting and/or were not notified of when they invested in the product. This may be the case even where the assessed value at the time of setting the DTA was reasonable.



This may increase the importance of the DTA capping/valuation analysis, as well as the level and frequency of monitoring; and

- (e) *fund level vs investment option level materiality* – related to the above point on exposure to risk of DTA write-downs is that small differences in fund level caps can result in more material differences at the investment option level. This may increase the importance of the appropriateness of the DTA capping/valuation analysis, as well as the level and frequency of monitoring.

This Information Note does not prescribe a particular method for setting DTA caps / triggers. Nonetheless, it is noted that some fund managers have adopted an approach of setting caps at both the overall entity as well as investment option levels.

These fund managers consider that setting a smaller cap / trigger at the entity level compared with the investment option level assists in managing the issues mentioned above.

3.9 Loss-selling rules

Where simple loss-selling rules based on nominal tax rates have been established, theoretically the DTA value for each investment option involves considering not only the likelihood of making capital gains on assets it owns (will own), but also its entitlement to sell losses to other investment options that make capital gains.

The approach may need to be further adapted if loss-selling rules, other than applying simple nominal tax rates to the amount of the loss, are established.

Such analysis, particularly if based on stochastic or scenario analysis, may be highly complex to implement and involve subjective assessments and assumption setting. Therefore some in industry have adopted more straightforward approaches that involve separately considering the DTA at the overall fund and the individual investment option levels.

3.10 Tax rate

As noted in Section 2, the discounting of capital gains is determined after applying any losses against realised gains. This means that losses effectively provide a 10% shield when they are offset against gains on assets held for more than 12 months, or 15% when offset against assets held for less than 12 months.

Therefore, the value of any excess losses (leaving aside issues of recoverability or discounting for the time value of money) depends on whether they are offset against short or long gains.

Alternatives include basing the rate on historic experience and expected future proportions of short/long gains or using a 10% rate which may provide an implicit allowance for time



value of money effects and recoverability (or may also be consistent with the loss-selling rules with other investment options, notwithstanding that the losses may be offset against the investment options' own gains).

3.11 Discounting for time value of money

The [Guide](#) recognises that managers may, taking into account unitholder equity considerations, decide to discount deferred tax provisions (both assets and liabilities) for time value of money effects (APRA and ASIC, 2008, pp58, 68-69).

Notwithstanding these statements, there appears to have been a shift in industry amongst those that previously did discount towards moving to undiscounted deferred tax provisions, including where the deferred tax is an asset. This is not surprising as [AASB 1038 \(Life Insurance Contracts\)](#), which governs life insurance accounting, changed from requiring to prohibiting the discounting of deferred tax in 2003.

While a potential driver is consistency with accounting standards, the desire for simplicity and the potential risk of errors through misapplication of discounting have also been considerations.

Another less obvious benefit of not discounting, although only applicable when deferred tax is a liability not an asset, is its robustness to changing circumstances such as large cash outflows or fund closure.

For example, if large cash outflows result in asset realisation and conversion of deferred tax into current tax, a unit price based on undiscounted provisions may best match the impact on the fund of the realisation of the leaving unitholder's share of fund assets, minimising unit price impacts for ongoing unitholders.

However, these "robustness" advantages of not discounting may not apply for superannuation business where the deferred tax is an asset. This is because large cash outflows often lengthen the expected time frame to convert the deferred tax asset into current tax, increasing the time value of money effects rather than reducing them. This fund level result (where the DTA value reduces) contrasts with the benefit for exiting unitholders which is based on the full nominal face value of their share of the DTA.

In many cases, the cost to the unit price of not discounting may appear to be hidden. However, this is not the case where investment options borrow or invest in derivatives (to obtain asset exposure equal to the value of the DTA) and they incur a more explicit interest cost.



The decision not to discount a deferred tax asset may be based on either:

- (a) materiality grounds; or
- (b) for managers that adopt a 10% nominal tax rate (rather than a weighted average of the 10% and 15% tax rates), that such adoption implicitly includes an allowance for time value of money effects.

As noted above, when considering the potential materiality of not discounting it may be important to consider investment option level DTAs which, depending on the manager's policy and approach, may be much larger than the entity level caps.

3.12 Consistency from period to period

A consideration for the DTA method is the consistency of the results with those from the previous calculation.

For example, some rules may seem to produce reasonable DTA values at a given point-in-time, but result in movements over time (which may involve increases or decreases) that are inconsistent or difficult to explain, particularly at the investment option level.

This can be an issue for certain methods, including those where significant judgment is applied in determining the final values. Consistency with existing values is also a consideration when implementing or changing the DTA valuation method.

3.13 Asset base for analysis

When performing DTA valuation analysis, members should be aware that all or some of the returns generated by certain assets may not be capital gains and therefore not be able to be set off against capital losses.

The mix of assets in a fund between those which are expected to provide significant capital gains and those which are not, can change over time and this may impact the DTA valuation analysis.

3.14 Life Ordinary funds

Investment returns from Life Ordinary unitised business is taxed on revenue account and losses may be deductible against taxable income from business other than the unitised funds.



3.15 Requirements set out in constituent documents

In some cases, constituent documents or other marketing material (including trust deeds, policy documents, product disclosure statements, other hard copy or electronic material, etc) may set out details of the methodology or approach to determining tax values, including DTAs.

3.16 Specific circumstances of the fund

Fund-specific circumstances are a key driver of expectations of future cashflows and fund performance. These may vary significantly between different VPSTs/superannuation funds/PSTs. Examples of issues to consider include (this list is not intended to be exhaustive):

- ▶ expectations for net cashflows – this is likely to be impacted by expected growth from new unitholders and the behaviour and profile of existing unitholders. For example, their age, propensity to switch/exit (including to investment options with a higher/lower proportion of assets on capital account), whether unitholders are retail/institutional, etc;
- ▶ different investment styles and asset holding periods/turnover rates; and
- ▶ expectations about future changes to structures/mergers/terminations, etc.

4. Monitoring

The DTA, and its likely value/recoverability, changes daily with investment performance and fund cashflows. However, in industry, it is common to undertake periodic reviews of DTA as many systems are unable to provide detailed analysis each day.

In particular, some unit pricing systems have limited capability to incorporate tax information across investment options. This means that tax entity-based capping/analysis often requires calculations to be performed in tax modules outside of the unit pricing system.

Given the level of market volatility as well as the potential for significant cash outflows, undertaking monthly or less frequent analysis may expose the fund to significant unit price movements where the approximate daily tax calculation involves a “rate times earnings” approach, effectively providing full tax value for losses since the most recent review date.

Where daily analysis is not feasible, one approach to managing this risk is setting thresholds for market movements that, if reached, would result in a review of the DTA, even if this was in between the scheduled review dates.

Similarly, monitoring could be established for large cashflows, particularly outflows that impact likely future recoverability of the DTA. In some instances, it may be considered



appropriate to adjust the DTA value and unit price in respect of a large cash outflow before it is processed and paid. This may assist in avoiding disadvantaging continuing unitholders.

5. Other practical issues

5.1 Tax realignments and DTA valuation/capping

Often the unit pricing tax calculation involves approximations and, as a result, realignments are performed with more accurate calculations for accounts/tax returns.

Differences may emerge because of methodology differences, including the impact of more accurate approaches to tax on both realised/unrealised capital gains and income.

Other factors that may contribute to differences include data differences and, if applicable, errors (which may occur in either calculation).

Managers may develop attribution-type analyses to quantify impacts of each source of difference and set tolerance levels for any unexplained or residual difference.

5.2 Governance and staff involved

Governance is a focus of the [Guide](#) and is regarded as a key overarching driver for good unit pricing practice and reducing the risk of unit pricing errors. The importance of governance, including ensuring accountability and clear delegation over complex areas such as tax, is a particular emphasis (APRA and ASIC, 2008, p65).

While the role the member has in terms of governance may vary according to the nature of the engagement, it is noted that governance has a role across all aspects of policy, processes and controls referred to in this Information Note.

The approach to DTAs is included in the unit pricing policy and there may be other internal documentation which is not part of a formal approved policy but that provides further detail on methodology, data and processes. While ultimate responsibility rests with the trustee/board, it is not uncommon for the approval of the tax in unit pricing policy that covers DTAs to be delegated to a unit pricing senior management group comprising, say, a tax specialist and an actuary. A unit pricing specialist, legal, fund accounting and product manager may also form part of this group.

Actuaries and tax specialists may also be involved in designing the control framework that covers the day-to-day implementation and tax calculations, including DTA monitoring processes. Independent review and other detective controls (such as attribution analysis) can be particularly effective in identifying issues in the unit pricing tax calculation.



Complex judgments in relation to DTA capping and allocation of realignment benefits/costs may also involve senior staff across different areas and the clarity and effectiveness of communication between the tax and unit pricing areas is critical.

5.3 Communication to unitholders

While the effect of caps on, and changes to the valuation of, DTAs can be very significant, the Committees are not aware of any attempt to notify unitholders directly of the actions taken or the implied consequences.

The published accounts of superannuation funds do, however, disclose the size of the fund's DTA.

6. Conclusion

Given the recent performance of investment markets, a particular issue for managers of taxed funds is the valuation and monitoring processes for DTAs.

The valuation of this asset is complex because its returns depend on the future outcomes of many factors. For some of these factors, assumptions for modelling are not market observable.

Data availability may also present challenges for valuing and monitoring DTAs resulting in requirements to exercise judgment and develop approximate methods.

Therefore, it is reasonable to expect some diversity in approaches as managers develop solutions taking into account systems constraints and their philosophies on unitholder equity.

In some cases, the DTA value may be small and, given that a range of valuations may be considered reasonable, selecting a single value may not seem a substantial risk issue. Clearly, simplicity is desirable and materiality is a consideration.

However, it is also important that DTA approaches are robust to changing circumstances and the possibility that the DTA may be significant, particularly at the investment option level. In such cases, care is required to confirm that the values adopted are reasonable and that unitholders are not being exposed to risks they are not expecting. Valuations should also take account of any material impacts resulting from loss-selling rules and the ability to offset losses in one investment option against gains in other investment options.

While the use of stochastic or scenario analysis for DTA valuation is a developing area, it may have application in highlighting areas of greatest divergence with the simplified approach. It may also be used to supplement simplified analysis as one useful piece of alternative and additional analysis when making judgments about the appropriate DTA value.



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END OF INFORMATION NOTE