Regulatory Impact Statement

Financial arrangements – agreements for the sale and purchase of property or services

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

The question in this RIS is whether the tax rules that apply to taxpayers for returning income and expenditure on agreements for the sale and purchase of property or services (the "arrangements") should be changed in order to:

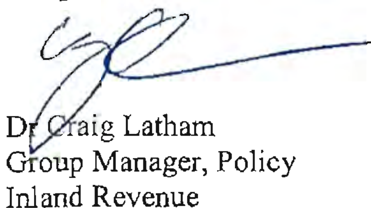
- reduce the complexity of calculations and increase overall compliance;
- minimise the volatility of taxable income in comparison to accounting income; and
- ensure that interest calculation for tax purposes reflects the economic reality.

Public consultation was targeted at business taxpayers, since non-business taxpayers do not generally have any significant arrangements of this type. The submissions received influenced the design of the options, particularly for the application dates and the rules recommended for taxpayers who do not use full accounting standards. Although the consultation pointed to the significant impact of the compliance costs and volatility, we are unable to quantify this impact and are not aware of any significant risk to the revenue base. Also, we assume that the overall net tax base effect across all affected taxpayers is fiscally neutral.

The analysis is based on the existing policy that the arrangements are treated as financial arrangements for tax purposes. The analysis also assumes that existing alternative methods in tax legislation for returning income and expenditure on financial arrangements are appropriate for the arrangements.

There are no other key gaps, assumptions, dependencies, significant constraints, caveats or uncertainties concerning the analysis.

None of the recommended options impair private property rights, reduce the incentives for businesses to innovate and invest, impose additional compliance costs, restrict market competition, or override fundamental common law principles.



Dr Craig Latham
Group Manager, Policy
Inland Revenue

5 December 2012

STATUS QUO AND PROBLEM DEFINITION

1. For tax purposes, agreements (other than short term agreements) for the sale and purchase of property and services (the "arrangements") are financial arrangements and are therefore subject to the financial arrangements (accruals) rules.

2. The arrangements are treated as financial arrangements because they can include interest due either to prepayments or to the deferral of payments for the property or services. The accruals rules were designed to include all arrangements that may include an interest component.

3. An example is an arrangement for the deferred settlement in six months' time for a commercial property where the parties agree that the property is worth $1 million when possession passes (ie. at the current time). However, due to the deferred settlement in six months, the purchaser will pay $1,025,000. The accruals rules treat $25,000 of the amount paid as interest paid/received by the purchaser/seller for the six-month deferral period.

4. The accruals rules also apply to the foreign currency ("FX") component of financial arrangements. In the above example, if the price of the property was denominated in US dollars, the accruals rules would capture the US$25,000 as interest. They would also capture any FX gains or losses on the US$1,025,000 from the possession date to the date of payment six months later.

5. The question in this RIS is whether to change the tax rules that apply to taxpayers for returning income and expenditure on agreements for the sale and purchase of property or services in order to:

- reduce the complexity of calculations and increase overall compliance;
- minimise the volatility of taxable income in comparison to accounting income; and
- ensure that interest calculation for tax purposes reflects the economic reality.

Compliance

6. For many business taxpayers there are ongoing and unnecessary compliance problems and significant compliance costs with using the current tax rules. Although these tax rules apply to many imports and exports of goods (trading stock etc.) and services, New Zealand is generally an importer of capital equipment and the compliance problems and costs are mostly in this area. Most businesses that are affected will be larger companies, and generally they will use International Financial Reporting Standards (IFRS) for financial reporting (IFRS taxpayers).

7. IFRS taxpayers have sophisticated accounting systems which give an appropriate, but different, treatment of the arrangements for accounting purposes, including the FX and interest components. These taxpayers then have to maintain separate complex work papers and spread-sheets to calculate taxable income and expenditure for the arrangements. In many cases, taxpayers have to engage external accountants and tax agents to complete these tasks.

8. At present, a number of taxpayers, for various reasons, do not fully comply with the detail required by the tax rules. We have evidence of technical non-compliance by at least one taxpayer, although, to date, this has not affected the tax take. During consultation we became anecdotally aware that a few other taxpayers might not be complying with the detail of the

rules (for example, the Corporate Taxpayer Group acknowledged certain technical non-compliance).

9. We are aware that there are significant compliance costs caused by the current rules. While this is not a formal estimate, after informal discussions with the two major submitters we believe that the compliance cost savings would be in the order of $3 million to $5 million per annum. This would be because separate tax calculations by most importers of capital equipment (the IFRS taxpayers) would not be required if the proposals in this paper are adopted. As is noted below, the major IFRS submitters explicitly noted this compliance cost reduction.

Tax volatility (and revenue fluctuations)

10. The rules can result in volatile taxable income or expenditure. As a consequence, the revenue collected also suffers from this volatility. The tax volatility is the result of using forward exchange rates for the arrangements when matching hedging arrangements are not used to offset the FX risks. Although this is not the case for the majority of taxpayers, the impact on the taxable income of those who are affected can be very significant in any income year.

11. A simple FX volatility example might concern an unhedged contract to buy a depreciable asset for delivery in twelve months. The forward rate at the date the contract is entered into is .8, at the intervening balance date it is .72. The ten percent movement, when multiplied by the contract cost of the asset results in a deductible loss for the year to the balance date. Where the asset is large (as is frequently the case for fixed assets) the volatility can be significant.

12. Then suppose the loss reverses and the currency to settle is purchased at .8. The previously reported book loss totally reverses in the next year. If the cost of the asset is $100 million, then the volatility is $10 million for each of the years, even though, in this case it is net nil over both years. Further, IFRS accounting will completely ignore both of these movements.

13. Although we are unable to quantify the level of volatility across the tax base, we are aware that, for some taxpayers, the volatility can be very significant when compared to their core taxable income.

Inappropriate tax outcomes where no economic interest income or expenditure

14. The rules allow interest income or expenditure to be imputed in some cases where it does not exist economically. This conflicts with the tax policy for financial arrangements which seeks to tax only the final economic income or expenditure over the life of the arrangement. Any advantages resulting from the imputation of non-economic interest into arrangements are counter to the policy intent of the accruals rules, and are therefore inappropriate tax outcomes.

15. The deductions for imputed interest could give significant timing advantages to taxpayers, and taxable income could be artificially reduced (although the impact of the deductions should reverse on maturity of the arrangements). For example, where plant and equipment are imported, deals may be structured to convert some of the capital cost of depreciable assets into a notional interest charge. The consequent timing advantage would not reverse until the assets are fully depreciated. As New Zealand taxpayers are significant

importers of plant and equipment there is, at least conceptually, scope to structure arrangements to obtain this timing advantage.

16. At present, we are not aware of any significant risk to the revenue base of this.

OBJECTIVES

17. The objectives are to:

- reduce the complexity of calculations and increase overall compliance;
- minimise the volatility of taxable income in comparison to accounting income; and
- ensure that interest calculation for tax purposes reflects the economic reality.

REGULATORY IMPACT ANALYSIS

18. There are four options considered for the FX component of the arrangements (FX in the table below) and three options for the interest component (INT in the table below) that wholly or partly achieve the desired objectives. These options (some of which are co-recommendations as noted) are highly technical in nature and we have sought to summarise the options in the table, which also outlines the economic and compliance implications. Otherwise, no fiscal, social environmental or cultural costs are expected to arise under the recommended options.

19. Although the recommended option(s) reduce compliance costs significantly, all of the potential changes alter the timing of tax obligations rather than the amount of tax payable. The timing outcomes for different transactions and different taxpayers will differ: for some taxpayers the changes will result in a bring-forward of tax whilst for others they will give a delay. Because of the wide range of taxpayer specific circumstances and the interaction of these circumstances with foreign exchange movements, the overall net effect is assumed to be fiscally neutral.

Options	Costs	Benefits	Recommendation & impact (compared to *status quo*)
FX 1: use spot FX rates without hedge accounting	- No overall reduction of compliance costs for IFRS taxpayers who hedge the arrangements. - No reduction in volatility of taxable income for taxpayers who hedge the arrangements. - May not increase voluntary compliance.	- Non-IFRS taxpayers would have reduced compliance costs.	**Not recommended.** **Net impact:** marginally positive.

FX 2: use forward FX rates with an expected value alternative (which does not tax unrealised FX gains/losses)	- May increase planning opportunities in some circumstances.	- Reduced compliance costs for taxpayers with unhedged arrangements. - Reduced volatility of taxable income for taxpayers with unhedged arrangements.	**Not recommended.** **Net impact:** marginally positive.
FX 3: use spot FX rates with hedging (giving IFRS accounting equivalent results)	- At the margin planning risks may be increased for IFRS taxpayers.	- Taxpayers would have reduced compliance costs. - Non-IFRS taxpayers would have less volatile taxable income.	**Recommended** for non-IFRS taxpayers who consistently include FX hedging amounts in values for trading stock and depreciable assets in their accounting systems. **Net impact:** marginally positive.
FX 4: follow accounting treatment, especially for IFRS taxpayers and non-IFRS taxpayers who elect to use IFRS accounting	- At the margin non-IFRS taxpayers may be able to adopt inappropriate tax treatments/increase planning risks.	- Significant compliance cost savings for the IFRS taxpayers. - Significantly reduces volatile taxable income for the IFRS taxpayers.	**Recommended** for IFRS taxpayers and non-IFRS taxpayers who have adopted IFRS GAAP accounting. **Net impact:** significantly positive.
INT 1: interest for tax when the parties explicitly agree it (all taxpayers)	- May not discourage planning opportunities for arrangements between NZ and overseas-related parties.	- Significantly reduces compliance costs for all taxpayers. - Reduces planning risks. - Accords with commercial reality and may therefore encourage voluntary compliance.	**Not recommended.** **Net impact:** positive, but not the most beneficial option.
INT 2: current general rules but only in very restricted circumstances	N/A	- Reduces compliance costs. - Reduces planning risks.	**Recommended** for non-IFRS taxpayers. **Net impact:** positive, but not the most positive for IFRS taxpayers.
INT 3: follow accounting treatment	- Not available for non-IFRS taxpayers, so they would use option INT 2 above.	- Significantly reduces compliance costs for IFRS taxpayers. - Reduces planning risks for IFRS taxpayers.	**Recommended** for IFRS taxpayers, with option INT 2 for non-IFRS taxpayers. **Net impact:** the most positive option overall.

CONSULTATION

20. The full Generic Tax Policy Process GTPP) was followed for consultation. An issues paper was released in July 2012, seeking consultation on the tax treatment of these arrangements. Seven submissions were received in response to the issues paper. The submissions reflect the views of the Corporate Taxpayer Group (33 IFRS taxpayers); two individual IFRS taxpayers (members of the Corporate Taxpayer Group); three of the large accounting practices; and the New Zealand Institute of Chartered Accountants. As a result,

alternative solutions for the tax treatment of the arrangements were considered and are covered in this RIS for options FX 3, FX 4 and INT 2 above.

21. All the submissions support the general direction of the suggested changes to the tax rules for these arrangements. The submissions made by the Corporate Taxpayer Group and the two individual IFRS taxpayers were explicit and unanimous that the proposals for IFRS taxpayers provide compliance costs savings and eliminate the volatility between accounting and tax positions. Naturally submitters were more reticent on the present non-compliance with the technical detail of the rules, but the Corporate Taxpayer Group's submission did acknowledge this technical non-compliance.

22. The Corporate Taxpayer Group's submission agreed with all the substantive suggestions about the IFRS accounting treatment for tax, except the suggestion for the imputation of IFRS interest in arrangements when the parties have not agreed that there is interest. This matter has been discussed with the submitters and the outcome of those discussions (and other discussions) is reflected in the summary of the submissions in the table below:

	Submission	Officials' comments	Impact on proposals
1.	IFRS treatment of interest should not override lowest price clauses or interest agreed commercially.	IFRS should reflect the commercial reality of most arrangements and therefore is appropriate.	No change to proposed IFRS treatment of interest.
2.	An expected value method which does not tax unrealised FX gains/losses should apply to the current FX forward rate treatment.	This may allow some taxpayers to eliminate the volatility of taxable income but does not have any advantages over using spot rates or following the accounting treatment.	No change to the proposed treatment of the FX component.
3.	The FX component proposed spot exchange rate treatment should be further considered for non-IFRS taxpayers	We agree with the submission and propose more flexibility.	Some hedging treatment is to be allowed for trading stock and depreciable assets where it is used in accounting systems, and IFRS accounting would be allowed for non-IFRS taxpayers who choose to adopt IFRS accounting.
4.	Interest should not be imputed into arrangements for non-IFRS taxpayers where it has not been agreed commercially.	The rules for non-IFRS taxpayers are mirroring the IFRS treatment and are appropriate. Significant complexity has been removed for non-IFRS taxpayers.	No change to the proposed changes for the interest component for non-IFRS taxpayers.
5.	For existing arrangements transitional rules – a case-by-case transitional approach under care and management should apply, rather than the proposed legislative approach.	The proposed legislative approach for transition is compliance friendly and poses no fiscal risk. The submission is not considered workable and would cause compliance difficulties.	One change to the original suggestions is proposed for IFRS taxpayers who would be allowed to use the IFRS treatment of new forward exchange contracts designated as hedges of existing arrangements.
6.	The mandatory application of the proposed new rules should not apply from the 2012-13 income year as most taxpayers are already well into that year.	We agree with the submission.	We now propose that the new rules should apply from the 2013-14 income year. However, IFRS taxpayers would be able to elect to apply them from the 2011-12 income year.

CONCLUSIONS AND RECOMMENDATIONS

23. Based on the above analysis our conclusions and recommendations are set out below.

IFRS taxpayers – FX and interest components

24. The IFRS treatment would be mandatory for taxation purposes for IFRS taxpayers (option **FX 4** above and option **INT 3** above). The suggested IFRS treatment would not extend to any capitalisation of interest paid (e.g. bank interest) into the cost of the underlying item.

25. There are significant compliance benefits for IFRS taxpayers to use the IFRS accounting treatment for both the FX and interest components for returning income and expenditure for tax on these arrangements. Following the IFRS treatment for tax also reduces the volatility between accounting income and taxable income, which is a primary concern for some IFRS taxpayers.

26. The submission of the Corporate Taxpayer Group (representing the 33 corporate IFRS taxpayers) agrees with the mandatory IFRS treatment. The submission does raise a question about overriding any contractual interest in these arrangements with the IFRS imputation of interest. However, after discussion and consideration, we conclude that the IFRS treatment of interest would reflect the contractual position in most, but not all, cases.

Non-IFRS taxpayers

27. ***FX component*** – the general rule to value the property or services denominated in foreign currency would be the aggregate of the NZ dollar amounts using actual spot exchange rates at payment dates/recognition dates (including an appropriate accounting treatment in some cases, which can be the IFRS treatment where it is adopted for financial reporting) (option **FX 3** above). There would be two exceptions:

- for trading stock and consumables, any FX variations from hedges would be included in the value of the stock where they are included in the stock values in the taxpayer's stock system; and

- for depreciable property, FX variations from "qualifying" hedges would be included in the value of the property where it is also included for tax depreciation calculations.

28. ***Interest component*** – interest would only be imputed in the agreements on a future value or discounted value basis in limited circumstances (option **INT 2** above).

29. Non-IFRS taxpayers would continue to have some compliance issues with the proposed treatment of these arrangements. This is inevitable, given the wide range of businesses that do not use IFRS or do not have to prepare general purpose financial reports at all. The proposed new rules for these taxpayers are designed to be as compliance-friendly as possible, and allow some pragmatic choices to be made. They will still be simpler than the present rules.

IMPLEMENTATION

30. We propose that the new rules generally be made effective for new agreements from the 2013–14 income year. We consider that this would be the least disruptive application date for

the majority of taxpayers, and will not impact on provisional tax payments for current income years.

31. However, we propose that IFRS taxpayers can make a once-and-for-all election to apply the IFRS accounting treatment to new arrangements from the 2011-12 income year. This would include any designated hedges, the cost of the underlying item and any interest component. Officials consider that there is no risk to the revenue base from allowing this treatment from the 2011-12 income year.

32. We also propose that the tax treatment for any existing agreements, associated hedges and the underlying property or services for income years before 2013–14, where the methods used are the proposed new rules, be validated retrospectively. We understand that many IFRS taxpayers are effectively using the IFRS treatment for tax, especially where the arrangements are hedged for accounting purposes. We also understand that many non-IFRS taxpayers will be basing the tax treatment on their hedge accounting treatment of trading stock and depreciable assets. The past tax treatment of the arrangements in foreign currency, and the valuation of the underlying property or services in those arrangements based on spot exchange rates at payment and/or rights dates, would also be validated.

33. We consider that existing positions should be confirmed to prevent unnecessary disputes, as those treatments cause only some timing differences compared to the current rules. Existing agreements would continue to use the treatment they adopted in returns before the 2013–14 income year until they mature – that is, agreements would not be allowed to change to another current or new alternative method. This would prevent the rules from being cherry picked and would also prevent risks to the revenue base. However, there would be one exception whereby IFRS taxpayers can elect that forward exchange contracts entered into from the 2011–12 income year, which are designated as hedges of the FX risks on existing arrangements, can follow the IFRS accounting treatment for tax.

34. The new rules would be administered by Inland Revenue through existing channels. There are no systems or design matters specifically catering for the arrangements which need to be addressed for the new rules. Taxpayers would continue to make any calculations for the arrangements not already included in the financial accounts and include the appropriate amounts in their tax returns. A Tax Information Bulletin item would be published, fully explaining the new rules for taxpayers and Inland Revenue employees when the legislation is passed.

MONITORING, EVALUATION AND REVIEW

35. Officials would informally monitor the introduction and transition to the proposed new rules to ensure consistency with the underlying policy framework.

36. Given the impact of the proposals on a relatively small number of taxpayers and the involvement of a number of key representative bodies, where any issues are raised officials would determine whether there are substantive grounds for review under the GTPP.

37. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the GTPP. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves a post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, changes identified as necessary for the

new legislation to have its intended effect would generally be added to the tax policy work programme, and proposals would go through the GTPP.