

The tax consequences of adopting international financial reporting standards

An officials' issues paper

September 2006

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And by the New Zealand Treasury*

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Key to standards abbreviations:

Financial Reporting Standards and New Zealand Equivalent International Accounting Standards referred to in this issues paper

FRS-1	Financial Reporting Standard No. 1, Disclosure of Accounting Policies
FRS-4	Financial Reporting Standard No. 4, Accounting for Inventories
FRS-13	Financial Reporting Standard No. 13, Accounting for Research and Development Activities
NZ IAS 2	New Zealand Equivalent to International Accounting Standard 2, Inventories
NZ IAS 8	New Zealand Equivalent to International Accounting Standard 8, Accounting Policies, Changes in Accounting Estimates and Errors
NZ IAS 18	New Zealand Equivalent to International Accounting Standard 18, Revenue
NZ IAS 38	New Zealand Equivalent to International Accounting Standard 38, Intangible Assets
NZ IAS 39	New Zealand Equivalent to International Accounting Standard 39, Financial Instruments: Recognition and Measurement
NZ IAS 41	New Zealand Equivalent to International Accounting Standard 41, Agriculture

Chapter 1

INTRODUCTION

- 1.1 New Zealand businesses are following the worldwide move to adopt what are known as International Financial Reporting Standards (or IFRS) for financial reporting purposes. The adoption of IFRS has been allowed from 1 January 2005, and is mandatory for financial reports for periods beginning on or after 1 January 2007.
- 1.2 The adoption of IFRS will introduce significant changes into New Zealand's financial reporting practices. Because current taxation policies are linked to some accounting practices, changes to the accounting practices brought about by IFRS need to be reviewed to ensure that tax law continues to meet the needs of modern business practice and to maintain the principles and integrity of the tax system.

Scope

- 1.3 This issues paper considers the tax policy issues that could arise from the adoption of IFRS within the context of existing policy on alignment between tax and accounting. As such, it does not propose to consider a comprehensive alignment of tax legislation with accounting standards at this time.
- 1.4 The paper examines areas where tax legislation is currently aligned with specific accounting standards or generally accepted accounting practice (or GAAP), with a view to ensuring that taxpayers can continue to use the accounting standards under IFRS for taxation purposes. Other possibilities for alignment are also considered because significant changes have been introduced in these areas under IFRS that seem relevant for taxation purposes.
- 1.5 The technical discussions in this paper relate to the trading stock rules, research and development expenditure, financial arrangements, revenue recognition, GAAP and implementation issues that could arise from possible legislative changes.
- 1.6 The paper suggests a number of changes to the relevant tax rules. After analysis of submissions on the suggested changes, we will make formal recommendations to the government on what we think the resulting legislative changes should be.
- 1.7 We expect to recommend that the changes be included in a bill to be introduced in mid-2007, with legislation likely to be enacted in late 2007. The changes would generally apply from the 2008-09 income year.

Summary of suggested changes

Trading stock

- Trading stock valuation rules should continue to be aligned with the valuation methods adopted for accounting purposes, but references to FRS-4 and FRS-1 should be amended to refer to NZ IAS 2 and NZ IAS 8, respectively.
- Primary sector taxpayers who are using NZ IAS 41 should be allowed to use the simplified cost method and market value method, designed for low turnover traders, to value their trading stock.

Research and development

- The core standards governing the accounting treatment of R&D expenditure under NZ IAS 38 are substantially the same as those under FRS-13 and should continue to be appropriate for taxation purposes.
- Minor legislative amendments will be necessary to adjust the references to FRS-13 and to remove references to paragraphs 5.4 and 2.3 of FRS-13 because those standards are no longer applicable under IFRS. However, it may be necessary to ensure that immaterial R&D expenditure that has been written off for financial reporting purposes is subjected to the appropriate standards in NZ IAS 38 before they are allowed as a deduction for taxation purposes.

Financial arrangements

- The financial arrangement rules should continue to define and govern the taxation of financial arrangements, including derivatives, for taxation purposes. Taxpayers should be able to continue to use the methods prescribed under the financial arrangement rules to calculate the income and expenditure of financial arrangements.
- Taxpayers will be allowed to use the financial reporting methods under NZ IAS 39 for taxation purposes, subject to adjustment for credit impairments unless the impairments are deductible under section DB 23.
- The tax treatment of bad debts should not be aligned with the treatment of credit impairments under NZ IAS 39. A deduction for credit impairment should be allowed for taxation purposes only if the bad debt deductibility rules in section DB 23 of the Income Tax Act 2004 are satisfied.
- The IFRS accounting treatment of fees that are an integral part of a financial arrangement is similar to that of the current taxation rules in substance. Therefore the tax treatment should be explicitly aligned in legislation with financial reporting treatment.
- Derivative instruments that are part of a cash flow hedge or a hedge of net investments in a foreign operation should continue to be taxed under the financial arrangement rules, as they are presently.
- The underlying items in a fair value hedge should continue to be taxed as if they were not part of a hedge.

Revenue recognition

- Revenue recognition for taxation purposes should continue to follow the accounting practice, which has been formalised in NZ IAS 18, although Inland Revenue should monitor the interpretation and application of the standards for taxation purposes.
- The recognition of warranty income as a separate revenue stream and the spreading of warranty income over the term of the warranty under NZ IAS 18 is an appropriate revenue recognition approach for taxation purposes.
- Legislative amendment may be required to ensure that provisions for warranty costs, which could arguably still be deductible in accordance with the principles established in *CIR v Mitsubishi Motors NZ Ltd*,¹ are not deductible at the time of sale if the revenue from warranty contract is deferred under NZ IAS 18.
- Legislative amendment will be necessary to recognise as income the amount of previously unrecognised income that has been recorded directly to the shareholders' funds during the transition year.

Generally accepted accounting practice – GAAP

- The use of “generally accepted accounting practice” in tax legislation is ambulatory in that as GAAP changes with the adoption of IFRS for financial reporting purposes, these changes will be accepted for taxation purposes. Legislative changes to deal with unexpected tax consequences arising from these provisions after the adoption of IFRS should be considered where appropriate.

Implementation dates

- The suggested legislative changes should generally apply from the 2008-09 income year, and Determination G30 should be withdrawn at the same time. Taxpayers would be able to make any adjustments required as a result of suggestions in this issues paper in the 2008-09 income year.

1.8 Submissions are sought on these suggestions and on other IFRS-related issues. Officials will consider additional legislative changes if appropriate.

How to make a submission on the suggested changes

1.9 We would appreciate receiving any comments on the suggested changes by 20 October 2006.

¹ *CIR v Mitsubishi Motors NZ Ltd* [1995] 3 NZLR 513.

1.10 Submissions should be sent to:

Tax Consequences of Adopting IFRS
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington
New Zealand

1.11 Alternatively, submissions can be made in electronic form, in which case “Tax Consequences of Adopting IFRS” should appear in the subject line. The electronic address is:

policy.webmaster@ird.govt.nz

1.12 Please note that submissions may be the subject of a request under New Zealand’s Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If there is any part of your submission that you consider could be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

ALIGNMENT OF TAX LEGISLATION AND ACCOUNTING PRACTICES

- 2.1 Although accounting and tax systems share substantial fields of interest and are intricately linked, tax legislation in New Zealand has not relied on accounting principles to calculate income and expenditure for taxation purposes generally. This approach follows largely from the recommendation of the Consultative Committee on the Taxation of Income from Capital² in that:

“... (c) the Act should provide greater statutory detail on problem areas of tax accounting without attempting to provide a complete code for the calculation of income. Essentially, the extent of statutory detail is a matter of degree, however, the Committee believes that the quantum of taxable income should be determined by Parliament as far as is practically possible;

(d) the tax system should not rely on undefined principles of commercial accountancy practice as a primary basis for the calculation of income, however such practice should be a reference point for the Commissioner and the Courts in the interpretation and application of the Act.”

- 2.2 The possible alignment of tax legislation and accounting practices was considered when detailed rules were developed for taxation purposes. To date, this alignment has occurred in a number of circumstances. Accounting standards have been explicitly incorporated into the tax legislation for trading stock and research and development expenditure. Tax legislation also relies on GAAP for revenue recognition and refers in many instances to “generally accepted accounting practice”, commercial practice or acceptable commercial practice.
- 2.3 Although New Zealand reporting practices have generally been harmonised with international accounting standards, the adoption of IFRS may be a significant change for some New Zealand businesses. In particular, the emphasis on fair value accounting for financial assets is a significant shift from the historical cost approach adopted by financial institutions for their loans. IFRS also introduces hedge accounting rules into New Zealand financial reporting practices.

² Consultation Committee on the Taxation of Income from Capital, *Tax Accounting Issues*, (Wellington, February 1991), para 1.4.

- 2.4 We think it is inappropriate to consider a comprehensive alignment of tax legislation with accounting standards at this time. Nevertheless, the paper later examines areas where tax legislation is currently aligned with specific accounting standards or generally accepted accounting practice, and considers other possibilities for alignment such as the use of fair values and hedge accounting rules.

Unintended consequences arising from IFRS

- 2.5 The adoption of IFRS may result in significant changes to the financial statement positions of the reporting firms. These changes may have flow-on consequences for taxation purposes. The areas where tax legislation and accounting practice are directly or indirectly aligned will need to be monitored to ensure that the alignment envisaged in the tax legislation continues to be appropriate under IFRS. Further legislative changes may be necessary to deal with any consequences arising from the adoption of IFRS that were not intended by the legislation.

Compliance issues

- 2.6 The adoption of IFRS means significant changes to the accounting practices of some taxpayers and may have some tax compliance implications. When taxpayers rely on accounting profits as a starting point for their tax calculation, for example, the adjustments that they will have to make to arrive at the appropriate tax calculation may be significantly different under IFRS.
- 2.7 The tax compliance implications of the adoption of IFRS are still being worked through by New Zealand businesses and tax practitioners. Appropriate administrative responses to the compliance issues in some areas will be considered by the Inland Revenue as these implications become better understood.

Chapter 3

TRADING STOCK VALUATION

- 3.1 The trading stock valuation rules for taxation purposes are aligned with the accounting treatment in FRS-4 in a number of ways. Trading stock is valued at “lower of cost or market selling value” for taxation purposes under sections EB 6 and EB 11 of the Income Tax Act 2004, in accordance with FRS-4. Under section EB 7, cost is determined on the basis of the first-in first-out cost method or the weighted average cost method, which is consistent with the methods required under FRS-4. Furthermore, when the cost method is used for taxation purposes, the taxpayer must include and allocate costs under GAAP so that the value of the trading stock is not materially different from the value obtained by applying FRS-4.
- 3.2 Discounted selling price and replacement value (see sections EB 9 and EB 10) are the other two methods of valuation allowed under the trading stock rules if these methods are also used by the taxpayer for financial reporting purposes. When a taxpayer uses the market selling value for tax purposes, some expected costs of selling can be deducted from the market selling value provided that the taxpayer also did the same when calculating net realisable value for financial reporting purposes.
- 3.3 Under the new standards, NZ IAS 2 will replace FRS-4. The two are substantially the same with regards to the basic valuation methods, so the adoption of IFRS should not affect the ability of taxpayers to use the existing valuation methods under the current taxation rules. Potential problems with the valuation of agricultural produce are considered below.
- 3.4 We suggest that trading stock valuation rules continue to be aligned with the valuation methods adopted for accounting purposes, and that references to FRS-4 be amended to refer to NZ IAS 2.

Consistency and disclosure requirement

- 3.5 Sections EB 12 and EB 22 of the Act require trading stock to be valued consistently from one period to another and to all items of a similar nature for taxation purposes. Any change in trading stock valuation method should also be disclosed. This consistency and disclosure requirement is linked to the standards that normally apply for financial reporting purposes under FRS-1.³

³ The same consistency and disclosure requirement applies to the use of cost-flow methods for excepted financial arrangements under section ED 1 for a person who complies with generally accepted accounting practice.

- 3.6 With the adoption of IFRS, reporting entities must comply with the consistency requirements in NZ IAS 8 for financial reporting purposes. It requires an entity to apply its accounting policies consistently for similar transactions, other events and conditions. However, the entity can change its accounting policy if the change is required by a “Standard” or an “Interpretation” or results in the financial statements providing reliable and more relevant information. When changes have been made, the entity is required to disclose the impact and nature of these changes.
- 3.7 The consistency and disclosure requirements under NZ IAS 8 are substantially the same as those under FRS-1. We believe that these requirements should continue to apply to trading stock valuation for taxation purposes.⁴ Legislative change will be required to replace references to NZ IAS 8 with references to FRS-1.
- 3.8 Low turnover traders who do not comply with GAAP have to meet a different consistency requirement defined in sections EB 22(2) to EB 22(4). The Act also specifies a consistency requirement for taxpayers who do not comply with GAAP, to ensure that they use a consistent cost-flow method to value their excepted financial arrangements. These requirements are not affected by the adoption of IFRS.

Agricultural produce

- 3.9 Under IFRS, taxpayers in the primary sector may be required to use the fair value method under NZ IAS 41, instead of NZ IAS 2, to value their harvested trading stock. Primary sector producers who are required to use the fair value method under NZ IAS 41 may be unable to comply with some of the existing requirements under the trading stock rules for taxation purposes.

Primary sector producers

- 3.10 For taxation purposes, the trading stock valuation rules may apply to harvested crops (that is, once the crops have been severed from land). Primary sector producers (who are not low turnover traders) can, in theory, use cost (sections EB 6 to EB 8), discounted selling price (section EB 9), replacement price (section EB 10) or market selling value (section EB 11) to value their trading stock. However, they may not be able to meet the legislative criteria in sections EB 6 to EB 11 in practice if they are required to adopt NZ IAS 41, since the standards require harvested crops to be valued at fair value for accounting purposes, while the tax rules assume that the accounting methods are primarily cost-based.

⁴ The same standard should also continue to apply to the use of cost-flow methods for excepted financial arrangements.

Primary sector producers who are low turnover traders

- 3.11 The problem is alleviated if the primary sector producers are low turnover traders. Low turnover traders have more flexibility in the methods they can use to value their trading stock for taxation purposes. In addition to the methods available in sections EB 6 to EB 11, they may, in theory, use any of the low turnover valuation methods prescribed in sections EB 15 to EB 21 or the special method for low value trading stock in section EB 23.
- 3.12 However, if low turnover traders have to comply with IFRS and use a fair value method to value their trading stock for accounting purposes, the valuation methods available under the taxation rules are cost under sections EB 16 and EB 17 or market value method in section EB 21.
- 3.13 We suggest that when primary sector taxpayers are using NZ IAS 41 for financial reporting purposes they be allowed to use sections EB 16 and EB 17 or EB 21 to value their harvested trading stock for taxation purposes.
- 3.14 The taxation treatment of livestock and unharvested crops should not change.

Summary of suggested changes

- Trading stock valuation rules should continue to be aligned with the valuation methods adopted for accounting purposes, but references to FRS-4 and FRS-1 should be amended to refer to NZ IAS 2 and NZ IAS 8, respectively.
- Primary sector taxpayers who are using NZ IAS 41 should be allowed to use the simplified cost method and market value method, designed for low turnover traders, to value their trading stock.

Chapter 4

RESEARCH AND DEVELOPMENT EXPENDITURE

- 4.1 The tax rules for research and development (R&D) expenditure under section DB 26 determine when it is deductible for taxation purposes with reference to the accounting standards in FRS-13. Tax deductions for R&D expenditure are allowed for taxation purposes if they are recognised expenses under paragraphs 5.1 or 5.2 of FRS-13, and under paragraph 5.4 of FRS-13 for capital development costs that exceed the recoverable amount. The same standards of deductibility apply, for taxation purposes, to R&D expenditure that has been written off as immaterial under FRS-13.
- 4.2 Small R&D expenditure (\$10,000 or less) is also deductible if the amount is not material for financial reporting purposes, and the taxpayer has recognised the amount as an expense for financial reporting purposes.

Implications of IFRS

- 4.3 With the adoption of IFRS, FRS-13 is superseded by NZ IAS 38, an accounting standard on intangibles which also governs the accounting treatment for R&D expenditure. NZ IAS 38 provides that expenditure on R&D is recognised as an expense when it is incurred unless the criteria for recognition of development expenditure as an intangible asset are satisfied. Although these criteria, which are listed in paragraph 57 of NZ IAS 38, are worded differently from those in paragraph 5.3 of FRS-13, the new standards are largely consistent with the old standards.
- 4.4 As the core standards governing the accounting treatment of R&D expenditure under NZ IAS 38 are substantially the same as those under FRS-13, we suggest amending the relevant legislation to clarify that the relevant standards in NZ IAS 38 will determine the tax treatment of R&D expenditure for taxation purposes.

Cost in excess of recoverable amount and immaterial amount

- 4.5 When an intangible asset arising from the development phase qualifies for recognition under NZ IAS 38 it is measured initially at cost. As such, capital development costs in excess of recoverable amounts that could be written off under paragraph 5.4 of FRS-13 are no longer available under NZ IAS 38. References to paragraph 5.4 of FRS-13 should therefore be removed from section DB 26 of the Act.

- 4.6 References to the materiality standards in paragraph 2.3 of FRS-13 also need to be removed because it is no longer applicable under NZ IAS 38. Under IFRS, the materiality standards, which are in NZ IAS 1, apply only to disclosures and presentation of items in the financial reports. However, it may be necessary to retain the existing provision in the Act without a specific reference to accounting standards, to ensure that R&D expenditure that has been written off for financial reporting purposes as immaterial is still subjected to the appropriate standards in NZ IAS 38 before it will be allowed as a deduction for taxation purposes.

Summary of suggested changes

- The core standards governing the accounting treatment of R&D expenditure under NZ IAS 38 are substantially the same as those under FRS-13 and should continue to be appropriate for taxation purposes.
- Minor legislative amendments will be necessary to adjust the references to FRS-13 and to remove references to paragraphs 5.4 and 2.3 of FRS-13 because those standards are no longer applicable under IFRS. However, it may be necessary to ensure that immaterial R&D expenditure that has been written off for financial reporting purposes is subjected to the appropriate standards in NZ IAS 38 before they are allowed as a deduction for taxation purposes.

Chapter 5

FINANCIAL ARRANGEMENTS

- 5.1 Under IFRS, the accounting treatment for financial assets and financial liabilities is governed by NZ IFRS 7, NZ IAS 32 and NZ IAS 39. These standards introduced a number of significant changes to the accounting practice in this area.

Impact of IFRS on the financial arrangement rules

- 5.2 The financial arrangement rules in Subpart EW of the Income Tax Act 2004 set out a number of spreading methods to ensure that all income and expenditure of a financial arrangement are spread over the term of the arrangement. These spreading methods are set out in section EW 14. The principles governing the operation of these spreading methods are set out in the 1997 government discussion document *The Taxation of Financial Arrangements*:

“ 1.9 When the financial arrangement is entered into, the expected cashflows (and other consideration) are used in determining what amounts of income or expenditure will be spread. Thus expected income or expenditure is spread over the term of the financial arrangement, but all income or expenditure, expected or unexpected, is taken into account on maturity or disposal. The exception to this is where a market valuation method of spreading is used, because this brings unexpected income or expenditure to account at each balance date.

1.10 The rules provide the methods by which the income and expenditure are spread over the term of the arrangement. The primary method is the yield to maturity method. Other methods are acceptable if they produce a result which is not materially different from yield to maturity, are commercially acceptable, and are used by the taxpayer in its financial reporting. Other spreading methods, including an annual market valuation, are permissible provided certain criteria are met.”

- 5.3 The primary method of spreading income and expenditure under the financial arrangement rules is the yield to maturity method. Some taxpayers are also allowed to choose the straight line method or the market valuation method.
- 5.4 Taxpayers who cannot use one of the primary methods can use a method prescribed in a determination or its alternative (section EW 20) provided the specified criteria are met. For example, accrual determinations set out an expected value approach for calculating income and expenditure of financial arrangements denominated in foreign currency and forward contracts. If a determination is not available, taxpayers can use the method they have adopted for financial reporting purposes (section EW 21). If the financial reporting method is not an option because a taxpayer does not prepare

financial accounts, the taxpayer may use a method that conforms to commercially acceptable practice (section EW 22) provided the method allocates a reasonable amount of income and expenditure to each income year over the term of the financial arrangement.

- 5.5 The financial arrangement rules should continue to govern the taxation of financial arrangements, including derivatives, for taxation purposes. Taxpayers can continue to use the methods prescribed under the financial arrangement rules to calculate income and expenditure of financial arrangements. These methods include the expected value approach prescribed in the accrual determinations for financial arrangements denominated in a foreign currency and forward contracts.

Financial reporting methods

- 5.6 With the adoption of IFRS, the financial reporting treatment of financial assets and financial liabilities is now governed entirely by NZ IAS 39. Most financial assets and financial liabilities that are within the scope of NZ IAS 39 are brought to tax under the financial arrangement rules. Although changes in the accounting practice brought about by NZ IAS 39 should not affect the tax treatment of these financial assets and liabilities in principle, compliance costs could be reduced if the methods used for accounting purposes could also be used for taxation purposes.
- 5.7 NZ IAS 39 requires gains and losses of financial assets and financial liabilities that are within the scope of the financial arrangement rules for taxation purposes to be reported using either the fair value method or the effective interest method. A derivative instrument, for example, must be measured initially and subsequently at fair value. The gains or losses resulting from fair value movements are recognised in the income statement every year.⁵ Even so, many financial assets such as loans and receivables and held-to-maturity investments and financial liabilities that are not held for trading purposes can continue to be accounted for on the basis of the effective interest method.

Consistency with the financial arrangement rules

- 5.8 The accounting methods prescribed in NZ IAS 39 are generally consistent with the principles of financial arrangement rules for taxation purposes. The effective interest method adopted under NZ IAS 39 is similar to the yield to maturity method prescribed under the financial arrangement rules.⁶ In addition, the fair value method under NZ IAS 39 is substantially the same as the market valuation method when there is an active market for the financial instrument or when there is a reliable market price.

⁵ The exceptions are available for sale financial assets and instruments in a cash flow hedge relationship when their gains and losses are recorded directly in shareholders' equity.

⁶ The effective interest method calculates and allocates the interest income and expense of a financial asset or a financial liability over the relevant period based on the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts over the life of the asset or liability to the net carrying amount of the financial asset or financial liability.

- 5.9 We suggest that when the financial reporting methods under NZ IAS 39 require taxpayers to report gains and losses of financial assets and financial liabilities in the income statement using either the fair value method or the effective interest method, they should be able to use the same method for taxation purposes. However, as discussed earlier, credit impairment adjustments required under NZ IAS 39 will be allowed for taxation purposes only if the bad debt deduction rules in section DB 23 are satisfied.
- 5.10 This suggestion should result in considerable simplification for taxpayers in the way they account for their financial assets and financial liabilities that are within the scope of both NZ IAS 39 and the financial arrangement rules in the Act.

Impairment of financial assets and bad debts

- 5.11 The accounting treatment for credit impairments of financial assets is governed by NZ IAS 39.⁷
- 5.12 Allowance must be made for credit impairments for all financial assets under NZ IAS 39 if there is objective evidence that impairment losses have been incurred. Impairments can arise from an event or a combination of events that impact on the estimated future cash flows of the financial assets. These events include significant financial difficulty on the part of the issuer or obligor, a breach of contract and other subjective assessments about when it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation. Impairments can also be claimed when there is observable information indicating a measurable decrease in the estimated future cash flows from a group of financial assets even if the decrease can not yet be identified with the individual financial assets in the group.
- 5.13 The reporting entity is required to recognise impairment losses, which can include both specific and general provisions for doubtful debts, in its income statement for financial reporting purposes. Any subsequent reversal is recognised as income in the income statement.

Tax treatment of credit impairments

- 5.14 The deductibility of bad debts for taxation purposes is entirely governed by section DB 23. General provisions for doubtful debts that have been recorded for financial reporting purposes are currently not deductible for taxation purposes. Specific provisions for bad debts are allowed as deductions for taxation purposes only if they have been written off as bad and the relevant requirements of section DB 23(2) through (5) are satisfied.

⁷ Interest revenue (including interest accrued on impaired debts) is recognised in accordance with NZ IAS 18 if it is probable that the economic benefits will flow to the entity. When uncertainty arises with respect to an amount already included in revenue, the uncollectible amount is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

- 5.15 Bad debts associated with financial arrangements are allowed if the taxpayer satisfies the provisions in section DB 23(2) or DB 23(3). Section DB 23(2) allows bad debts as deductions if they have been written off and the amount is attributable to the income of the financial arrangement. Section DB 23(3) allows bad debt deductions for amounts owing under a financial arrangement when the taxpayer is in the business of dealing in or holding the financial arrangements. These restrictions are consistent with bad debt deductibility rules in Australia.⁸

Aligning tax and accounting treatment of credit impairments

- 5.16 The process of recognising credit impairments under NZ IAS 39 is triggered by the objective evidence that credit impairments have occurred. Nevertheless, the process of determining the nature and quantum of credit impairments involves subjective judgement. Officials believe that allowing deductions for provisioning of credit impairments creates inconsistency in the tax legislation because tax legislation does not normally allow deductions for items that are in the nature of provisions.
- 5.17 A complete alignment of the tax treatment of bad debts and the accounting treatment of credit impairments under NZ IAS 39 would mean that all provisions for doubtful debts would become deductible for taxation purposes. Although NZ IAS 39 provides a more stringent approach to the provisions of bad and doubtful debts than current accounting practice does, this new approach will still carry significant revenue costs that are unacceptable to the government. We estimate that the revenue costs to the government of a complete alignment between accounting and tax treatment of credit impairments would be over \$250 million in the transition year if the complete alignment applied only to the major banks in New Zealand. The full revenue costs would be higher if the complete alignment applied more generally to all taxpayers.
- 5.18 While these revenue costs could be limited by specifying an upper limit for provisions for doubtful debt allowed as deductions for taxation purposes, we do not consider this to be a good policy design. Specifying an upper limit for allowable bad debts for taxation purposes would encourage taxpayers to take the full amount as deductions regardless of the commercial reality. The upper limit would also unduly penalise taxpayers who have actual bad debts that exceed the limit for commercial reasons.
- 5.19 We do not suggest any changes to the existing tax treatment for bad debts. An impairment of a financial asset that has been written off under NZ IAS 39 should be allowed as a deduction for taxation purposes only if the bad debt deduction rules in section DB 23 are satisfied.

⁸ Australia allows a bad debt deduction if there is a physical write-off of the debt and either the debt has been brought into account by the taxpayer as assessable income or the taxpayer is in the business of lending money.

Tax treatment of fees

- 5.20 For taxation purposes, all contingent fees paid in relation to a financial arrangement are subject to the financial arrangement rules and spread over the term of the financial arrangement. Non-contingent fees that are payable whether or not the financial arrangement proceeds are excluded from the financial arrangement rules and are brought to tax as these fees are “derived” or “incurred”.
- 5.21 For financial reporting purposes, fees that are an integral part of the effective interest rate of a financial instrument are generally treated as an adjustment to the effective interest rate. Even so, fees that are integral to a financial instrument that is measured at fair value are recognised for accounting purposes when the instrument is initially recognised.
- 5.22 Our view is that the accounting treatment of fees that are an integral part of a financial arrangement is similar in substance to the current taxation rules for contingent fees. We suggest replacing the distinction between “contingent” and “non-contingent” fees for taxation purposes with the distinction between “integral” and “non-integral”. Legislative amendment is likely to be necessary to align the tax treatment explicitly with the financial reporting treatment.
- 5.23 Other fees that are not an integral part of a financial arrangement will continue to be subject to tax in accordance with the general taxation principles of “derivation” and “incurred”. As discussed in the next chapter, fee income will almost always be brought to tax as revenue based on the accounting treatment.

Hedge accounting rules

- 5.24 A derivative instrument that has been designated as a hedge and is an effective part of a hedging relationship is subject to special hedge accounting rules under NZ IAS 39. Special accounting treatment also applies to the underlying items being hedged.
- 5.25 Under the hedge accounting rules, income and expenditure on both the hedge instrument and the hedged risks of the underlying items in a fair value hedge are recognised on an unrealised basis. For example, when a firm commitment to purchase raw materials in US dollars is the underlying hedged item of a fair value hedge, the fair value movements in the US dollar commitment are recognised as profits or losses on a fair value basis, together with the derivative instrument even though the costs of the raw material can not be recognised yet.

- 5.26 On the other hand, hedge accounting rules also allow the deferral of income or expenditure on hedge instruments that are part of the cash flow hedges and hedges of net investments until the underlying hedged risks are realised. For example, if a forward rate agreement is used to hedge a cash flow interest rate risk on a floating rate loan, the gains or losses on the forward rate agreement can be deferred until the underlying cash flow risk impacts the income statement.
- 5.27 The hedge accounting rules are intended to create a matching effect for the accounting treatment of the hedge instrument and the underlying hedged item. This is achieved for accounting purposes by accelerating the recognition of gains or losses on the hedged items in a fair value hedge and deferring the recognition of gains or losses on the “effective” component of a cash flow hedge or a hedge of net investments in a foreign operation.

Current taxation rules for items in a hedge relationship

- 5.28 Current taxation rules do not incorporate hedge accounting rules. Gains or losses on the derivative hedge instruments are reported in accordance with the financial arrangement rules in the Act. Gains or losses on the hedged items are reported in accordance with general taxation principles on income and expenditure, unless these items are within the scope of the financial arrangement rules. This means that there is no explicit matching of gains and losses arising from items in a hedge relationship. Nevertheless, a degree of matching is already possible for taxation purposes, since many items in a hedge relationship are within the scope of the financial arrangement rules.
- 5.29 Table 1 summarises the accounting and tax treatment of different types of hedge relationships. Matching will result from the application of the financial arrangement rules for examples 3, 4, 5 and 7, when the hedge instruments and the underlying hedged items are all financial arrangements under the financial arrangement rules. Matching is also possible in example 2 when a forward currency contract is used to hedge a forecast purchase of raw materials if the taxpayer elects to use Determination G 14B. Determination G 14B effectively allows the gains and losses on the forward currency contract to be deferred until the contract matures. As the financial arrangement rules already provide for methods of calculating income and expenditure that could create a matching effect for items in a hedge relationship, specific hedge accounting rules are unnecessary in these circumstances.

Table 1: Accounting and taxation treatments of different hedge relationships

Examples	Hedge Instrument ⁹	Hedged Items ¹⁰	Accounting Treatment under NZ IAS 39	Taxation Treatment
1	Derivative Instrument – forward currency contract	Firm commitment to purchase capital asset in USD ¹¹	Fair value hedge – FX risk	No matching
2	Forward currency contract	Forecast raw material needs (e.g. oil) in USD	Cash flow hedge – FX risk	Matching possible under Determination G14B
3	Currency swaps	Fixed rate FX Loans	Fair value hedge – FX risk	Matching possible within the financial arrangement rules
4	Interest rate swaps	Fixed rate domestic loans	Fair value hedge – interest rate risk	Matching possible within the financial arrangement rules
5	Interest rate swaps	Floating rate domestic loans	Cash flow hedge – interest rate risk	Matching possible within the financial arrangement rules
6	Currency futures (USD)	Investments in USD shares	Fair value hedge – FX risk	No matching
7	Currency futures (EURO)	Investments in fixed rate, held to maturity debt securities in EURO ¹²	Fair value hedge – FX risk	Matching possible within the financial arrangement rules

5.30 For taxation purposes, no matching is possible in examples 1 and 6 when a derivative instrument is used to hedge a firm commitment to make a purchase of capital asset or a portfolio of share investment. The lack of matching in these scenarios for taxation purposes exists because although the hedge instrument is within the financial arrangement rules, the taxation of the hedged item depends on whether the underlying item is on revenue or capital account. Hedge accounting rules cannot be introduced for taxation purposes unless we are also prepared to review these fundamental tax principles that govern New Zealand taxation laws.

⁹ A derivative instrument (except for written options) can be a hedge instrument if it has been designated as a hedge and is an effective part of a hedging relationship. Internal hedges do not qualify for hedge accounting treatment in the consolidated financial reports – an instrument needs to involve an external third party to be a hedge instrument. A hedge instrument can be designated partly as a hedge instrument – for example, 50% of the notional amount may be designated as a part of hedge relationship. Two or more instruments can be viewed in combination and jointly designated as the hedging instrument. In addition, a single hedge instrument can be designated as a hedge of more than one type of risk subject to designation and effectiveness requirements.

¹⁰ Hedged items can be a single (or a group of) asset(s), liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation. Groups of assets and liabilities are to be aggregated only if the individual assets or liabilities in the group share the risk exposure that is designated as being hedged. A financial asset or financial liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value provided that effectiveness can be measured.

¹¹ A non-financial asset or non-financial liability can be designated as a hedged item for foreign currency risks. If the asset is hedged for all other risks, it has to be designated in its entirety.

¹² A held to maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk. However, a held to maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

Complexity of hedge accounting rules

5.31 International experience suggests that if hedge accounting rules are adopted for taxation purposes, the guidelines governing the designation and effectiveness of hedges in NZ IAS 39 will have to be modified and incorporated into the tax legislation.¹³ These guidelines are necessary to limit the opportunities for taxpayers to abuse the hedging rules for taxation purposes. However, the rules are very complex and could increase compliance and administrative costs significantly.

Is legislative change needed?

5.32 Hedge accounting rules modify the character and timing of items in a hedge relationship. Gains and losses on derivative instruments that are part of a cash flow hedge or a hedge of net investments in a foreign operation can be deferred under the hedging rules. This treatment is inconsistent with the purpose of the existing financial arrangement taxation rules, which require expected income and expenditure on a derivative instrument to be spread over the term of the arrangement.

5.33 We consider that all derivative instruments, including those that are part of a cash flow hedge or a hedge of net investments in a foreign operation, should be brought to tax under the financial arrangement rules.

5.34 Hedge accounting rules will also allow a taxpayer to accelerate income and expenditure on the underlying hedged items that have been designated as part of a fair value hedge. Established tax principles, such as the non-taxation of capital gains and taxation timing based on realisation, will be modified to the extent that the gains and losses are arising from an item that has been designated as an underlying hedged instrument in a fair value hedge.

5.35 Our view is that it is inappropriate to modify the general taxation principles for items in a hedge relationship. The hedged items in a fair value hedge should continue to be taxed as if they are not part of a hedge.

Views sought

5.36 The hedge accounting rules are not considered to be appropriate for taxation purposes because they will change the taxation treatment for financial instruments and any items being designated as a hedged item. If hedge accounting rules were incorporated into the tax legislation, they would also likely be accompanied by a set of tax guidelines on the designation and effectiveness of hedges, which are very complex and have significant compliance and administration costs. Furthermore, there are already comprehensive financial arrangement rules that allow many items that could be in a hedge relationship to be brought to tax consistently.

¹³ To qualify for hedge accounting rules under NZ IAS 39, the hedge instrument has to be designated at the inception of the hedge, the hedge has to be assessed and determined to be actually “highly effective” on an ongoing basis, and the hedge effectiveness can be reliably measured. Furthermore, the reporting entity needs to determine the proportion and period in which to assign the derivative as a hedge instrument. For details of the guidelines, see paragraphs 71 to 84 and paragraph 88 of IAS 39.

- 5.37 Submissions are sought on specific instances where the application of general tax principles and the financial arrangement rules to a hedge relationship lacks clarity and thus adversely affect the effectiveness of a taxpayer's hedging strategy. Special rules may be considered for these special circumstances, when appropriate, to ensure that hedged relationships are not unduly distorted by the tax rules.

Summary of suggested changes

- The financial arrangement rules should continue to define and govern the taxation of financial arrangements, including derivatives, for taxation purposes. Taxpayers should be able to continue to use the methods prescribed under the financial arrangement rules to calculate the income and expenditure of financial arrangements.
- Taxpayers will be allowed to use the financial reporting methods under NZ IAS 39 for taxation purposes, subject to adjustment for credit impairments unless the impairments are deductible under section DB 23.
- The tax treatment of bad debts should not be aligned with the treatment of credit impairments under NZ IAS 39. A deduction for credit impairment should be allowed for taxation purposes only if the bad debt deductibility rules in section DB 23 of the Income Tax Act 2004 are satisfied.
- The IFRS accounting treatment of fees that are an integral part of a financial arrangement is similar to that of the current taxation rules in substance. Therefore the tax treatment should be explicitly aligned in legislation with financial reporting treatment.
- Derivative instruments that are part of a cash flow hedge or a hedge of net investments in a foreign operation should continue to be taxed under the financial arrangement rules, as they are presently.
- The underlying items in a fair value hedge should continue to be taxed as if they were not part of a hedge.

Chapter 6

REVENUE RECOGNITION

- 6.1 Current taxation rules governing the derivation of income are complex, although a number of guidelines on how and when income is derived have been established by case law. The income derivation rules in taxation are based primarily on normal accounting principles and commercial practice.
- 6.2 With the adoption of IFRS, the accounting principles on revenue recognition are formalised in NZ IAS 18. The standards provide that revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. These revenue recognition criteria are substantially similar to the principles in the New Zealand Statement of Concepts, which preceded IFRS. As such, the new standards should continue to be appropriate for taxation purposes.
- 6.3 We do not suggest introducing any legislative change to the revenue recognition principles for taxation purposes at this stage. Inland Revenue is monitoring the application and interpretation of NZ IAS 18 for taxation purposes, and further legislative changes may be considered at a later stage.
- 6.4 In general, the recognition of expenditure for taxation purposes is governed mostly by statutory provisions in the Act. As such, the adoption of IFRS is not expected to have a similar impact on the treatment of expenditure for taxation purposes.

Treatment of warranties

- 6.5 In *CIR v Mitsubishi Motors NZ Ltd*,¹⁴ the Privy Council held that “[a]s the term “profits or gains” is not defined, these words must therefore bear their ordinary meaning as understood by a businessman or accountant”, but an expenditure may be deducted only if it has been incurred. Further, estimated warranty costs were held to be deductible at the time of sale because the defects that manifested themselves within the warranty period were presumed to be present at the time of sale and are not a contingency.
- 6.6 Under NZ IAS 18, any identifiable service fees included in the price of a product must be deferred and recognised as revenue over the period during which the service is performed. The amount of revenue deferred will include the expected costs of the services and a reasonable profit on those services.
- 6.7 As such, any fees and profits associated with a warranty contract provided together with a sale must be recognised over the term of the warranty. This new method of recognising warranty income is broadly consistent with the approach taken by the Court of Appeal in *Mitsubishi Motors New Zealand Limited* (1994) 16 NZTC 11,099.

¹⁴ *CIR v Mitsubishi Motors NZ Ltd* [1995] 3 NZLR 513.

- 6.8 We see the recognition of warranty income as a separate revenue stream and the spreading of warranty income over the term of the warranty contract under NZ IAS 18 to be an appropriate approach for taxation purposes.
- 6.9 The adoption of NZ IAS 18 appears to have modified the principles of revenue recognition that underpin *CIR v Mitsubishi Motors NZ Ltd*. In *CIR v Mitsubishi Motors NZ Ltd*, the Court held that provisions for warranty costs should be deductible for taxation purposes at the time of sale on the presumption that warranty revenue had been recognised. As NZ IAS 18 requires the deferral of warranty income, and if this approach is accepted for taxation purposes, then provisions for warranty costs should not be deductible at the time of sale.
- 6.10 Legislative amendment may be required to ensure that provisions for warranty costs, which could arguably still be deductible in accordance with the principles established in *CIR v Mitsubishi Motors NZ Ltd*, are not deductible at the time of sale if the recognition of revenue from warranty contract is deferred under NZ IAS 18.

Revenue recognition during transition to IFRS

- 6.11 Financial reporting entities are required to restate their financial statements in the year of transition from the old accounting standards to IFRS. For example, a company that moves to IFRS for its 2008 year will have to prepare the 2008 financial statements using IFRS and restate the 2007 financial statements. The “change” from old to new accounting standards is dealt with by way of adjustments directly to shareholders’ funds.
- 6.12 If a stream of income had been recognised under the old accounting practice in 2007 but IFRS requires that income to be recognised in 2008, the income which would have been reported in 2007 and subjected to tax then could be reported again in 2008 as an adjustment in the year of transition. This income should not be subject to tax again in 2008, and section BD 3(6) of the core provisions of the Income Tax Act 2004 ensures that does not occur.
- 6.13 The opposite problem could also happen during the transition year. If an income stream that would have been recognised in 2008 under the old accounting practice is now recognised in 2007 under IFRS, the income stream is simply not recognised as income by the company in either 2007 or 2008. This amount will be recorded directly in the shareholders’ funds as part of the transitional adjustment. This income should be taxable in the year of the transition.
- 6.14 Even though the revenue recognition for taxation purposes continues to follow the accounting approach generally, legislative amendments will be necessary to recognise as income the amount of previously unrecognised income recorded directly in the shareholders’ funds as part of the transition year.

Summary of suggested changes

- Revenue recognition for taxation purposes should continue to follow the accounting practice, which has been formalised in NZ IAS 18, although Inland Revenue should monitor the interpretation and application of the standards for taxation purposes.
- The recognition of warranty income as a separate revenue stream and the spreading of warranty income over the term of the warranty under NZ IAS 18 is an appropriate revenue recognition approach for taxation purposes.
- Legislative amendment may be required to ensure that provisions for warranty costs, which could arguably still be deductible in accordance with the principles established in *CIR v Mitsubishi Motors NZ Ltd*,¹⁵ are not deductible at the time of sale if the revenue from warranty contract is deferred under NZ IAS 18.
- Legislative amendment will be necessary to recognise as income the amount of previously unrecognised income that has been recorded directly to the shareholders' funds as part of the transition year.

¹⁵ *CIR v Mitsubishi Motors NZ Ltd* [1995] 3 NZLR 513.

Chapter 7

GENERALLY ACCEPTED ACCOUNTING PRACTICE – GAAP

- 7.1 The Income Tax Act 2004 uses “generally accepted accounting practice” (GAAP) repeatedly. It is defined in section OB 1 as the definition in section 3 of the Financial Reporting Act 1993.¹⁶ This definition has not changed as a result of IFRS, so it does not need to be amended.
- 7.2 What constitutes GAAP, however, will change as a result of the adoption of IFRS. For example, internally generated goodwill will no longer be recognised, thereby reducing reported total assets. On the other hand, IFRS requires the recognition of derivative assets and liabilities at their fair values and deferred tax assets/liabilities that were previously not recognised. It is therefore likely that IFRS will have a mixed impact on the balance sheet items.
- 7.3 In our view, the changes brought about by IFRS should automatically be incorporated into the tax legislation where the concept of GAAP is relied upon. In these circumstances, the use of GAAP in the tax legislation is ambulatory – meaning that its definition in tax law will change in accordance with changes in GAAP’s constituent parts. Therefore no changes to tax legislation are suggested.

The use of GAAP in tax legislation and IFRS

- 7.4 A number of tax consequences may arise as a result of IFRS because financial items reported for financial reporting purposes under GAAP are used in tax legislation.
- 7.5 An example of tax consequences that could arise from the adoption of IFRS is in the application of thin capitalisation rules.¹⁷ Thin capitalisation rules limit interest deductions that some taxpayers can claim for taxation purposes if their debt level exceeds a certain level. The maximum amount of allowable debt under these thin capitalisation rules is determined with reference to an asset base calculated under GAAP. As such, the adoption of IFRS is likely to affect the maximum amount of interest that will be allowed for these entities.

¹⁶ Financial statements and group financial statements comply with GAAP only if they comply with applicable financial reporting standards, and in relation to matters for which no provision is made in applicable financial reporting standards and that are not subject to any applicable rule of law, accounting policies that (i) are appropriate to the circumstances of the reporting entity; and (ii) have authoritative support within the accounting profession in New Zealand.

¹⁷ Different thin capitalisation rules apply to foreign controlled entities in general, New Zealand banking groups and conduit relief companies. The concept of “generally accepted accounting practice” is used in these rules in various ways to determine the maximum allowable debt or minimum capital requirement (for New Zealand banking groups).

7.6 Other areas where GAAP has been used in the tax legislation include the following:

- The calculation of deemed underlying foreign tax credits and underlying foreign tax credits rely on a tracking account balance and after-income tax earnings that are calculated on the basis of GAAP.
- Section CB 27 recognises an excess amount paid when assuming employment income obligations under a sale of business in line with GAAP.
- The deferred deduction rule in section GC 29 requires the total deductions, assessable income and cost of property of a group of persons that may be involved in arrangements where money is not at risk to be calculated on a consolidated basis by eliminating intra-group balances in accordance with GAAP.
- Taxpayers may use the accounting profits method to calculate their foreign investment fund income under section EX 40 if the net after-tax accounting profits or losses of the fund are calculated under GAAP.
- When private insurers maintain reserves for claims relating to events covered by the Accident Insurance Act 1998, section EZ 27 recognises the difference between the closing value and opening value of the reserve as income or deduction, provided that the reserve is calculated having regard to GAAP, generally accepted actuarial practice and the present value of expected future payments.
- Section CD 41 requires the un-repatriated income balance, calculated using total shareholders' funds in accordance with GAAP, of a controlled foreign company to be non-negative.
- "Controlled petroleum mining company", "controlled petroleum mining holding company", "controlled petroleum mining trust" and "controlled petroleum mining holding trust" are all defined in section OB 1 using net assets as specified in the entities' account prepared under GAAP.
- Sections DP 10 and DB 22 allow certain costs of timber and specified minerals to be deducted when the amount is treated as a cost by the taxpayer under GAAP for financial reporting purposes.

7.7 No legislative changes to these areas appear to be necessary because of the ambulatory nature of the use of GAAP in tax legislation. Even so, submissions are invited from taxpayers on specific areas where the adoption of IFRS may create unexpected tax consequences. Legislative changes to deal with these consequences may then be considered.

Chapter 8

EFFECTS OF SUGGESTED IMPLEMENTATION DATE

- 8.1 We have suggested that possible legislative changes discussed in this paper should generally apply from the 2008-09 income year, given that amending legislation is unlikely to be introduced until the middle of 2007, and unlikely to be enacted until late 2007. Determination G30, which was issued as a transitional measure to deal with the tax consequences of IFRS, will be withdrawn at the same time.
- 8.2 This general application date may not be suitable for some changes because taxpayers who are early adopters of IFRS (whose earliest IFRS balance date could be 31 December 2005) may have filed their tax returns by then. In that case, they could make any required adjustments – such as recognising previously unrecognised income recorded directly in the shareholders' funds during the transition year – in the 2008-09 income year.
- 8.3 Taxpayers may also have adopted a specific interpretation of the existing tax legislation that may not be consistent with officials' interpretation or the suggestions contained in this issues paper. Transitional arrangements will be considered for taxpayers in this position.
- 8.4 Submissions are sought on areas where earlier application of the changes suggested in this issues paper may be helpful or where transitional arrangements may be required.

Summary of suggested changes

The suggested legislative changes should generally apply from the 2008-09 income year, and Determination G30 should be withdrawn at the same time. Taxpayers would be able to make any adjustments required as a result of suggestions in this issues paper in the 2008-09 income year.