

**New Zealand's Thin Capitalisation Rules
and the Adoption of International Financial
Reporting Standards in New Zealand**

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Financial Reporting Standards in New Zealand**

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ABSTRACT

In response to Australia's decision to adopt international financial reporting standards (IFRSs) from 2005, New Zealand has subsequently decided to follow. New Zealand reporting entities are required to adopt IFRSs from 2007 with the option of early adoption from 2005.

As New Zealand is one of many jurisdictions where different rules are employed to determine income for financial reporting and tax purposes, it would seem to a casual observer that the adoption of IFRSs in New Zealand is unlikely to have any income tax implications for New Zealand companies. This is not entirely correct. There are links between financial reporting standards and the determination of taxable income under New Zealand income tax law in respect of certain matters.

One such area is the application of the New Zealand thin capitalisation rules in subpart FG of the Income Tax Act 2004. The rules rely upon values taken from a taxpayer's financial statements to determine the taxpayer's debt percentage and consequently the extent to which a deduction for interest expense will be apportioned. Therefore the adoption of IFRSs in New Zealand potentially could affect a taxpayer's New Zealand tax liability if the thin capitalisation rules have application.

This paper seeks to examine the changes in IFRS and their impact on the New Zealand thin capitalisation provisions. In particular it will examine the changes in the IFRS Standards concerning the measurement and valuation of assets and the effect on the safe harbour provisions. In addition, the paper will consider the implications for tax advisers and their clients in complying with the new standards and the transitional issues involved.

1 INTRODUCTION

New Zealand is one of many jurisdictions where different accounting rules are employed to determine income for financial reporting and tax purposes. Despite different rules being used, financial reporting principles and standards used for financial reporting purposes impact upon tax accounting rules in a variety of ways. These include the use of financial reporting principles and standards to resolve matters not explicitly provided for by statute; as an input to the tax policy process and in some instances explicit delegation of matters to financial reporting principles and standards by statute.

Given this relationship between financial reporting principles and standards and tax rules, the announcement two years ago by the New Zealand Accounting Standards Review Board that New Zealand would adopt International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) from 1 January 2005¹ has potential income tax consequences. This is especially so where tax statutes contain specific reference to financial reporting practices and standards.

One such area in the New Zealand tax regime is the thin capitalisation rules in Subpart EW of the Income Tax Act 2004.² The rules contain a “safe-harbour” provision which rely upon financial statements produced in accordance with financial reporting principles and standards to operate. This article examines the consequences of New Zealand adopting IFRS for New Zealand taxpayers subject to the New Zealand thin capitalisation rules. This article will also examine the effect of the changes in accounting standards on the valuation of assets, and the determination of profit in the context of the thin capitalisation rules.

2 THE RELATIONSHIP BETWEEN ACCOUNTING PRINCIPLES AND STANDARDS AND TAX LAW IN NEW ZEALAND

For the most part financial reporting principles and standards have played a limited role in New Zealand in the determination of income for tax purposes. This role appears to have steadily diminished from where it was when income tax was first enacted in 1891, however,

¹ Subsequently deferred to 1 January 2007, with the option of adopting from 1 January 2005. It should be noted that due to the requirement to publish comparable data for the preceding period, this will effectively require some companies to adopt the standards for the previous year so that comparable information can be presented in their accounts.

developments over the past two decades have shown financial reporting principles and standards do still have considerable relevance to the determination of taxable income in certain situations.

In the period 1891 to 1916 when income tax was first introduced, considerable reliance was placed upon financial reporting principles and standards in determining income derived from the carrying on of a business. Only the net profit of a business was expressly subject to tax by statute and by implication such amounts had to be determined in accordance with commercial and accounting practice in the absence of any statutory direction. This reliance upon commercial and accounting practice in determining business income started to change with the enactment of the Land and Income Tax Act of 1916 when deductions were first subject to specific statutory tests, prohibiting the deduction of expenditure or losses unless permitted otherwise by statute. As New Zealand's tax law developed further, issues concerning assessability of receipts and deductibility of expenses/losses have increasingly become codified. Until the mid-1980s, rules concerning the timing (or allocation) of income or expenditure to particular income years, however, were not substantially codified and continued to rely for the most part upon common law principles.

The difficulty associated with this approach became apparent during the late 1970s and early 1980s. Despite a substantial increase in reported corporate profitability over that period, income tax collections from the corporate sector did not correspondingly increase. Apart from weak international tax rules,³ one of the reasons for this was the absence of robust timing rules in the ITA 1976 and manipulate the recognition of income and expenditure to minimise their taxable incomes. This problem was recognised in the 1986 Budget which led Parliament to enact specific timing rules for prepayments⁴ and financial arrangements⁵. Parliament did not, however, enact any comprehensive rules on tax accounting at this time, and matters not covered by these new provisions still remained subject to common law.

² All references in this article are to the Income Tax Act 2004 unless otherwise noted.

³ Deficiencies in the international tax rules were addressed in the 1987 Budget and resulted in the enactment of comprehensive CFC and FIF rules along with a new trust tax regime.

⁴ Section EA 3(8) of the ITA2004 and Determination E11.

⁵ Subpart EW.

In 1993 the core provisions underlying the New Zealand income tax regime were reviewed. The Working Party on the Reorganisation of the Income Tax Act⁶ recommended that the core principles of the Income Tax Act should be based on the incorporation of accounting principles in the determination of taxable income. This view, however, was not adopted as the Consultative Committee on the Taxation of Income from Capital recommended that a more ad hoc or piecemeal approach be used in determining accounting and taxable income. This view was ultimately adopted in the document *Core Provisions: Reworking the Income Tax Act* in 1995, where it was stated:

“... the government has decided that it would be inappropriate at this stage to incorporate an explicit reference to GAAP in the core provisions of the Act.”⁷

When the revised core provisions were enacted in the Income Tax Act 1994 (ITA 1994), despite the Government’s rejection of references to GAAP in the core provisions, explicit direction was for the first time provided in the Act as to how items of income and expenditure were to be allocated to specific income years when determining taxpayer’s income. This direction is now found in Subpart BD of the ITA 2004.

Under section BD 3(1) and (2) of the ITA 2004, any (gross) income of a taxpayer must be allocated to an income year in the year it is *derived*, unless there are specific timing rules elsewhere in Act that provide for “allocation on another basis”. Similarly, under section BD 4(2) any expenditure or loss has to be allocated to an income year in the year it was *incurred* unless specific timing rules exist elsewhere in the Act that provide for “allocation on a different basis”. Where specific rules do not exist, sections BD 3(3) and 4(3) require the concepts of derivation and incurrence to be determined with regard to case law on these issues.

It cannot be asserted, however, that sections BD 3 and 4 codify the law regarding the timing of income and expenditure for tax purposes. The sections merely confirm what has been the case for many years, that unless there are specific timing rules in the ITA 2004, items of income and expenditure must be allocated using common law principles i.e. with reference to case law.

⁶ Working Party on the Reorganisation of the Income Tax Act 1976, *First Report of the Working Party*, 1993, Wellington.

⁷ See W Birch and W Creech, *Core Provisions: Rewriting the Income Tax Act – A Discussion Document*, Wellington, May 1995, paragraphs 5.27-5.28.

By the time sections BD 3 and 4 were enacted, there was already a substantial body of case law (both in New Zealand and Australia) concerning derivation and incurrence for tax purposes. In most of the leading New Zealand authorities, careful consideration has been made of financial reporting practices and standards in resolving the issues under review. This can be seen in *CIR v National Bank of New Zealand Limited* (1976) 2 NZTC 61,150 concerning the derivation of interest income on doubtful loans and *CIR v Farmers' Trading Company Limited* (1982) 5 NZTC 61,200 concerning the recognition of gross income from installment sales. References to financial reporting practices and standards can also be seen in *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 concerning whether provisions for warranty expenses in respect of new cars sold were incurred, and in *Hawkes Bay Power Distribution Limited v CIR* (1999) 19 NZTC 15,226 concerning whether electricity not metered, invoiced or paid for at balance date was income derived for tax purposes. Financial reporting practice and standards was also considered in *Auckland Gas Company Limited v CIR* (1997) 18 NZTC 13,408 concerning whether expenditure by taxpayer was deductible as repairs or maintenance or not.

Since the comprehensive overhaul of New Zealand's income tax laws commenced in the mid-1980s, financial reporting practices and standards have interacted with tax law in three further ways. The first is where financial reporting principles and standards have become inputs in parts of the tax reform process.⁸ The tax reform process became much more open from the mid-1980s, resulting in (among other things) the widespread use of official discussion documents and issues papers to consult with interested parties on proposed tax reforms. These documents and papers usually contain a detailed explanation of what is proposed and the underlying rationales.⁹ Where relevant, many make reference to financial reporting practice and standards which have often led to a closer alignment of tax provisions with established financial reporting standards when proposals are eventually enacted. Good examples of this

⁸ This role was outlined by the Government in 1995 in *Core Provisions: Rewriting the Income Tax Act – A Discussion Document*, (ibid) at paragraph 5.28.

⁹ The tax reform process itself became standardised which became known as the “generic tax policy process” (GTPP). Refer Rt. Hon. Sir Ivor Richardson; “The Impact and Influence of Accounting and Economic Principles on Taxation Law”, *New Zealand Journal of Taxation Law and Policy*, Volume 4, March 1998, pages 18-37.

can be seen in the rules for the valuation of inventories and the treatment of research and development expenditure.¹⁰

The second is the incorporation of references to financial reporting practices into tax statutes. Under the financial arrangement rules (subpart EW), taxpayers are permitted to depart from one of the approved spreading methods if the new method “has regard to the principles of accrual accounting” and “conforms with commercially acceptable practice”.¹¹ Also of note is that to depart from one of the approved spreading methods under the financial arrangement rules, the alternative method adopted must also be used by the person for financial reporting purposes. This is also a requirement for the list of exclusions (Determination E11) from the requirement to comply with the prepayment rules in section EA 3.¹²

The third case where financial reporting practices and standards and tax accounting interact, is with the enactment of provisions in the Income Tax Act that require the use of values contained in a taxpayer’s financial statements in calculating that person’s taxable income. This occurs in the following areas:

- (1) Thin capitalisation rules –subpart FG.
- (2) Foreign attributed income excess interest allocation rules –subpart FH.
- (3) Application of the accounting profits method under the FIF rules –sections EX 40(2) and 42.
- (4) Calculation of underlying foreign tax credits to be credited against foreign dividend withholding payment (FDWP) liabilities –section LF 3.

In this particular context, the adoption of IFRS in New Zealand from either 2005 or 2007 has the potential to affect the calculation of a taxpayer’s tax liabilities. In the next section the thin capitalisation rules will be reviewed to identify how this can occur.

¹⁰ Refer SB Law, “Harmonisation of Tax and Accounting: A Policy Perspective”, *New Zealand Journal of Tax Law and Policy*, Vol 10, 2004, pages 39-52.

¹¹ Sections EW 16(2)(a) and (b); EW 18(1)(d); EW 20(2)(c) and (d); EW 21(d); EW 22(e).

¹² This link here is consistent with the objective of minimising compliance costs which is the reason for the permitted exceptions from section EA 3 provided for in Determination E11.

3 NEW ZEALAND'S THIN CAPITALISATION RULES

New Zealand's thin capitalisation rules are found in Subpart FG of the Income Tax Act 2004. The objectives of the rules, provided as an aid to statutory interpretation, are contained in section FG 1:

.... the purpose of this Subpart is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expenditure of the group of entities of which the New Zealand taxpayer is a part.

For the thin capitalisation rules to apply and consequently apportion deductions for interest expense, two conditions must be met:

- (1) the taxpayer must fall within one of three ownership tests specified in section FG 2(1);
and
- (2) the taxpayer's "New Zealand group debt percentage" must exceed the "safe-harbour" levels specified in section FG 3.

If only one of these two conditions is met, no apportionment of interest expense can occur. In addition, the taxpayer must not at anytime during the income year be a "reporting bank".¹³ Such entities are required to apply special thin capitalisation rules that apply to banks only.¹⁴

3.1 Ownership test - Section FG 2

The rules can potentially apply to any taxpayer who at anytime during the income year falls within any one of the four following categories:

- (i) a non-resident who is not a company. Non-resident individuals and partners are therefore brought within this limb.¹⁵
- (ii) a non-resident company if no resident person has a direct "ownership interest" equal or greater than 50% and a non-resident has a direct "ownership interest" (including associated persons) equal to or greater than 50%.¹⁶

¹³ As defined in section FG 8D.

¹⁴ Refer sections FG 8B-8J.

- (iii) a New Zealand resident company if one non-resident person has a 50% or greater “ownership interest” in the company or control of the company “by any other means whatsoever”.¹⁷
- (iv) a trustee of a non-qualifying trust¹⁸ 50% or more settled by a single, non-resident person.¹⁹

Ownership of companies is determined using a concept of “ownership interest” which applies only to the thin capitalisation rules.²⁰ A person’s “ownership interest” is²¹ the sum of all direct and indirect ownership interests held by a person in a company, plus the direct and indirect ownership interests held by persons associated²² with that person.²³ A taxpayer’s “direct ownership interest” is determined by taking the highest percentage of the four tests in section EX 5(1).²⁴ Special rules exist to deal with a chain of companies.²⁵

¹⁵ Section FG 2(1)(a). The application of the thin capitalisation rules to individuals and partnerships are not considered further in this article.

¹⁶ Section FG 2(1)(b).

¹⁷ Section FG 2(1)(b).

¹⁸ Defined in section OB 1.

¹⁹ Section FG 2(1)(c). Under section FG 2(7) a trust will be treated as being settled 50% or more if the total value of all settlements by one non-resident person (including those of associated persons) exceeds 50% or more of all settlements on the trust. The application of the thin capitalisation rules to trusts is not considered further in this article.

²⁰ It is very similar to the “control interest” tests used in the Controlled Foreign Company (CFC) regime. Refer Subpart CG.

²¹ Section FG 2(2).

²² Defined in section OD 7. Under section FG 2(6) if a non-resident has no direct or indirect ownership interests in the company, any relative of that person who is resident in New Zealand are not associated persons in respect of that company.

²³ Section FG 2(2).

²⁴ Section FG 2(3). These four tests are the (a) percentage of capital; (b) percentage of rights to vote or to participate in certain decision making with regarding to the management or operation of the company; (c) percentage of entitlement to company income; and (d) percentage of entitlement to the company’s net assets upon winding up.

²⁵ Section FG 2(4). If a person’s direct ownership interest (along with the direct ownership interests of associated persons) is below 50%, the ownership interest in the lower-tier company is obtained by multiplying the interest in the top-tier company and the top-tier company’s interest in the lower-tier company. But where the ownership interest in the top-tier company is 50% or more, their ownership interest in the lower-tier company is deemed to be the top-tier company’s ownership interest in the lower-tier company –thus effectively treating the interest in the top-tier company as being 100%.

3.2 The “safe-harbour” test

New Zealand’s thin capitalisation rules have an unusual “safe harbour” provision in that two ratios (or percentages) are taken into account. The rules apply if the New Zealand taxpayer group has a “debt percentage” which exceeds the *greater* of:

- (1) the safe-harbour 75% limit; *or*
- (2) 110% of the “worldwide group debt percentage” of the group to which they belong.²⁶

The safe-harbour 75% “debt percentage” is roughly equivalent to a 3:1 debt/equity ratio and is designed to exclude most taxpayers that operate with a commercially realistic debt/equity ratio on the grounds of reducing compliance costs. The policy objective behind the 110% worldwide debt percentage provision is to not penalise a New Zealand entity if the group to which they belong is highly geared. This provision allows them to be geared to a comparable level as the whole worldwide entity is.

3.2.1 Calculating the “debt percentage”

The “debt percentage” must be calculated for the New Zealand taxpayer group. If there is more than one company in the group resident in New Zealand, then the “debt percentage” must be calculated on a consolidated basis for all group New Zealand resident companies so that all inter-company balances are eliminated.²⁷

The “group debt percentage” is calculated as follows:²⁸

$$\frac{\text{Total Debt of NZ Taxpayer Group}}{\text{Total Assets of NZ Taxpayer Group}}$$

Taxpayers have three options as to when they must calculate their “debt percentage” for an income year. They can calculate it on a daily basis; a quarterly basis or using year-end values only.²⁹

²⁶ Section FG 3.

²⁷ Section FG 4(9).

²⁸ Section FG 4(1).

²⁹ Section FG 4(5).

Total debt is defined as “financial arrangements”³⁰ which provide capital to the taxpayer (or another group member) and for which interest deductions have been permitted other than for foreign exchange variations.³¹ Thus interest-free loans (denominated in any currency) will be excluded and essentially treated as equity, as will accrual accounting provisions, deferred tax and other similar liabilities or provisions.

The definition of “financial arrangement” is taken from the financial arrangement rules contained in Subpart EW. The definition is extremely broad and robust and will encompass all types of security that are closely substitutable for debt and could potentially include some instruments that may not be accrued on a taxpayer’s balance sheet such as swaps. Similarly, interest expense may be deemed to arise in certain instances from such financial arrangements.³²

In calculating the debt percentage, a deduction is allowed from the amount of total debt *and* total assets of the taxpayer group for any funds on-lent at interest by the taxpayer to all unassociated persons and associated non-resident persons.³³ As a result, financial institutions would not normally suffer an adjustment of deductible interest under these thin capitalisation rules.³⁴

The valuation of the taxpayer’s debt is calculated pursuant to the financial arrangement rules in Subpart EW. Therefore the values adopted in the calculation of a taxpayer’s debt percentage could differ from that used for financial reporting purposes under *NZ IAS 39* (Financial Instruments: Recognition and Measurement).³⁵ This is unusual given that the taxpayer’s assets

³⁰ Defined in sections OB 1 and EW 3.

³¹ Section FG 4(2).

³² Eg: Deferred settlements for real estate transactions, or extended trade credits. Under Determinations G16A and G20 if a trade credit is granted for a period of more than 63 days, an interest component arises from the transaction. Therefore interest expense will be deemed when an extended trade credit (beyond 63 days) is granted by an associated party.

³³ Section FG 6(1). The same applies in calculating a taxpayer’s “worldwide group debt percentage” under section FG 6(2).

³⁴ In 2005 specific thin capitalisation rules were enacted for financial institutions in sections FG 8B-8J. The rules apply based according to capital adequacy ratios imposed upon banks by the Reserve Bank of New Zealand.

³⁵ This could occur where the taxpayer accounted for financial arrangements denominated in a foreign currency for tax purposes using Determinations G9C and 14B (using a forward rate

(including financial assets) can be calculated using values adopted for financial reporting (and hence in future to be determined in accordance with *NZ IAS 39*).

The methods for calculating the value of a New Zealand group's total assets are specified in section FG 4(3). Taxpayers can elect to use either:

- (i) the values shown in the financial accounts of the New Zealand group; or
- (ii) the net current value of the assets; or
- (iii) in respect of trading stock, which is valued at market selling value in calculating the taxpayer's income, the market selling value; or
- (iv) in the case of a finance lease which is not accounted for as a finance lease in the taxpayer's accounts, the adjusted tax value of the leased asset; or
- (v) if permitted under generally accepted accounting principles in New Zealand, a combination of financial accounting and market values.³⁶

Under section FG 4(4) the amount of total assets must be calculated in accordance with generally accepted accounting practice except for items falling within (iii) and (iv) above. This provision appears to prevent taxpayers including assets for the purpose of calculating their debt percentage that would not be permitted to be recognised as an asset for financial reporting purposes. Assets are to be valued using the amounts determined for financial reporting purposes with the option of using "net current value" which would be obviously chosen if higher than existing book values. Temporary reductions in the balance of financial arrangements or increases in the value of assets must be ignored if the reductions have the purpose or effect of defeating the intent and application of the thin capitalisation rules.³⁷ The amount of a taxpayer group's assets is also to be reduced by any deduction permitted under section FG 6(1) for interest-bearing financial arrangements owing to the taxpayer group, after elimination of inter-company balances.

Where debt or assets are denominated in a foreign currency, they must be converted to New Zealand dollars using the spot rate on the date the calculation was being made.³⁸ Taxpayers

approach) while for accounting purposes the financial arrangements would be reported under *NZ IAS 39* using a mark-to-market approach.

³⁶ Section FG 4(3)(a)-(d).

³⁷ Section FG 4(8).

³⁸ Section FG 4(7).

can also elect to use a forward exchange rate applicable on the first day of the income year.³⁹ This latter provision appears to depart from the principle that interest-bearing debt should be valued using methods approved under the financial arrangement rules. It could also result in values for assets that are different from those reported in the taxpayer’s financial statements.

3.2.2 Calculation of “worldwide group debt percentage” section FG 5

This percentage is substantially calculated on the same basis as the taxpayer’s New Zealand group debt percentage under section FG 4. However, it must be calculated at the end of the accounting year that is closest to the beginning of the taxpayer’s income year.⁴⁰ Taxpayers have an option as to how the percentage can be calculated. They can use amounts taken from the financial statements of the taxpayer’s worldwide group,⁴¹ provided the debt and assets are calculated:

- (i) under a financial reporting standard in a consistent and non-distorting manner which is generally equivalent to generally accepted accounting principles in New Zealand; and
- (ii) in accordance with the financial reporting standards of the country which are applied in the preparation of that group’s consolidated financial accounts.⁴²

Taxpayers can alternatively elect to use either of the bases specified in section FG 4(2) and (5) for calculating total debt and assets of the New Zealand group. If the worldwide group is a company, the values of debt and assets are required to be determined on a consolidated basis, using methods similar to those for consolidated entities in New Zealand.⁴³ Deductions are allowed from the total assets and debt of the worldwide group for any amounts on-lent at interest under section FG 6(2). If it is impractical for a taxpayer to calculate its worldwide group debt percentage, due to an inability to comply with the requirements of section FG 5(1)-(11), the taxpayer can elect that the Commissioner estimate the percentage.⁴⁴

³⁹ Section FG 7.
⁴⁰ Section FG 5(1).
⁴¹ Section FG 5(2).
⁴² Section FG 5(4).
⁴³ Section FG 5(8) and (10).
⁴⁴ Section FG 5(12)(a). Under section FG 5(12)(b) if the Commissioner is not asked, or cannot reasonably make an estimate, the percentage is set at 68.1818%.

3.3 Apportionment of interest deductions

If a taxpayer falls within one of the three ownership limbs in section FG 2(1) and has a “New Zealand group debt percentage” in excess of the limits specified in FG 3, under section FG 8(1) any interest expense claimed as a deduction for tax purposes under sections DB 6, 7 and 8⁴⁵ is *reduced* by the amount calculated under the following formula:

$$(I - GI - IFD) \times \frac{TNZD - NZDA}{TNZD} \times \frac{NZDP - TDP}{NZDP}$$

- I = Interest that would be otherwise deductible (including foreign exchange gains/losses); and
GI = Interest payable on inter-company balances are excluded under consolidation accounting; and
IFD = Deductible foreign exchange gains/losses arising on non-interest bearing debt excluded under FG 4(2).
TNZD = Total NZ group debt, before exclusion of funds on-lent under FG 6.
NZDA = Amount of funds on-lent under FG 6.
NZDP = Taxpayer’s NZ group debt percentage for the income year, being the percentage of total debt over total assets.
TDP = For companies or trusts it is the greater of 75% or 110% of the taxpayer’s worldwide group debt percentage; and in all other cases it is 75%.

The above formula is applied to all members of the New Zealand group. As the formula is an averaging one, taxpayers are not required to identify specific borrowings of any taxpayer in their group.⁴⁶

Any interest expense disallowed as a tax deduction under the above formula is not reclassified as a dividend. Nor can any amount disallowed be carried forward and deducted in a subsequent year if the taxpayer’s debt percentage falls below the specified safe-harbour levels. Nor is any adjustment made for any minority interests held by New Zealand residents.

4 SAFE HARBOUR LIMIT & IFRS

As noted earlier, section FG 4(3) states that in calculating the assets the relevant entity may use the values shown in the financial accounts of the New Zealand Group. With the requirement that companies adopt IFRS standards in their accounts it is appropriate to assess the impact of

⁴⁵ These provisions specify the rules for interest deductibility.

⁴⁶ Under section FG 8(2) there is scope for companies that are members of a wholly-owned group to elect to transfer the disallowed interest deduction between them. Such a transfer may have consequences for future tax loss carry-forwards.

some of the key standards as they relate to the valuation of assets. A table listing the New Zealand’s Accounting Standards issued by the Accounting Standards Review Board and the new IFRS are contained below:

Earlier NZ Accounting Standard		NZ Equivalent IFRS: 2005
FRS 3	Property, Plant and Equipment*	NZ IAS 16 Property, Plant and Equipment NZ IAS 36 Impairment of Assets
ED 87** FRS 13	Intangible Assets Research & Development	NZ IAS 38 Intangible Assets --
SSAP 12^	Income Tax	NZ IAS 12 Income Tax

Note: * Coverage on Impairment limited to Property, Plant and Equipment.
 ** Issued as an Exposure Draft, but never issued as a FRS (NZ).
 ^ Never issued as a FRS by the Accounting Standards Review Board and this standard predates that body.

An analysis of the main changes arising from the new standards is as follows:

4.1 Intangible assets

The standard *NZ IAS 38* defines an intangible asset as an identifiable non-monetary asset without physical substance. The standard states that in order to meet the identifiability criterion it is necessary that:

- the asset is separable either individually or together with a related contract asset or liability; or
- arises from contractual or other rights.

In particular the standard states that an intangible asset should only be recognised if:

- it is probable the future economic benefits that are attributable to the asset will flow to the entity; and
- and the cost of the asset can be measured reliably.

As a result of those criteria, the standard states that expenditure on research should be expensed and development expenditure only carried forward if certain conditions are met.

An important feature of the new standard is that it prohibits internally generated brands, mastheads, publishing titles, customer lists and other similar items being recognised as an

asset.⁴⁷ Therefore, any entity which has assets in their financial accounts comprising such assets will need to remove them by way of a write down. As a consequence of this standard, companies which have a large amount of their asset in such assets will need to write them down which in turn will affect their asset base for thin capitalisation purposes.

An interesting example of this issue is provided by an Australian company, Southcorp Ltd. The company wrote down its internally generated intangible assets relating to its brand name by an amount of \$A800m in anticipation of the new IFRS standard on Intangibles. However, in January 2005 Fosters Ltd made a takeover bid for Southcorp. Such a takeover placed a value on the Identifiable Intangibles in the form of brand names which had previously been written down. Under the new Standard *NZ IAS 38* if such a transaction occurred in New Zealand, and the takeover succeeded, the takeover would give rise to a new identifiable asset in the form of a brand name which could be formally recognised as an asset. This is because the brand name is no longer an internally generated asset but rather an asset which has been subject to an external market transaction.

The standard also requires an intangible asset to be measured, after initial recognition, at cost, less any accumulated amortisation and any impairment losses. Alternatively the standard allows an intangible asset to be revalued to its fair value less any amortisation or impairment loss. However, this alternative can only be used where there is an active market. Adoption of this alternative therefore raises the question of whether an active market exists and whether a fair value could be determined. In many cases it would seem that this will not be a practical or viable alternative for many companies. However, where there is an active market for identifiable intangibles this may give rise to companies being able to revalue such assets and increase their asset base for the purposes of the safe harbour rules.

Another important part of the standard is that it prohibits the amortisation of an asset with an indefinite useful life. Such assets are required to be tested for impairment annually and whenever there is an indication that the asset may be impaired. This situation contrasts significantly with FRS-36 concerning goodwill which required such an amount to be written off over a period not exceeding twenty years. The result of this change means that where goodwill has been recognised in the accounts as a result of an external transaction it is not

⁴⁷ NZ IAS No. 38 –Intangible Assets, at paragraph 63.

subject to amortisation if it has an indefinite life. This in turn will have an impact on the entity's asset base under the safe harbour rules.

4.2 Impairment of assets

The Standard *NZ IAS 36* is an important standard which deals with the Impairment of Assets. It is also a standard which has a strong interface with *NZ IAS 38*. The standard requires an entity to recognise an impairment loss if its assets are carried at more than their recoverable amounts. The recoverable amount is determined by comparing the carrying amount with the amount that may be recovered through use or sale of the asset (the standard also lays down rules when an entity should reverse an impairment loss).

The standard requires that for assets excluding goodwill or those assets with an indefinite life, that the entity makes an assessment at each reporting date of any asset that may be impaired. In determining whether this has occurred the entity should have regard to both internal and external sources of information. The internal information would be based on matters such as physical damage to the asset or obsolescence. External factors would refer to matters such as a decline in the assets value, changes in technology or economic conditions. Where such circumstances indicate that an asset may be impaired, then the assets recoverable amount must be determined. This is based upon the higher amount of its fair value less costs to sell and its value in use. Fair value is defined to mean fair value less costs to sell as evidenced by a binding sale agreement or best estimate of the amount the asset could be sold for. However, value in use is based on an assessment by management of the expected future cash flows attributable to the use of the asset in its current condition.

From this analysis the standard states that where an assets recoverable value is less than its carrying amount, it has been impaired. As a result the carrying amount should be reduced to its recoverable amount.

In comparison with the previous standard relating to the treatment of goodwill FRS-36 (relating to goodwill on consolidation only), the *NZ IAS 38* takes a different perspective. *NZ IAS 38* states that an intangible asset with an indefinite life shall not be amortised. An indefinite life is based on the view that there is no foreseeable limit of the period over which the asset is expected to generate net cash inflows for the entity. The outcome of this change is that an entity may recognise purchased goodwill in the balance sheet at its acquisition cost

without the need for it to be amortised. Consequently whereas in the past amortisation was required of goodwill, the new Standard does not require it unless the goodwill has been impaired. The effect on the balance sheet is to increase the recorded asset base as goodwill is no longer amortised. As a result the safe harbour debt percentage will decrease because of the increased asset base, although this will depend upon if any impairment losses arise. In addition, it should be noted that this only applies in respect of purchased goodwill and not that which is internally generated. Moreover, where the acquisition cost of purchased goodwill exceeds its recoverable amount then it needs to be written down to such an amount. From a compliance point of view, such a process therefore requires an entity to regularly review its assets and assess whether any write down is required and the effect on the safe harbour debt amount assessed.

4.3 Property, plant and equipment assets

Where an entity may be at risk of breaching the safe harbour debt percentage, the revaluation of its assets may seem an appropriate strategy to pursue. In this respect, the standard *NZ IAS 16* 'Property, Plant and Equipment' is relevant. This standard provides the accounting treatment for property, plant and equipment. In particular, it focuses on such matters as the recognition of assets, their carrying amount, depreciation and impairment losses.

NZ IAS 16 requires all property, plant and equipment items to be recognised at cost upon acquisition. However after acquisition, the entity is able to choose between cost basis or a revalued basis of recognition. It is important though that where the revalued basis is chosen, it must be applied to the entire class of property. Therefore, under the cost model the carrying amount of each item within the class is its cost, less any accumulated depreciation and impairment loss. Under the revaluation model, the carrying amount of each item within the class is its fair value less any accumulated depreciation and impairment losses. The revaluation model requires revaluation to be made regularly to ensure that the carrying value is not materially different from the fair value of the asset.

Where an entity seeks to rely on the safe harbour debt rules and revalues its assets there is another reason why consideration should be given to *NZ IAS 16*. The reason for this is that while it seems there is an upside, by way of revaluation to increase the value of assets, there is also a down side where the value of the asset decreases. This is because under the revaluation model, regular revaluations must be made to recognise not only increases in asset values but

also decreases in asset values. Consequently due to changes in technology, obsolescence or the economic cycle, it is possible that adoption of the revaluation option could provide a decline in the asset base under the safe harbour rules.

A new feature of *NZ IAS 16* is that if the revaluation model is adopted, the effect of any upwards revaluation must be tax effected. Under the provisions of *NZ IAS 12* a deferred tax liability is recognised in the entity's balance sheet when there is a taxable temporary difference between the tax base of the asset and its carrying amount for balance sheet purposes. Therefore, any upward revaluation of a non-current asset, such as that undertaken under *NZ IAS 16* results in its carrying amount in the balance sheet exceeding its tax base. Under *NZ IAS 12*, however, a tax liability will need to be recognised being a deferred tax liability of 33% of the amount revalued.

Any such increase in the deferred tax liability as a result of an upward revaluation, however, will not have any effect on the entity's debt percentage. This is because the total debt taken into account when calculating the debt percentage comprises only financial arrangements (as defined in section EW 3) that are interest-bearing and not any provisions or other non-interest bearing liabilities. This is a major point of difference between the New Zealand thin capitalisation rules and the Australian ones where under the Australian rules "non-debt" liabilities are required to be taken into account when calculating net assets.

On a practical note there is also the issue arising under *NZ IAS 16* that where an entity has chosen to recognise assets on a revalued basis, the revaluations will have to be undertaken by suitably qualified valuers. It is likely that employees of the entity would not be acceptable as valuers for this purpose. Consequently an independent and qualified valuer would be necessary.

4.4 Deferred tax assets

With the introduction of *NZ IAS 12* entities could be required to recognise tax assets when under the earlier standard SSAP-12 this was not required.⁴⁸ As the New Zealand thin capitalisation rules require assets to be determined using "generally accepted accounting

⁴⁸ Refer I Bradley; "Tax Implications of Adopting International Financial Reporting Standards in New Zealand", *Tax Notes International*, Volume 36, No. 7, 15 November 2004, pages 617-618.

practice⁴⁹ in calculating a taxpayer's debt percentage, any tax assets arising under *NZ IAS 12* where none were previously recognised, will assist taxpayers to stay within the 75% safe harbour debt percentage.

4.5 Financial arrangements

The introduction of *NZ IAS 39* applying to financial instruments introduces a complex set of requirements to an area of financial reporting that was previously not subject to any New Zealand Financial Reporting Standard (or earlier Statement of Standard Accounting Practice – SSAP). This new standard may result in the possible recognition of assets arising from changes in the treatment of derivatives (such as forward exchange contracts) and other complex financial securities. Again as the thin capitalisation rules permit any assets recorded as an asset in a taxpayer's financial statement, the recognition of an asset where none was recognised previously, will assist taxpayers to stay within the 75% safe harbour debt percentage.

The introduction of *NZ IAS 39*, however, will have no impact upon how interest-bearing debt is valued for the purposes of calculating a taxpayer's debt percentage. They are required to be valued using tax values determined under the financial arrangement rules⁵⁰ which could well be different to those determined under *NZ IAS 39* for financial reporting purposes. While the objective of the financial arrangement rules is, in general, to align tax accounting for financial arrangements more closely with that for financial reporting, the introduction of Determinations G9C and G14B allowing financial arrangements denominated in a foreign currency to be reported on an expected value basis instead of mark-to-market basis means this outcome is not always certain.⁵¹

4.6 Offshore accounting standards and the worldwide group debt percentage

Entities are accorded considerable leeway in what financial data is used to calculate their parent's worldwide group debt percentage. Under section FG 5(4) this debt percentage is to be calculated using the amount for assets and interest-bearing debt from accounts prepared:

⁴⁹ Section FG 4(4).

⁵⁰ Refer section 3.2.1.

⁵¹ Under Determinations G9C and G14B the expected value method unrealised foreign exchange variations are determined using forward exchange rates determined at the time the financial

- (a) under a financial reporting standard in a consistent and non-distorting manner which is generally equivalent to generally accepted accounting principles in New Zealand; *and*
- (b) in accordance with the financial reporting standards of the country which are applied in the preparation of that group's consolidated financial accounts.

While the adoption of IFRS by New Zealand will not directly impact upon the calculation of a parent's worldwide group debt percentage, it must be remembered that New Zealand's adoption of IFRS has not been done so in isolation of similar developments in other countries. Where the adoption of IFRS in other jurisdictions has resulted in a significant change to the methods of accounting previously used (as could be the case in continental European countries) the changes in the reported values of assets in the financial statements of entities based in those jurisdictions could increase the amount of interest-bearing debt New Zealand subsidiaries of those entities could bear without falling outside the safe harbour ratio. Therefore the adoption of IFRS by parent companies in offshore jurisdictions could be of much greater significance for New Zealand subsidiaries subject to the thin capitalisation rules than will the adoption of IFRS in New Zealand.

5 A MATTER OF TRANSITION

While Australia has already adopted IFRS from 1 January 2005, New Zealand's entities must adopt IFRS from 1 January 2007, although they can elect to adopt them from 1 January 2005 if they so wish. As part of this transition process companies will need to focus on the new IFRS standards and assess their impact from a thin capitalisation perspective. As noted earlier, companies will need to provide comparative information in their financial statements for the purposes of the new standards. As a result, New Zealand companies will need to implement the standards with effect from 1 January 2006 as part of the process of providing comparable information for the year preceding formal adoption of IFRS. Companies who choose to adopt IFRS at an earlier date will need to address these issues immediately.

arrangement was entered into. Spot rates (mark-to-market) are only used when variations are actually realised.

In this context *NZ IAS 1* 'First Time Adoption of New Zealand Equivalencies to International Financial Reporting Standards' requires the opening balances to reflect IFRS and to recognise all assets and liabilities as required and derecognise those that are not permitted.

The application of this standard will require entities to apply the new IFRS and in the case of certain assets remove them from the balance sheet. This in turn will impact upon the safe harbour debt amount. Also as indicated above there are some standards which will require independent assessments and valuation of assets as part of the transition process. For example, under *NZ IAS 38* entities will need to identify whether any intangible assets will need to be written down. This will require an identification of such assets and the value placed on them for accounting purposes. Such a process will require a detailed understanding of the standard and a formal process to identify and value the affected assets. This issue also extends to *NZ IAS 36* which deals with the impairment of assets. Processes of identification and assessment to determine whether there has been any impairment is necessary. Such a process again may require detailed analysis and assessment of a company's intangible assets.

Because of the transitional provisions and the due date for transitional data to be provided, entities will need to put in place a system of independent assessment to analyse the consequences of the change. This is not only important from an accounting perspective it is also necessary to determine the effect on asset values and the flow on effect for thin capitalisation purposes.

6 A MATTER OF COMPLEXITY

In recent years there has been some debate concerning the complexity of tax law and the matter of compliance costs. In relation to this issue, there has been debate as to what extent tax law should interface with accounting principles which under the ITA is currently limited to a few areas including thin capitalisation, the subject of this article.

The outcome of this interface is that taxpayers and their advisers are faced with increased compliance costs. This is because they need not only to understand the increased complexity and volume of tax law, but also understand accounting standards. With the adoption of IFRS, this matter will become even more complex.

On this matter, D Ascenzo and England⁵² commented that while there may be a desire to increase the interface of accounting and tax rules, there may be considerable difficulties and costs in doing so. Part of this difficulty is due to the fact that Generally Accepted Accounting Principles (GAAP) are based on the need to generate financial reports for external users rather than to measure taxable income. Consequently while the courts have been prepared to look at the accounting tax interface it should be remembered that the judiciary is constrained by the tax legislation and the wording therein. In this respect, the precision required is of a higher order than that required for accounting principles.⁵³

The outcome of these changes is that there will be an increase in the complexity of the task in understanding tax law and as a result an inevitable increase in compliance costs.

With the move to adopt IFRS the ASRB has signaled a significant change in direction in the standard setting process of accounting standards. This also takes on an important dimension in regards to tax law. This is attributable to the fact that on occasion, tax does recognise the accounting tax interface. One such area is in determining what the safe harbour limit for an entity is. Detailed knowledge of IFRS and some standards in particular (such as *NZ IAS 16, 36, 38*) will be crucial to ensure that the relevant provisions are not breached.

7 CONCLUSION

With the move by New Zealand to adopt IFRS issued by the IASB there will be important changes for the accounting profession as the new standards come in to force in 2007. However, from a taxation point of view there will also be important changes and there are a number of areas of tax law which interface with accounting. One such area is thin capitalisation and the operation of the safe harbour provision contained in those rules.

In this respect, the new IFRS will impact on the recognition and valuation of assets. In particular, the standards *NZ IAS 36* and *38* may require the write down or removal of assets from the balance sheet. Such issues will require careful consideration by taxpayers and their advisers as to how they affect their thin capitalisation compliance. At the same time such a

⁵² In D Ascenzo and A England *The Tax and Accounting Interface* 15th Australian Tax Teachers Association Conference, Auckland, 2003. See also J Freedman, "Deferring Taxable Profits in a Changing Accounting Environment", *British Tax Review*, [1995] 434-444.

move has added to the complexity of tax law as advisers and taxpayers will need to become aware of the new IFRS and their consequences.

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C Elliffe and S Law, *Research and Development: Trading Stock and Accounting Standards*, ICANZ, National Tax Conference, 2001.