STAFF PAPER

IFRS Interpretations Committee Meeting

March 2013

Project	IAS 19 *Employee Benefits*—Discount rate for defined benefit liability: pre-tax rate or post-tax rate?		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. In February 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request for guidance on the calculation of defined benefit obligations. In particular, the submitter asked the Interpretations Committee to clarify whether, in accordance with IAS 19 *Employee Benefits* (2011), the discount rate used to calculate a defined benefit liability should be pre- or post-tax.

2. We performed outreach on this topic with the IASB's Employee Benefits Working Group (EBWG), the International Actuarial Association (IAA), national accounting standard-setters and regulators. The results of this outreach are not included in this paper, because the deadline for replying to the outreach request is Monday 11 March. We will present the results of this outreach during the March Interpretation Committee meeting.

3. The submission is reproduced in full in Appendix C.

Objective

4. The objective of this paper is to:

(a) provide background information on the issue raised in the submission;

(b) provide an analysis of the issue;

(c) present a preliminary[1] assessment of the issue against the Interpretations Committee's agenda criteria included in the *Due Process Handbook* issued in February 2013;

(d) make a preliminary[2] recommendation that the Interpretations Committee should not take this issue onto its agenda; and

(e) ask the Interpretations Committee whether it agrees with the staff recommendation.

Background information

5. Paragraphs 76 and 130 of IAS 19 (2011) state that:

> 76 Actuarial assumptions are an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. Actuarial assumptions comprise:
>
> …
>
> (iv) taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service.
>
> 130 In determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation (paragraph 76). Other administration costs are not deducted from the return on plan assets.

6. Paragraphs BC121-BC122 of IAS 19 (2011) explain that:

> BC121 The amendments made in 2011 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) other taxes should be included as a reduction to the return on plan assets.
>
> BC122 The Board noted that IAS 19 requires an entity to estimate the ultimate cost of providing long-term employee benefits. Thus, if the plan is required to pay taxes when it ultimately provides benefits, the taxes payable will be part of the ultimate cost. Similarly, the ultimate cost would include any taxes payable by the plan

[1] Subject to the result of the outreach.

[2] Subject to the result of the outreach.

when the contribution relates to service before the period (such as in the case of contributions to reduce a deficit).

Staff analysis

Description of the issue

7. The tax regime in a jurisdiction is the following:
   (a) the entity receives a tax deduction for contributions made to the plan;
   (b) the plan pays tax on contributions received and on investment income earned; but
   (c) the plan does not receive a tax deduction for benefits paid.
8. The submitter thinks that:
   (a) the fact that investment income and contributions received are taxable, but benefits paid are not deductible for tax purposes, has led to the uncertainty;
   (b) if the principles in IAS 19 are applied, a fully funded plan invested in government bonds[3] of appropriate duration should result in a zero net balance on the balance sheet of the entity, and in no future impact in the entity's income statement (in respect of past service).
9. An example of this fact pattern is the following.

Example
The plan must pay a single benefit that amounts to CU70[4] cash a year in perpetuity.
The plan holds sufficient assets to fund those benefits.
The pre-tax, risk-free interest rate is 10 per cent.
Tax on investment income is 30 per cent.

[3] In this jurisdiction there is no deep market in high quality corporate bonds, so government bond rates are used to determine the discount rate.

[4] In this staff paper, currency amounts are denominated in 'currency units' (CU).

If the fund was designed to be fully funded and to invest solely in risk-free assets, the income statement would be:

Investment income	CU100
Tax	CU(30)
Investment income after tax	CU70
Benefits	CU(70)
Net income	Nil

This income statement would imply that CU1,000 of risk-free assets are required to generate the CU70 of cash per year that is necessary to pay the CU70 of benefits (non-deductible for tax purposes).

If a pre-tax discount rate (10 per cent) were used to determine the present value of the defined benefit obligation (ie the present value of CU70 a year in perpetuity), the resulting liability would be CU700 (ie CU 70/10 per cent). This would result in a fund surplus of CU300 (assets of CU1,000 less the liability of CU700) being shown on the entity's balance sheet. This implies that the entity could be repaid an amount of CU300 and still have a fully funded scheme. Some think that this is incorrect because the remaining CU700 of assets would only generate CU49 of cash after tax, which is insufficient to pay the CU70 of cash benefits.

However, if a post-tax, risk-free discount rate (7 per cent) is used to determine the present value of the defined benefit obligation, the resulting liability would be CU1,000 (ie CU70/7 per cent). This would exactly match the CU1,000 of assets and therefore the scheme would be fully funded.

10. Some think that the result of the example above implies that in this situation (ie investment income and contributions received are taxable, but benefits paid are not deductible) the post-tax discount rate should be used. However, others question whether a post-tax discount rate is permitted by IAS 19 (2011).

11. The submitter notes that two views exist in practice:

    (a) **View 1—post-tax discount rate is appropriate**. IAS 19 is silent on whether the discount rate should be pre or post-tax. A post-tax rate is

appropriate in the fact pattern described (investment income and contributions received are taxable, but benefits paid are not deductible).

(b) **View 2—pre-tax discount rate is appropriate**. IAS 19 does not mention, and therefore does not envisage, a tax adjustment to the discount rate. The inclusion of future tax payments on investment income in the measurement of the defined benefit obligation is inconsistent with IAS 19.

12. We will analyse these views in the following paragraphs.

View 1—post-tax discount rate is appropriate

13. Proponents of this view think that future tax payments on investment income affect the cost to the entity of providing benefits earned by employees. According to paragraph BC75 of IAS 19 (2011), the amendments made in 2011 are consistent with the view that a net defined benefit liability is equivalent to a financing amount owed by the entity to the plan. Similarly, a net defined benefit asset is an amount owed by the plan to the entity. Consequently, a plan that is fully funded by risk-free assets should show a zero net defined benefit obligation. As illustrated by the example, this outcome is only achieved when tax paid by the plan on the plan's investment income is taken into account in calculating the defined benefit obligation, because it is part of the ultimate cost of providing benefits.

14. They also think that discounting the expected benefits payable at a post-tax discount rate is one way of including expected tax payments on investment income as part of the ultimate cost of providing benefits. The same result could be achieved by discounting the expected benefits payable plus the tax payable on the future investment returns at a pre-tax discount rate (ie CU70/7 per cent = CU100/10 per cent = CU1,000). Consequently, the critical question is whether the expected tax payments on the investment income of the plan should be taken into account in determining the ultimate cost of providing benefits. They think that in this fact pattern, the expected tax payments should be taken into consideration.

15. In their view, the calculation of the defined benefit obligation should be independent of the funding status of the plan. The calculation of the defined benefit obligation should be the same regardless of whether the plan is funded or unfunded. In an unfunded situation, the defined benefit obligation should represent the amount that an entity would need to pay to settle the obligation at balance date. This equates to the cash that the plan would need to invest in risk-free assets now to ensure that the after-tax return on those assets is sufficient to fund the benefits payable (ie CU1,000 in the example).

16. They also think that a post-tax discount rate is not inconsistent with the requirements of IAS 19, because the Standard is silent on this matter. Consequently, in this fact pattern the use of a post-tax discount rate represents the economic reality. The use of a pre-tax or post-tax discount rate would depend on the tax regime applicable to the pension fund.

View 2—pre-tax discount rate is appropriate

17. Proponents of View 2 think that the amendments to IAS 19 made in 2011 clarify that taxes on investment income are not an actuarial assumption that determines the ultimate cost of providing post-employment benefits. They note that IAS 19 (2011) is clear that taxes relating to contributions and benefits should be taken into account in determining the ultimate cost of providing benefits (IAS 19.76(b)(iv)). Furthermore, according to paragraph 130 of IAS 19, the return on plan assets includes any tax payable by the plan itself other than tax included in the measurement of the present value of the defined benefit obligation. They therefore maintain that the Standard is clear that tax on investment income (which is not a tax relating to contributions or benefits) should be taken into account in determining the return on plan assets but not in determining the defined benefit obligation.

18. They also noted that paragraph BC122 of IAS 19 (2011) mentions only taxes on contributions and benefits payable within the context of estimating the ultimate cost of providing long-term employee benefits. Consequently, the inclusion of future tax payments on investment income in the measurement of the defined benefit obligation is inconsistent with the requirements of IAS 19.

19. They think that tax payments on the investment income earned by a long term employee benefit fund should be reflected in the expected and actual return on assets. They note that the tax depends on the investments made by the plan and if the plan is unfunded then no tax would be payable. They argue that paragraph BC 130[5] of IAS 19 is clear that the measurement of the liability should be independent of the plan assets. The use of a different discount rate when benefits may be funded or unfunded or where the tax payable varies with investment choices in a funded plan conflicts with this principle.

20. In their view, the argument that having plan assets sufficient to meet the defined benefit obligation should generate sufficient net income to meet the obligation is mixing measurement of the liability with the returns on assets and the recognition of taxes on those assets. They maintain that using a post-tax rate is inconsistent with the view in IAS 19 that a tax on the investment income is an expense relating to the plan assets, not to the payment of the benefits in respect of current and past service.

21. They also note that the use of a pre-tax discount rate is consistent with the accounting of other long term provisions, for example it is consistent with paragraph 47 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Staff analysis and view

22. We think that IAS 19 does not explicitly address this issue (ie pre-tax or post-tax discount rate) because we think that:

    (a) the underlying principle is that the discount rate used should be consistent with the cash flows;

[5] This paragraph states that [emphasis added]: Some believe that, for funded benefits, the discount rate should be the expected rate of return on the plan assets actually held by a plan, because the return on plan assets represents faithfully the expected ultimate cash outflow (ie future contributions). IASC rejected this approach because the fact that a fund has chosen to invest in particular kinds of asset does not affect the nature or amount of the obligation. In particular, assets with a higher expected return carry more risk and an entity should not recognise a smaller liability merely because the plan has chosen to invest in riskier assets with a higher expected return. **Consequently, the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan**.

(b) paragraphs 83-86 of IAS 19 (ie the paragraphs that provide guidance on the determination of the discount rate) do not specify whether the discount rate should be pre- or post-tax; and

(c) the IASB in its December 2010 meeting[6] decided not to provide guidance on whether tax payments on the return on plan assets should be included in the measurement of the defined benefit obligation (in our view, this is the issue). Indeed:

(i) the Exposure Draft *Defined Benefit Plans* (the ED) did not propose detailed guidance regarding what taxes should be included in the measurement of the defined benefit obligation.

(ii) Some respondents to the ED suggested that the estimated taxes on the return on plan assets should be included in the defined benefit obligation.

(iii) In December 2010, the staff recommended that the IASB should not provide guidance on this issue (as proposed in the ED) because the issue is problematic and cannot be addressed expeditiously. The IASB decided *to confirm the proposals in the ED for the accounting for taxes payable by the plan.*[7]

23. We think that IAS 19 is clear that taxes should be taken into account either in determining the return on plan assets or in determining the defined benefit obligation. The Standard is clear that taxes on contributions and benefits related to current and prior years services should be included in the measurement of the defined benefit obligation, but it is not clear about taxes on the return on plan assets.

24. Consequently, in our view, in this specific fact pattern the tax payments on the investment income may be included in the ultimate cost of providing benefits and so a post-tax discount rate may be used.

[6] http://www.ifrs.org/Meetings/Pages/IASB-Board-Meeting-13-December-2010.aspx See agenda paper 11C

[7] See IASB Update December 2010.

Preliminary agenda criteria assessment

25. We do not expect that this issue is having a widespread effect, because it is caused by the specific tax regime in the jurisdiction of the submitter. However, if the results of our outreach will show us that the issue is widespread and that divergence in practice exists, we will modify our assessment.

26. An abstract of the *Due Process Handbook* issued in February 2013 is reported in Appendix B of this paper.

Staff recommendation

27. On the basis of our technical analysis, we think that:

    (a) IAS 19 does not specify whether the discount rate should be pre- or post-tax; and that

    (b) in this specific fact pattern a post-tax discount rate may be used.

28. On the basis of our preliminary assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda, because we do not expect that this issue is having a widespread effect. However, if the results of our outreach will show us that the issue is widespread and that divergence in practice exists, we recommend that the Interpretations Committee should address this issue as part of the broader issue about the discount rate that it is currently discussing.

29. Our proposed tentative agenda decision is included in Appendix A of this paper.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree that IAS 19 does not specify whether the discount rate should be pre- or post-tax and that in this specific fact pattern a post-tax discount rate should be used? 2. Does the Interpretations Committee agree with the staff's preliminary recommendation (ie the Interpretations Committee should not take this issue onto its agenda; however, if the results of our outreach will show us that the issue is widespread and that divergence in practice exists, we

recommend that the Interpretations Committee should address this issue as part of the broader issue about the discount rate)?

3. Does the Interpretations Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A—Proposed wording for tentative agenda decision[8]

A1 The proposed wording for the tentative agenda decision is presented below.

IAS 19 *Employee Benefits*—Pre-tax or post-tax discount rate

The Interpretations Committee received a request for guidance on the calculation of defined benefit obligations. In particular, the submitter asked the Interpretations Committee to clarify whether, in accordance with IAS 19 *Employee Benefits* (2011), the discount rate used to calculate a defined benefit liability should be a pre-tax or a post-tax rate.

The tax regime in the jurisdiction of the submitter can be summarised as follows:

(a) the entity receives a tax deduction for contributions made to the plan;

(b) the plan pays tax on contributions received and on investment income earned; but

(c) the plan does not receive a tax deduction for benefits paid.

The Interpretations Committee noted that:

(a) paragraphs 83-86 of IAS 19 (2011) do not specify whether the discount rate should be a pre-tax or post-tax rate;

(b) IAS 19 does not provide guidance on whether taxes on the return on plan assets should be included in the measurement of the defined benefit obligation; and

(c) the discount rate used should be consistent with the cash flows.

The Interpretations Committee observed that in absence of specific guidance, in the fact pattern described by the submitter, a post-tax discount rate may be used, provided that it is consistent with the cash flows.

On the basis of the above and because the issue arises in a jurisdiction with a particular tax regime, the Interpretations Committee [decided] not to add this issue to its agenda.

[8] Subject to the result of the outreach.

Appendix B—Abstract of the *Due Process Handbook* (February 2013)

5.16 …The Interpretations Committee should address issues:

(a) that have widespread effect and have, or are expected to have, a material effect on those affected;

(b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and

(c) that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.

5.17 The issue should be sufficiently narrow in scope that it can be addressed in an efficient manner by the Interpretations Committee, but not so narrow that it is not cost-effective for the Interpretations Committee and interested parties to undertake the due process that would be required when making changes to IFRSs.

5.21 The solution developed by the Interpretations Committee should be effective for a reasonable period of time. Accordingly, the Interpretations Committee would not normally develop an Interpretation if the topic is being addressed in a forthcoming Standard. However, this does not prevent the Interpretations Committee from acting on a particular matter if the short-term improvements can be justified.