Art or Science? Industry Approaches to Tax in Unit Pricing

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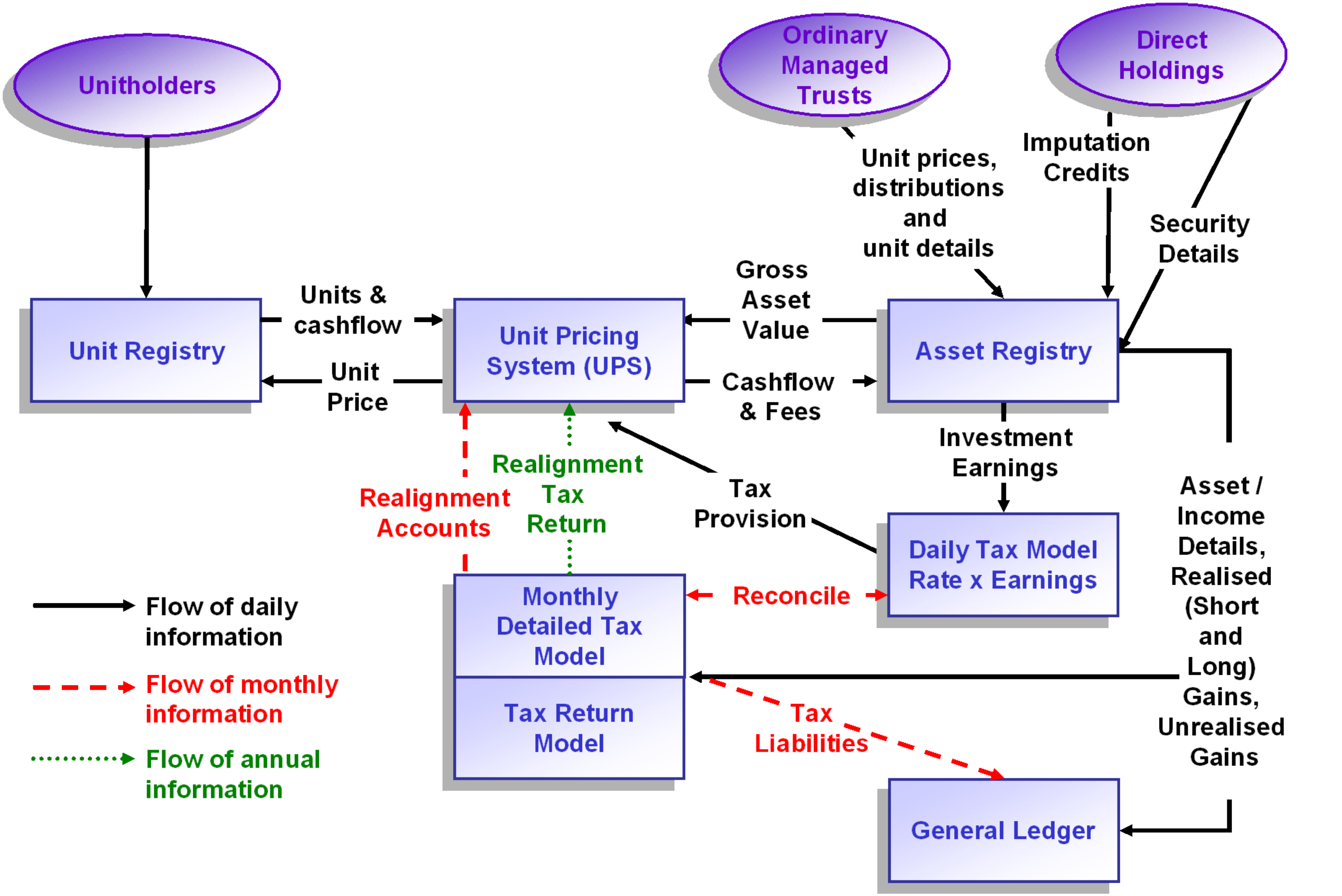
Introduction

- Background
- Deferred tax assets
- Approximate daily tax and reconciliations to detailed tax model
- Tax payments and parcel selection
- Discussion


Unitholders
Ordinary Managed Trusts
Direct Holdings
Unit prices, distributions and unit details
Imputation Credits
Security Details
Unit Registry
Units & cashflow
Unit Price
Unit Pricing System (UPS)
Gross Asset Value
Cashflow & Fees
Asset Registry
Investment Earnings
Realignment Accounts
Realignment Tax Return
Tax Provision
Daily Tax Model Rate x Earnings
Monthly Detailed Tax Model
Tax Return Model
Reconcile
Asset / Income Details, Realised (Short and Long) Gains, Unrealised Gains
Tax Liabilities
General Ledger
Flow of daily information
Flow of monthly information
Flow of annual information

Deferred Tax Assets

- Global financial crisis
  - Substantial and broad based falls across growth asset classes that superannuation is invested in.
- DTA valuation and monitoring are key current issues for fund managers.

Deferred Tax Assets

- Issues to consider:
  - Nature of asset – implications for simple valuation approaches.
  - Level of analysis – tax entity or investment option?
  - Frequency of monitoring.
  - Discounting for time value of money effects.

DTA – Valuation / Capping Approach

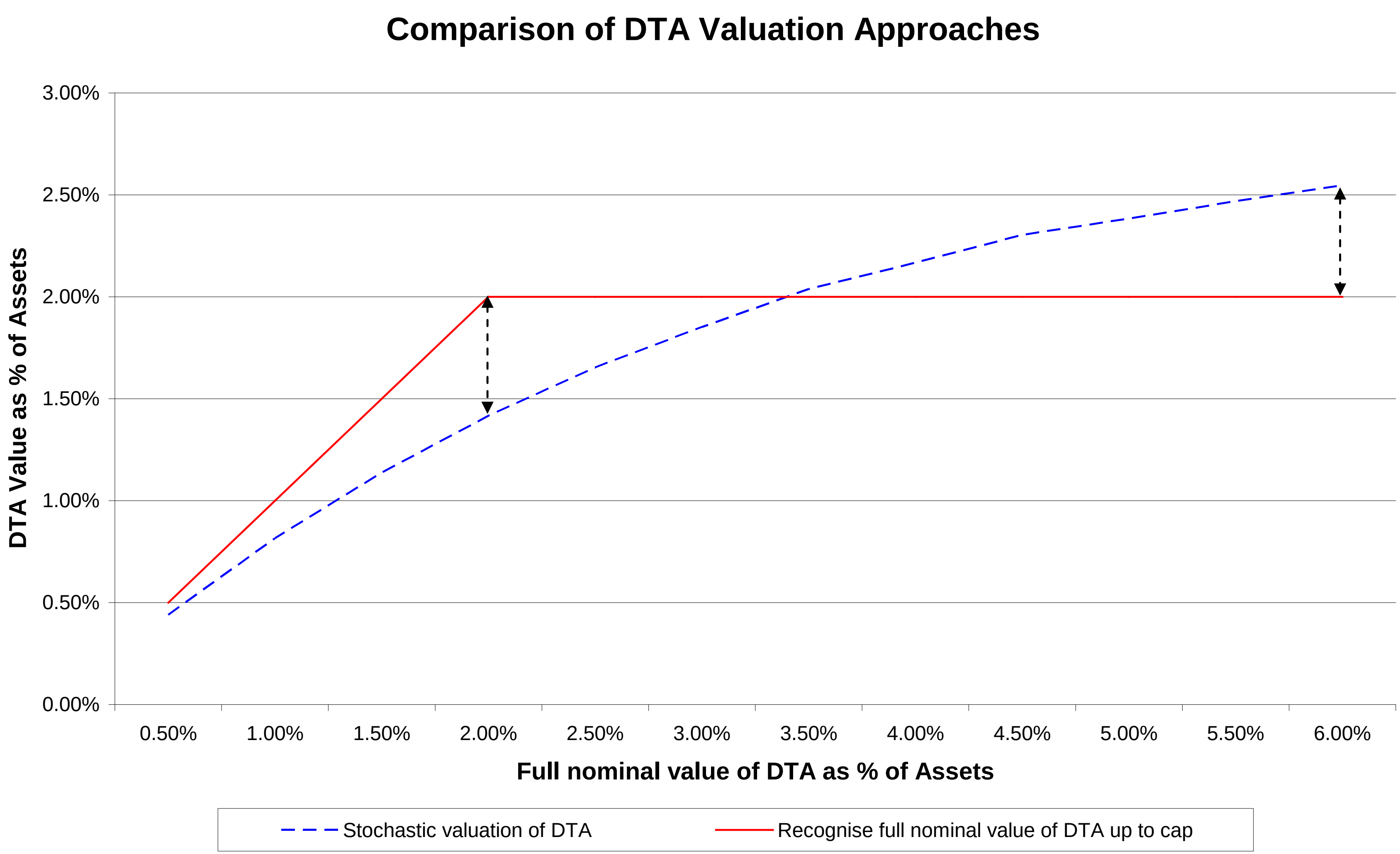
- Deterministic approach:

Expected Growth Rate x Years x Tax Rate

- Formula provides cap/trigger level (e.g. cap/review when DTA is 2% of fund assets)

DTA – Valuation Stochastic Approach

- Stochastic/scenario approach:
  - DTA similar to call-option => theoretical case that analysis linked to projected future outcomes better reflects characteristics. However:
    - Assumptions for certain key parameters not market observable.
    - Implementation complex.
  - Stochastic/scenario analysis nonetheless useful:
    - Spotlight areas departure with simplified approach.
    - Alternative valuation view to support cap/value calculated on simplified approach.


Comparison of DTA Valuation Approaches
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
DTA Value as % of Assets
0.50%
1.00%
1.50%
2.00%
2.50%
3.00%
3.50%
4.00%
4.50%
5.00%
5.50%
6.00%
Full nominal value of DTA as % of Assets
Stochastic valuation of DTA
Recognise full nominal value of DTA up to cap

DTA: Tax Entity or Investment Option Analysis

- Tax law does <u>not</u> recognise distinctions between investment options within tax entity.
- "Loss-selling" rules:
  - Part of tax in unit pricing policy.
  - Typically based on nominal value (between 10%-15%).
  - Ex post "appears" to favour investment option with losses but really just rules set up in advance.
  - Theoretically loss-selling rules are determinant of value of losses => one argument supports case DTA value should take account of overall tax entity position.

Overall conclusion: important to set "loss-selling" rules and consider implications for DTA valuation and monitoring.

DTA: Tax Entity or Investment Option Analysis

- However, overall tax entity level focus may miss implications of large investment option level DTAs, such as:
  - Asset allocation impacts.
  - Time value of money.
  - Exposure to risks unitholder not expecting.
- Therefore may need to consider frequency of monitoring/disclosure.

Other DTA Issues

- Tax rate
  - Tax rate for losses is 10% or 15% depending offset long/short gains.
- Discounting for time value of money
  - Shift to not discounting
  - Large cash outflows may <u>increase</u> time value effects where deferred tax is an asset
- Monitoring
  - Avoid spikes in unit price
  - Risks unitholders not expecting

Daily tax method – Rate x Earning

- Detailed calculation may not be cost effective.
- However, some managers found the use of detailed calculations practical.

Daily tax method – Rate x Earning

- Advantage of more detailed approaches:
  - Simplifies reconciliations with detailed calculations.
  - Improves use of daily tax model as independent check on detailed calculation.
  - Reduced risk/judgement required for allocating differences.
  - Reduced time/effort maintaining estimation parameters

Imputation Credits

- Issues
  - Timing of recognition.
  - Use of preliminary information.
  - Timing of updating after receive final information.

Reconciling daily tax model against detailed tax model – Level of precision

- Differences emerge due to:
  - Methodology differences
  - Data differences
  - Model errors
- Quantify each of these impacts.
- Set a tolerance level for any unexplained or residual difference.
- If the unexplained is above the tolerance level, further analysis undertaken.
- Some managers have developed more systemised and automated approaches to the analysis.

Reconciling daily tax model against detailed tax model – Allocation of differences

- Issue – how to allocate the identified differences between the daily unit pricing tax calculation and the detailed tax calculation.
- Amount to allocate may be positive or negative.
- Guide recommends that any differences be allocated equitably, taking into account the reasons for the difference and the nature of the products.

Reconciling daily tax model against detailed tax model – Allocation of differences

- Additional issue of how the differences should be allocated across investment options.
  - High-level approaches appropriate for immaterial amounts.
  - Allocate differences to the investment options that generated them.
- Principle can be applied to synergy differences generated by interactions between investment options.
- More detailed daily unit pricing tax calculations reduces size of differences.

Other Practical Issues

- Tax payments
- Parcel selection

Conclusion / Discussion

- Deferred tax asset valuation and monitoring:
  - Have we got the right balance between analysis and judgement?
  - How should actuaries be involved?
- How much diversity in tax in unit pricing practice is appropriate?

Presenters' Details

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