

Financial arrangements – the sale and purchase of property or services

An officials' issues paper

July 2012

Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury

First published in July 2012 by the Policy Advice Division of the Inland Revenue Department, PO Box 2198, Wellington 6140.

Financial arrangements – the sale and purchase of property or services – an officials’ issues paper.
ISBN 978-0-478-27199-7

CONTENTS

CHAPTER 1	Introduction	1
	Problem and suggested solutions	1
	Submissions	2
CHAPTER 2	The current tax treatment	3
CHAPTER 3	IFRS GAAP treatment	6
	Hedging FECs – IFRS GAAP treatment	7
	Criteria for IFRS GAAP hedge accounting	8
	IFRS GAAP interest amounts	9
	Trading stock	9
	Summary of IFRS GAAP accounting	9
CHAPTER 4	Policy discussion of FX component	12
	Policy rationale and history of current rules	12
	Discussion of the tax approach of the FX component	13
	Agreements for commodities or assets substituted for money	15
CHAPTER 5	Alternative treatments for the FX component	16
	Discussing the alternatives	16
	Summary of any IFRS GAAP tax treatment of foreign currency agreements for the sale and purchase of property or services and associated FEC hedges	18
	Other matters related to the suggested alternatives	19
CHAPTER 6	Default future value and discounted value interest calculations	23
	Policy rationale and history of the current law	23
APPENDIX		28

CHAPTER 1

Introduction

- 1.1 Over the past few years some taxpayers and their advisers have raised concerns over the complexity of the rules governing agreements for the sale and purchase of property or services (referred to in this paper as “the agreement/s” or “these agreements”), especially when they are in a foreign currency. Further, there can be considerable volatility caused by some of the methods mandated for these agreements in Determination G29 that some taxpayers would regard as inappropriate. We accept that these concerns are valid.
- 1.2 Current tax law requires these agreements when they are in foreign currency to be considered as two separate components. The first component is taxed as a forward contract for foreign exchange (FEC) from the date the agreement is entered into until the date the first rights in the goods pass or the services are performed (the rights date).
- 1.3 It is this first component that is mainly causing concern.
- 1.4 The second component, if it exists, is an interest-bearing loan. These loans can result from both prepayments and deferred payments made under these agreements. The proposals in this paper about this component apply to agreements in New Zealand currency as well as foreign currencies.
- 1.5 This paper briefly outlines the policy settings for the current law and suggests some pragmatic changes to the rules which we consider should remedy these difficulties without introducing inappropriate tax-base effects. The paper is of necessity technical and presumes that readers are familiar with the relevant tax legislation and determinations.

Problem and suggested solutions

- 1.6 Our preferred solutions are:
 - IFRS GAAP treatment would be mandatory for taxation purposes for IFRS taxpayers. This includes the treatment of any designated hedge, any interest involved, the tax book value of the resultant “underlying” item and the “rights” date. This proposed IFRS GAAP treatment does not extend to any capitalisation of interest into the cost of the underlying item.
 - For non-IFRS taxpayers, the general rule to value the property or services would be the aggregate of the NZ\$ amounts using actual spot rates at payment dates. There would be three exceptions:
 - for trading stock and consumables, FX amounts from hedges would be included in the value of the stock where they are included in the stock values in the taxpayer’s stock system;

- for depreciable property, FX amounts from qualifying hedges would be included in the value of the property; and
 - interest would only be imputed into the agreements on a future value or discounted value basis in limited circumstances.
- 1.7 We suggest that the new rules be made effective for the 2011–12 income year for those taxpayers who wish to apply them to new agreements in that year. Otherwise taxpayers will apply the new rules to new agreements from the 2012–13 income year. The choice of application date will apply to all new agreements from the relevant income year.
- 1.8 We also suggest that the tax treatment for any existing agreements and associated hedges for past years where the methods used are either current or the proposed new alternatives be retrospectively validated. Existing agreements would continue to use those methods until they mature – that is, they will not be allowed to change to another current or new alternative method.
- 1.9 It is proposed that these agreements be dealt with by the rules included in primary legislation from the time the proposed amendments are made. Following consultation, any changes to the rules will be included in a future tax bill.
- 1.10 These proposals are detailed in the following chapters.

Submissions

- 1.11 Submissions on this paper should be made by 17 August 2012 and can be addressed to:
- Financial arrangements
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington 6140
- Or email: policy.webmaster@ird.govt.nz with “Financial arrangements” in the subject line.
- 1.12 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

The current tax treatment

2.1 The taxation of agreements for the sale and purchase of property and services can be summarised as follows:

- The property or services included in the agreement are valued and the difference (if any) between that value and the amounts paid for the property or services are treated as interest to be spread under the accrual rules.
- The value of the property or services can be calculated a number of ways: the lowest price that would have been agreed at the contract date for payment in full at the first rights date (usually to possession or income) or when the services are provided; the cash price as per the Credit Contracts and Consumer Finance Act 2003 if it applies; the future or discounted value of the payments made; or by a determination made by the Commissioner.
- Where the lowest price is expressed in foreign currency, there are a number of exchange rates available which can be used to convert the lowest price to New Zealand currency.
- Determination G29 sets out the exchange rates and spreading methods to be used for foreign currency agreements for the sale and purchase of property or services.
- Methods A and B in Determination G29 are available for general use and use the forward rate from the contract date to the rights date or final payment date to convert the value of the lowest price in foreign currency to New Zealand currency. The changes in that value due to FX variations until the rights date or final payment date are taxable. The end result for the lowest price is equivalent to the tax treatment of a FEC.
- Methods C and D use spot rates at different times and are only available for agreements for trading stock. Method E also uses a spot rate and is available for taxpayers whose gross income does not exceed \$2.5 million.
- The underlying property or services in the agreement are valued at the lowest price for the other provisions of the Income Tax Act 2007 – for example, capitalisation/depreciation of fixed assets, trading stock, sales revenue and revenue account property.
- Any FEC used to hedge the cashflows associated with the property or services in an agreement is a separate financial arrangement and dealt with separately under the accrual rules.

- 2.2 Over the past few years some taxpayers and their advisers have raised concerns about the current tax rules for these agreements. These concerns are primarily about the use of Methods A and B in Determination G29 which are difficult to comply with and cause considerable volatility. Some taxpayers have made submissions suggesting alternative methods to the current tax treatment.
- 2.3 We accept that there are difficulties in applying the legislation for these agreements.
- 2.4 When agreements are not fully hedged, the use of Methods A and B in Determination G29 can provide very volatile unrealised FX gains and losses for tax at intervening balance dates, as well as recognising items for tax at values which do not represent the cash paid/received under the agreement.
- 2.5 For example, take the purchase of an asset for US\$100 for delivery and payment in full in 12 months' time which is not hedged with a FEC. Under Determination G29 (Methods A or B), the forward rate from the date the agreement is entered into up to the delivery/payment date is used to measure the value of the asset and any FX gain or loss on the agreement. The forward rate is 0.70 and the spot rate at the date of delivery/payment is 0.80. The asset will be capitalised and depreciated at NZ\$143 (US\$100@0.70) for tax and the cash paid for the asset is NZ\$125 (US\$100@0.80). The difference of NZ\$18 is taxed as a FX gain on the agreement and is progressively taxed on an unrealised basis when the agreement spans income years.
- 2.6 Some taxpayers have submitted that, at the least, an expected value approach should be allowed for the FX gains and losses, to reduce volatility caused by taxation of the unrealised FX gains/losses in income years prior to maturity of the agreement.
- 2.7 Because of the compliance problems, we understand that some taxpayers are attempting to comply with the current rules in alternative ways which give results which approximate the Determination G29 calculations. For example, when payments under an agreement are hedged with FECs, they are returning a corresponding gain/loss on the agreement as is returned on the FECs without necessarily doing the full Determination G29 calculations.
- 2.8 When alternative compliance techniques are being used there is continuing uncertainty for taxpayers and the potential for disputes. It is good policy to address this situation by providing alternative methods that are easy to comply with.
- 2.9 We are not aware of any significant difficulties with the use of Methods C, D and E in Determination G29. Methods C and D can be used for appropriate agreements for trading stock irrespective of the use of Methods A and B for agreements for other items. Method E is available for use for agreements for any items, provided the taxpayer's income does not exceed \$2.5 million.

- 2.10 Determination G29 does not currently apply to agreements for services. The changes proposed in this paper should probably be extended to services in an appropriate manner. It is also noted that section EW 35 of the Income Tax Act 2007 does not include services and this appears to be an oversight which should be corrected to be consistent with section EW 32.

CHAPTER 3

IFRS GAAP treatment

- 3.1 The basic IFRS GAAP treatment of an agreement is to record the property or services at the spot exchange rate on the dates that the transactions first qualify for recognition. These dates may coincide with the dates of payments but often do not.
- 3.2 The rules for the IFRS GAAP recognition of the goods or services in an agreement are generally as follows:
- Assets – when it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably.
 - Liabilities – when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
 - Income – when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.
 - Expenses – when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets.
- 3.3 Where the payment dates do not coincide with the relevant items' recognition dates there will often be FX gains/losses recognised in the profit and loss account. The FX gains/losses are calculated as the difference between the spot exchange rates on the recognition dates and the payment dates.
- 3.4 When prepayments, deposits or instalment payments (collectively called prepayments in this paper) are paid/received there can be two treatments. They can be recognised as monetary items at the spot values on the payment dates. They are revalued to spot rates at subsequent reporting dates until the assets/liabilities/revenue items are recognised, with the revaluation gains/losses going to the profit and loss account. The prepayments are included in the value of the relevant items at the spot rates on the dates the items are recognised.
- 3.5 However, in practice we understand that most of these payments are treated as non-monetary items at historic cost. They are recognised in the items' values at the spot rates on the prepayments dates – that is, with no subsequent revaluation to spot rates after the dates of the prepayments and no revaluation gains/losses going to the profit and loss account.

Hedging FECs – IFRS GAAP treatment

Designated cashflow hedges

- 3.6 When agreements are hedged with FECs which are designated as cashflow hedges for accounting, FX gains/losses on the FECs up to the date of recognition of the hedged items are included in the amounts recorded for those items. These FX gains/losses on the FECs may have been included in an equity reserve (cashflow hedge reserve) prior to the relevant hedged item being recognised. FX gains/losses on the FECs from the recognition date of the items through to the settlement of the FECs are required to be included in the profit and loss account, along with the FX gains/losses for the spot rates mentioned in para 3.3 above.
- 3.7 When prepayments (both monetary and non-monetary items) are hedged with FECs designated as cashflow hedges, any FX gains/losses on the FECs are included in the values of the prepayments recognised on the balance sheet. The prepayment amounts (revalued to spot rates for monetary items) and the final payment amount (spot or hedged rates) are aggregated and recognised as the IFRS GAAP value of the item (and capitalised if they are a fixed asset).
- 3.8 The IFRS GAAP recognised values for items that are the subject of these agreements can therefore be a mixture of payments made at spot rates and associated hedging gains/losses up to the recognition dates. They will almost never be the same amounts that are used as the cost (lowest price) for tax purposes for Methods A and B of Determination G29.

Designated fair value hedges

- 3.9 We understand that these agreements are rarely hedged with FECs that are designated as fair value hedges. Where FECs are designated as fair value hedges of these agreements, the gain or loss on the FEC goes to the profit and loss account. The gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognised in profit and loss.
- 3.10 The overall result is that the recognised amount of the hedged item includes gains/losses on the hedged items attributable to the hedged risk – that is, it will be capitalised at the hedged rate to the extent it is hedged. The profit or loss account will include gains and losses on both the FEC and the agreement and will be neutral to the extent that the designated hedge is effective.
- 3.11 As with designated cashflow hedges, the IFRS GAAP recognised values for items subject to these agreements can be a mixture of spot rates and associated hedging gains/losses.

Rolled hedges

- 3.12 We understand that IFRS GAAP hedging rules allow for hedges to be rolled¹ when payment dates in these agreements are changed. The FX gains/losses on the FECs at the point they are rolled will be retained in the cashflow hedge reserve for designated cashflow hedges and be included in the recognised amount for the hedged item as described above, along with gains/losses on the replacement FEC. Designated fair value FEC hedges which are rolled will be treated similarly and dealt with as described above for designated fair value hedges. Undesignated hedges which are rolled are fair valued at all times through the profit and loss account (including the gain/loss at the point they are rolled) so these are effectively treated as a realisation for accounting purposes.

Criteria for IFRS GAAP hedge accounting

- 3.13 GAAP hedge accounting starts when an item (usually a financial arrangement) is designated as a hedge of another item under GAAP hedging criteria. The hedging criteria are quite strict about what can be designated as a hedge, and designation can only occur on a prospective basis. For FECs, any unrealised FX gains/losses prior to a FEC being designated as a hedge are taken to the profit and loss account and will not be included in amounts subsequently recognised for the hedged item. If a hedge (say FEC) is de-designated as a hedge before it matures, unrealised gains/losses on the hedge for the period it is designated as a hedge are included in the value of the hedged item. Gains/losses on the hedge subsequent to de-designation are included in the profit and loss account and do not affect the value of the hedged item.
- 3.14 GAAP hedge accounting for these agreements will probably be cashflow hedging and not fair value hedging. However, the result under both types of hedging for the value of the hedged item and amounts in the profit and loss account is likely to be the same.
- 3.15 Some taxpayers may not take out specific hedges for these agreements because they consider that they are economically hedged in other ways. For example, by projected sales in the relevant foreign currency over the periods of the agreements. They will account for both the sales and the assets resulting from the agreements at spot exchange rates on the dates they settle.
- 3.16 However, both economically and in cash terms, the taxpayer has effectively fully offset any foreign exchange exposure on the agreements with the receipt of the foreign sales.

¹ The FEC is extended beyond its original maturity and any FX gain or loss on the existing FEC at the point it is extended is included in the extended FEC and will be realised at the new maturity date.

IFRS GAAP interest amounts

- 3.17 IFRS GAAP will capture any actual interest in the agreement price by including it in the profit and loss account at the effective interest rate. This approach is used generally for financial arrangements in IFRS GAAP and is acceptable under the IFRS financial reporting method for tax.
- 3.18 IFRS GAAP may impute interest into deferred property settlements based on the fair value of the consideration received or receivable. It would not usually require the imputation of interest if the amount was immaterial or the period of deferral was less than 12 months.

Trading stock

- 3.19 In some situations (not mass produced/high volume inventory) the GAAP costs in the valuation of trading stock include interest and other costs (such as derivatives hedging amounts) which are considered to be part of the interest costs.
- 3.20 NZ IAS 39 (para 98) allows foreign exchange hedging gains/losses previously recognised in other comprehensive income to be included in the cost of the relevant non-financial asset. This has been a common accounting treatment for many taxpayers both pre- and post-IFRS GAAP. The result is recognition of trading stock at a cost using the FEC hedged exchange rate.

Summary of IFRS GAAP accounting

- 3.21 The following is a high level summary of present IFRS GAAP accounting:
- IFRS GAAP generally accounts for these agreements at the spot rate when the underlying item is first recognised.
 - Where hedging is involved, FX fluctuations on the hedging instrument for the period of the hedge will be included in the IFRS GAAP values recognised for the underlying item. FX variations on the items included in the agreements and any hedging instruments after the recognition of the underlying item generally go through the profit and loss account.
 - IFRS GAAP designated hedging criteria are reasonably strict and designated hedging can only be done on a prospective basis.
 - IFRS GAAP will capture any actual and imputed interest for the agreement by including it in the profit and loss account.
 - Trading stock – both IFRS and pre-IFRS GAAP allow FX gains/losses on associated hedging FECs to be included in the cost of trading stock.

Examples of the IFRS GAAP tax treatment of goods included in foreign currency agreements for the sale and purchase of property or services

Example 1: Purchase of trading stock

This example is based on the following assumptions:

The trading stock is purchased within one accounting/income year and is either on hand or not on hand at year-end.

The US\$ spot rate at settlement is 0.80 and the forward rate to settlement from the contract date is 0.70.

The cost of the stock is US\$100.

A FEC is taken out which is a full hedge of the cost of stock.

The IFRS GAAP results are set out for three situations: the hedges are designated as cashflow hedges, the hedges are not designated, and there are no hedges at all.

Year of purchase	Stock on hand year-end			Stock not on hand year-end		
	Designated hedge	Not designated	No hedge	Designated hedge	Not designated	No hedge
Opening stock (say)	0	0	0	0	0	0
Purchases (US\$100 @ 0.70/0.80)	-143 *	-125	-125	-143 *	-125	-125
Less: Closing stock	143 *	125	125	0	0	0
Cost of goods sold	0 *	0	0	-143 *	-125	-125
Sales	0	0	0	200	200	200
COGS	0	0	0	-143 *	-125	-125
FEC gain/loss	0	-18	0	0	-18	0
Gross profit/taxable income	0	-18	0	57	57	75

*(the designated hedge column effectively includes \$18 debit for a FX loss on the hedge in the purchase/value of stock)

Following year (where relevant)

Sales	200	200	200	0	0	0
COGS	-143*	-125	-125	0	0	0
Gross profit/taxable income	57	75	75	0	0	0
Gross profit/taxable income both years	57	57	75	57	57	75

The trading stock is valued at the forward rate in the designated hedge situation and that value will be included in the cost of goods sold in the relevant year when the goods are sold. Where the hedge is undesignated, a timing difference occurs for the \$18 between the two years when the stock is on hand at the end of the first year.

Example 2: Purchase of a depreciable asset

This is a summary of the detailed example set out in the Appendix. The example is based on the following assumptions:

The purchase of a depreciable asset for US\$100 in 12 months, which is the IFRS GAAP recognition date/tax rights date.

The payments are – US\$50 in 6 months (payment A, a non-monetary item for IFRS GAAP), and US\$50 at the recognition/rights date in 12 months (payment B).

Both payments are hedged from the beginning with FECs designated as cashflow hedges.

The forward rate for payment A is 0.72 and the forward rate for payment B is 0.65.

The spot rate for payment A is 0.65 and the spot rate for payment B is 0.80.

The IFRS GAAP results are set out for three situations: the hedges are designated as cashflow hedges, the hedges are not designated, and there are no hedges at all.

	Designated	Not designated	No hedges
Summary of IFRS GAAP entries			
Asset	146 DR	139 DR	139 DR
Cash	146 CR	146 CR	139 CR
P&L	0	7 DR	0

The asset is capitalised at the forward rates via the FECs (in the designated hedge case) or the spot rates (in the other two cases). Where the hedges are not designated there is a difference between the amount capitalised and the cash paid which is reflected in the profit and loss account. This impact will be spread over the term of the agreement depending on the durations of the FECs hedging the payments. The full example in the Appendix includes a balance date 3 months before payment B/the recognition date to demonstrate the effect of cashflow hedging at that point.

CHAPTER 4

Policy discussion of FX component

- 4.1 Current law requires foreign currency agreements for the sale and purchase of property or services to be effectively taxed as two separate components.
- 4.2 The first component is taxed as a FEC from the date the agreement is entered into until the date the first rights in the goods pass, or the services are performed (the rights date), or the final payment is made. However there is no expected value approach available for these agreements as there is for FECs (as outlined in Determination G14B). As a consequence, the FX component is taxed under Methods A and B of Determination G29 on unrealised gains/losses each year. This can result in volatile taxable income over the term of the agreement.
- 4.3 Another effect of the FX component tax treatment is that the property or services included in agreements are also taxed, based on values using forward rates. For example, a fixed asset being purchased with an agreement is capitalised and depreciated based on the forward rate, irrespective of whether the agreement is hedged with a separate FEC.

Policy rationale and history of current rules

- 4.4 The background to the current rules is summarised in the statement in the *Tax Information Bulletin*, Vol 7, No 9 (February 1996).

A deferred settlement FX ASAP is the economic equivalent of an ASAP denominated in New Zealand dollars plus two separate financial arrangements:

- A FEC, in which one party agrees to exchange a foreign currency for New Zealand dollars at a future time. This is for the period between the date of entering into the FX ASAP and date of delivery of the property.
- A foreign currency denominated loan for the period between the date of delivery of the property and payment.

Therefore, the tax treatment of a FX ASAP should, as far as practical, be consistent with the tax treatment of these other financial arrangements.

FX component

- 4.5 The policy outcome described above was influenced by the court decision in the *Dewavrin*² case. One of its findings was that the changing New Zealand currency value of the property in an agreement should be spread over the term of the contract.

² *CIR v Dewavrin Segard (NZ) Ltd* (1994) 16NZTC 11,048; (1994) 18 TRNZ509 (CA).

- 4.6 Following this case, the policy for the FX component focussed on the appropriate method to value the property or services in an agreement and how to tax the FX component under the accrual rules.
- 4.7 It was considered that the spot rate at the rights date accorded with legal precedence, economic theory and commercial practice. At the start of the contract the spot rate on the (future) rights date is not known so the forward rate from the contract date to the rights date was used as the best estimate. The forward rate is consequently used to establish the tax cost/value of the property/services included in the agreement and the amount of any notional loan from the rights date to the settlement date.
- 4.8 It was also concluded that the FX component was the same in principle as a usual FEC and should be taxed the same way. At that time the taxation of FECs under the accrual rules was essentially on a market/fair value approach and there was no expected value approach available.

Discussion of the tax approach of the FX component

- 4.9 We have considered two aspects of this approach. The first is that there is no expected value method available for spreading the FX gains/losses on the agreements. An expected value method would allow volatility to be removed until any FX gain/loss is realised. FECs have an expected value method applied to them (according to Determination G14B).
- 4.10 The second aspect is treating the FX component of these agreements as a usual FEC.
- 4.11 The Determination G29 tax treatment under methods A and B can be demonstrated by the following simplified examples:
- Assumptions:
 - For simplicity there is no agreed/real interest in the purchase price agreed for the property. Therefore there is no loan to be dealt with under some of the provisions in Determination G29.
 - The possession/rights date for the property is the same as the payment date, again for the sake of simplicity.
 - A foreign currency agreement for the sale and purchase of property or services is to purchase an asset for US\$100 in 12 months. The forward rate at the beginning is 0.70 and the spot rate at delivery is 0.80. The taxpayer does not hedge the purchase with a separate FEC.

- The tax result is:

Capitalise asset at the forward rate (US\$100 @ 0.70)	= DR Asset NZ\$143
Pay cash at spot rate = US\$100 @ 0.80	= CR Cash NZ\$125
Recognise a one-off FX gain	= CR Income NZ\$18

4.12 The asset is then depreciated based on the NZ\$143 with a one-off taxable gain of NZ\$18 on the agreement at maturity per the base price adjustment (BPA) = all consideration received/paid = consideration received being the value of the asset at the forward rate (NZ\$143) and consideration paid being the cash at the spot rate (NZ\$125). The BPA result could go either way based on the spot rate at delivery compared with the forward rate at the beginning.

4.13 Any separate hedging FEC will be dealt with in its own right and does not affect the taxation of the agreement under Determination G29 (see further comments below about hedging).

4.14 A usual FEC is taxed as follows, assuming the same facts as above, except that the item being purchased is US\$100 cash at the forward rate of 0.70:

Pay cash at the forward rate = US\$100 @ 0.70	= CR Cash NZ\$143
Bank US\$ at spot rate = USD @ 0.80	= DR Cash NZ\$125
Recognise one-off FX loss on FX contract	= DR Income NZ\$18

4.15 The recognition of the one-off loss for the FEC is based on the value of the US\$100 being only NZ\$125 at the spot rate at maturity compared with the purchase price of NZ\$143. In this case the asset is correctly recognised at the spot rate at delivery (NZ\$125 DR to bank account) and if it continued to be held in the form of a US\$ deposit it will be revalued periodically at the relevant spot rate. This is an appropriate tax treatment for the purchase of the foreign currency asset.

4.16 For the purchase of an unhedged item the concerns are the use of the forward rate and the compulsory recognition of an FX gain or loss. This is especially the case when IFRS accounting uses the spot rate and accordingly does not recognise any FX component.

4.17 The original policy approach may have been recognising that in many cases taxpayers were hedging these agreements with matching FECs. In such cases the taxpayer would be effectively paying for the asset at the forward rate and it would be appropriate to capitalise and depreciate the asset at that value. However, the agreement is a separate financial arrangement from any hedging FEC and, in principle, its tax treatment should stand alone. (See the discussion below of alternative options to deal with the FX component of these agreements.)

- 4.18 One aspect of the development of the financial arrangements rules is the reluctance to amalgamate the taxation of hedging instruments with the underlying hedged items. However, if a separate FEC is used to fully hedge a foreign currency agreement for the sale and purchase of property or services, the tax position is that the one-off FX gain/loss at maturity of the agreement will be offset by a corresponding one-off FX loss/gain on the FEC. Also, the asset will be capitalised at the forward rate according to Determination G29 which is the amount of cash paid under the hedging FEC to purchase the overseas currency. The overall tax result in this case is an appropriate policy outcome and we note it is the IFRS GAAP designated hedging result.
- 4.19 While the FX component of these agreements may not be economically equivalent to a usual FEC we consider that they do contain an FX element which has to be dealt with under the financial arrangements tax rules.
- 4.20 However, chapter 5 discusses some alternative tax treatments of the FX component in certain situations. These alternative treatments are suggested as pragmatic ways of dealing with the difficulties faced by many taxpayers.

Agreements for commodities or assets substituted for money

- 4.21 The current rules tax these types of agreements where applicable through including them in the definitions of “forward contract” and “future contract”. This is appropriate and in accordance with the original policy intent. There are no changes suggested to the current treatment of these financial arrangements.

CHAPTER 5

Alternative treatments for the FX component

5.1 Pragmatic alternative tax treatments of the FX component are discussed in this chapter as follows:

- For IFRS taxpayers the IFRS GAAP treatment as described earlier would be the tax treatment. This would include relevant FX amounts for designated FEC hedges which are included in the IFRS GAAP values of goods or services. However, the IFRS GAAP treatment would not be available for FX amounts for designated FEC hedges included in the IFRS GAAP amounts recognised for capital goods or services, except to the extent the assets are depreciable. In these cases the FEC hedges would continue to be taxed as separate financial arrangements.
- For non-IFRS taxpayers the general rule to value the property or services would be the spot rates at the payment dates. There would be two exceptions, the first being for trading stock which would allow FX amounts from hedges to be included in the value of stock when these are included in the stock values in the taxpayer's stock system. The second is for depreciable property where FX amounts from qualifying hedges would be included in the value of the property.

Discussing the alternatives

IFRS taxpayers

5.2 The IFRS GAAP treatment as described above would be compulsory for tax for IFRS taxpayers. This treatment would include FX amounts for designated FEC hedges in the values of goods or services. This treatment of the hedging FEC coincides with the current Determination G29 (methods A and B) treatment of the FX component at the forward rate and is compliance-friendly. This treatment is appropriate for a hedged agreement.

5.3 Compared with the status quo, the inclusion of FEC hedging amounts in the value of goods or services in agreements is a compliance concessionary treatment. These amounts would otherwise be taxable at maturity of a FEC and including them in the value of goods or services per IFRS GAAP is a timing issue which merely re-spreads these amounts for tax. The re-spreading is considered acceptable as over time the gains and losses being spread should even out. It is also noted that it is hard to forecast at any time whether there will be FX gains or losses on FECs. This treatment will also apply to amounts included in the cashflow hedge reserve and subsequently the value of the underlying item for designated hedges which are rolled. Undesignated rolled hedges would continue to have a base price adjustment (BPA) applied to them for tax at that point.

- 5.4 Hedging FEC gains/losses included in the value of goods and services will need to be excluded from consideration for the purposes of the BPA, and possibly for spreading purposes as well.
- 5.5 We consider that this option should not be available for a FEC hedging non-taxable/capital goods or services, except for assets which are tax depreciable. The hedging FECs in these cases would continue to be taxed as stand-alone financial arrangements. It may also be necessary to include recapture rules for hedging amounts included in the cost of depreciable items which are subsequently disposed of at an amount in excess of cost (discussed in “potential permanent differences” below).
- 5.6 We suggest that it be mandatory for IFRS taxpayers to follow the IFRS GAAP treatment in all cases where the IFRS GAAP is the basis for financial reporting. This is effectively the modified fair value method. There are two main reasons for this suggestion. The first is that it is the most compliance-friendly approach for these taxpayers because it follows the profit and loss account result of the agreements and any designated hedges. Secondly, there is a concern that allowing IFRS taxpayers to use an alternative expected value approach for these agreements may provide a significant fiscal risk, where they can result in leaseback transactions (as discussed below).

Tax rules and GAAP

- 5.7 Previous working groups have reported on various aspects of the alignment of the accounting and tax treatments of financial arrangements. The 1990 tax simplification report made the following comment:
- Wherever possible, the accruals determinations should be aligned to the New Zealand Society of Accountants’ statements of standard accounting practice (SSAPs).
- 5.8 Including hedging foreign exchange gains/losses with income/expenditure on the underlying hedged item for tax purposes has been considered by various working groups in the past, especially the Valabh Committee in its 1991 report. One aspect considered by that committee was the treatment of hedging foreign exchange instruments, primarily financial arrangements. It concluded that the two arrangements should continue to be taxed separately. The conclusion was influenced by the difficulties of identifying which hedges were for particular underlying transactions and policy concerns about FX hedging gains/losses for non-taxable hedged items.
- 5.9 We note that the IFRS GAAP rules for designated hedging mean it is easier to identify which financial arrangements are being used to hedge particular FX exposures. However, there are situations when taxpayers choose not to adopt designated hedging for accounting when they are economically hedged. In these situations it will be difficult for tax purposes to consider allowing hedging gains/losses to be included in the taxation of underlying items such as fixed assets and trading stock. As discussed in the 1991 report, there is no ability to allow hedging gains/losses on financial arrangements to be included in items that are not taxable, such as non-depreciable capital account items, for example.

- 5.10 We acknowledge that the tax rules do follow the accounting treatment in some areas. These include financial arrangements where the financial accounting treatment is an alternative spreading method available to many taxpayers. It also applies generally to the valuation of trading stock.
- 5.11 Further, IFRS tax spreading methods follow IFRS GAAP hedging to an extent. The modified fair value method excludes some amounts recognised in equity reserves in years prior to the BPA. The amounts in equity reserves mostly arise from cashflow hedge accounting.

Trading stock

- 5.12 Many agreements are for trading stock and the tax treatment of trading stock is generally based on GAAP costs/valuations. This is acceptable tax policy.

Summary of any IFRS GAAP tax treatment of foreign currency agreements for the sale and purchase of property or services and associated FEC hedges

- 5.13 The following table summarises how the suggested IFRS GAAP (GAAP in the table) tax treatment would apply:

GAAP Treatment	FX agreement	FEC
No FEC	Capitalise at spot rate = GAAP, with any GAAP loan interest & FX gains/losses taxed in profit and loss account.	N/A
FEC not designated as a hedge	Capitalise at spot rate = GAAP, with any GAAP loan interest & FX gains/losses taxed in profit and loss account.	GAAP profit and loss account includes all fair value gains/losses on FEC. Use IFRS financial reporting method (fair value). OR G14B (expected value).
FEC designated as cashflow hedge	Capitalise at FEC hedged amount = GAAP, with any GAAP loan interest & FX gains/losses taxed in profit and loss account.	Fair value gains/losses on FEC in cash flow hedge reserve. Use modified fair value (mandatory) as the hedge is locked into the agreement for tax accounting.
FEC designated as fair value hedge (unlikely)	Capitalise at hedged amount per fair value hedging = GAAP * with any GAAP loan interest & FX gains/losses taxed in profit and loss account. * Capitalisation includes any FX amounts attributable to the hedged risk on firm commitments recognised in the balance sheet as DRs/CRs under fair value hedging prior to recognition of the underlying item. Those same amounts (in reverse) have been included in the profit and loss account under fair value hedging.	GAAP profit and loss account includes all fair value gains/losses on FEC. Use modified fair value (mandatory) as the hedge is locked in to the agreement for tax accounting.

Non-IFRS taxpayers

- 5.14 It is suggested 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. This would be the general rule for non-IFRS taxpayers, with two exceptions:
- *Trading stock* – Where a taxpayer’s trading stock system includes FX amounts from FEC hedges in its cost and value for trading stock, that treatment would be followed for tax.
 - *Depreciable assets* – A taxpayer would include FX amounts from qualifying FEC hedges in the cost of the assets for tax purposes and those amounts would be excluded from being taxed for the FEC.
- 5.15 *Qualifying FEC hedges* – The criteria for qualifying FEC hedges would be strict to prevent inappropriate risks to the tax base. Only over-the-counter FECs with recognised or approved financial institutions in New Zealand would be qualifying hedges. There will probably be other necessary requirements regarding documentation and perhaps elections to evidence the hedges. It is assumed that most non-IFRS taxpayers with these agreements are only using FECs to hedge them and do not have FECs for other purposes. Otherwise, it may be difficult to allow this treatment where the use of FECs is not restricted to hedging. We are not yet convinced that this suggestion can be legislated and complied with in an appropriate manner. Submissions are specifically requested on this.
- 5.16 *Transitional matters* – See the comments at the end of this chapter for the suggested general transitional measures that would apply to both IFRS and non-IFRS taxpayers.

Other matters related to the suggested alternatives

Consistency/anti-arbitrage

- 5.17 The consistency/anti-arbitrage rules will not need to be amended if the IFRS GAAP treatment is compulsory for these agreements for IFRS taxpayers.
- 5.18 There may be concern that the IFRS GAAP hedging rules may provide opportunities for taxpayers to declare or not declare FEC hedges of agreements to get the best tax result. The IFRS hedging criteria are quite strict about what can be designated as a hedge and when hedging starts and stops. For FECs, any unrealised FX gains/losses prior to a FEC being designated as a hedge are taken to the profit and loss account and will not be included in amounts subsequently recognised for the hedged item. If a hedge (say FEC) is de-designated as a hedge before it matures, unrealised gains/losses on the hedge up to the point it is de-designated are subsequently included in the value of the hedged item. Gains/losses on the hedge subsequent to de-designation are included in the profit and loss account and do not affect the value of the hedged item.

- 5.19 These hedging rules should mean that the risk of manipulation of hedging for tax purposes is small. For FEC hedges, FX gains/losses on the FEC prior to designation and after de-designation are taken to the profit and loss account and will be taxable at that point. They are not included in the values of the goods/services on a retrospective basis so that there is no ability for taxpayers to retrospectively decide to include/not include amounts related to FEC hedges in the values for goods or services. It is only the FEC gains/losses during the period of hedge designation which are included in the IFRS GAAP values of the goods or services.
- 5.20 For non-IFRS taxpayers, the suggested changes outlined above are a significant departure from the current tax treatments of both the hedged item and the FEC hedges, and therefore may carry significant risk for the revenue base. Consequently, it will be necessary to have robust criteria for the qualifying hedges and for the 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.

IFRS recognition date and the tax rights date

- 5.21 The IFRS GAAP recognition rules would generally coincide with the rights dates for possession and dates for provision of services which are used for tax. At the very least they will be reasonably approximate to those dates and there is only a small risk of significant timing mismatches between the two. We consider that using the GAAP recognition concepts for goods and services included in these agreements is acceptable for tax purposes.

Potential permanent differences

- 5.22 Including FX gains/losses on these agreements in the value of assets by using IFRS GAAP rather than taxing them separately under the current rules has the potential to create significant permanent differences. These will occur when depreciable assets are sold in excess of their cost and the resulting (net) gains are not subject to tax. It is noted that the FX amounts included in the cost of the assets could be either gains or losses and that a taxpayer will have to apply the same treatment to all these agreements.
- 5.23 These factors will tend to negate the impact of the non-taxation of FEC gains/losses over time and make it less of a concern. However, we are considering if it is necessary to include recapture provisions for any FEC gains/losses included in the cost of these items. Submissions are specifically requested on this.

Sale/leaseback transactions

- 5.24 We are aware that some assets subject to these agreements become sale/leaseback transactions at the point of delivery of the goods/assets. Under the current tax treatment, the ability to make some agreements sale/leaseback transactions while making others direct purchases (without a sale/leaseback) can result in risks to the tax base.

- 5.25 The Determination G29 treatment of an unhedged foreign currency agreement for the sale and purchase of property or services which is assigned to a financier just prior to the delivery of the goods would give a net nil tax result for the assignor (the original purchase party to the agreement). The current Determination G29 treatment (without an expected value alternative) would create unrealised FX gains/losses in the years prior to the BPA. When the agreement is assigned to a third party lessor under a sale/leaseback transaction, a BPA is required for the agreement.
- 5.26 The consideration received for the assignment of the agreement will be the value of removal of the assignor's obligation to purchase the goods. This will be the value of the goods at the spot rate at that time. The consideration paid for the assignment will be the loss of the right to receive the goods which will also be valued at the spot rate at that time. These two amounts will net to zero in the BPA. Any income/expenditure in prior years will be reversed by the BPA to give an overall net nil result for tax for all years.
- 5.27 The overall result on assignment of the agreement for the assignor is no taxable income/deductions. If the goods were depreciable assets it would capitalise them at the spot rate on delivery under the leaseback transaction (a finance lease for tax).
- 5.28 This situation could be managed to produce the most advantageous result for the taxpayer. Where the maturity of an agreement was to produce taxable income as a result of the final "a – b" calculations of methods A and B, the agreement could be assigned. A sale/leaseback transaction would be put in its place and this would give the net nil result outlined above. Where the agreement "a – b" calculations produced an overall net loss, the agreement would not be assigned. The asset would be capitalised at the forward rate and the FX loss taken for tax.
- 5.29 The unrealised gains/losses under the "a – b" calculations would be taxable in the years before the BPA but the choice to assign and enter into a sale/leaseback may still be advantageous. If an expected value alternative was provided for and used by a taxpayer, there would be no "a – b" FX gains/losses in the years before the BPA. In this case the choice to assign would be even more appealing in many cases, where there is an overall gain on the agreement.
- 5.30 The IFRS GAAP treatment may not provide the same opportunity for these agreements. It would probably deal with both the sale/leaseback transaction and the outright purchase at the spot rates on delivery. For a hedged agreement it would probably deal with both transactions at the hedged rate. We are continuing our analysis of the IFRS GAAP treatment of this matter to confirm there are no revenue base concerns.

Transitional issues

- 5.31 Because of the widespread compliance difficulties with the existing rules referred to earlier, it will be necessary to provide appropriate transitional provisions for existing agreements and any new alternatives provided.

- 5.32 We suggest that agreements in place at the time of any amending legislation using methods which are either existing or suggested new alternatives provided in amended legislation be retrospectively validated to prevent any 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 under the conditions outlined above.
- 5.33 New alternative methods provided in any amending legislation would only be applied to new agreements entered into from the date of amending legislation.
- 5.34 We specifically request submissions on this suggestion.

CHAPTER 6

Default future value and discounted value interest calculations

- 6.1 As previously discussed (see chapter 4), the tax rules require foreign currency agreements for the sale and purchase of property to be effectively taxed as two separate components.
- 6.2 The second component of an agreement can be an interest-bearing loan in foreign currency (an FX loan). These loans can result from both prepayments and deferred payments made under agreements. The loan value is identified primarily by one of two methods. The original method is essentially the difference between the cash payments and the lowest price that would have been agreed at the time the agreement is entered into for full payment at the rights date. It was originally aimed at deferred payment situations. The second method is the difference between the future or discounted values of the payments before or after the rights date and the present value of those payments at the rights date. Any FX loans are now taxed under Determination G9C, which is an expected value method.
- 6.3 The calculation of interest under the first method is appropriate when the parties have agreed on a lowest price applicable at the rights date.
- 6.4 Section EW 32(5) of the Income Tax Act 2007 is the relevant legislation:
- Future or discounted value
- (5) 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, of the amounts paid or payable on the date on which the first right in the property is transferred or the services are provided, as determined by the Commissioner under a determination under section 90AC(1)(i) of the Tax Administration Act 1994.
- 6.5 The future or discounted value (FV/DV) approach is the third alternative in section EW 32 for determining the relevant values. However, if neither of the first two alternatives applies, the FV/DV method automatically applies. This means that in many cases either Inland Revenue or taxpayers are able to impute a loan and interest into agreements irrespective of whether the parties have negotiated or agreed an interest component.
- 6.6 The discussion which follows applies to both foreign currency and New Zealand currency agreements.

Policy rationale and history of the current law

- 6.7 The background to the current law is summarised in the statement in the *Taxation Information Bulletin*, Vol 7, No 9 (February 1996) outlined in chapter 3.

The FX loan component

- 6.8 The inclusion of any loan component in agreements is an inherent part of the policy purposes in the original accrual rules and is not disputed. The loan component was included in the policy makeup to apply when the parties include interest in the payments. The original policy discussion implies that any interest will apply when there are deferred payments (after the rights date).

FV/DV calculation of the value of property or services

- 6.9 When the tax treatment of these agreements was examined by the property consultative group³ in 1988, its conclusions emphasised that tax law should not impute/force interest into agreements where the parties did not contemplate there was any interest. The group noted that this was also the original policy outlined in the 1987 report of the consultative committee on the accrual rules. The group did acknowledge that any prepayments or deferral of payments would usually have a time value-of-money aspect. However, it emphasised that it was not up to tax law to force the recognition of interest if the parties considered there was no loan/interest in the agreements.
- 6.10 Despite this, a “back-up” alternative to calculate the value of the property in an agreement was provided, being the discounted value of amounts paid for the property in a determination made by the Commissioner. This may have been in response to a concern that there had to be a mechanism for interest to be recognised for tax when it had been hidden in the payments by the parties.
- 6.11 In 1999, the discounting alternative was enhanced to allow future valuing of payments made before the rights date so that the value could be calculated by using either the DV or FV methods, or a combination of both. The motivation for the change was the absence of a FV method to deal with prepayments when there was no agreed lowest price. It does not appear that there was a re-examination of the overall policy framework about the FV/DV alternative at that time.
- 6.12 The result is that the DV or FV method of calculating the value of property can be used when there is no lowest price agreed between the parties or they simply do not address it. The latter is very likely when non-residents are a party to the agreement and have no interest or knowledge of New Zealand tax matters.
- 6.13 A taxpayer may be able to choose to use the DV/FV alternative to get the best tax result for the agreement. When a foreign supplier is involved and there is a deferral of payment, the DV method could be used to always impute interest into an agreement. This situation is likely to be very common and could apply to any agreement for a term greater than 93 days, with those less than 93 days being excepted financial arrangements. Given that New Zealand is a net importer of capital equipment, the imputation of interest in these agreements is likely to work against the revenue base. For trading stock and services this is of less concern because of the short-term nature of the relevant agreements.

³ Report of Consultants on the Effect of the Accruals Regime on Property Transactions 1988

- 6.14 In reverse, Inland Revenue could attempt to impose interest on a DV/FV basis on any or all agreements over 93 days if it considered there was no agreed lowest price.
- 6.15 It is unclear how the policy development over the years has resulted in the current default approach being FV/DV in all cases. However, it appears that the current position goes beyond the original policy intent.
- 6.16 In its support is the concept that inherently there is a time value-of-money in all prepayments and deferred payments under these agreements. As well, the second alternative in the hierarchy of methods to value property or services in an agreement is the cash price if the agreement is a credit contract. That implies that payments in excess of the cash price are interest for tax in those cases.
- 6.17 It is also noted that IFRS GAAP will probably impute interest on a DV basis into long-term and large monetary liabilities resulting from these agreements in some circumstances when there are deferred payments.
- 6.18 We suggest that it is not appropriate that this 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. If it were removed both Inland Revenue and taxpayers would not be able to impute interest into agreements on this basis.

How have overseas jurisdictions dealt with the FV/DV issue?

- 6.19 The tax treatment of deposits/prepayments and deferred payments in various overseas tax jurisdictions is illustrated in the following table and based on the following assumptions/facts:
- an agreement for purchase of equipment for \$1,000 for delivery 12 months from the contract date;
 - various alternatives ((a) to (e) below) for payment of the \$1,000; and
 - there is no “agreed lowest price” for New Zealand tax purposes which means either Inland Revenue or the taxpayer have the ability to impute interest into the contract on a FV/DV basis.

6.20 The table describes if there is a loan/s and interest for tax purposes in the five jurisdictions. IFRS GAAP treatment is essentially the UK tax treatment.

	a.	b.	c.	d.	e.
New Zealand	Yes	No	Yes	Yes	Yes
UK	No	No	No	Yes	No
Australia	No	No	No	No	No
USA	No	No	No	Yes	No
Canada	No	No	No	Maybe	No

a. Pay in full at contract date

b. Pay in full at rights date

c. Payment deferred to 1 month after rights date

d. Payment deferred to 12 months after rights date

e. Progress payments up to and including rights date

6.21 New Zealand appears to be out of step with the other jurisdictions for scenarios (a), (c) and (e). Scenario (d) (payment deferred for 12 months (or longer)) seems to be in step with the other jurisdictions. The IFRS GAAP treatment will probably include interest on an effective interest basis in the case of scenario (d).

Suggested alternative treatments for the default FV/DV of payments approach to calculate the loan and interest components

6.22 We suggest the following options to deal with this:

- Eliminate the ability to use FV/DV altogether as an alternative available to impute interest into an agreement.

This option would remove the ability of both taxpayers and Inland Revenue to impute interest into agreements. Interest would only be included in agreements if the parties explicitly identified the interest component in the agreement. However, this is not our preferred option.

- Follow the IFRS GAAP treatment for agreements which may include the discounted value treatment of the amounts paid for the property/services in some cases when payments are deferred. This option would apply if the IFRS GAAP treatment of agreements is allowed for tax.

This option would retain the discounted value treatment of loans and interest to the extent it was performed for IFRS GAAP purposes. However, it would eliminate the ability of both Inland Revenue and taxpayers to impute interest into any or all agreements.

This outcome would still be consistent with the original policy intentions and be compliance-friendly.

- For non-IFRS taxpayers, modify the existing FV/DV rules to apply only in certain circumstances. For example, they would apply to significant prepayments for property which was in a substantially completed state or for services yet to be performed more than 12 months before the rights date, and to deferred payments made more than 12 months after the rights date.

This treatment would be in line with the suggested treatment for IFRS taxpayers and significantly reduce the imputation of interest into agreements when it is not appropriate.

APPENDIX

Example: IFRS GAAP treatment of the purchase of a depreciable asset

The example is based on the following assumptions:

The purchase of a depreciable asset for US\$100 in 12 months, which is the IFRS GAAP recognition date/tax rights date.

The payments are – US\$50 in 6 months (payment A, a non-monetary item for IFRS GAAP), and US\$50 at the recognition/rights date in 12 months (payment B).

Both payments are hedged from the beginning with FECs designated as cashflow hedges.

The forward rate for payment A is 0.72 and the forward rate for payment B is 0.65.

The spot rate for payment A is 0.65 and the spot rate for payment B is 0.80.

A balance date falls three months prior to the recognition/rights date when the spot rate is 0.75.

The IFRS GAAP results are set out for three situations: the hedges are designated as cashflow hedges, the hedges are not designated, and there are no hedges at all.

	Designated		Not designated		No hedges	
	P&L	B/S	P&L	B/S	P&L	B/S
<i>Contract date</i>	0	0	0	0	0	0
<i>Payment A date</i>						
Cash (FEC or spot)	0	69 CR		69 CR		77 CR
Prepayment (non-monetary)	0	69 DR		77 DR		77 DR
P&L			8 CR			
<i>Balance date</i>						
Payment B FEC FV to CFHR	0	11 Dr				
FEC Derivative	0	11 CR	11 DR	11 CR		
Subtotal for 1st year	0	0	3 DR	3 CR	0	0
<i>Payment B: Rights date</i>						
Payment B to asset	0	77 DR	15 DR	62 DR		62 DR
Cash (FEC or spot)	0	77 CR		77 CR		62 CR
Reverse CFHR	0	11 CR				
Reverse FEC derivative	0	11 DR	11 CR	11 DR		
Reverse prepayment		69 CR		77 CR		77 CR
Prepayment to asset		69 DR		77 DR		77 DR
Subtotal for 2nd year	0	0	4 DR	4 CR	0	0
Summary of GAAP entries						
Asset		146 DR		139 DR		139 DR
Cash		146 CR		146 CR		139 CR
P&L		0		7 DR		0

The asset is capitalised at the forward rates via the FECs (in the designated hedge case) or the spot rates (in the other two cases). Where the hedges are not designated there is a difference between the amount capitalised and the cash paid which is reflected in the P&L. This P&L impact will be spread between income years over the term of the agreement depending on the terms of the FECs hedging the payments.