Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Volume 4

International Financial Reporting Standards

KiwiSaver (Supplementary Order Paper)

Other matters

8 October 2007

Prepared by the Policy Advice Division of Inland Revenue, The Treasury and the Ministry of Economic Development

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International Financial Reporting Standards

OVERVIEW

Clauses 25, 26, 34 to 38, 40, 45 to 58, 135(15), (19), (21), (32), (34) and (51), 164 and 184

The bill proposes a number of changes to ensure that taxpayers who adopt international financial reporting standards (IFRS) can continue to use tax rules that rely on accounting practice. The biggest change proposed in the bill is to allow IFRS accounting methods to be used as a basis to spread income and expenditure under the financial arrangement tax rules.

Key features of the proposed amendments

Use of IFRS spreading methods for financial arrangements

The proposed amendments will generally require taxpayers who prepare IFRS financial accounts to use IFRS spreading methods for taxation purposes. From a policy perspective, this is the correct treatment because aligning the tax timing rules with IFRS will reduce the compliance costs associated with applying the more sophisticated accounting rules required by IFRS.

However, submissions have raised concerns around many derivative financial instruments and foreign-currency denominated financial arrangements where the IFRS fair value (market value) accounting treatment would create too much volatility in the income and expenditure calculation if adopted for tax. This is because the fair value (market value) treatment would recognise gains and losses before they are realised.

Submissions have stated that in these instances the IFRS method should not be the default method, and alternative methods that are consistent with the financial arrangement rules (but without the undesirable effects of volatility) should be provided.

Officials agree that the volatility that results from using the fair value method or foreign-currency denominated financial arrangements is inappropriate in some situations. It was first proposed to deal with this problem by allowing taxpayers to use alternative methods set out in determinations. However, after further consideration, officials now believe that, to provide more certainty, it would be better to set out alternative spreading methods that avoid the volatility problem within the core tax legislation.

Alternative spreading methods

Officials have consulted with some of the submitters who were concerned about the volatility issue. We recommend that, to deal with their concerns, alternative spreading methods should be provided in legislation.

Two alternative spreading methods are recommended in legislation for derivative instruments and foreign-currency denominated financial arrangements. Under the first alternative method, taxpayers would be allowed to defer any gains and losses that have been reported in equity reserves under IFRS. The second alternative method would require taxpayers to spread a reasonable amount of income and expenditure based on expected considerations over the term of a financial arrangement.

These alternative methods would address most, if not all, the volatility concerns that taxpayers have. Details of how the method would apply in practice to some financial instruments could also be provided in the *Tax Information Bulletin* that follows the enactment of this tax bill.

Other spreading methods

We also recognise that there are technical concerns around the availability of alternative methods set out in determinations because taxpayers may be unable to meet some conditions or the determinations are not wide enough in scope. We recommend that these determinations be amended by legislation where possible to make them more flexible.

Issues were also raised concerning the present determinations that define the financial arrangement portion of a wider arrangement (for example, optional or mandatory convertible notes). Likewise, the status of the current determination on long-term agreements for the sale and purchase of property was raised. We recommend that the existing tax treatment set out in determinations should continue to apply.

To provide flexibility to deal with complex derivative instruments, the bill provides a structure that allows taxpayers to apply for, and the Commissioner to issue, new determinations to deal with specific financial arrangements.

IFRS METHOD

Issue: Mandatory adoption of the IFRS fair value accounting method for taxation purposes

Submissions
(91 – New Zealand Institute of Chartered Accountants, 85A – Minter Ellison Rudd Watts, 74R – Deloitte, 54 – ASB Bank, 49 – Contact Energy Limited, 46 – TrustPower, 33 – Corporate Taxpayers Group)

The IFRS fair value method should be elective, and not be compulsory or become the default method.

The Commissioner should determine alternative methods that are able to be used.

A safety mechanism from the mandatory application of the fair value method is needed.

Mandatory application should only apply if the "amortised cost" method is used under IFRS.

Comment

Under the proposed amendments, taxpayers who prepare IFRS accounts will be required to use the IFRS accounting method to calculate the timing of their taxable income and expenditure under the financial arrangement tax rules. From a policy perspective, this is desirable because accounting rules have become more sophisticated under IFRS and it will reduce compliance costs if the tax rules are aligned with IFRS.

However, using the IFRS method to calculate the timing of income and expenditure does create volatility because the method brings in unrealised gains and losses. The IFRS method can thus create unfair results when applied for tax purposes, particularly if taxpayers are not actively trading in financial arrangements.

It is important to recognise that the IFRS fair value method does not apply to all financial arrangements. Many New Zealand dollar-denominated financial assets and most financial liabilities are accounted for using the effective interest method under IFRS. This method, which is equivalent to the yield to maturity method under the old financial arrangement rules, applies to held to maturity investments, loans and receivables and all non-derivative liabilities. The fair value method does, however, apply to all financial arrangements that are held for trading purposes, all derivative instruments and financial assets/liabilities that are hedged.

Existing financial arrangement timing rules incorporate market value-based methods that bring to tax all gains and losses (including unrealised gains and losses) arising from financial arrangements. However, the present market value-based method is elective and is applied only by taxpayers who are actively trading in the financial arrangements. At present, taxpayers can also reduce volatility in their income and expenditure by using one of the methods specified in determinations that remove the "unexpected" components (the volatility) from the tax net.

Officials agree that there should be alternatives to the fair value method. Alternative spreading methods are recommended below for foreign-currency denominated financial arrangements and arrangements that are fair-valued under IFRS so that taxpayers are not forced into the IFRS method.

Recommendation

That the submission be accepted in principle.

Issue: Modification of the IFRS method for taxation purposes

Submissions
(74R – Deloitte, 54 – ASB Bank, 33 – Corporate Taxpayers Group)

If the IFRS fair value method is mandatory, then at a minimum, fair value movements that are reported in the statement of changes in equity should not be returned for taxation purposes.

Comment

Under the IFRS hedge accounting rules, the fair value movements of a cash flow hedge instrument or a hedge of net foreign investments can be reported in the statement of changes in equity, instead of the profit and loss statement. This has the effect of removing some volatility from the profit and loss account. Financial assets that are available for sale also qualify for this accounting treatment.

This accounting treatment essentially allows any profit and loss on the hedge instrument or available for sale financial assets to be deferred until the underlying item or event being hedged is realised.

A financial arrangement can qualify for this hedge accounting treatment if certain criteria are met. The financial arrangement has to be designated as a hedge at inception, and the hedge relationship and effectiveness of the hedge has to be measured and documented. In addition, there are rules around the types of financial instruments that can be used as a hedge instrument, the sort of exposure that can be hedged and the effectiveness of the hedge relationship.

Officials have recommended below that the amounts deferred under IFRS can also be removed for taxation purposes to deal with the volatility problem, subject to appropriate safeguards.

More extensive alignment with the IFRS hedge accounting treatment is not recommended because the revenue risks of such an alignment can not be evaluated properly at this stage. Although safeguards are provided by the IFRS hedge accounting rules, these rules are new to the financial reporting environment in New Zealand. The hedging rules are complex and it is not yet clear how they will be applied in practice.

We believe that the risk benefit ratio is such that this submission should be noted and we will continue to monitor the application of the IFRS hedge accounting rules in practice.

Recommendation

That the submissions be noted.

Issue: Alternative methods to exclude volatility

Submissions
(91 – New Zealand Institute of Chartered Accountants, 74R and 74A – Deloitte, 54 – ASB Bank, 49 – Contact Energy Limited, 46 – TrustPower, 33 – Corporate Taxpayers Group)

Alternative spreading methods (or the expected value method) should be provided in legislation for some financial arrangements that would otherwise use the IFRS fair value method and create volatility.

Comment

To address the volatility concerns, we recommend two alternative methods for derivative instruments that would be fair valued under IFRS and foreign-currency denominated financial arrangements.

Under the first alternative method, taxpayers would be allowed to defer any gains and losses that have been reported in equity reserves under IFRS. This would apply to financial arrangements that qualify and are effective cash flow hedges or hedges of net foreign investments under IFRS.

The second alternative method would require taxpayers to spread a reasonable amount of income and expenditure based on expected payments. This means that any in-built gains and losses on these instruments would have to be spread in accordance with the objective of the financial arrangement rules.

These alternative methods will only be available if some conditions are met. For example, the alternative methods would not be allowed if a taxpayer is in the business of dealing in the financial arrangement. The IFRS fair value method is appropriate and volatility is unlikely to be a significant problem for taxpayers that are in the business of dealing in the financial arrangement. Similarly, financial instruments that have been entered into for speculative purposes would not be able to use this method.

There is insufficient information on the types of derivative instruments and their IFRS effect. Therefore it is necessary to further limit the risks by limiting the availability of the alternative methods. This consideration will be balanced against the need to alleviate concerns about volatility under the IFRS method.

Recommendation

That the submissions be accepted, subject to appropriate safeguards.

Issue: Alternative method based on pre-IFRS GAAP

Submissions
(80 – Rio Tinto, 74R – Deloitte, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

An alternative method to IFRS that has regard to pre-IFRS GAAP should be acceptable. Taxpayers should have the option to apply an alternative method to IFRS which:

- is consistent with the purpose of the financial arrangement rules (that is, based on the principles of accruing income or expenditure over the life of the financial arrangement);
- is consistently applied by taxpayers over the life of the financial instrument; and
- has regard to pre-IFRS GAAP.

Comment

The submissions are driven by taxpayers' concerns that the fair value method under IFRS would become the method they must use for taxation purposes. Although following IFRS methods for taxation purposes would save compliance costs, the fair value method would create volatility for taxpayers if adopted for taxation purposes. Officials agree that the fair value method should not be compulsory.

However, pre-IFRS GAAP is not an acceptable benchmark for taxation purposes. The policy intention of aligning accounting practice and tax rules would be compromised if taxpayers were allowed to rely on pre-IFRS GAAP rather than the IFRS rules beyond the transition periods provided in the bill. This option would also potentially create undesirable tax planning opportunities.

Instead, we have recommended two alternative methods that would deal with the volatility problem.

Recommendation

That the submissions be declined.

Issue: Alternative methods for derivative instruments

Submissions
(74R – Deloitte, 49 – Contact Energy Limited)

An alternative method is needed for complex derivative instruments such as cross-currency interest-rate swaps.

Alternative methods are needed, as fair value is not appropriate for derivative financial instruments where there is an intention to hold until maturity.

The expected value method should be applied to foreign currency options.

Comment

The alternative methods recommended earlier as alternatives to the IFRS fair value method could be applied to these financial arrangements.

The proposed legislation is unlikely to provide absolute certainty to all the complex derivative instruments that taxpayers may enter into. However, the proposed legislation does provide a structure that is sufficiently flexible to deal with new or innovative financial arrangements.

If taxpayers do not or cannot meet the requirements to use the alternative methods, they can apply to the Commissioner for taxpayer or product-specific determinations. The Commissioner may also issue additional determinations to deal with particular types of financial arrangements.

Recommendation

That the submissions be declined.

Issue: Who must use the IFRS method

Submission
(71 – PricewaterhouseCoopers)

It should be made clear who must apply the IFRS method.

Comment

Under the proposed legislation, "a person who is a party to a financial arrangement must use the IFRS method if the person prepares financial reports for financial arrangements using NZ IAS 39". The submission points out that it is not clear who must apply the IFRS method because the term "financial reports" is not defined.

The policy intention is that any taxpayer who prepares "financial statements" that are in compliance with IFRS would use the IFRS method to calculate income and expenditure on their financial arrangements. We recommend that the legislation be amended to clarify this point.

Recommendation

That the submission be accepted.

Issue: IFRS method for branch equivalent calculation

Submission
(71 – PricewaterhouseCoopers)

International standards should be acceptable for the purpose of calculating a controlled foreign company's (CFC's) branch equivalent income. For this purpose IFRS should mean "NZ IAS 39 or its equivalent" in the CFC's country of residence.

Comment

Taxpayers with a controlled foreign company (CFC) are required to calculate the branch equivalent income of the CFC using New Zealand tax law. The proposed legislation allows taxpayers who prepare financial statements that comply with IFRS to use the method adopted in the financial statements for taxation purposes. This means that the IFRS method must be a method that is compliant with the New Zealand equivalent to IFRS.

The CFC rules are currently under review. However, the New Zealand equivalent to IFRS is based on international accounting standards that are used in many other countries. If a CFC prepares its accounts based on international accounting standards, then the method used in the CFC's financial accounts should also be acceptable in principle.

Recommendation

That the submission be noted.

Issue: 63rd day election criteria under Determinations G9C and G14B

Submissions
(74A – Deloitte)

The Commissioner should be able to accept late elections.

The period allowed for electing into Determinations G14B and G9C should be extended to any time during an income year for a new company or new groups of companies which are established during an income year.

Special rules are needed for companies that begin transactions covered by the determinations during an income year.

Comment

The bill provides an option for taxpayers to use specific spreading methods set out in determinations (namely G9C, G14B and G27) instead of IFRS methods. Determinations G9C and G14B provide methods which allow taxpayers to spread only their "expected" income and expenditure under foreign currency financial arrangements and forward contracts.

Under the current Determinations G9C and G14B, taxpayers must elect to use these determinations on or before the 63rd day of their accounting period for the income year. If a taxpayer is a member of a group of companies, the group must elect into the determinations on or before the earliest 63rd day of the accounting periods of all group members.

An early election notice is necessary because taxpayers should not be allowed to opt into the expected value treatment only when their tax positions under the alternative spreading methods are known. This would create an opportunity for taxpayers to self-elect into the determinations only when the tax outcome suits them.

However, the election criteria in Determinations G9C and G14B are too restrictive and do not take into account new companies that begin business part-way through the year or companies that enter into a transaction that is covered by the determinations part-way through the year.

Despite the provisions in the Determinations G9C and G14B, a taxpayer should be allowed to use these determinations if the taxpayer has notified the Commissioner of the election:

- on or before the 63rd day in the first accounting period or on the first balance date, whichever is earlier, if the taxpayer or the group is newly established; or

- on or before the 63rd day after the first transaction that falls into either Determinations G9C or G14B were entered into by the taxpayer or any member of the taxpayer's group.

In addition, the Commissioner should be able to accept late elections, as recommended.

Recommendation

That the submissions be accepted.

Issue: Determination G14B and foreign currency options

Submission
(74A – Deloitte)

Determination G14B should be extended to include foreign currency options.

Comment

Determination G14B currently covers forward contracts for foreign exchange and commodities. The economic characteristics of forward contracts are fundamentally different from options contracts. As such, it would not be appropriate to extend the scope of Determination G14B to cover foreign currency options.

Options are rights, but not obligations, to buy or sell specified amounts of foreign currency or commodities at a fixed price, either at a fixed time (European options) or over a period of time (American options). Unlike forward contracts that represent obligations, options are rights which need not be exercised. For example, the holder is not obligated to exercise an option that has an intrinsic loss (that is, when the price stated in the option is less favourable than the market price at exercise date). Furthermore, options can be exercised at a particular date or any time over a period, whereas obligations under forward contracts must be met at a fixed date.

Nevertheless, we agree that the tax treatment of options contracts needs further clarification. Under IFRS, options are accounted for based on fair value and this may not be appropriate for taxation purposes. The alternative legislative methods recommended earlier could apply to foreign currency options. Under the alternative method, a reasonable amount of income or expenditure, based on expected considerations, would be spread over the term of the options.

Recommendation

That the submission be noted.

Issue: Alternative methods to determinations

Submissions
(74R – Deloitte, 71 – PricewaterhouseCoopers, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

The proposed alternative method to determination does not require a materiality criterion.

The alternative method to determinations should not have to conform with "commercially acceptable practice".

Comment

Alternative methods are accepted instead of the method(s) prescribed in determinations if they comply with certain conditions. The conditions proposed in the bill, which are based on existing rules, require that an alternative method:

- has regard to the principles of accrual accounting;
- conforms with commercially acceptable practice; and
- results in the allocation to each income year of amounts that are not materially different from the method prescribed in the relevant determinations.

The alternative method to determinations is not intended as a default method. From a policy perspective, it is intended that taxpayers who may not have applied the specific determinations in every way could be treated as complying with the determination method if the outcome of applying the alternative method is not materially different from the method(s) set out in a determination.

Therefore, the key condition for this method is that it must result in an allocation that is not materially different from the determination method.

Nevertheless, in the context of the expected value determinations listed in the bill, the requirement to conform with "commercially acceptable practice" could be difficult to apply under the IFRS financial reporting environment. This is because "commercially acceptable practice" would be dictated by IFRS and the IFRS treatment would, in most cases, be quite different from the methods provided by the determinations. It is recommended that this condition be removed.

Recommendation

That the submission be accepted in part.

Issue: Application of the determination method to foreign-currency denominated financial arrangements

Submission
(Matter raised by officials)

The ability to use appropriate determinations should be extended to foreign-currency denominated financial arrangements.

Comment

The bill includes an option for taxpayers to use a method set out in specific determinations instead of the IFRS fair value method.

However, the scope of when taxpayers can elect to use this option needs to be expanded so that it covers foreign-currency denominated financial arrangements. For example, taxpayers with foreign-currency denominated financial arrangements are not required to fair-value the financial arrangements under IFRS. Instead, foreign exchange gains and losses on these financial arrangements are reported at prevailing market exchange rates, but technically they are not fair valued. These taxpayers should still be allowed to use the determinations for taxation purposes.

Recommendation

That the submission be accepted.

ELECTION INTO ALTERNATIVE METHODS

Submission
(65A – New Zealand Bankers Association)

Taxpayers should be allowed to opt into the determinations anytime during the transition to IFRS-based rules and when IFRS accounting treatment changes.

Comment

There are some uncertainties around when taxpayers are allowed to elect into the determination methods.

Taxpayers are transitioning to the IFRS-based financial arrangement spreading rules in the 2005–06, 2006–07 and 2007–08 income years as they adopt IFRS for financial reporting purposes. These taxpayers would be expected to use the IFRS methods or one of the alternative methods set out in the bill. They should be able to opt into these alternative methods at any time during the transition period, and the proposed bill should be modified to allow this. To provide certainty, this requirement should over-ride all election criteria that may be more strictly required by the specific determinations.

Taxpayers who use the IFRS-based rules may change their accounting treatment as their circumstances change after the transition years. The bill also needs to provide certainty for these taxpayers to elect into the alternative methods allowed in determinations. We recommend that the bill be amended to allow taxpayers to opt into the methods set out in determinations or another alternative method if their IFRS accounting treatment has changed.

Recommendation

That the submission be accepted.

Issue: Contracts for differences

Submissions
(80 – Rio Tinto, 74R – Deloitte, 49 – Contact Energy Limited, 46 – TrustPower, 33 – Corporate Taxpayers Group)

Alternative methods are needed as taxation based on the fair value approach is not appropriate for contracts for differences.

Comment

The transition to IFRS has created a particular problem for the tax treatment of contracts for differences, the most typical examples of which are those used in the electricity industry. Under IFRS, these contracts are measured at fair value. Submissions have raised concerns that the IFRS fair value method is inappropriate for these instruments as they are typically used as hedges of future cash flows that are not in the tax net. Taxing these instruments on a fair value basis would also create significant practical problems because of volatility.

Officials agree that the IFRS fair value method should not be compulsory for these contracts. It is intended that contracts for differences should be treated as forward contracts. Taxpayers that comply with the requirements set out in the alternative "expected value" method recommended earlier could apply that method to these contracts. Taxpayers should also be able to elect into the Determination G14B treatment or alternative to the determination method.

However, there are uncertainties around whether these contracts are "forward contracts" as defined in section OB 1 of the Income Tax Act 2004. One interpretation is that contracts for differences are not forward contracts because the underlying commodities under these contracts are never delivered. We recommend that the current definition of "forward contracts" be amended to ensure that contracts for differences are covered.

The consistency criteria in Determination G14B may be too restrictive for contracts for differences. The requirement to apply the same treatment for other forward contracts and foreign currency loans would not apply in this unique case as the contracts are typically used to hedge commodity prices that relate to the taxpayers' ordinary business. We recommend that this consistency requirement be relaxed.

Recommendation

That the submissions be accepted.

Issue: Interest-free loans

Submission
(61 – KPMG)

Alternative methods may be needed for interest-free loans as IFRS may require the loan to be recorded at its present value.

Comment

We agree there may be IFRS-related problems with such loans. For example, an interest-free loan from a parent to a subsidiary is classified as equity. Therefore, having tax follow the accounting treatment may be appropriate. If interest-free loans are characterised as equity, then it is not strictly within the scope of the financial arrangement rules. This would seem to produce an appropriate tax outcome.

On the other hand, some of these loans may be treated as debt and discounted to present value. The difficulty then is determining the amount of interest, if any, that should be included for taxation purposes.

The problems associated with interest-free loans are wider than the IFRS-related issues. Further work would need to be done to resolve these problems.

Recommendation

That the submission be declined.

HYBRID ARRANGEMENTS

Submissions
(95 – New Zealand Law Society, 91 – New Zealand Institute of Chartered Accountants, 85A – Minter Ellison Rudd Watts, 74R – Deloitte, 71 – PricewaterhouseCoopers, 65A – New Zealand Bankers Association, 61 – KPMG, 54 – ASB Bank)

The determinations dealing with the allocation of consideration between financial arrangements and excepted financial arrangements (Determinations G5C, G22 and G22A) should be retained.

Comment

Hybrid arrangements are arrangements that are part debt and part equity. Determinations G5C, G22 and G22A (which replaces G22) deal with these financial arrangements under the existing tax rules. These determinations deal with the separation of equity and debt components and how the income and expenditure of the debt component should be calculated.

It is intended that these determinations would continue to apply under the proposed rules. Determinations G5C, G22 and G22A were issued under the authority of current section EW 6, which is not being amended by the proposed legislation. By implication, these determinations should continue to apply to taxpayers that adopt IFRS-based spreading rules for taxation purposes.

Nevertheless, it may not be sufficiently clear that once a debt component is separated from the equity component, the income and expenditure of the financial arrangement component should be calculated using the determinations instead of IFRS.

The proposed legislation should ensure that income and expenditure of a hybrid arrangement that is covered by determinations G5C, G22 and G22A continues to be dealt with under these determinations rather than IFRS. The IFRS treatment could be accepted as an alternative if the outcome is not materially different from the method set out in the determinations.

Recommendation

That the submissions be accepted.

FINANCIAL ARRANGEMENTS THAT ARE EQUITY INSTRUMENTS UNDER IFRS

Submission
(97 – Russell McVeagh)

An equity instrument under IFRS can still be a financial arrangement for taxation purposes:

- Section EW 15B(1) needs to contemplate this possibility and should read: "a person who is a party to a financial arrangement must use the IFRS method for that arrangement if the person uses NZ IAS 39, in respect of that financial arrangement, for the purposes of preparing the person's financial reports".
- Section EW 22(d)(ii) also needs to contemplate this possibility with the proposed wording: "does not apply NZ IAS 39, in respect of income derived or expenditure incurred under that financial arrangement, for financial reporting purposes".

Comment

The submission is predicated on the assumption that equity instruments under IFRS could fall within the definition of a financial arrangement for taxation purposes. However, it is not clear from the submission how this could be the case and no concrete example was provided.

Officials agree that there is a possibility that a financial arrangement for taxation purposes could be treated as equity for accounting purposes. In this case, the IFRS method would not be appropriate.

We recommend that an alternative method should be provided based on the existing yield to maturity method, rather than the solution proposed in the submission. If accepted, the overall effect of the submission is that taxpayers who prepare IFRS accounts would be allowed to use the default method under section EW 22, which is intended only for taxpayers who do not prepare IFRS accounts. This is clearly inappropriate from a tax policy perspective.

Recommendation

That the submission be noted and an alternative method based on yield to maturity should be provided.

LONG-TERM AGREEMENTS FOR SALE AND PURCHASE OF PROPERTY

Issue: Determination G29

Submission
(Matter raised by officials)

Section EW 15 should be clarified to confirm that existing Determination G29 should apply.

Comment

A property agreement in which the settlement is deferred is a financial arrangement. This type of agreement is within the financial arrangement rules if the deferral is for a significant period of time (more than 93 days). In these cases, the agreement contains a loan between the buyer and the seller. Interest income and expenditure (including any foreign exchange gains and loses) embedded in the agreement should be accrued for taxation purposes.

The current tax treatment of agreements for the sale and purchase of property when the consideration is in foreign currency is governed by Determination G29. The determination interacts with a number of other provisions in the tax legislation to deal with the foreign currency components of deferred property settlement.

Determination G29 approves the adoption of three alternative exchange rates for converting the foreign-currency denominated property price into New Zealand dollars. The rates are the spot rate on the rights date, spot rate on the contract date, or the spot rate on the payment date. These rates are in addition to the rates available under section EW 34 (namely, forward rate to rights date or forward rate to payment date). Determination G29 also prescribes the method for calculating income and expenditure based on the exchange rates used.

We recommend that the methods set out in Determination G29 be preserved. An IFRS method would be accepted if it produces results that are not materially different from one of the methods prescribed under Determination G29.

Recommendation

That the submission be accepted

Issue: IFRS treatment or Determination G29

Submission
(71 – PricewaterhouseCoopers)

Section EW 15 should be clarified to confirm that the IFRS accounting method supersedes existing Determination G29 even where no unrealised foreign exchange gain/loss is recognised in the profit and loss account/balance sheet for accounting purposes.

Comment

The submission suggested that one possible treatment for long-term agreements for the sale and purchase of property under IFRS is to recognise the prepayment as deposits at the prevailing spot rate. This treatment is inconsistent with the current rules in Determination G29 – where taxpayers are allowed to use different exchange rates, but using the prevailing spot rate is not one of the options.

Recognising prepayments on long-term property agreements at spot rate is too simplistic and is inconsistent with the purpose of the financial arrangement rules.

Recommendation

That the submission be declined.

Issue: IFRS treatment for tax depreciation purposes

Submission
(71 – PricewaterhouseCoopers)

The bill should be clarified to confirm that the tax depreciation base cost of fixed assets is equivalent to the accounting depreciation base cost adjusted for any foreign exchange movements which have previously been taxed or deducted.

Comment

The interaction between the value of property under the financial arrangement rules and for other tax act purposes (such as depreciation) is governed by section EW 35. This provision is outside the scope of the proposed amendments.

We recommend that the existing approach under section EW 35 be preserved. However, as part of the normal tax policy work programme, officials will further consider whether the various IFRS treatments that could apply to these and other similar arrangements are acceptable for tax purposes.

Recommendation

That the submission be noted.

SHARED EQUITY MORTGAGES

Submission
(62 – Rismark International)

Taxation rules inadvertently create a major barrier to the introduction of private-sector shared equity mortgages to the New Zealand market.

Comment

Shared equity mortgages or equity finance mortgages are essentially housing loans that have no interest repayment. Instead, the lenders receive a share of the change in the property value when the loan matures or when the loan is repaid.

For example, a lender could provide initial capital of 20 percent, or $60,000, for a borrower to purchase a house that costs $300,000. No interest would be payable on this loan, but the borrower would have to share any capital gains or losses on the property with the lender. If the property value increases to $400,000 the lender will share in the $100,000 increase with the borrower.

Under the Rismark products, the same lender will take a 2:1 payout, which is 40 percent in the same example. If the property value decreases, the lender and the borrower will also share the losses. In this case, the lender that provides 20 percent finance will share 20 percent of the losses.

We also understand from Rismark that their products will be generally available to the public. Anyone interested in using shared equity mortgages could take up these mortgages instead of conventional mortgages offered by commercial banks.

A number of taxation concerns could arise for the lenders and borrowers of these shared equity mortgages.

Taxation of lenders

For the lenders, current taxation rules require these mortgages to be taxed on a market value basis. Rismark has indicated that the product would not be commercially viable if taxes have to be paid on this basis. As tax liabilities are not matched to cash, Rismark says it would make the product difficult to securitise and they would have difficulties in attracting investors to supply funds for this product.

Rismark has requested that shared equity mortgages be taxed on a cash-flow realisation basis. This means that the tax liability would occur only when the mortgages mature or are repaid. Rismark's submission states that this is the tax treatment for their products in Australia.

Taxing these mortgages only when the loan matures or when the loan is repaid would be problematic under New Zealand's taxation rules. The main problem is that allowing shared equity products to be taxed on a cash-flow realisation basis would essentially be providing a tax concession for this product over more conventional mortgages. It is difficult to predict what this tax concession is likely to do but one possible scenario is that shared equity mortgages could replace conventional mortgages, at least in some segments of the housing market. Taxing the income of lenders on a cash-flow realisation basis could also create adverse tax planning opportunities as lenders could deduct their funding costs for these mortgages on an accrual basis.

Taxation of borrowers

Although Rismark has not made a submission on the taxation of borrowers under a shared equity mortgage, some taxation concerns do arise for borrowers as well.

Many borrowers of shared equity mortgages would not come within the tax net because the property would mostly be owner-occupied housing. However, under current taxation rules, income could arise for these borrowers if they repay less than the original loan amount when the property value has fallen. This is the case generally under current taxation rules when borrowers are relieved from repaying their loans in full or when the loan is remitted.

In the case of shared equity mortgages, it would seem unfair for a tax liability to arise because any increase in economic wealth resulting from the loan remission is clearly offset by a decrease in the property value. If special rules were to be developed for these shared equity mortgages, more work would be needed to distinguish between these mortgages and other conventional housing loans.

For products that are offered by Rismark, there is nothing to prevent the borrowers from using these mortgages to purchase rental property. Property could also be rented out temporarily, have fee-paying boarders, or be used as a home office. In these cases, there could be a problem in determining the interest expense that borrowers could claim against their taxable income. These and other issues would have to be worked through.

Tax policy process

Any taxation rules developed for shared equity mortgages would have wider implications and would need to be considered carefully. More analysis and consultation is required on the tax treatment of these products. The stakeholders (including banks and other financial institutions as well as Rismark and Housing New Zealand Corporation (HNZC), which offers similar products) should be consulted. The Reserve Bank may also have a view on the tax treatment of this product.

Officials recommend that as the issues raised by the submission are complex and have wider implications, further work should be done according to the generic tax policy process.

Recommendation

That the submission be noted.

CONSISTENCY REQUIREMENTS

Issue: Consistent use of IFRS method across similar arrangements

Submissions
(91 – New Zealand Institute of Chartered Accountants, 65A – New Zealand Bankers Association, 23 – ISI)

Different methods may be used for tax purposes as a result of different accounting methods being used under IFRS (for example, swaps entered into for different purposes) – this should be allowed.

Comment

Current tax rules require the same spreading method to be applied to all financial arrangements that are the "same or similar". Officials agree that this requirement is too stringent under the IFRS-based spreading rules, as IFRS allows different methods to be used depending on the purpose of the financial asset.

Even if the same method is prescribed by IFRS – for example, the fair value method – some instruments qualify as cash-flow hedges or hedges of a net foreign investment and can be reported differently for accounting purposes. In this case, it might be appropriate for taxpayers to use the IFRS fair value method for some instruments and the alternative spreading methods for the instruments that have been treated as cash-flow hedges or hedges of a net foreign investment.

We recommend that different spreading methods be allowed for financial arrangements that are the same or similar for taxation purposes if the arrangements qualify for different accounting treatment under IFRS.

Recommendation

That the submissions be accepted.

Issue: Anti-arbitrage consistency requirements

Submission
(Matter raised by officials)

Consistent spreading methods should be adopted for financial arrangements that are in a hedge relationship under IFRS.

Comment

Taxpayers can use IFRS methods or a number of alternative methods to spread their financial arrangement income and expenditure. These alternative methods are provided to ensure that taxpayers are not forced to apply the IFRS method.

However, it would not be correct for disparate spreading methods to be used when the financial arrangements are part of a hedge relationship under IFRS. If this is allowed, taxpayers may be able to apply the IFRS method selectively to realise losses on one instrument, and to defer gains on the other instrument using an alternative method.

We therefore recommend that taxpayers who adopt these alternative spreading methods must use similar methods (and must not use the IFRS market value or fair value-based method) to account for financial arrangements that are part of a hedged relationship under IFRS.

Recommendation

That the submission be accepted.

Issue: Consistent use of non-IFRS methods over time

Submission
(Matter raised by officials)

Taxpayers who have elected to use one of the exceptions to IFRS should be allowed to revert to the IFRS method if a new method is used under IFRS which the taxpayer would like to follow for taxation purposes.

Comment

Under the proposed bill, taxpayers may elect to use an alternative spreading method that is not based on IFRS – for example, by using one of the determinations. In this case, taxpayers must use the spreading method over the financial arrangement's entire term, unless they have a sound commercial reason for a change of method.

Taxpayers should be allowed to change the spreading method if their accounting treatment changes subsequently and they wish to follow the new IFRS method for taxation purposes. Alternatively, they may no longer meet the conditions set out in the alternative methods and need to revert back to the IFRS methods.

We recommend that a change of method should be allowed in these circumstances. A change of method adjustment would be required in accordance with existing rules.

Recommendation

That the submission be accepted.

Issue: Change of method adjustment

Submission
(65A – New Zealand Bankers Association)

Taxpayers should be required to perform the base price adjustment instead of a change of method adjustment when they change from the IFRS fair value method to an alternative spreading method.

Comment

Normally taxpayers that change their spreading methods are required to perform a change of method adjustment. The change of method adjustment brings the tax position of the taxpayers up-to-date as if the new method of spreading has been applied throughout the term of the financial arrangements.

The submission proposes that a change of method adjustment could be replaced with the base price adjustment. At the point of change, taxpayers would treat the old financial arrangement as being realised, and a base price adjustment is calculated. The taxpayer would effectively be treated as having entered into a new financial arrangement and the new method would apply to the financial arrangement. The consideration paid for the new financial arrangement is the market value at the time the change of method takes place.

A base price adjustment is more appropriate than a change of method adjustment when a taxpayer is moving from the fair value method under IFRS to an expected value approach (say under G14B). The change of method adjustment would reverse all the market value movements in previous years, recalculate the income and expenditure under the new method and require the difference to be included for taxation purposes in the year of adjustment. If the new method does not require any income or expenditure to be spread, then the change of method adjustment would allow all previous gains and losses to be reversed in the year the change of method occurs. This may create opportunities for tax avoidance.

Recommendation

That the submission be accepted.

Issue: Interaction between the determination method for IFRS and non-IFRS taxpayers

Submissions

(71 – PricewaterhouseCoopers, 65A – New Zealand Bankers Association)

Interaction between the IFRS method and the alternative methods is unclear.

A taxpayer applying the alternative method should be treated as continuing to apply the IFRS method for the purpose of consistency requirement.

Comment

The bill introduces a number of spreading methods for taxpayers who prepare IFRS accounts. These methods are the IFRS methods (either yield to maturity or fair value) and the methods set out in determinations and their alternatives. New spreading methods are also recommended, as discussed earlier, so that taxpayers are not forced into the IFRS fair value treatment. All these methods are different in scope, application and effect.

The legislation will clarify that IFRS methods are in fact not the same as the methods set out in determinations. However, taxpayers will be allowed to change from one method to the other, in some circumstances, as explained earlier. A change of method adjustment or a base price adjustment would be required depending on the circumstances of this change of method.

Recommendation

That the submissions be declined.

APPLICATION DATES

Issue: Application dates

Submissions
(85A – Minter Ellison Rudd Watts, 74R – Deloitte, 54 – ASB Bank, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

The IFRS-based rules should not become compulsory until 2008–09.

Comment

The proposed application date for the adoption of IFRS for taxation purposes is the 07–08 income year generally. This is because taxpayers who adopt IFRS for accounting purposes should do so at the same time for taxation purposes. As the adoption of IFRS is compulsory from 1 January 2007, the adoption of IFRS for tax purposes would not be later than the 2007–08 income year, except for a small group of taxpayers as discussed below.

The alignment between adoption of IFRS for accounting and tax purposes would ensure that taxpayers do not have to prepare two sets of accounts. Any transitional adjustment that could arise from the adoption of IFRS would also be dealt with at the same time.

Recommendation

That the submissions be declined.

Issue: Application dates for taxpayers with an early balance date

Submission
(71 – PricewaterhouseCoopers)

Taxpayers with early balance date (between 1 October and 30 December) who are not early adopters for financial reporting purposes can only apply the new rules from the 2008–09 income year.

Comment

The submission points out that taxpayers with an early balance date (between 1 October and 30 December) who are not early adopters would not be able to comply with the proposed IFRS-based rules in the 2007–08 income year. This is because they would not have adopted IFRS for accounting purposes in their 2007–08 income year, as the accounting period for the 2007–08 year begins before 1 January 2007. For this group of taxpayers, the application date of the proposed rules would have to be the 2008–09 income year.

Recommendation

That the application date be extended to the 2008–09 income year for taxpayers with an early balance date (between 1 October and 30 December) who are not early adopters of IFRS for financial reporting purposes.

Issue: Grandparenting provision should be extended until the 2008–09 income year

Submissions
(74R – Deloitte, 71 – PricewaterhouseCoopers, 54 – ASB Bank, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

The old financial arrangement rules should be allowed and the new rules should not become compulsory until the 2008–09 income year.

Comment

The grandparenting provision in the bill allows the old financial arrangement rules to be applied until 2007–08 income year, even if the taxpayer was an early adopter of IFRS.

These deferred application dates are provided because significant changes are proposed to the financial arrangement rules in the bill. Early adopters of IFRS should be allowed to use the old financial arrangement rules even though they have adopted IFRS for accounting purposes in the 2005–06 and 2006–07 income years. It is expected that the bill will be enacted in time for the 2007–08 income year, although that is somewhat later than would be ideal.

Officials believe that the certainty advantage being sought is achieved with the other amendments being proposed, and that the costs of the suggested deferral are unnecessary.

Recommendation

That the submissions be declined.

Issue: Retrospective application date

Submissions
(91 – New Zealand Institute of Chartered Accountants, 61 – KPMG)

For early adopters, the application date should be aligned if taxpayers have filed their income tax return based on IFRS.

Comment

The current early adoption proposals already allow taxpayers sufficient flexibility. This is because they have the choice of whether or not to adopt IFRS for their financial arrangements. The other proposed IFRS changes are technical but in general are taxpayer friendly.

Recommendation

That the submissions be declined.

Issue: Drafting of provision

Submissions
(74R – Deloitte, 54 – ASB Bank, 33 – Corporate Taxpayers Group)

The grandparenting provision does not work properly because section EW 21 (and other methods under the old financial arrangement rules such as alternatives to YTM and determinations or the market value method) still requires the same method to be used for financial reporting purposes.

Comment

It is intended that the old financial arrangement rules be preserved during the grandparenting period. The submissions point out that some of the methods under the old financial arrangement rules require taxpayers to use the same method for financial reporting purposes. Given that taxpayers have already transitioned to IFRS for accounting purposes, it would not be possible to apply the same method as that prescribed under the old financial arrangement rules.

Section EW 23 already outlines the circumstances where it is not necessary to adhere to the same method for financial reporting purposes. To be clear, it may be necessary to list the grandparenting period as a reason for not having to adhere to the requirement to use the same method for financial reporting purposes.

Recommendation

That the submissions be accepted.

Issue: Grandparenting and consistency requirement

Submissions
(74R – Deloitte, 54 – ASB Bank, 33 – Corporate Taxpayers Group)

Taxpayers should not breach the consistency requirement if there is a change of method required at the end of the grandparenting provision.

Comment

Taxpayers who rely on the grandparenting provision would be using the old financial arrangement rules and the associated methods. Transitioning to IFRS-based spreading rules at the end of the grandparenting period may require a change of spreading methods.

It is necessary to ensure that taxpayers can change their spreading methods at the end of the grandparenting period without breaching the consistency requirement. We recommend that the bill be amended to provide this certainty.

Recommendation

That the submissions be accepted.

Issue: Scope of fees to be spread under the financial arrangement rules

Submissions
(74R – Deloitte, 54 – ASB Bank, 33 – Corporate Taxpayers Group)

Expenditure from certain fees should be deductible immediately, even if they are spread for financial reporting purposes, including fees:

- for evaluating the creditworthiness of the borrower;
- for obtaining legal advice;
- for preparing and processing documents, closing the transactions; and
- paid to a third-party broker for bringing a new customer.

If the fee is also to be spread for taxation purposes, then additional income arising from this should be spread over three years.

Alternatively, changes should be elective at this stage.

Comment

The bill proposes that fees that are non-integral to financial arrangements will be ignored when calculating income or expenditure under the financial arrangement spreading rules. This is intended to align the fees treatment under the financial arrangement rules with the IFRS spreading method. However, this intention might not be fully reflected in the proposals in the bill.

The effect of this alignment is that any fees that have been spread under IFRS will be spread for taxation purposes. As noted below, some transaction costs are included as effective yield under IFRS and spread for financial reporting purposes.

There are two reasons for this approach. First, the move to more reliance on IFRS timing rules pre-supposes that the IFRS timing rules produce a good reflex of income. If spreading some costs associated with a financial arrangement achieves this under IFRS, then it is not clear why it would not be a good policy to follow this practice for taxation purposes. Second, an alignment between tax and accounting rules would reduce compliance costs (although we note that, in general, taxpayers would rather incur more compliance costs if that is going to accelerate deductions). Taxpayers who adopt IFRS spreading methods for taxation purposes would not be required to identify different types of fees that have been included in the IFRS calculation and deal with them individually for taxation purposes.

The submissions appear to be referring to fees that are spread under IFRS. It is true that for a number of taxpayers an alignment with IFRS treatment may result in a change of timing for the deduction of fees. Rather than an "up front" deduction, fees will require spreading and be deductible over time. Taxpayers who adopt IFRS spreading methods may thus find that their tax treatment of fees associated with financial arrangements has changed.

Taxpayers who do not adopt the IFRS method would only be required to spread contingent fees, as they do currently. The proposed rules also do not change the tax treatment of fees more generally – for example, fees for services or other fees not related to a financial arrangement are not affected by the proposed legislation.

However, we believe it should be clarified that for all fees associated with financial arrangements, their timing for taxation purposes should be the same as is used by taxpayer for financial reporting purposes.

Recommendation

That the submissions be declined, but that it be clarified that the tax treatment of all fees associated with financial arrangements be aligned to the actual financial reporting method.

Issue: Interaction between fees and fair value method

Submissions
(74R – Deloitte, 33 – Corporate Taxpayers Group)

It is necessary to clarify that fees are recognised immediately if the underlying instrument is fair valued.

Comment

When a financial arrangement is fair valued under IFRS, fees that relate to the financial arrangement are recognised immediately as income or expenditure in the income statement. This treatment for fees is consistent with the fair value treatment of the financial arrangement, meaning that all market value gains and losses are recognised immediately.

It would be consistent with the policy intention to allow the same treatment for taxation purposes. This is inherent in the proposals and should be clarified.

Recommendation

That the submissions be accepted.

Issue: Scope of fees to be spread under the financial arrangement rules

Submission
(91 – New Zealand Institute of Chartered Accountants)

The legislation should be clarified to say that both fees and transaction costs are to be spread over the life of a financial arrangement as per NZ IAS 39.

Comment

The bill proposes that fees that are non-integral to financial arrangements will be ignored when calculating income or expenditure under the financial arrangement spreading rules. The effect is that anything that has been spread under IFRS will also be spread for taxation purposes.

The submission points out that some transaction costs that are directly attributable to a financial arrangement are spread as part of the effective yield calculation under IFRS. This accounting treatment should be accepted for taxation purposes.

We agree that it would be consistent with the policy intention to accept the accounting treatment for transaction costs when taxpayers have adopted IFRS spreading methods.

Recommendation

That the submission be accepted.

Issue: Guidance for taxpayers who do not prepare financial reports

Submission
(74R – Deloitte, 33 – Corporate Taxpayers Group)

More guidance is needed on the meaning of "non-integral" fees for taxpayers who do not prepare financial reports.

Comment

The changes relating to fees only apply when IFRS financial statements are prepared. The concept of non-contingent fees would continue to apply to taxpayers who do not prepare IFRS financial statements.

Recommendation

That the submission be declined.

RELIEF FROM UNACCEPTABLE TAX POSITION PENALTY

Issue: Scope of relief

Submission
(91 – New Zealand Institute of Chartered Accountants)

Relief should apply to taxpayers who follow the IFRS methodology in error on the mistaken assumption that because the old accounting rules are acceptable for tax purposes that IFRS methodology is also acceptable for tax.

Comment

Tax liabilities are generally calculated on the basis of income tax legislation rather than accounting standards. Even though tax rules do rely on accounting practice in a number of areas, the relationship between accounting practice and tax is complex. This is the case under the old accounting rules as well as under IFRS, although officials acknowledge that with the introduction of IFRS there is real tension in some areas between IFRS timing rules and historical tax rules.

Taxpayers should be expected not only to take reasonable care when relying on accounting practice for taxation purposes but also to ensure that the reliance on accounting practice does not result in an unacceptable tax position. This is the requisite standard under the old accounting rules and should not be relaxed as taxpayers move to IFRS accounting rules.

The proposed legislative relief from unacceptable tax position penalties is provided for early adopters of IFRS who may be filing their tax returns before the bill is enacted. This is intended as a narrowly targeted relief for these taxpayers in the 2005–06 and 2006–07 income years. It is anticipated that the legislation will be enacted before the 2007–08 income year and this would be adequate for most taxpayers, except for the few that have a very early balance date.

Recommendation

That the submission be declined.

Issue: Relief should be extended to the 2009–10 income year

Submissions
(74R – Deloitte, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

Relief should be extended until the 2009–10 income year for all taxpayers.

Comment

The proposed legislative relief from unacceptable tax position penalties is provided for early adopters of IFRS who may be filing their tax returns based on IFRS as early as the 2005–06 income years. The proposed cut-off date for legislative relief is the 2006–07 income year because the legislation is expected to be enacted by the 2007–08 income year. We do not believe it is necessary to extend the application date of the proposed legislative relief.

Recommendation

That the submissions be declined.

Issue: Conditions for relief

Submissions
(74R – Deloitte, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

Conditions that taxpayers have to satisfy to qualify for relief are not clear. In particular:

- Why is the link to accounting treatment necessary?
- What is "full disclosure"?

Comment

The proposed legislative relief from the unacceptable tax position penalty is linked to accounting treatment because a tax position can be taken on the basis of the tax legislation alone. This tax position may have nothing to do with the changes that might be brought about by the adoption of IFRS for taxation purposes. A taxpayer that took an unacceptable tax position in this situation should not be protected from the unacceptable tax position penalties.

The objective of providing legislative relief from the unacceptable tax position penalty is to provide reassurance to early adopters of IFRS in circumstances when they rely on IFRS accounting practice for taxation purposes. The proposed relief would apply only if a tax shortfall arises because of actual or potential application of IFRS.

In addition, the accounting treatment that has been used for tax purposes (which gives rise to the tax shortfall) must be acceptable accounting practice under IFRS. This condition is necessary to ensure that the unacceptable tax position penalty is applicable if tax positions are taken on the basis of an unreasonable IFRS interpretation.

The "full disclosure" requirement is not a condition that can be defined precisely and set in legislation. In principle, sufficient information needs to be provided to the Commissioner so the Commissioner is in a position to assess the IFRS-related tax position. What constitutes full disclosure would vary depending on circumstances. For example, a taxpayer who provides a tax adjustment schedule listing an aggregate amount representing IFRS-related adjustment may be taken as full disclosure in some circumstances. More detailed information may be required in other circumstances.

Recommendation

That the submission be declined.

Issue: Application to the 2005–06 income year

Submission
(91 – New Zealand Institute of Chartered Accountants)

A number of taxpayers adopted IFRS in their 2005–06 income year. The relief needs to cover the 2005–06 income year for early adopters and the proposed legislation needs to be redrafted.

Comment

It is intended that the legislative relief be available for the 2005–06 income year, as well as the 2006–07 income years. The proposed section 141B(1B)(b) covers the period between the first day of the first income year that a taxpayer adopts IFRS and the last day of the 2006–07 income year.

The policy intention is that, for a taxpayer who adopts IFRS in the 2005–06 income year, the legislative relief would cover both the 2005–06 and 2006–07 income years. The current provision in the bill already achieves this policy intention.

Recommendation

That the submission be noted.

IMPAIRMENT OF FINANCIAL ASSETS

Issue: Deductibility of credit impairments

Submissions
(95 – New Zealand Law Society, 91 – New Zealand Institute of Chartered Accountants, 65A – New Zealand Bankers Association)

Tax deductions for bad debts should be aligned with credit impairments under IFRS.

Comment

The deductibility of bad debts for taxation purposes is entirely governed by the bad debt deductibility rules in section DB 23. General provisions for doubtful debts that have been recorded for financial reporting purposes are currently not deductible for taxation purposes. Bad debts are allowed as deductions only if they have been written off.

An alignment between the IFRS treatment of credit impairments with the tax treatment would most likely reduce compliance costs of banks and financial institutions. It is also true that the credit impairment rules are more precise under IFRS than they have been under the old accounting practice.

However, the credit impairment adjustments under IFRS are still only an accounting estimate. An alignment with IFRS in this area would essentially allow banks and financial institutions to treat the credit impairment estimate as deductible for taxation purposes.

The revenue cost of such an alignment is also very significant. Initial estimates suggest that allowing credit impairments to be deductible for taxation purposes would cost, on a one-off basis, over $250 million if the rules apply to the four major banks. The costs would be higher if other financial institutions are taken into account. Further, consideration would have to be given to trade doubtful debts.

On balance, we do not recommend an alignment with IFRS treatment. The present tax treatment for bad debts should not be changed.

Recommendation

That the submissions be declined.

Issue: Scope of limitation on impaired credit adjustments

Submission
(65A – New Zealand Bankers Association)

If impaired credit adjustments are not deductible, then it should be clarified that the credit impairment add-back adjustment only applies to a financial arrangement which is an asset.

Comment

The policy intention behind the credit impairment add-back is to ensure that taxpayers who adopt the IFRS methods are not using the methods as a "backdoor" to claim the credit impairment adjustment. Instead, the present tax treatment of bad debts should continue to apply for IFRS taxpayers.

However, the proposed adjustment appears to be too wide, as it covers the impaired credit adjustment that could be made to financial liabilities as well as financial assets. From a policy perspective, the adjustment should only be necessary for financial arrangements that are financial assets.

Recommendation

That the submission be accepted.

THIN CAPITALISATION RULES

Submissions
(74R – Deloitte, 33 – Corporate Taxpayers Group)

Pre-IFRS asset values should be grandparented for the purpose of the thin capitalisation rules.

Comment

The current thin capitalisation rules have a safe harbour debt-to-asset ratio of 75 percent. This is generally understood to be a generous safe harbour. The adoption of IFRS may adversely affect a taxpayer's ability to meet the safe harbour ratio. However, this would occur only if a large intangible asset (for example, goodwill) has to be removed from the balance sheet under IFRS. It may be appropriate to consider providing a special relief if taxpayers are in this position.

Officials have discussed the impact of IFRS on the thin capitalisation rules with taxpayers as part of the consultation process leading up to the tax bill. To date, we are not aware of any taxpayer whose thin capitalisation position would be significantly adversely affected by the adoption of IFRS.

Recommendation

That the submission be declined.

TAX ADJUSTMENT FOR MOVEMENTS IN EQUITY RESERVES

Issue: Movements in equity reserves

Submission
(49 – Contact Energy Limited)

What mechanism is in place to adjust for items recycled from equity through the income statement if they have been recognised in tax calculations in an earlier year?

Comment

An accounting adjustment which transfers an amount from equity reserves to income statement should not in itself create any tax consequences. If the accounting record is relied upon for taxation purposes, this adjustment should be removed for tax purposes.

However, such an accounting record is likely to be triggered by a realisation event – for example, when the financial arrangement matures. The financial arrangement rules provide that a base price adjustment is required when a financial arrangement matures. This is not linked to the accounting treatment. If a base price adjustment is performed on a financial arrangement, the outcome should be brought in for taxation purposes.

In practice, these adjustments are done through tax adjustment schedules.

Recommendation

That the submission be declined.

REMEDIAL UNIT FOR PROBLEMS RELATING TO ADOPTION OF IFRS

Submissions
(74R – Deloitte, 65A – New Zealand Bankers Association, 54 – ASB Bank, 49 – Contact Energy Limited, 33 – Corporate Taxpayers Group)

A remedial unit should be established to deal with ongoing problems that may arise from the adoption of IFRS.

Comment

We recognise that the transition from current accounting practice to IFRS for taxation purposes does create uncertainties for taxpayers. The proposed bill is the first step towards dealing with these uncertainties.

Resources are currently not available to establish a formal remedial unit.

The officials involved in these proposals will monitor outcomes and will react as promptly as possible to any problems as they arise.

Recommendation

That the submissions be declined.

AVAILABILITY OF IFRS STANDARDS

Submission
(95 – New Zealand Law Society)

Accounting standards referred to in the tax legislation must be publicly available.

Comment

We agree that this would be the desired outcome.

The relevant New Zealand accounting standards are currently available on the New Zealand Institute of Chartered Accountants (NZICA) website.

Recommendation

That the submission be noted.

DRAFTING ISSUES

Issue: Heading of section EW 19

Submission
(65A – New Zealand Bankers Association, 23 – ISI)

"Choice among YTM, SL and MV methods" is a clearer heading.

Section EW 19 should read, "If the person is not required to use the IFRS method under EW 15B, a person may…" instead of, "A person who…".

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Unacceptable tax position penalty

Submission
(Matter raised by officials)

Proposed section 141B(1C) could be redrafted as follows:

- the word "wholly" in subparagraph (c) is redundant;
- "due to application of IFRS" could be clearer instead of "due to accounting" in subparagraph (d).

Comment

The changes are necessary to better reflect the policy intention.

Recommendation

That the submission be accepted.

KiwiSaver
(Supplementary Order Paper)

OVERVIEW

This section covers:

- submissions on Supplementary Order Paper No. 130;
- a number of additional matters identified by officials; and
- two late submissions (100 – Alzheimers Wairarapa Inc and 101 – New Zealand Absolute Return Association).

Submissions relating to the design and administration of the member tax credit are still under consideration and will be provided to the Committee in due course.

WORDING IN SOP

Submission
(91 and 91A – New Zealand Institute of Chartered Accountants)

NZICA supports the amendments made in SOP No. 130, however it considers that the opening wording of section KJ 3 could be improved. It is also concerned with the clarity of the language in new section KJ 4(3)(b).

Comment

Officials agree that the current wording and language used in sections KJ 3 and KJ 4 of the SOP should be amended for greater clarity.

Recommendation

That the submission be accepted.

PROCESS

Submission
(23A – Investment Savings & Insurance Association of NZ Inc)

As many of the issues raised in submissions on the main bill and the SOP relate to the efficient and practical administration of schemes from 1 October 2007, consideration should be given to speeding the passage of the bill to reduce the uncertainty that would otherwise result during the period from 1 October until the bill is passed.

Comment

Officials acknowledge the concern raised in the submission. The bill is expected to be reported back to the House by the Finance and Expenditure Committee by early November. It is the government's intention that the bill will be enacted as soon as possible after the report-back to Parliament.

Recommendation

That the submission be noted.

SINGLE PROVIDER RULE

Submission
(101 – New Zealand Absolute Return Association)

The single provider rule contained in section 53 of the KiwiSaver Act 2006 should be abolished and instead, KiwiSaver investors be allowed to access a range of providers, with no more than 20 percent of their assets in any single provider.

Comment

Section 53 of the KiwiSaver Act 2006 specifies that a person may be a member of only one KiwiSaver scheme at a time, but can have more than one account or investment product in any one scheme. The ability to invest in a number of investment products allows the member to diversify their investment and manage risk.

The reason that the single provider rule was introduced was to avoid the proliferation of small accounts and to ease the administrative burden on Inland Revenue, as Inland Revenue needs to know which scheme a member is enroled in. This would not be possible if a member is allowed to join multiple schemes. Furthermore, the rule enables a member to more effectively track their accounts, thereby reducing the likelihood of lost accounts. The objective of diversification may be accomplished through the various products the KiwiSaver scheme subsequently invests in.

Allowing access to multiple providers involves obvious costs and complexity for all parties in terms of administering the various components of KiwiSaver and ensuring there are no over- or under-payments of entitlements. A "20 percent" rule, as proposed, would require members to have at least five providers, and policing the rule would impose further compliance and complexity.

It should also be noted that the regulatory arrangements for KiwiSaver schemes have been developed to be especially robust in light of the incentives to participate. The requirements relating to independent trustees and fees ensure that KiwiSaver schemes are subject to appropriate supervision and that investments are priced appropriately. This also helps mitigate any risk of having a single account with a provider. The decision to invest in KiwiSaver is an investment decision, which carries some investment risk. Members should assess these risks and choose an option that best suits them.

Recommendation

That the submission be declined.

EMPLOYER CONTRIBUTIONS

Submission
(99 – Alzheimers Wairarapa Inc)

Employer contributions should be either exempt or the employer tax credit raised to $30 per week per employee for all non-profit organisations with charitable status.

Comment

Exempting a particular class of employer from the compulsory employer contribution would be unfair on employees. Likewise, providing a higher level of tax credit for these employers would be unfair to other employers and, if the credit was not reflected in contributions to employees, would in effect be an additional subsidy to those employers with no countervailing increase in service levels.

The tax credit reimburses employers for contributions that they are required to make, up to a maximum of $20 a week for each employee. The following table shows the maximum annual gross salary or wages covered by the tax credit:

From	Compulsory employer contribution as a percentage of gross salary or wages	Maximum annual tax credit available	Annual gross salary or wages completely offset by the value of the employer tax credit
1 April 2008	1%	$1,040	$104,000
1 April 2009	2%	$1,040	$52,000
1 April 2010	3%	$1,040	$34,667
1 April 2011	4%	$1,040	$26,000

Based on these figures, the effect on community organisations is unlikely to be significant before 1 April 2009 at the earliest.

Funding agencies, such as the Ministry of Social Development, are aware that providers of community-based services have concerns about meeting the difference between the compulsory employer contribution and the tax credit.

Agencies have undertaken to report to Ministers by the end of this year on the options for addressing the funding concerns of community and voluntary organisations and other similar bodies in the medium-term.

Recommendation

That the submission be declined.

APPLICATION OF SECTION 153 OF THE KIWISAVER ACT AND REGISTRATION AS A PORTFOLIO INVESTMENT ENTITY

Submission
(Matter raised by officials)

Section 153 of the KiwiSaver Act 2006 should be amended so that KiwiSaver schemes registered under an umbrella superannuation scheme trust can be treated as separate for the purposes of the portfolio investment entity (PIE) rules.

Comment

Under the KiwiSaver Act a KiwiSaver scheme can be established under the umbrella trust deed that also governs a registered superannuation scheme. A number of KiwiSaver schemes have established themselves under this mechanism, including a default provider.

Section 153 of the KiwiSaver Act 2006 treats the umbrella trust, the registered superannuation scheme and the KiwiSaver scheme as the same entity for the purposes of the Income Tax Act 2004 and the Tax Administration Act 1994. The purpose of the provision was to ensure that no tax implications arise upon establishment of KiwiSaver schemes and on the transfer of assets between a registered superannuation scheme and the KiwiSaver scheme.

A concern has been raised that this provision prevents a registered superannuation scheme and a KiwiSaver scheme from registering as separate portfolio investment entities. It is understood that separate registration may be desirable for compliance and risk-management purposes, such as ensuring that the KiwiSaver scheme portfolio investment entity eligibility is not dependent on the registered superannuation scheme. A default KiwiSaver scheme is required to be a portfolio investment entity.

Officials consider that section 153 should be amended to exclude the portfolio investment entity rules from the application of this provision. This would allow the KiwiSaver scheme to register as a portfolio investment entity in its own right if it meets the eligibility criteria.

Recommendation

That the submission be accepted.

APPLICATION OF SECTION NC 15(8) OF THE INCOME TAX ACT TO THE KIWISAVER ACT

Submission
(Matter raised by officials)

The KiwiSaver Act and the employer tax credit rules should be amended so that reference to "PAYE period" relates to a filing requirement that an employer has under the PAYE rules.

Comment

The term "PAYE period" is defined in the KiwiSaver Act and the employer tax credit rules as having the same meaning as in section NC 15(8) of the Income Tax Act. The term "PAYE period" in this section only applies to large employers, specifically the periods from the 1st to the 15th of the month and the 16th to the end of the month that dictate their twice-monthly payments. The 1st to the 15th of the month and the 16th to the end of the month periods do not apply to small employers.

To better reflect the policy intent, officials consider that the KiwiSaver Act and the employer tax credit rules should be amended so that reference to "PAYE period" relates to a filing requirement that an employer has under the PAYE rules.

Recommendation

That the submission be accepted.

OTHER CONTRIBUTIONS THAT COUNT

Issue: Double-dipping

Submission
(87 and 87A – ASFONZ)

The proposed changes in SOP No. 130 do nothing to alleviate employer concerns over the possibility of legislatively sanctioned double-dipping by employees in respect of employer contributions towards employees' retirement.

The blanket exclusion from double-dipping proposed for any employee who is a Member of Parliament, a judicial officer, or a sworn member of the Police should be extended to every employee. Therefore, the "other contributions" definition could end before the four listed conditions.

Paragraph 230(A)(2) should be amended to accommodate any employer unable to prevent compulsory employer contributions increasing their employer contributions in relation to a "class of employees".

Comment

Volume 2 of the Officials' Report recommends a number of changes to the "other contributions" provisions of the bill (see pages 22, 30, 33 to 35, 39 to 40 and 41). These changes aim to alleviate the concerns of employers currently making contributions to registered superannuation schemes to reduce the risk of double-dipping. Specifically, the Report recommends the replacement of the immediate vesting requirement with a requirement that for any employer contribution to count as a compulsory KiwiSaver contribution, the contribution must vest within five years (which is considered the "norm" for many existing schemes). Further, the Report also recommends the extension of the employment conditions to encapsulate any collective agreements finalised before 17 May 2007.

The presumption underlying the policy is that, over time, employers will be able to further reduce the risk of double-dipping through remuneration bargaining with new employees to accommodate the new savings environment. The proposed amendment to clause 230(A)(2) aims to alleviate concerns about double-dipping in relation to specific situations when employer and employee do not have the same bargaining flexibility. Members of Parliament, judicial officers, and sworn members of the Police are excluded, as their terms and conditions are set by third-parties (the Remuneration Authority) or potentially under binding arbitration.

The proposed amendment also allows for regulations to be made to cover other classes of employee (both public and private) in similar situations. Officials note that it is unlikely to apply to the private sector.

Recommendation

That the concerns of employers and the corresponding recommendations in Volume 2 of the Officials' Report be noted.

That the submission on removing all requirements for the "other contributions" test and clause 230(A)(2) of the KiwiSaver Act 2006 be declined.

COMPLYING SUPERANNUATION FUNDS

Issue: Lump sum withdrawals

Submission
(87 and 87A – ASFONZ)

The proposed change to clause 144 allowing members to require withdrawals for complying superannuation funds to be paid as a lump sum is superfluous.

Relief is required to imply the lump sum withdrawal conditions into the terms of any complying superannuation fund trust deed and related disclosure document in existence when the date the bill comes into force.

Comment

The purpose of the proposed change to clause 144 relating to members being able to require withdrawals for complying superannuation funds to be paid in a lump sum is to ensure that complying superannuation funds do not lock members into the purchase of annuities. This makes complying superannuation funds more comparable with KiwiSaver. While officials recognise that many schemes already offer this facility, it is useful to note that some existing schemes do require the purchase of an annuity on reaching the age of entitlement. This will ensure that these schemes establish a lump sum withdrawal facility if they seek to establish complying fund status.

The submission has also recommends that, to ensure that no existing complying funds are rendered non-compliant on enactment of the bill, it would be useful to have the requisite term implied into all complying fund trust deeds, to apply irrespective of anything in the trust deed to the contrary. Officials believe that this will be a prudent measure.

Recommendation

That the terms relating to withdrawal lump sums be implied into all complying fund trust deeds, to apply irrespective of anything in the trust deed to the contrary, and that the rest of the submission be noted.

Issue: Participation agreements

Submission
(87A – ASFONZ)

The key policy objective of a member needing to lock in savings until retirement is more simply addressed by removing the requirement for participation agreements altogether.

Comment

The submission notes that while there is no particular concern with the filing of participation agreements, the key objective of lock-in can better be served by removing any requirement for participation agreements. This would require the lock-in provision to be included in the trust deeds.

Lodgement of the participation agreement provides assurance to the government that employers providing access to complying funds provide access on the terms determined as necessary by the legislation. It creates greater transparency about the design of such schemes and ensures that they are aligned with the design of KiwiSaver.

Recommendation

That the submission be declined.

Issue: Annual reports

Submission
(87 and 87A – ASFONZ)

The requirement for additional annual report content should be reworded so that there is an obligation placed upon trustees to provide a summary of changes to any participation agreement to members covered under the relevant participation agreement, with the trustees required to provide a full set of these summaries to the Government Actuary when forwarding the full annual report.

Comment

This is already current market practice. The proposed amendment to the Superannuation Schemes Act cements this practice by requiring schemes to provide supplementary reports to the annual reports to members affected by the change, and a full set of amendments to the regulator. This is necessary because of the added tax incentives provided to KiwiSaver schemes, and ensures ongoing compliance with the complying superannuation fund criteria.

Recommendation

That the submission be declined.

Issue: Person with employment income opting in

Submission
(Matter raised by officials)

Clarification is required for persons with employment income that choose to opt in.

Comment

The policy intent of the opting-in rules is that if a person is receiving salary or wages, the person is required to have KiwiSaver contributions deducted from their salary or wages. The intention is that the same rules will apply to a self-employed person who earns a salary or wages. To provide some flexibility, an employee can nominate which employer this opt-in relates to if the employee has two or more jobs. In addition, deductions are required to be made from any new employment started after opting in.

Officials are aware of a couple of instances where a self-employed person with employment income who is opting in via a provider is contending that a self-employed person with employment income can opt in as a self-employed person only and that KiwiSaver contributions are not required to be deducted from their current salary or wage income.

Officials consider that the policy intent is reflected in the current legislation as there is a requirement for persons opting in via a provider to specify the name of the employer if the person is an employee.

However, to remove any doubt, officials recommend that the legislation be clarified to ensure that if a person is opting in and that person is an employee, then KiwiSaver contributions are required to be deducted from their salary or wages.

It is recommended that the amendment apply from the date of assent.

Recommendation

That the submission be accepted.

Issue: Definition of "salary or wages" and ACC weekly compensation and paid parental leave

Submission

(Matter raised by officials)

The definition of "salary or wages" in section 4 of the KiwiSaver Act should be amended to clarify that ACC weekly compensation and paid parental leave are treated as salary or wages for the purposes of KiwiSaver.

Comment

The definition of "salary or wages" in the KiwiSaver Act as it relates to ACC weekly compensation and paid parental leave creates an interpretation issue. This is because the definition of salary or wages excludes payments that are treated as income under section CF 1 of the Income Tax Act 2004 (which includes paid parental leave and ACC weekly compensation). However, the definition used by the KiwiSaver Act specifically includes these payments as salary or wages.

The policy intent is that ACC weekly compensation and paid parental leave are to be treated as salary or wages for KiwiSaver purposes as KiwiSaver deductions are required to be made if a recipient is a KiwiSaver member, but only if the recipient requests deductions to be made. Receiving ACC weekly compensation and paid parental leave is not treated as new employment for the purposes of the KiwiSaver Act.

Officials consider that exclusion from the definition of "salary or wages" for payments that are treated as income under section CF 1 of the Income Tax Act should be clarified so that the exclusion does not apply to ACC weekly compensation or paid parental leave. This would remove any doubt over the application of KiwiSaver to ACC weekly compensation and paid parental leave.

The proposed amendment should apply from 1 July 2007.

Recommendation

That the submission be accepted.

Other matters

MINOR TECHNICAL DRAFTING CHANGES

Submissions
(Matter raised by officials)

Officials have identified three minor technical drafting matters not dealt with elsewhere in the Officials' Report.

The drafting of proposed changes to the final calculation of Working for Families Tax Credits when payments have been made in interim instalments, overlooked the need to subtract parental tax credits received. Consequently, a small technical adjustment to a formula in section KD 7A(3) of the Income Tax Act 2004 is required to correct the oversight.

Drafting for the proposed inclusion of the fair dividend rate rules to qualifying assets in the calculation of a life insurers' policyholder base tax only considered the situation of direct investment or investment in a portfolio investment entity. The drafting inadvertently omitted instances where life insurers invest into a portfolio investment entity, which in turn invests into another a portfolio investment entity or entities, including those in lower tiers of the investment chain. This omission should be rectified.

It is also currently proposed that funds held for unit-linked life policies may adopt certain aspects of the portfolio investment entity rules in calculating its life insurance tax liabilities. However, to remove a potential ambiguity of interpretation, the current drafting needs to clarify that funds held for unit-linked life policies qualify for the proposed rules as part of the life insurer, and not as a person separate from the life insurer.

Comment

These minor technical changes are necessary to ensure that the proposed legislation reflects the policy intent.

Recommendation

That the submissions be accepted.

DEFINITION OF "DEPRECIABLE PROPERTY"

Submission
(71 – PricewaterhouseCoopers)

Section EE 7 of the Income Tax Act 2004 should be amended to ensure that all items listed in Schedule 17 fall within the definition of "depreciable property".

Comment

The submission is outside the scope of the bill. There is an established process for the handling of alleged unintended changes as the result of the rewrite of the Income Tax Act. This requires persons who consider that the rewrite process has resulted in an unintended change to refer the matter to the Rewrite Advisory Panel for its consideration.

Recommendation

That the submission be declined.