Regulatory Impact Statement

Financial arrangements – the treatment of interest-free and reduced-interest loans under IFRS

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options for clarifying the financial arrangements rules, to ensure that notional amounts of interest or one-off adjustments that arise because of the accounting treatment of interest-free or reduced-interest loans are ignored for tax purposes.

There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties that have been identified. However, our preferred option will be partly retrospective in that it will affect past positions taken, but from a prospective date. This will ensure that taxpayers who have claimed deductions contrary to the policy intent will be returned to the intended tax position. Taxpayers will be required to pay provisional tax on the basis of the new rule before it is enacted, although the introduction of the bill will give them notice of the required treatment. We believe this is appropriate in these circumstances. Claiming deductions for expenses that are not incurred is clearly inconsistent with the underlying policy and the purpose of the financial arrangements rules.

We engaged in only limited consultation as we did not want to draw undue attention to the issue because wider knowledge of this issue poses a revenue risk. We also expect the number of affected taxpayers to be very small (it is estimated that fewer than 20 taxpayers will be affected) and the proposed solution is straightforward. We have consulted with a senior accountant in a large accounting firm, who supported the proposal. We have also consulted with the Treasury, which agrees with our analysis.

This clarification of the law will be communicated by releasing a commentary explaining the effect of the clarification on the introduction of the bill, and writing a Tax Information Bulletin item once the bill receives Royal assent. Given the small scale of the problem and the nature of those possibly impacted (large businesses) we believe this is sufficient to communicate this clarification of the law.

The proposed change does not impose any new significant compliance costs on affected taxpayers. The proposed rule also does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

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6 March 2013

STATUS QUO AND PROBLEM DEFINITION

1. Interest-free loans are financial arrangements and are thus taxed under the financial arrangements rules. Broadly speaking, the financial arrangements rules require expected income and expenditure to be spread over the life of the financial arrangement using a "spreading method".

2. At present, there is uncertainty as to the correct tax treatment of interest-free (and reduced-interest) loans for taxpayers that comply with the International Financial Reporting Standards (IFRS) accounting rules. No actual interest payments will be made under an interest-free loan. Accordingly, there should be no income or deductions to spread for tax purposes.

3. This is not necessarily the tax treatment that such loans receive. For accounting, IFRS requires that the value of an interest-free or reduced-interest loan be reduced on initial recognition, so the loan is effectively split into two components:

(a) a full-interest loan for a lesser amount; and

(b) a contribution of equity in the case of a related-party loan, or a one-off adjustment in the firm's profit and loss account in the case of unrelated lending.

4. This IFRS accounting treatment therefore gives rise to notional payments in a company's accounts. For example, a company that has an interest-free loan will make book entries for interest payments as if it were a full-interest loan, even though it will make no actual interest payments.

5. Some taxpayers have argued that the current drafting of tax legislation allows these notional payments to have a tax effect (i.e. that they are deductible/ taxable).[1] This is because the legislation containing the detailed rules that provide for what is taxable and what is deductible is capable of being read as allowing for deductions in the situation described above. The counter-argument is that Parliament would not have intended for these notional payments to have a tax effect (i.e. that they should not be deductible/taxable) and the rules should be read consistently with that intention so as to deny deductions where there is an interest-free loan. It is unclear which interpretation would be accepted by the Courts. Therefore, it is appropriate that the legislation be amended to make it clear that deductions are not allowed in this situation.

6. We are not aware of many taxpayers who are arguing that these notional amounts should have a tax effect. The size of the problem is small (it is estimated that fewer than 20 taxpayers will be affected). Nevertheless, we consider it important for the law to be clarified because not only is this inconsistent with the policy intent, the potential ability for taxpayers to claim tax deductions on notional payments carries a fiscal risk.

7. It should be noted that if the argument above (that the notional book entries can have a tax effect) is accepted, the result for a taxpayer can either be an increase or decrease in tax liability; its effect depends on how a taxpayer has structured the loan and whether they are a borrower or lender.

OBJECTIVES

8. The objectives are to:

[1] These anomalies would eventually be cancelled out when the loan is repaid, but in the interim there could be important timing effects.

(a) Ensure that one-off adjustments to the value of a loan on initial recognition and notional amounts of interest are ignored for tax purposes, consistent with the policy intent; and
(b) Protect the integrity of the tax base by ensuring the fiscal risk associated with the status quo is removed.

REGULATORY IMPACT ANALYSIS

Option one: retain the status quo

9. Under option 1 the ambiguity in the legislation relating to interest-free and reduced interest loans would not be removed. This would mean that taxpayers could continue to argue that tax deductions were available for notional amounts recognised in the IFRS accounts.

Option two: amend the legislation to remove the ambiguity

10. Under option two the ambiguity in the legislation relating to interest-free and reduced-interest loans would be removed by ensuring that one-off adjustments to the value of a loan on initial recognition and notional amounts of interest are ignored for tax purposes, consistent with the policy intent.

11. Options one and two are analysed in the table below:

Options	**Meets objective?**	**Comment**	**Fiscal / economic**	**Social environmental**
Option 1: status quo No change to legislation relating to interest-free and reduced-interest loans.	No. This option does not meet the objective as there would still be an argument that taxpayers could claim tax deductions for notional amounts recognised in the IFRS accounts.	Not viable. As a matter of policy, taxpayers should not be able to claim deductions for expenses not actually incurred (or be taxed on income that is not actually derived). Not addressing the ambiguity results in uncertainty.	Potential fiscal risk as there is an argument that taxpayers can claim tax deduction even though no economic expense has been incurred. While the tax deduction would eventually be clawed back, it would still result in a time value of money advantage for taxpayers.	No impact
Option 2 – remove the ambiguity	Yes. It would ensure that there were no tax deductions	As a matter of policy, taxpayers should not be	Removing the ambiguity removes the fiscal risk.	No impact.

The ambiguity in the legislation relating to interest-free and reduced-interest loans would be removed by ensuring that one-off adjustments to the value of a loan on initial recognition, and notional amounts of interest are ignored for tax purposes, consistent with the policy intent.	or taxable income for amounts unless they were economically incurred or derived.	able to claim deductions for amounts not actually incurred (or taxed on income that is not actually derived). Amending the legislation to remove the ambiguity would remove taxpayers' ability to argue this position. Amending the legislation to remove the ambiguity would increase certainty.	Removing the ambiguity may result in minor adverse provisional tax implications for some taxpayers.	

Conclusion on the options

12. The recommended approach is to amend the legislation in relation to interest-free or reduced-interest loans to ensure that one-off adjustments to the value of a loan on initial recognition are ignored for tax purposes. This will ensure that taxpayers cannot claim tax deductions for amounts not incurred (or are not taxed on income that is not actually derived). Amending the legislation to remove the ambiguity would remove taxpayers' ability to argue this position. The other option – retaining the status quo – is not recommended as it would preserve taxpayers' ability to argue that tax deductions are available for amounts not economically incurred. This would result in a potential fiscal risk and would not remove the current uncertainty.

Date of application

13. In terms of application dates, the two options we considered were:

(a) Applying the amendments from the beginning of the income year that the bill containing the amendment is introduced (the 2013–14 income year), and

(b) Applying the amendments from the beginning of the income year following the enactment of that bill (the 2014-15 year).

14. We prefer option (a). Option (a) will potentially have a back-dated effect: taxpayers will be required to pay provisional tax on the basis of the new rule before it is enacted, although the introduction of the bill will give them notice of the required treatment. Claiming deductions for expenses that are not incurred is clearly inconsistent with the underlying policy

and the purpose of the financial arrangements rules. It is worth noting that only large taxpayers will be affected, who we expect will be well advised and aware that claiming these notional deductions is inconsistent with the purpose of the rules. Option (a) reduces the potential fiscal risks associated with the status quo as early as possible.

15. The later application date, Option (b), carries the risk of making more taxpayers aware of the potential tax advantage of the current situation, increasing the fiscal risk.

16. No social or environmental impacts have been identified for either option.

Existing arrangements

17. In terms of existing arrangements (for example, interest-free loans that were entered into in prior years), we considered:

(a) clawing back any notional deductions previously claimed (and, for those paying tax on notional interest amounts, providing refunds), with the clawed-back amounts being payable (or returned) in the 2014/15 income year; and

(b) not clawing back previously claimed/paid amounts until the loan is repaid.[2]

18. We prefer option (c). Again, this is on the basis that it is inappropriate to claim deductions for expenses that are not incurred. Option (c) returns the taxpayer to the correct position as soon as possible. Option (d) defers (but does not prevent) the adjustment until future income years, which would provide the taxpayer with an ongoing time value of money advantage (or disadvantage in the case of interest income). We therefore consider it appropriate for deductions already claimed to be clawed back; the alternative would be allowing taxpayers to keep an improper advantage and would exacerbate the fiscal impact of the current situation.

19. Option (c) is beneficial for any taxpayers that have had to pay tax on notional amounts arising from the accounting treatment of interest-free or reduced-interest loans.

20. Option (d) will have a slightly negative fiscal impact, but due to the small scale of the problem at present this will not be significant or measurable.

21. No social or environmental impacts have been identified for either option.

CONSULTATION

22. We have engaged in limited consultation with a senior accountant in a large accounting firm. He supported our preferred approach as outlined above. He supported a 1 April 2013 application date for the clarification (effectively the same as the application date we propose) and the clawback being performed in the 2013/14 income year. We prefer a later date for the clawback, as it will ensure the relevant bill will have received Royal assent before taxpayers are required to pay back tax on any notional amounts previously claimed.

23. We engaged in only limited consultation as we did not want to draw undue attention to this issue because wider knowledge of this issue poses a revenue risk. As with a prospective application date, drawing attention to the issue would allow taxpayers time to create arrangements that take advantage of the current situation. In addition, based on the small size of the problem and straight-forward nature of our proposed solution we did not consider wider consultation to be necessary.

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[2] As described above, previously claimed/paid amounts will eventually be clawed back in any event when the loan is repaid (or a base price adjustment is triggered for another reason).

24. We have also consulted with the Treasury, which agrees with our analysis.

CONCLUSIONS AND RECOMMENDATIONS

25. The recommended option is to clarify that notional amounts of interest and one-off adjustments to the value of a loan on initial recognition should be ignored in the IFRS financial reporting spreading method. The application date for this clarification should be the beginning of the 2013/14 income year.

26. We recommend the creation of a rule requiring taxpayers who have been claiming deductions for these notional amounts (or paying tax on them) to repay these deductions (or receive a refund of the tax payments) in their 2014/15 income year tax return.

27. This will effectively clarify how the financial arrangements rule spreading methods should apply to reduced-interest or interest-free loans. It also minimises the fiscal risks associated with the status quo.

IMPLEMENTATION

28. The necessary legislative changes will be included in the scheduled April 2013 tax bill. There are no administrative impacts. Enforcement will carried out through Inland Revenue's standard risk monitoring and audit processes.

29. We will communicate this clarification by releasing a commentary explaining what a change does on the introduction of a bill, and writing a Tax Information Bulletin item once the bill receives Royal assent. Given the small scale of the problem and the nature of those possibly impacted (large businesses), we believe this is sufficient to communicate this clarification of the law.

MONITORING, EVALUATION AND REVIEW

30. The need for this clarification has come from Inland Revenue's standard monitoring of how tax laws are being applied in practice. This monitoring is ongoing and will continue once the clarification is in place.