



## WEEKLY COMMENT: FRIDAY 21 NOVEMBER 2014

1. This week and in the following two weeks I am going to look at the amendments to the financial arrangements rules enacted in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. The amendments are mainly concerned with foreign currency agreements for the sale and purchase of property or services (“foreign ASAPs”).
2. Separate rules apply to IFRS and to non-IFRS taxpayers. This week I look at the foreign ASAPs rules for IFRS taxpayers. Next week and the week after that I will look at the foreign ASAPs rules for non-IFRS taxpayers.
3. The new laws affecting foreign currency agreements generally apply from the 2014-15 income year. Foreign currency agreements entered into before the 2014-15 income year remain subject to the old rules. However, taxpayers can apply the new rules retrospectively from the 2011-12 income year, providing their tax returns reflect that treatment – discussed in relation to IFRS taxpayers in paragraph 25 onwards below.

### **Foreign currency agreements for the sale and purchase of property or services**

4. The amendments follow from an Officials’ Issues Paper *Financial arrangements – the sale and purchase of property or services*, which I reviewed in *Weekly Comment* 11 July 2012. There I also reviewed the current rules affecting IFRS and non-IFRS taxpayers. I noted that:
  - (a) Section EW 15H requires the mandatory use of certain Determinations, which include *Determination G29* (the modified method using the expected value approach in *Determination G9C*), and s. EW 15C(2) denies IFRS taxpayers the ability to use the fair value, modified fair value or expected value methods if s. EW 15H applies; and
  - (b) Section EW 14(2) requires non-IFRS taxpayers to use *Determination G29* without modification (i.e. using *Determination G9A*) if they either do not comply with the requirements to use one of the non-Determination methods listed in s. EW 14(2).
5. Please refer to *Weekly Comment* 11 July 2012 for a more detailed explanation of the current rules and *Determination G29*.

### **Foreign currency agreements affected by the new rules**

6. Not all foreign currency agreements are affected. The rules specify the threshold where some part (but not all) of the consideration is denominated in a foreign currency. The new definition in s. YA 1 defines a “**foreign ASAP**” as meaning a financial arrangement that is an agreement for the sale and purchase of property or services if, at the time the ASAP is

entered into, 50% or more of the consideration in New Zealand dollars is in a foreign currency, measured using spot rates at that time.

### **IFRS taxpayers**

7. Section EW 15D states the general IFRS rules. Under the IFRS financial reporting method, a person must allocate an amount to an income year under the IFRS rules, modified, as applicable, under s. EW 15D(2).
8. Under new s. EW 15D(2)(ae), if the financial arrangement is a **foreign ASAP**, or is an **IFRS designated FX hedge** for a foreign ASAP, sections EW 32 and EW 33B apply to value, for IFRS rules, the relevant property or service. Section EW 32 provides the general valuation rule. Section EW 33B adjusts the value when there is an "IFRS designated FX hedge", which is defined in s. YA 1 as meaning an "FX hedge" that is designated, under IFRS rules, as a hedge for a foreign ASAP for which s. EW 32(2B) applies. An FX hedge is defined in s. YA 1 as meaning a financial arrangement that is a hedge of foreign exchange risk.
9. Consequential amendments to sections EW 15D(2B)(b), EW 15F(1)(bb) and EW 15G(1)(bb) mean that income and expenditure for a foreign ASAP cannot be calculated using *Determination G29*, the expected value method or the modified fair value method respectively. Section EW 15H(1)(d) has been repealed so that *Determination G29* cannot be used to value property or services or spread income and expenditure for a foreign ASAP.
10. Section EW 15I applies so as to require the mandatory use of a yield to maturity method for an agreement for sale and purchase of property and services if s. EW 15H does not require IFRS taxpayers to use *Determination G29*. Section EW 15I(b)(iii) has been replaced so that s. EW 15I will not apply to a foreign ASAP other than life financial reinsurance.
11. Section EW 15I will continue to apply to an agreement for the sale and purchase of property and services that is not a foreign ASAP, and also to a foreign ASAP that is life financial reinsurance. Income and expenditure on these financial arrangements will continue to be spread under s. EW 15I.

### **General rule for valuing property or services that are the subject of a foreign ASAP**

12. Section EW 32 applies when an original party to an agreement for the sale and purchase of property or services, a hire purchase agreement, a specified option, or a finance lease pays or is paid consideration that includes property or services. The value of the property or services is determined by applying s. EW 32(2B) to EW 32(6) in numerical order until a subsection applies. The application of s. EW 32 is modified by sections EW 33B, EW 33C and EW 34.
13. New s. EW 32(2B) states the general rule for valuing property or services relating to a foreign ASAP of an IFRS taxpayer: the value of the property or services is the value under IFRS rules, modified on account of FX hedges as provided by s. EW 33B. It is noted on page 78 of *Tax Information Bulletin* Vol. 26 No. 7 August 2014 (the "TIB item") the values under IFRS rules will usually be amounts in New Zealand dollars at the time they are recognised in IFRS financial statements, using spot rates to convert foreign currency amounts.
14. Note that s. EZ 75 overrides s. EW 32(2B) for foreign ASAPs entered into in earlier years to which the rules are able to be retrospectively applied under s. EZ 75, as discussed in paragraph 25 onwards below.

### **Adjusting the value for IFRS-designated FX hedges**

15. Under s. EW 33B(1) and (3), the value of property or services relating to a foreign ASAP of an IFRS taxpayer, as determined under s. EW 32(2B), is *modified by the amount attributed under IFRS rules to that value* on account of a relevant IFRS designated FX hedge when:
- (a) The foreign ASAP relates to:
    - (i) Property that is or will be depreciable property or revenue account property; or
    - (ii) Services, the sale or purchase of which, as relevant for the person, gives rise to assessable income or deductions under this Act outside of the financial arrangements rules; and
  - (b) The person holds an IFRS designated FX hedge in relation to the foreign ASAP.
16. Note that it is the amount attributed under IFRS rules, which is taken into account. The tax values for the property or services described in paragraph 15 above are those used in the IFRS financial statements, including amounts attributed to them for IFRS designated FX hedges.
17. Under s. EW 33B(5), amounts relating to an IFRS designated FX hedge that are attributed to the value of property or services under s. EW 33B are excluded from being taken into account when the financial arrangements rules (i.e. spreading method and base price adjustment) are applied to the hedge itself. It is noted in the TIB item that:
- “This prevents double counting of these amounts under the two financial arrangements. ... These amounts will usually be allocated to reserves in “Other Comprehensive Income” in the IFRS financial statements until the property or services are recognised in the financial statements.”
18. Under s. EW 33B(1) amounts from IFRS designated FX hedges are included in the tax values of only depreciable or revenue account property or assessable/deductible services (as set out in paragraph 15 above) when the foreign ASAP relates to such property. It is noted in the TIB item that:
- “Therefore the rules do not apply to IFRS designated FX hedges for foreign currency ASAPs for non-revenue account property that is not depreciable property and non-deductible/non-taxable services. Hedges for these matters will continue to be treated as stand-alone financial arrangements. All consideration for, and under those hedges, will continue to be spread under the present rules. ...
- This is the appropriate policy outcome. ... IFRS designated FX hedges are financial arrangements which, in the absence of the new tax rules, would be fully taxed under the financial arrangements rules. Where the hedges are for non-revenue account property, amounts relating to the hedges should continue to be taxed under the financial arrangements rules because they otherwise would not be in the tax base.”
19. Note that s. EZ 75 overrides s. EW 33B for foreign ASAPs entered into in earlier years to which the rules are able to be retrospectively applied as discussed in paragraph 25 onwards below.

**TIB item example of a depreciable asset acquired by an IFRS taxpayer**

20. The example on page 79 of the TIB item shows how the new rules apply to the purchase of a depreciable asset by an IFRS taxpayer and is based on the following assumptions:
- (a) The purchase of a depreciable asset for US\$100,000 in 12 months (being the IFRS GAAP recognition date).
  - (b) The payments are US\$50,000 in 6 months (payment A, a non-monetary item for IFRS GAAP), and US\$50,000 at the recognition date in 12 months (payment B).
  - (c) Both payments are hedged from the beginning with forward exchange contracts (FEC/s) designated as cashflow hedges. However, for comparison the example includes the treatment where both payments are not hedged at all, and where the hedge is not designated.
  - (d) The forward (FEC) rate for payment A is 0.72 and the FEC rate for payment B is 0.65.
  - (e) The spot rate for payment A is 0.65 and the spot rate for payment B is 0.80.
  - (f) A balance date falls three months prior to the recognition date when the spot rate is 0.75.
21. The IFRS GAAP results are set out for three situations:
- (a) The hedges are designated as cashflow hedges;
  - (b) The hedges are not designated as hedges; and
  - (c) There are no hedges at all.
22. When the hedges are designated as cashflow hedges:
- (a) On the date of Payment A, the payment is recognised as a prepayment on the Balance Sheet at the FEC rate – i.e.  $\text{USD}50,000/0.72 = \text{NZ}\$69\text{k}$ :
    - (i) Prepayment DR \$69k; and
    - (ii) Cash CR \$69k.
  - (b) On balance date, the amount still payable in respect of Payment B at the spot rate would be  $\text{USD}50,000/0.75 = \text{NZ}\$66\text{k}$ . However, the amount actually payable for Payment B at the FEC rate is  $\text{USD}50,000/0.65 = \text{NZ}\$77\text{k}$ . The notional loss of \$11k is recorded on the Balance Sheet as:
    - (i) Cashflow Hedge Reserve (Reduction in Shareholders' Funds) DR \$11k; and
    - (ii) FEC Fair Value (Additional Liability) CR \$11k.
  - (c) On the IFRS recognition date Payment B is recorded as part of the asset purchase at the FEC rate of NZ\$77k, Payment A is transferred from Prepayments to the asset, and the Cashflow Hedge Reserve entry is reversed:
    - (i) Asset (Payment B) DR \$77k;
    - (ii) Cash (Payment B) CR \$77k;
    - (iii) Asset (Payment A) DR \$69k;
    - (iv) Prepayments (Payment A) CR \$69k;
    - (v) FEC Fair Value DR \$11k; and
    - (vi) Cashflow Hedge Reserve CR \$11k.

- (d) The overall result is that the accounting and tax value of asset is recorded at the amount actually paid under the FECs – i.e. \$146k.
- (e) There is no impact on the P&L up to the IFRS recognition date and therefore no income or expenditure under the financial arrangements rules for tax up to that point.

23. When the hedges are not designated:

- (a) On the date of Payment A, the payment is recognised as a prepayment on the Balance Sheet at the spot rate – i.e.  $\text{USD}50,000/0.65 = \text{NZ}\$77\text{k}$ , but because the amount actually paid at the FEC rate is only \$69k, there is a profit recognised of \$8k:
  - (i) Prepayment DR \$77k;
  - (ii) Cash CR \$69k;
  - (iii) Profit CR \$8k.
- (b) On balance date, the amount still payable in respect of Payment B at the spot rate would be  $\text{USD}50,000/0.75 = \text{NZ}\$66\text{k}$ . However, the amount actually payable for Payment B at the FEC rate is  $\text{USD}50,000/0.65 = \text{NZ}\$77\text{k}$ . The notional loss of \$11k is recorded on the P&L and the Balance Sheet as:
  - (i) FEC Fair Value Loss (P&L) DR \$11k; and
  - (ii) FEC Fair Value (Additional Liability – Balance Sheet) CR \$11k.
- (c) On the IFRS recognition date Payment B is recorded as part of the asset purchase at the spot rate of  $\text{USD}50,000/0.80 = \text{NZ}\$62\text{k}$ , Cash is reduced by the actual payment at the FEC rate of NZ\$77k, the difference is a loss that is taken to the P&L, Payment A is transferred from Prepayments to the asset, and the FEC Fair Value liability entry is reversed:
  - (i) Asset (Payment B) DR \$62k;
  - (ii) Loss on FEC (Payment B – P&L) DR \$15k;
  - (iii) Cash (Payment B) CR \$77k;
  - (iv) Asset (Payment A) DR \$77k;
  - (v) Prepayments (Payment A) CR \$77k;
  - (vi) FEC Fair Value (Additional Liability – Balance Sheet) DR \$11k; and
  - (vii) FEC Fair Value (Gain – P&L) CR \$11k.
- (d) The overall result is that the accounting and tax value of asset is recorded at the spot rates on the dates of the payments – i.e. \$139k, the amounts actually paid under the FECs is \$146k, and the difference is a loss recognised in the P&L of \$7k.
- (e) The loss of \$7k in the P&L is expenditure under the financial arrangements rules for the undesignated IFRS FX hedges. The spreading of this expenditure will depend on which of the available spreading methods is being used for these types of financial arrangements.

24. When there are no hedges:

- (a) On the date of Payment A, the payment is recognised as a prepayment on the Balance Sheet at the spot rate – i.e.  $\text{USD}50,000/0.65 = \text{NZ}\$77\text{k}$ , which is also the amount paid:
  - (i) Prepayment DR \$77k; and
  - (ii) Cash CR \$77k.

- (b) On balance date there is nothing to recognise.
- (c) On the IFRS recognition date Payment B is recorded as part of the asset purchase at the spot rate of  $\text{USD}50,000/0.80 = \text{NZ}\$62\text{k}$ , which is also the amount paid, and Payment A is transferred from Prepayments to the asset:
  - (i) Asset (Payment B) DR  $\$62\text{k}$ ;
  - (ii) Cash (Payment B) CR  $\$62\text{k}$ ;
  - (iii) Asset (Payment A) DR  $\$77\text{k}$ ;
  - (iv) Prepayments (Payment A) CR  $\$77\text{k}$ ;
- (d) The overall result is that the accounting and tax value of asset is recorded at the spot rates on the dates of the payments – i.e.  $\$139\text{k}$ , which is the amount actually paid.
- (e) There is no impact on the P&L and no income or expenditure for tax under the financial arrangements rules.

### **Retrospective application of the rules**

25. Section EZ 75 contains a “savings” position for IFRS taxpayers who have filed returns of income for foreign currency ASAPs essentially based on the new rules for years prior to the 2014–15 year. This is apparently a concession to retrospectively sanction previous non-compliance with the correct rules, however, the concession will only apply if the new rules have been applied consistently.
26. Section EZ 75 applies when a person uses IFRSs to prepare financial statements and to report for financial arrangements, and:
- (a) The person has a financial arrangement that is a foreign ASAP for which the new rules in s. EW 32 apply to value the relevant property or services; and
  - (b) The person enters into the foreign ASAP before the end of the 2013–14 income year; and
  - (c) For the foreign ASAP, the person has filed returns of income in accordance with s. EZ 75 for the 2013–14 income year and every earlier income year.
27. Under s. EZ 75(2), the person may:
- (a) Treat the amendments to s. EW 32 and the new s. EW 33B as applying to the financial arrangement for the 2013–14 income year and every earlier income year; or
  - (b) Treat the amendments to s. EW 32 as applying, but excluding s. EW 33B, in which case, the IFRS value of the property or services is adjusted for tax purposes by excluding any amounts attributable to FX hedges.
28. In addition, under s. EZ 75(3), the person is allowed to modify the IFRS treatment by adding or subtracting, from the value of the property or services, amounts arising from spot rate revaluation of payments already made at the time the property or services are recognised under IFRS rules. This additional concession is explained in the TIB item as follows:
- “Section EZ 75(3) modifies the treatment under subsection (2) for payments that have been made prior to the property or services being recognised in IFRS financial statements. These payments will have been recognised at their original New Zealand dollar amounts using the spot exchange rates at that time. This modification allows those payments to be revalued for tax using spot exchange rates at the point they are recognised in IFRS financial statements.

Those payments will not have been revalued in the IFRS financial statements from the amounts recognised at the spot exchange rates when they were paid. However for tax the revaluation changes on the amounts paid have been taxed and the value of the property or services adjusted by the same amounts compared with the values recognised in IFRS financial statements.”

A handwritten signature in black ink that reads "Arun David". The signature is written in a cursive, slightly slanted style.

Arun David, Director,  
DavidCo Limited