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WEEKLY COMMENT: WEDNESDAY 11 JULY 2012

1. On 5 July Inland Revenue released An Officials' Issues Paper *Financial arrangements – the sale and purchase of property or services* ("the Paper"). The focus is on the current tax treatment prescribed in Financial Arrangements *Determination G29: Agreements for sale and purchase of property denominated in foreign currency: exchange rate to determine the acquisition price and method for spreading income and expenditure* page 7, Tax Information Bulletin Vol 8, No 4 (September 1996). Submissions are due by 17 August.

2. The paper contains significant suggested changes to the way in which the following components of foreign currency agreements for the sale and purchase of property will be taxed:
   - The deemed interest component; and
   - The deemed foreign exchange gain/(loss) component.

3. The main problems identified are:
   - Because an expected value approach is not available in respect of the FX component, there can be significant exchange differences that arise when an Agreement for Sale and Purchase ("ASAP") spans one or more balance dates.
   - The property subject to an ASAP is capitalised and depreciated at the forward exchange rate, regardless of whether the ASAP is hedged with a separate Forward Exchange Contract ("FEC").
   - Officials have expressed concern that the ability to impute interest into all agreements for a term greater than 93 days works against the revenue base.

4. The different tax treatments suggested are as follows:

   (a) For taxpayers who use New Zealand Equivalents to International Financial Reporting Standards ("IFRS taxpayers") IFRS GAAP treatment, except for capitalisation of interest, will be mandatory.

   (b) Non-IFRS taxpayers will aggregate the NZ$ amounts of the payments made at the spot rates at the various payment dates for valuing the goods and services under the agreements. However, FX amounts from FEC hedges would be included:

   (i) In the values of trading stock if that is the taxpayer's non-tax treatment; and

   (ii) In the depreciable value of depreciable assets.

   Such FX amounts would not be taxed as part of FECs.

   (c) The ability of non-IFRS taxpayers to impute interest into deferred property settlements will be severely limited. Imputed interest will only be allowed for:

(i) Significant prepayments more than 12 months before the rights date for property that was in a substantially completed stage, or for services yet to be performed; or

(ii) Deferred payments made more 12 months before the rights date.

(d) All of the changes proposed will be extended so as to include services. It is noted, at paragraph 2.10 of the Paper that section EW 32 (Value of Property or Services) includes services in the valuation rules, whereas section EW 35 (Value relevant for non-financial arrangements tax rules) does not.

(e) No changes are proposed for agreements for commodities or assets substituted for money – i.e. futures contracts – as these are taxed currently as either forward contracts or future contracts.

5. The transitional rules proposed, on which submissions have been requested, are as follows:

- New alternative methods would only be applied to new agreements entered into from the date of amending legislation.
- Agreements in place at the time of amending legislation using existing methods or suggested new alternatives would be retrospectively validated to prevent disputes over past returns.
- There will be no ability to change the methods used for agreements and any FEC hedges in past returns when the returns have been filed.

Current tax law: *Determination G29* mandatory for IFRS taxpayers

6. Under current tax law, taxpayers who use New Zealand Equivalents to International Financial Reporting Standards ("IFRS taxpayers") are allowed, under section EW 15C(1), the option of using:

(a) The Fair Value Method used for IFRS financial reporting method with modifications for credit impairment, borrowing costs and equity reserves adjustments (section EW 15D: *IFRS Financial Reporting Method*); or

(b) A Determination alternative for non-hedges, or hedges of financial arrangements for which the fair value method is not used: *Determinations G3, G9C, G14B & G27* (providing specified requirements are met) or other Determinations or a Determination alternative (section EW 15E: *Determination Alternatives*); or

(c) The Expected Value Method that has the features of the approach described in *Determinations G9C & G14B* for foreign currency financial arrangements that are non-hedges, or hedges of financial arrangements for which the fair value method is not used (section EW 15F: *Expected Value Method*); or

(d) A Modified Fair Value Method for foreign currency financial arrangements that are non-hedges, or hedges of financial arrangements for which the fair value method is not used, under which amounts allocated to equity reserves under IFRS reporting are not required to be returned for tax purposes (section EW 15G: *Modified Fair Value Method*).

(e) However, section EW 15C(2) denies IFRS taxpayers the above options if either of sections EW 15H or EW 15I applies:

(i) Section EW 15H requires the mandatory use of certain Determinations, which include *Determination G29*, which must be applied using *Determination G9C* (expected value approach for foreign currency financial arrangements) and not

Determination G9A. The other mandatory Determinations are *Determinations G5C* (MCNs), *G22* (NZ$ OCNs convertible by the holder) and *G22A* (NZ$ OCNs). Under section EW 15H a Determination alternative can be used where the results are not materially different.

(ii) The use of Determinations including the YTM method are also mandatory under section EW 15I if the mandatory use of the Determinations in section EW 15H does not apply, and the financial arrangement is treated as an equity instrument under IFRS, or is an operating lease under IFRS, or is an agreement for the sale and purchase of property or services.

Current tax law: use of *Determination G29* by non-IFRS taxpayers

7. Non-IFRS taxpayers are required, under section EW 14(2) to use one of the listed spreading methods:

   (a) The YTM method or an alternative; or

   (b) The straight-line method if the value of financial arrangements is ≤ $1,850,000 and the method is used of all financial arrangements; or

   (c) A market valuation method if the person is a dealer in financial arrangements of that class; or

   (d) A Determination method or alternative if the YTM, straight-line or market valuation methods cannot be used; or

   (e) A financial reporting method or a default method essentially if a Determination does not apply.

8. Non-IFRS taxpayers who do not comply with the requirements to use the non-Determination methods listed above must use *Determination G29* without modification – i.e. without substituting the use of *Determination G9C* for *G9A*.

9. However, non-IFRS taxpayers whose gross income (including the gross income of associated persons) is less than $2,500,000 in the year in which they become a party to the ASAP may use "Method E" in *Determination G29* under which the spot rate on the payment date(s) is used to calculate the NZ$ value of both the payments and the lowest price (see paragraph 11(c) below).

Current tax treatment under *Determination G29*

10. There are two components of a foreign currency ASAP that are taxed under *Determination G29*:

    (a) *A deemed interest component* resulting from any deferral of the payment of the purchase price, based on comparing:

    (i) The lowest price (converted into NZ$) that the parties would have agreed on based on payment in full on the date on which the first rights in the property pass to the purchaser or when the services are provided ("the rights date"); and

    (ii) The actual price payable (converted into NZ$).

    (b) *A foreign exchange gain/(loss)* based on a notional FEC:

    (i) From the contract date to the rights date – "Method A" in *Determination G29*: or

    (ii) From the contract date to the settlement date – "Method B" in *Determination G29*.

11. There are three other methods also available under *Determination G29*, but only under specified circumstances:

    (a) "Method C": which uses the spot rate on the rights date to determine the value of the property in NZ$, and is available only for trading stock (other than land or shares);

    (b) "Method D": which uses the spot rate on the date the contract is entered into ("the contract date") to determine the value of the property in NZ$, and is also available only for trading stock (other than land or shares); and

    (c) "Method E": which uses the spot rate on the actual payment date(s) to convert the value of the property into NZ$ and is available only to taxpayers whose gross income (including the gross income of associated persons) is less than $2,500,000 in the year in which they become a party to the ASAP.

The lowest price

12. Under section EW 32 the lowest price can be calculated in 3 ways – which must be applied in numerical order - if the parties do not agree on a lowest price – i.e. if the ASAP does not contain a "lowest price clause":

    (a) The cash price under section 5 of the Credit Contracts and Consumer Finance Act 2003 if that Act applies; or

    (b) The future or discounted value of the payments made calculated by applying *Determination G21A: Agreements for sale and purchase of property denominated in foreign currency: discounted value of amounts payable* page 4, Tax Information Bulletin Vol 8, No 4 (September 1996); or

    (c) The value determined by the Commissioner when either party applies for a specific determination.

The deemed interest component

13. Because the ASAP is denominated in foreign currency, it is possible for a currency fluctuation element to creep into this part of the calculation as well, particularly if Method A is used, which converts the foreign currency "loan" into NZ$ using the method prescribed by *Determination G9A: Financial arrangements that are denominated in a currency or commodity other than New Zealand dollars*. Under Method A, the difference between the spot rate on the settlement date and the spot rate on the expected rights date forms part of the Income/(expenditure) on the loan.

14. Method B, on the other hand, treats the loan as if it were in NZ$ and ignores any exchange variation when calculating the deemed interest component. Only the actual deemed interest – the difference between the price actually paid and the lowest price is treated as the interest component.

15. When using Method A, IFRS taxpayers must use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*, instead of *Determination G9A*. This means that IFRS taxpayers use an expected value approach to calculate the exchange differential between the NZ$ value on the settlement date and the rights date for intervening balance dates, but the realised exchange variation becomes part of the Base Price Adjustment ("BPA") upon settlement.

The foreign exchange gain/(loss)

16. The foreign exchange gain/(loss) is calculated by comparing the NZ$ value of the lowest price at two exchange rates:
    - The lowest price at the spot rate on the rights date (Method A) or the spot rate on the settlement date (Method B); and
    - The lowest price at the forward rate on the contract date to the expected rights date (Method A) or the forward rate on the contract date to the settlement date (Method B).
17. There is no expected value approach available, so there can be significant exchange differences if the ASAP spans one or more balance dates.

Treatment of hedges

18. Any FEC hedge is treated as a separate financial arrangement and the tax treatment accorded that financial arrangement will apply.

Proposed changes for IFRS taxpayers

19. For IFRS taxpayers the IFRS GAAP treatment, except for capitalisation of interest, will be mandatory. However, in the case of non-depreciable capital assets or services, FX amounts from designated hedges cannot be capitalised. The proposed tax treatment for IFRS taxpayers can be summarized as follows (for simplicity I have just referred to assets):
    (a) The NZ$ tax value (i.e. for tax depreciation purposes) of the asset that is being bought or sold under the agreement will be the payment amount converted at the spot rate on the "recognition date" (i.e. when the asset meets IFRS GAAP recognition criteria).
    (b) Where an asset is hedged with an FEC that is a designated cashflow hedge, the NZ$ tax value of the asset will include FX gains/(losses) up to the date of recognition. [This is the usual position for trading stock where FX gains/(losses) on associated hedge FECs are included in cost of sales.] This option will only be available for assets that are tax depreciable. The Paper suggests that depreciation recovery rules may be required to cover hedging amounts included in the cost of depreciable assets. This is because "significant permanent differences" could arise when depreciable assets are sold in excess of cost and the gains are not taxable. Submissions are requested on this.
    (c) FX gains/(losses) prior to recognition of an asset, on an FEC that is a designated cashflow hedge, will be included in an equity reserve and will not form part of the entity's tax profit/(loss).
    (d) Where an asset is hedged with an FEC that is a designated fair value hedge, the NZ$ tax value of the asset will include changes in the fair value attributable to the hedged risk to the recognition date.
    (e) Post-recognition date exchange gains or losses on the asset and on an FEC that is a designated cashflow hedge will be recognised in the P&L for tax purposes; (the P&L impact of an effective fair value hedge would generally be neutral).
    (f) When performing the BPAs for FEC hedges, the amounts included as part of the cost of depreciable assets would need to be excluded from the BPA calculations.
    (g) Actual interest included in the agreement price will be included in the P&L at the effective interest rate and be taxable/(deductible).

(h) The P&L may include (taxable/deductible) imputed interest on deferred property settlements if the amount is material and the period of deferral is 12 months or more.

(i) As noted above, FX gains/(losses) up to recognition of an asset will not be able to be capitalised in the case of non-depreciable capital assets or services. All FX gains/(losses) on FECs hedging non-depreciable assets and services will be included in the BPA calculations for such FECs.

(j) The suggestion that IFRS GAAP treatment be mandatory for IFRS taxpayers means that any alternative expected value approach cannot be used. The reason given for this in the Paper is that there is a "significant fiscal risk" resulting from sale and leaseback transactions when such alternative approaches are made available. In broad terms, an expected value approach would result in an overall net nil result for tax, so would be preferred if the alternative IFRS approach gave rise to taxable income. On the other hand, if the IFRS approach resulted in a loss, that method would be preferred. Officials state that they are continuing to analyse this matter.

20. There are some simple examples of the IFRS GAAP treatment of the purchase of trading stock and a depreciable asset on pages 10 and 11 and the Appendix of the PDF version of the Paper. In both cases:

- In the case of a designated hedge, the trading stock or depreciable asset is capitalised at the forward rate.
- Where the hedge is not designated, or there is no hedge, the trading stock or depreciable asset is capitalised at the spot rate, and the FX variations are taken to the P&L. As a consequence, there is a timing difference between the recognition of the FX variations and the corresponding trading stock deduction or asset depreciation amount.

Proposed changes for non-IFRS taxpayers

21. The suggestion is that non-IFRS taxpayers aggregate the NZ$ amounts of the payments made at the spot rates at the various payment dates for valuing the goods and services under the agreements. However, there would be two exceptions:

(a) Trading stock: if the taxpayer values its trading stock by including amounts from FEC hedges, that treatment would be followed for tax.

(b) Depreciable assets: FX amounts from "qualifying hedges" would be included in the cost of depreciable assets and such amounts would not be taxed as part of FECs.

Qualifying hedges

22. Officials note that the criteria for qualifying hedges would need to be strict, as the use of such treatment may be difficult to police where the use of FECs is not restricted to hedging. The suggestions are:

- There should be robust criteria for qualifying hedges.
- Only over-the counter FECs with recognised financial institutions would qualify.
- There must be consistent use of the tax treatment for all FEC hedges of trading stock and depreciable assets during an income year and from year-to-year.
- There may be documentation and election requirements.

Imputed interest

23. As noted in paragraphs 13-15 above there is a deemed interest component in the *Determination G29* calculation. Under *Determination G21A* interest is imputed using a future value/discounted value ("FV/DV") approach. Officials are concerned that this works against the revenue base (paragraph 6.13).

24. Officials' concern is that when a foreign supplier is involved and there is a deferral of payment, the DV method could always be used to impute interest into an agreement. It is suggested that it is not appropriate that the DV method be potentially available for all agreements with a term greater than 93 days which are not for trading stock and where there is no recognition of interest in the agreement by the parties.

25. The imputed interest that is required to be recognised under IFRS using a DV approach is apparently less of a concern, as the rules are quite strict (see paragraph 19(h) above).

26. The proposals in the Paper are:

    (a) To allow the DV treatment of loans and imputed interest to the extent that it is required under IFRS GAAP for IFRS taxpayers; and

    (b) To limit the application of the FV/DV rules to non-IFRS taxpayers so that they apply only to:

        (i) Significant prepayments more than 12 months before the rights date for property that was in a substantially completed stage, or for services yet to be performed.

        (ii) Deferred payments made more than 12 months after the rights date.

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