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WEEKLY COMMENT: FRIDAY 5 DECEMBER 2014

1. This week I complete looking at the amendments to the financial arrangements rules enacted in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. Last week I looked at the new foreign ASAP rules for non-IFRS taxpayers and the valuation rules when a foreign ASAP expressly includes interest. This week I look at the valuation rules for 12-month ASAPs and non-12-month ASAPs for non-IFRS taxpayers.

2. As noted last week, the new rules apply from the 2014-15 income year. Foreign ASAPs entered into before the 2014-15 income year remain subject to the old rules. However, non-IFRS taxpayers can also apply the new rules retrospectively from the 2011-12 income year, providing their tax returns consistently reflect that treatment, as discussed last week.

3. The *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* also contains amendments to the rules allowing taxpayers to elect that short-term agreements for sale and purchase be treated as financial arrangements. These are discussed in **paragraph 21** onwards below.

Foreign ASAPs

4. As previously noted, the new rules apply only to a "**foreign ASAP",** defined in s. YA 1 as meaning a financial arrangement that is an agreement for the sale and purchase of property or services if, at the time the ASAP is entered into, 50% or more of the consideration in New Zealand dollars is in a foreign currency, measured using spot rates at that time. ASAPs that are not "foreign ASAPs" remain subject to the pre-existing rules.

Valuation for a 12-month ASAP

5. Under s. EW 32(2D), if the relevant financial arrangement is a foreign ASAP that is a **12 month ASAP**, the value of the property or services is the future value, or the discounted value, or a combination of both the future and discounted values, on the rights date, of the amounts paid or payable under the 12 month ASAP for the property or services. Foreign currency amounts are converted into New Zealand dollars using the rules in s. EW 33C and s. EW 33B may apply in relation to FX hedges if the non-IFRS taxpayer so elects, as discussed last week and re-stated in paragraphs 19-20 below.

6. A "12 month ASAP", as defined in s. YA 1:

   (a) Means an agreement for the sale and purchase of property or services (ASAP) for which an amount paid or payable for property or services is pre-paid (the **prepayment**) by reference to the rights date, and the prepayment is paid 12 months or more before the rights date, except if the prepayment is only:

(i) A payment for progress made on either making or constructing property, or providing services; or

(ii) A deposit for property or services paid within the first 3 months of the ASAP that, when aggregated with all other deposits paid within those first 3 months, totals 10% or less of the amount paid or payable for property or services; and

(b) Means an ASAP for which an amount paid or payable for property or services is delayed (the **deferment**) and the deferment is paid 12 months or more after the rights date, except if the deferment is only:

(i) An earnout amount based on business performance after the sale and purchase of property or services; or

(ii) An adjustment to the amount paid or payable for the property or service under a warranty; or

(iii) An adjustment to the amount paid or payable for the property or service on account of working capital.

7. It is stated on page 81 of *Tax Information Bulletin* Vol. 26 No. 7 August 2014 (the "TIB item") that the policy background is that significant pre-payments and delayed payments for property or services are in the nature of loans under the financial arrangements rules. Any interest component of the financial arrangement should be spread as income or expenditure for tax and not be included in the value of the property or services.

8. However, it is noted in the TIB item that prepayments are only taken into account if they are made 12 months or more before the rights date Similarly, deferments are only taken into account if they are more than 12 months after the rights date. Together with the specified exclusions for both prepayments and deferments, it is expected that these limitations should significantly restrict its application to a small number of foreign currency ASAPs of non-IFRS taxpayers and limit compliance for taxpayers. The limitations also reflect that there would not be a significant overall tax impact of prepayments or deferments within 12 months of the rights date.

9. The exclusions are meant to reflect amounts or adjustments that are commonly commercially agreed and included in ASAPs:

(a) Progress payments linked to progress on constructing property, which are not in the nature of loans;

(b) Deposits aggregating to 10% or less paid within the first three months of the contract are commonplace and are not loans;

(c) Earnout amounts are deferred due to uncertainty in the value of the business, and do not reflect any imputed interest element;

(d) Warranty adjustments can frequently take more than 12 months to determine and do not reflect imputed interest; and

(e) Working capital adjustments are commonly deferred for more than 12 months and do not include any imputed interest.

10. Property or services in a 12-month ASAP is valued at the future value, or the discounted value, or a combination of the two, on the rights date, of the amounts paid under the foreign currency ASAP. The interest component will be income or expenditure and be spread using an applicable spreading method.

11. It is noted on page 82 of the TIB item that it is intended that only pre-payments and deferred payments 12 months or more before or after the rights date will result in interest income or expenditure. So when a foreign currency ASAP also has pre-payments or deferred payments within 12 months of the rights date, they are ignored for calculating the value of the property or services and any interest income and expenditure.

12. The usual commercial principles to be employed in calculating future value or discounted value are embodied in *Determinations G21A* (discounted values for foreign currency ASAPs), *Determination G10B* (present value calculations) and *Determination G13A* (prices or yields). It is noted in the TIB item that while they do not expressly address future valuing, the principles to be applied are the same as for discounted/present valuing but in reverse.

13. Once the value of the property or services and any income or expenditure has been calculated in foreign currency, Determinations G9A or G9C may be applied as applicable to spread the income or expenditure on the deemed loans. Using Determinations G9A and G9B to spread the income or expenditure will need to meet the consistency requirements for the same or similar financial arrangements in s. EW 24. Other spreading methods in sections EW 16 to EW 22 may be applied as appropriate.

14. Foreign currency values of property or services are then converted into NZ dollars at spot rates under s. EW 33C and amounts for non-IFRS designated hedges can be included under s. EW 33B if relevant, as discussed last week and re-stated in paragraphs 19-20 below.

TIB example of future and discounted valuing of 12-month ASAP property

15. The following example of future valuing and discounted valuing of foreign ASAP property of a non-IFRS taxpayer is provided on page 84 of the TIB item.

16. The facts of the example are that a non-IFRS taxpayer agrees to buy trading stock for US$2 million for possession in 12 months' time (the rights date). The taxpayer pays US$1 million when the contract is signed 12 months before the possession date (the rights date), and US$1 million 12 months after the possession date. The payments do not fall within any of the exclusions in the definition of "12 month ASAP". The discount rate is assumed to be 4%:

    (a) The taxpayer first calculates the future value on the rights date of the US$1m paid 12 months before the rights date:

    (i) From Investopedia's future value calculator the future value of US$1 million paid 12 months before the rights date for one 12-month period at 4% per period is US$1,040,000 approximately. (www.investopedia.com/calculator/fvcal.aspx) This amount will be included in the value of the trading stock for tax.

    (ii) The taxpayer is treated as making a loan to the supplier of US$1 million from the date it is paid to the rights date. The deemed loan will earn US$40,000 interest over the 12-month period to the rights date.

    (b) The taxpayer then calculates the discounted present value on the rights date of the US$1m paid 12 months after the rights date:

    (i) From Investopedia's discounted value/present value calculator the discounted/present value of US$1 million paid 12 months after the rights date for one 12-month period at 4% per period is US$962,000 approximately. (www.investopedia.com/calculator/pvcal.aspx) This amount will be included in the value of the trading stock for tax.

(ii) The taxpayer is treated as receiving a loan for US$962,000 from the rights date to the final payment date. Interest of US$38,000 is paid on this deemed loan over that period.

(c) As the term of the foreign currency ASAP runs for 24 months it will be relevant to two or three income years. However each deemed loan only affects two income years.

(d) Spreading the income and expenditure on the deemed loans for tax may be achieved by various appropriate spreading methods:

(i) Determinations G9A or G9B (s. EW 20) could be applied to calculate how the income and expenditure is spread for each loan. They are both variants of YTM (yield to maturity) calculations (s. EW 16) for financial arrangements in foreign currency.

(ii) Section EW 17 (Straight-Line) may be applied if the total value of the taxpayer's financial arrangements is less than $1.85 million during the income year (which it would probably not be in this example).

(e) The trading stock is valued as follows:

(i) The trading stock is valued in foreign currency at US$2,002,000 approximately (US$1,040,000 + US$962,000) for tax and this will be the tax cost of the stock.

(ii) The foreign currency value will be converted to New Zealand dollars at the spot exchange rate on the rights date. If, for example, the spot exchange rate at the rights date is 0.8500, the New Zealand dollar value of the stock will be $2,355,294.

(iii) The taxpayer may hedge the US$1 million payment 12 months after the rights date and make an election under s. EW 33B(2) to include hedging amounts in the value of the trading stock. In that case, any gain or loss on the hedge will be included in the value of the trading stock which has been converted to New Zealand dollars.

(iv) For example, if there is a gain of $15,000 on the hedge, this will be included in the value of the stock to reduce the tax value of the stock to $2,340,294. The amount of the gain or loss on the hedge is not spread or included in the base price adjustment for the hedge.

Valuation of a foreign ASAP that is not a 12-month ASAP

17. New s. EW 32(2E) states that if the relevant financial arrangement is a foreign ASAP that is not a 12-month ASAP, the value of the property or services is the value expressly provided in the agreement as paid or payable for the property or services. As usual s. EW 33B may apply in relation to FX hedges (if the non-IFRS taxpayer so elects), and s. EW 33C applies to translate amounts into NZ dollars.

18. Under this rule, the value of the property or services is the amount stated, and is usually the aggregate of the amounts paid or payable for the property or services under the contract.

Application of the foreign currency conversion rules and inclusion of FX hedges

19. The foreign currency conversion rules and the inclusion of amounts relating to non-IFRS designated hedges discussed last week for non-IFRS taxpayers and foreign ASAPs that expressly include interest apply equally to the valuation rules discussed this week for foreign ASAPs that are 12-month ASAPs and to foreign ASAPs that are not 12-month ASAPs.

20. As discussed last week, adjustments for FX hedges are undertaken last – i.e. after the values of property or services has been determined under the valuation provisions and after the

foreign currency amounts determined under those valuation provisions have been converted into New Zealand dollars.

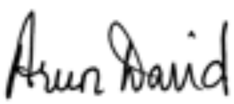
Amendments to elections to treat short-term agreements as financial arrangements

21. Section EW 8 was amended by the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013*, with effect from 27 September 2012, so that it applied only to a person carrying on a business of acquiring short-term agreements for sale and purchase for the purpose of collecting amounts owing, under the agreements, at the time of acquisition. Such a person could choose to treat all such acquired short-term agreements for sale and purchase as financial arrangements.

22. This amendment was made because the pre-existing rules apparently inadvertently allowed the acquisition price of short-term agreements to be deducted through electing into the financial arrangements rules. However limiting the ability to elect to taxpayers in the business of acquiring short-term agreements apparently went too far.

23. Section 75(2) of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* reverses that amendment and reinstates s. EW 8(1) and (2) as they were before the amendments effective from 27 September 2012. As a result, all persons who hold financial arrangements described in s. EW 5(21) to EW 5(25) may elect to treat all such arrangements, or a particular class of such arrangements identified by currency and/or the term of the agreements, as financial arrangements until 17 July 2013.

24. A further amendment in s. 75(3) of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* that applies from 17 July 2013, the date of assent of the *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013* limits the ability to elect into the financial arrangements rules to arrangements described in s. EW 5(21) to EW 5(25) for which the expenditure under the agreements satisfies the general permission for a deduction for the person and is not denied by a general limitation. This additional requirement is aimed at ensuring the acquisition price cannot be deducted by electing into the financial arrangements rules.



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