Technical annex

Summary of forthcoming legislation on the application of International Financial Reporting Standards (IFRS) for taxation purposes

New Zealand businesses are following the worldwide move to adopt International Financial Reporting Standards (IFRS) for financial reporting purposes. The adoption of IFRS for financial reporting purposes has been allowed since 1 January 2005 and is mandatory from periods beginning on or after 1 January 2007 for entities that have to comply with generally accepted accounting practice (GAAP).

As tax law relies on accounting practice in a number of areas, the adoption of IFRS for financial reporting purposes will have flow-on consequences for taxation purposes. In 2006, tax policy officials released an issues paper outlining the tax consequences of IFRS and seeking feedback on suggested changes to the relevant tax rules. As the government has announced, a tax bill containing the technical changes to deal with these flow-on consequences will be introduced in May 2007, with enactment expected in late 2007. Once enacted, the tax changes will generally apply from the date a taxpayer adopted IFRS.

In the meantime, this technical annex outlines how the forthcoming legislation is expected to work, to provide certainty for early adopters of IFRS, who may be in the process of preparing tax returns for the relevant periods.

General principle

Current taxation rules are linked to accounting practice in areas such as the treatment of trading stock, research and development expenditure and in areas where the Courts and tax legislation have relied on generally accepted accounting practice. Tax rules' reliance on accounting practice in these areas is "ambulatory" in principle, meaning that changes in accounting practice arising from the adoption of IFRS are brought into tax automatically.

Although some changes in accounting practice will be automatically reflected in tax law, others will require legislative change. The major IFRS-related amendment in the forthcoming tax bill will be to set out the circumstances where the IFRS timing of income from financial arrangements can be adopted for tax purposes. A number of other, more technical changes are also proposed.

Timing of IFRS adoption for taxation purposes

The legislative changes that will be included in the May 2007 tax bill will clarify that taxpayers who adopt IFRS for financial reporting purposes must also adopt IFRS for tax purposes. Any transitional adjustment arising from the adoption of IFRS for taxation purposes will be recognised contemporaneously.

Some taxpayers that adopted IFRS early have indicated that they would like to adopt IFRS for taxation purposes at the same time. The tax bill will generally require early adopters of IFRS for financial reporting purposes to adopt IFRS for taxation purposes contemporaneously. However, because of the potentially significant uncertainty created by legislation not being in place, the bill will allow early adopters of IFRS to use the existing financial arrangement rules (and pre-IFRS accounting practice), with mandatory IFRS adoption being required from the 2007-08 income year. This will be done by way of retrospective legislation.

Details of the proposed legislative changes

Changes to the financial arrangement spreading rules

Income and expenditure of financial arrangements are brought to tax under specific tax timing rules. The current rules require the income and expenditure of financial arrangements to be spread over the term of the financial arrangements based on several spreading methods, including the yield-to-maturity method and a method based on financial reporting practices.

With the adoption of IFRS, the accounting methods for financial arrangements have been formalised considerably. Income and expenditure of financial arrangements are calculated before their maturity using either the "fair value method" or the "effective interest method" under IFRS. Although the IFRS methods could, arguably, be applied for taxation purposes under the existing financial arrangement rules as the "financial reporting" methods, there are considerable uncertainties on the acceptability of these methods under the existing legislative provisions. The tax bill will set out the circumstances where IFRS methods will be required for taxation purposes.

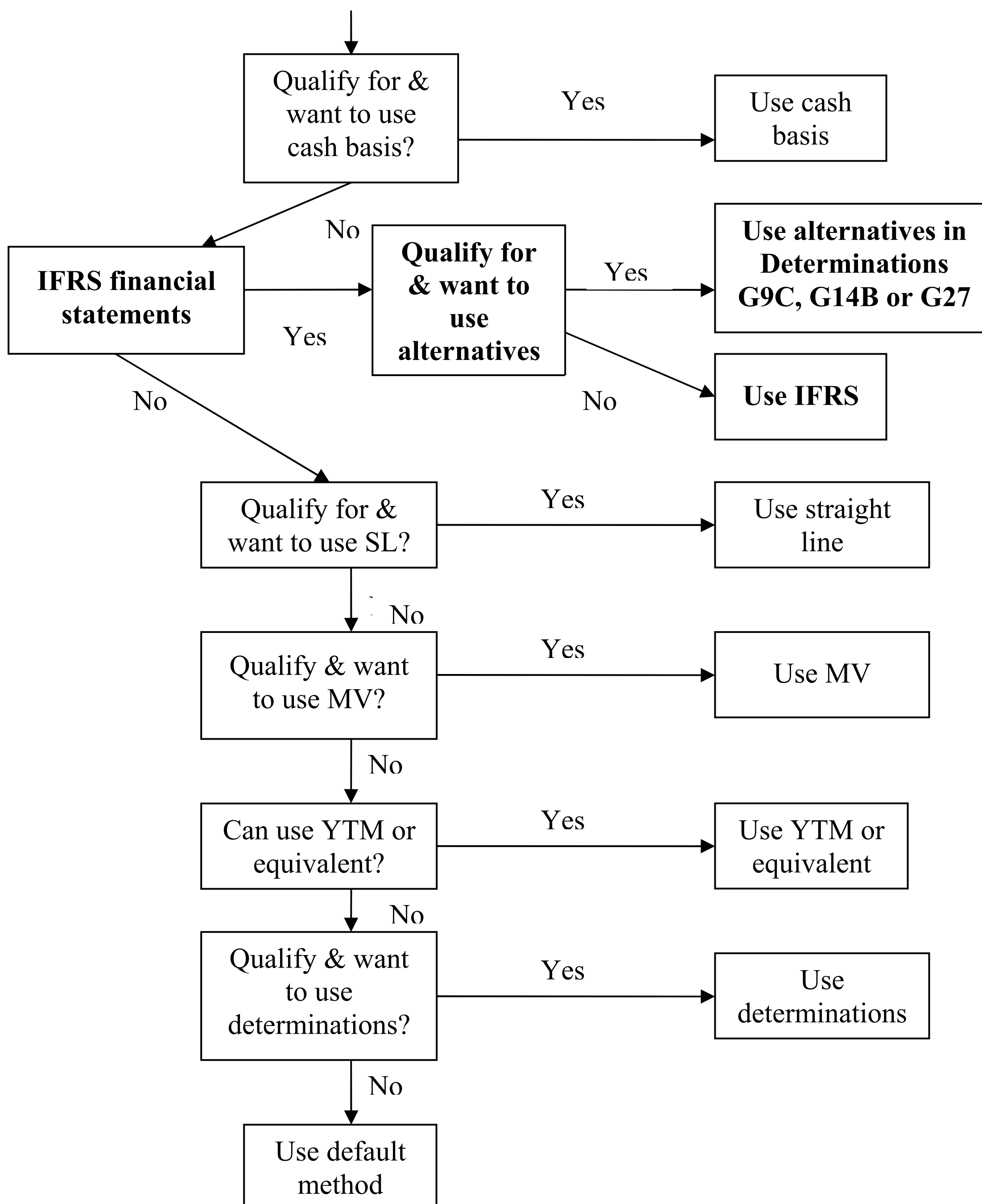
Taxpayers who prepare IFRS accounts will be required to follow the IFRS timing rules for taxation purposes, instead of applying the specific tax timing rules to spread the income and expenditure of financial arrangements. Taxpayers who do not prepare IFRS accounts will continue to apply the current tax timing rules for financial arrangements, except that they will not have the option of using the financial reporting method that is currently available. A summary of the spreading methods available to taxpayers under the proposed legislative changes is presented in Figure 1.

For IFRS methods to be acceptable for taxation purposes, taxpayers are expected to satisfy additional conditions. First, income and expenditure reported under IFRS in both the income statement and the statement of changes in equity should be included for taxation purposes, unless an alternative spreading method provided in one of the determinations described below is adopted. Second, credit impairment adjustments made under IFRS will have to be reversed out for taxation purposes. Credit impairments of financial arrangements will continue to be tax deductible only when the debt is actually written off as being bad.

In addition to the IFRS methods, the proposed legislation will provide other spreading methods based on the existing determinations. Taxpayers who prepare IFRS accounts will have the option of using the determination methods or an alternative that is not materially different from these methods. The existing determinations that will be available are:

- Determination G9C – Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach;
- Determination G14B – Forward contracts for foreign exchange and commodities: an expected value approach; and
- Determination G27 – Swaps (Method C as outlined in sub-clause 6(3)).

FIGURE 1
Proposed financial arrangement spreading rules



Scope of the changes to the financial arrangement rules

The proposed alignment between tax and accounting practice under IFRS applies only to the spreading rules (sections EW 12 to EW 22) and not to the definition of a "financial arrangement". The financial arrangement rules will continue to apply only to a "financial arrangement" as defined in the tax legislation. As such, the existing determinations that deal with the boundary between a "financial arrangement" and an "excepted financial arrangement" (Determination G5C and Determination G22A) will continue to be applicable to taxpayers who prepare IFRS accounts.

Furthermore, other aspects of the financial arrangement rules, such as the requirement to perform a base price adjustment calculation at maturity, will continue to apply to taxpayers who prepare IFRS accounts. These taxpayers will still be required to perform a base price adjustment, for example, at the maturity of their financial arrangements.

Transitional rules

The proposed legislative changes will also "grandparent" the existing financial arrangement spreading rules until the 2007-08 income year. Taxpayers will be allowed to apply these existing rules (and the pre-IFRS accounting treatment of financial arrangements) in the 2005-06 and 2006-07 income years even if they have adopted IFRS for financial reporting purposes for those years.

Trading stock and R&D expenditure rules

The current tax treatment of trading stock and research and development expenditure is explicitly linked to accounting practice. These tax rules will be updated to reflect changes brought about by IFRS. Specifically, the trading stock tax rules will be amended to ensure that primary sector taxpayers are able to continue using the existing cost and market value methods to value their trading stock for taxation purposes, even though they are required to "fair value" the trading stock under IFRS. Minor legislative amendments to the research and development rules are also required because some standards under the old accounting rules are no longer applicable under IFRS.

Compliance guidelines for early adopters

Early adopters of IFRS may be intending to apply IFRS for taxation purposes from the 2005-06 income year and will be filing their tax returns while the tax legislation is not yet in place. For information on filing see Inland Revenue's guidance check list for early adopters at: http://www.ird.govt.nz/business-income-tax/IFRS/

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