IASB Meeting | Agenda reference | 11C
Staff Paper | Date | Week commencing 13 December 2010

Project	**Post-employment benefits**
Topic	**Tax and administration costs**

Objective

1. This paper provides:
   (a) Background, including an overview of the proposals in the exposure draft *Defined Benefit Plans* (the ED) relating to the accounting for plan taxes and administration costs (paragraphs 3 - 8).
   (b) an overview of the responses to the ED (paragraphs 9 – 17).
   (c) a staff analysis and recommendation (paragraphs 18 – 30).
2. In summary, the staff recommends that the Board:
   (a) retain the existing requirements in IAS 19 related to accounting for administration costs.
   (b) confirm the proposals in the ED for the accounting for taxes payable by the plan.

Background

3. The ED proposed to clarify the treatment of tax payable by the plan and administration costs of managing plan assets.
4. Some have interpreted IAS 19 as excluding from the measurement of the defined benefit obligation taxes payable by a plan on contributions made by the entity. IAS 19 requires an entity to estimate the ultimate cost of providing long-term employee benefits. Thus, if the plan were required to pay taxes when it

ultimately provides benefits, the taxes payable would be part of the ultimate cost. Similarly, if the ultimate cost is to meet the amount of any deficit in the plan, that amount would include an amount for any taxes payable by the plan when the contribution is made. Accordingly, the ED proposed to amend IAS 19 to clarify that:

(a) the estimate of the defined benefit obligation includes the present value of taxes payable by the plan if they relate to service before the reporting date or are imposed on benefits resulting from that service, and

(b) if this is the case, those taxes should not be included as a reduction in the return on plan assets. Because service cost includes the present value of those taxes when employees render the related service, it would be double-counting to recognise those taxes for a second time when they are subsequently incurred.

5. The Basis for Conclusions expressed the Board's view that the treatment of plan administrative costs should depend on the nature of those costs. The only administration costs deducted in determining the return on plan assets should be costs of managing plan assets. Other administration costs, eg the cost of administering benefit payments, are unrelated to the plan assets. Thus funded and unfunded plans would measure the defined benefit obligation at the same amount. To the extent that future administration costs relate to the administration of benefits attributable to current or past service, the present value of the defined benefit obligation should include the present value of those costs.

6. In developing the proposals in the ED, the Board concluded that:

(a) when the ultimate cost of the benefit promise depends on the return on plan assets less asset management costs, the present value of those costs should be included in service cost and in the estimate of the defined benefit obligation when the employees render the related service.

(b) costs other than those included in the defined benefit obligation would be recognised in the period in which they are incurred and therefore could be deducted as period costs in determining the return on plan assets.

7. Therefore, the ED proposed to remove the options in IAS 19 for entities to include plan administration costs either as a reduction in the return on plan assets or in the actuarial assumptions used to measure the defined benefit obligation. The return on plan assets should include plan administration costs only if those costs relate to the management of plan assets.

8. The ED included the following amendments:

> 7 The return on plan assets is:
>
> (a) interest, dividends and other ~~revenue~~ income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less
>
> (b) any costs of managing plan assets ~~administering the plan (other than those included in the actuarial assumptions used to measure the defined benefit obligation)~~ and ~~less~~ any tax payable by the plan itself, other than tax on contributions relating to service before the reporting date or on benefits resulting from that service.
>
> 73 Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing ~~post-employment~~ long-term employee benefits. Actuarial assumptions comprise:
>
> …
>
> (b) financial assumptions, dealing with items such as:
>
> …
>
> (iv) taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service; and
>
> (v) the cost of administering claims and benefit payments relating to service before the reporting period.

Feedback received

9. Question 13 (c) and(d) of the ED asked:

> **Question 13**
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> The exposure draft also proposes to amend IAS 19 as summarised below:
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> …
>
> (c) Tax payable by the plan shall be included in the return on plan assets or in the measurement of the defined benefit obligation, depending on the nature of the tax. (Paragraphs 7, 73(b), BC82 and BC83)
>
> (d) The return on plan assets shall be reduced by administration costs only if those costs relate to managing plan assets. (Paragraphs 7, 73(b), BC82 and BC84–BC86)
>
> …
>
> Do you agree with the proposed amendments? Why or why not? If not, what alternative(s) do you propose and why?

10. There was significantly more support for the proposals regarding plan taxes than there was for the proposals regarding administration costs.

11. Some noted the interaction between these proposals and the amendments regarding the determination of finance costs. Because the ED proposed that the finance cost should be determined based on the net defined benefit asset or liability multiplied by the discount rate used to measure the defined benefit obligation, respondents noted that including any taxes and administration costs in the return on plan assets will result in those costs being presented as part of the remeasurements component.

12. The majority of respondents agreed with the proposed accounting for plan taxes however additional clarity was requested regarding how the proposals would be applied:

    (a) in specific tax regimes,

(b) to taxes paid by the employer,

(c) to contribution tax that is prepaid; and

(d) to taxes on the return on plan assets.

13. Some respondents consider taxes on the return on plan assets as an additional cost of funding the obligation, similar to taxes on contributions to the plan. Take for example a defined benefit obligation that is exactly matched by a high quality corporate bond portfolio. In a no-investment tax environment, the net interest cost is zero, and no gains and losses arise during the year. However, when the return on plan assets is reduced by tax, an actuarial loss will arise each year. Some respondents believe that the estimated tax on plan assets supporting accrued liabilities should be included in the defined benefit obligation. Respondents suggest that this could be achieved either by deducting the investment tax rate from the discount rate, or by including a specific provision for investment tax in the defined benefit obligation.

14. Some also requested clarification of the accounting for other levies imposed by government such as social security and solvency guarantees and whether they should be accounted for as plan taxes or as administration costs.

15. Some disagreed with the ED's underlying conceptual assumption that administration costs should be included in the defined benefit obligation because they represent part of the ultimate cost of providing the benefits. These respondents argue that the liability for the administration costs arises when the administration service is provided, as opposed to when the employee renders service and would prefer to expense such costs as incurred.

16. Both respondents that agreed and disagreed with the conceptual merits of the proposals raised concerns about the practical application of the requirements and how entities should estimate such costs and allocate them to current, past and future service. Difficulties include:

(a) identifying the costs to include – this might be straightforward for some plans. However for an in-house administered plan, determining what should be included becomes less clear (ie the staff administering the plan, staff supervising them, a portion of the rent, CEO's salary and so forth).

(b) allocating the costs between current service, past service and future service. This would be straightforward for closed plans, but difficult to do for the majority of open plans.

(c) distinguishing between asset management costs and plan administration cost. Some plans are charged a single asset-based fee for both administration of benefits and investment management. Depending on the entity's preference it could negotiate lower administration costs and higher asset management fees (or vice versa) in order to achieve an accounting result.

(d) the treatment of 'new expenses' that arise and whether these should be accounted for in the same way as actuarial gains or losses or in the same way as past-service cost.

17. Some respondents noted that the effect of diversity in treatment of administration costs could be significant. Some estimate that the Board's proposals would cause an increase in the defined benefit obligation of 5-6% if an entity previously did not include administration costs in the defined benefit obligation and that this percentage could be significantly higher if the plan is closed to future accrual.

Staff analysis and recommendation

18. The Board addressed the accounting for taxes paid by the plan and administration costs in the ED on the basis that:

(a) they could be addressed expeditiously.

(b) this issue does not require a fundamental review of defined benefit obligation measurement.

(c) addressing this issue would lead to a worthwhile improvement in the reporting of defined benefit plans.

19. The ED proposed that taxes payable by the plan should be included in the return on plan assets or in the measurement of the defined benefit obligation, depending on the nature of the tax and that the return on plan assets should be reduced by administration costs only if those costs relate to managing plan assets. However, it did not propose detailed guidance regarding what taxes and administration costs should be included in the measurement of the defined benefit obligation or how they should be attributed to periods of service.

20. There are two effects that arise from the different accounting treatments in IAS 19 for administration costs and taxes paid by the plan:

(a) Presentation - Costs accounted for as a reduction in the return on plan assets would be presented in the remeasurements component while the present value of costs accounted for as part of the defined benefit obligation would be presented together with service costs.

(b) Recognition – Costs accounted for as part of the defined benefit obligation would include the present value of all costs relating to past service, even if they are expected to arise in the future, while costs accounted for as part of the return on plan assets will include only those arising in the current period.

Administration costs

21. The staff have identified the following three approaches the Board could consider for administration costs:

(a) Confirming the proposals in the ED – This will limit the costs that can be deducted from the return on plan assets to the costs related to managing those assets. However the Board may need to provide additional guidance to address the practical difficulties noted by respondents in paragraph 16 such as splitting the costs between managing assets and administering the plan and splitting the costs of administering the plan between costs that relate to current and past service and cost related to future service. This will require the staff to perform additional work.

(b) Retaining the existing requirements in IAS 19 – This will maintain the status quo, however the Board should note that deducting administration costs from the return on plan assets will result in these costs being presented in the remeasurements component (refer paragraph 24 below).

(c) Requiring administration costs to be expensed as incurred – This will help address some of the practical concerns raised by respondents as costs will not need to be split between current and past service and future service. Under this approach all costs can be presented as part of the current service component which would also address the concerns about splitting costs between managing plan assets and other costs and the presentation of costs deducted from the return on plan assets as part of the remeasurements component. The staff consider this approach as a change to the fundamental measurement objective of IAS 19, that the defined benefit obligation should be determined based on the ultimate cost of the benefits. However this could be a pragmatic approach to addressing the concerns raised by respondents until a future fundamental review. This would also be consistent with the conclusion reached by the Pro-Active Accounting Activities in Europe (PAAinE) report dated November 2009, which stated that as a matter of practicality (and taking into consideration the likely materiality of such expenses) it would be more appropriate to expense the costs as incurred.

22. Paragraph BC86 of the Basis for Conclusions and some respondents suggest that current IAS 19 gives the entity the option to include administration costs either in the return on plan assets or the defined benefit obligations. The definition of the return on plan assets in current IAS 19 includes a deduction for any costs of administering the plan other than those included in the measurement of the defined benefit liability. Current IAS 19 requires that the measurement of the

defined benefit obligation to include an entity's best estimate of the variables that will determine the ultimate cost of providing the benefits (IAS 19 paragraph 73), however there are no specific requirements regarding how the costs of administering the plan should be take into account. The proposals in the ED were intended to clarify how an entity should take into account taxes and administration costs in determining the ultimate cost of benefits rather than changing the basic principles of measurement.

23. While the responses have indicated that diverse views exist regarding the accounting for such costs under current IAS 19, the practical issues raised by respondents will require further work and the responses indicate that the costs of estimating administration costs will exceed the benefits and therefore there will be a limited improvement to financial reporting. Therefore the staff recommend that the Board defer consideration of the accounting for administration costs. However, reverting to the existing requirements of IAS 19 will result in administration costs deducted from the return on plan assets being presented in the remeasurements component.

24. The ED proposed to delete paragraph 107 of IAS 19, which requires that in determining the expected return on assets, an entity deducts expected administration costs, other than those included in the actuarial assumptions used to measure the obligation. This paragraph was deleted due to the proposed definition of the finance cost component which eliminated the notion of an expected return on plan assets. As a consequence, administration costs included in the return on plan assets will be presented as part of the remeasurements component, because the finance cost component does not make any allowance for expected administration costs.

25. The staff believe that this result is reasonable if the costs are limited to costs related to the management of the plan assets, as this will result in the same service cost and defined benefit obligation for funded and unfunded plans. However if the Board decides to revert back to the current IAS 19 requirements, this may result in expenses other than costs of managing the plan assets being included in the return on plan assets, and therefore, may result in different

service costs and defined benefit obligations being recognised for funded and unfunded plans.

Question 1
Does the Board agree to retain the existing requirements in IAS 19 related to accounting for administration costs? If not, what do you propose and why?

Plan taxes

26. Current IAS 19 is silent regarding the accounting treatment of taxes related to defined benefit plans except for the definition of the return on plan assets which includes a deduction for taxes payable by the plan itself. Unlike administration costs, the definition is silent as to whether tax payable by the plan can be included in the measurement of the defined benefit obligation. Current IAS 19 requires that the measurement of the defined benefit obligation to include an entity's best estimate of the variables that will determine the ultimate cost of providing the benefits (IAS 19 paragraph 73), however there are no specific requirements regarding either taxes payable by the plan itself or taxes payable by the entity.

27. A wide variety of taxes on pension costs exists worldwide and it is a matter of judgement whether they are income taxes within the scope of IAS 12 *Income Taxes*, costs of liabilities within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or costs of employee benefits within the scope of IAS 19. Given the variety of tax arrangements, guidance on issues beyond those relating to taxes payable by the plan itself could not be developed in a reasonable period of time and therefore the staff consider that taxes other than taxes payable by the plan are beyond the scope of the proposed amendment.

28. Some respondents read the proposed amendments as requiring taxes on contributions paid before the related service to be recognised as an expense when paid, and recognised again when service is rendered. The staff will

consider drafting suggestions when drafting the final amendment to ensure that the taxes are recognised once when the related service is rendered.

29. Taxes payable on plan asset returns are more problematic. These taxes are similar to taxes on contributions to the plan, for example if a plan has a deficit, an entity will reduce that deficit either by paying further contributions or through the returns on its plan assets. However a plan that is taxed on investment returns would be required to hold more assets to fund the defined benefit obligation than a plan that is not taxed on investment returns. As noted above, some respondents believe this additional cost should be included in the measure of the defined benefit obligation (ie the defined benefit obligation should be grossed up to account for the cost of additional investment returns required to fund it). However it is not clear whether this additional cost relates to service before the reporting date. Additional work will be required to be performed to address these taxes.

30. Based on the above, the staff recommend that the Board confirm the proposals in the ED for the accounting for taxes payable by the plan and that the staff should not perform further work on this topic, other than drafting.

Question 2
Does the Board agree to confirm the proposals in the ED for the accounting for taxes payable by the plan? If not, what do you propose and why?