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In the wake of the GFC, Governments around the world are feeling the pressure of growing social needs in the community. At the same time, the tax base has reduced due to the decline in profitability of enterprise and reduced employment. These pressures have highlighted the lack of contribution being made by many (or most) multinational corporates to the tax base in the communities in which they operate and rely upon for their own success.

This lack of corporate contribution has led to increased Government, media and societal attention on the mechanisms employed by multinational corporate groups to reduce their tax contribution. One of these mechanisms involves artificially shifting the debt burden from low tax jurisdictions to high tax jurisdictions in order to maximise the group's tax deductions on interest payments. And in even more extreme cases, creating tax deductions on zero-coupon bonds.¹ Governments will often apply limits on the tax deductions available to multinational enterprises - known as thin capitalisation rules.

In many jurisdictions, limits are put on interest deductions based on a maximum acceptable debt to asset ratio or a ratio of interest deductions to earnings. The ratios are often calculated using the classification and valuation of assets, debts or earnings measured in accordance with International Financial Reporting Standards ("IFRS"). New Zealand applies a test based on the debt to asset ratio using the measurement bases available under the New Zealand Equivalents of IFRS ("NZ IFRS").²

An issue arises with the use of IFRS – it is notoriously malleable. IFRS is principle-based rather than strictly codified. It allows for professional judgment to be employed in the decisions whether to recognise and how to value an entity's assets and debts.

This study examines how NZ IFRS applies to the valuation of assets, considering how measurement choices can impact upon the debt to asset ratio calculation for the purpose of applying the thin capitalisation rules. The study considers whether the thin capitalisation rules should be based upon an alternative measurement for calculating assets – the tax base measurement. Using the tax base measurement of assets may help to reduce the inconsistency and manipulation of these ratio calculations and the resulting potential tax base erosion.

IFRS: Principle based

International Financial Reporting Standards are drafted by the International Accounting Standards Board, located in London. These standards are followed by many countries around the world including China, Germany, the UK and New

¹ *Alesco New Zealand Ltd v C of IR* (2013) 26 NZTC ¶21-003

² Income Tax Act 2007, s FE 5.

Zealand.³ One of the most fundamental features of the standards issued by IASB is that they are underpinned by the principles outlined in the bodies *Conceptual Framework*.⁴ This framework outlines the purpose of financial reporting and the qualities that the financial information must adhere to – including relevance, reliability, timeliness and usefulness. Within the financial reporting standards are principles that may be applied according to professional judgment with the overall objective being compliance with the fundamental qualitative characteristics identified in the Framework. An example of this can be found in IAS 16 Property Plant and Equipment. This standard prescribes the accounting treatment for property, plant and equipment. Property, plant and equipment should be depreciated over its useful life reflecting the pattern of the asset's future economic benefits t⁵. There is no prescribed depreciation rate for an individual asset – the method and rate of depreciation is determined by the management of the reporting entity. The depreciation method applied should best support the qualitative characteristics required of the financial information.

Another example of the application of management judgment is in relation to the IAS 1 Presentation of Financial Statements. One might think financial reporting standards would strictly prescribe the format and contents of the financial statements but that is far from the truth. IAS 1 does require specific statements to be prepared by entities but the name and format of those statements is highly variable. A Statement of Financial Performance may also be known as an Income Statement or a Profit and Loss Account or a Statement of Comprehensive Income! And the form the statement may take is equally as flexible. Items of expenditure may be grouped by expenditure type or by business function. Items may be separately identified on the statement or grouped together with the detailed disclosure in a note.

The point here is that IFRS is not prescriptive. It deliberately allows for professional judgment to take place with the overriding intention to provide useful information for decision makers.

Judgment will affect many aspects of the financial statements including the decision whether or not to recognise an item of income or expenditure or an asset or liability. Judgment will also impact the choices made when determining how to measure an element being presented as income, expenditure, an asset or a liability.

With so much flexibility available to preparers of financial statements applying IFRS, how might this impact upon New Zealand's thin capitalisation rules?

What is the relationship between IFRS and thin capitalisation?

³ IFRS are used in varying forms by over 100 countries although notably excluding the U.S. who have their own financial reporting standards issued by the Financial Accounting Standards Board (FASB). However, the FASB and the IASB have been working on harmonising their standards during much of the current century.

⁴ International Accounting Standards Board "The Conceptual Framework for Financial Reporting 2010" (London, IASB)

⁵ IAS 16, para 60.

The rules restricting interest deductions for New Zealand entities can be found in subpart FE of the Income Tax Act 2007. These rules restrict interest deductions for entities (both New Zealand resident and non-resident) that, because they have related entities in other jurisdictions, are able to shift the debt burden to New Zealand, therefore increasing the interest deductions and then reducing the tax liability.

The interest deduction limitations are based upon measures of the “debt percentage”. The debt percentage measures the amount of debt compared with assets. If the debt percentage of the New Zealand group is greater than 60% of assets and greater than 110% of the debt percentage of the worldwide group, interest deductions are restricted.⁶ The relevance of the debt percentage of the worldwide group is to allow for situations where the entire group is highly indebted – being a commercially driven outcome rather than an artificial allocation of the debt burden.

These maximum levels of debt are referred to as the “safe-harbour” – the thin capitalisation rules do not apply below these levels of debt. Interest deductions within the safe-harbour range can only be challenged using the general anti-avoidance provisions of the legislation.⁷ This is more difficult for the IRD to pursue.

Unusually in the context of the Income Tax Act 2007, the debt percentage relies upon “generally accepted accounting practice”.⁸ This is a legislated term that refers to compliance with the financial reporting standards issued in New Zealand by the External Reporting Board (“XRB”).⁹ The XRB adopts IFRS with minimal adaptation.¹⁰ The debt percentage is calculated by measuring the proportion of the entity’s debt to the total assets. Effectively measuring the proportion of assets that are funded by debt, with the balance being funded by shareholders as equity. This calculation is performed for the New Zealand group as a whole using the following formula:

$$\text{Debt percentage} = \frac{\text{Total group debt}}{\text{Total group assets}}$$

Where IFRS comes into play is in the measurement of assets. The Income Tax Act 2007 prescribes some methods to calculate assets but the default position is to use the measurement and recognition criteria given in the IFRS. This has the

⁶ Income Tax Act 2007, s FE 5.

⁷ Income Tax Act 2007, s BG 1.

⁸ Income Tax Act 2007, s FE 14.

⁹ Financial Reporting Act 2013, s 8.

¹⁰ The External Reporting Board (XRB) is given authority under s 12 of the Financial Reporting Act 2013 to issue financial reporting standards. From 2007, the XRB (and its predecessors) have adopted the standards issued by the IASB to ensure New Zealand produces financial reports that have international comparability and credibility. While some changes are made to disclosures and options when issuing the New Zealand equivalents of the international standards, the XRB does not adapt the standard in any way that would compromise the integrity of the international harmonisation.

benefit of minimal compliance as the entity will already be producing their financial statements in accordance with IFRS.

The measurement of debt under the thin capitalisation rules is referenced to the entity's financial arrangements for which interest deductions are being sought.¹¹ Therefore, IFRS is of minimal direct relevance in relation to the numerator of the debt percentage calculation.

It is in calculating the denominator, total group assets, that the IFRS rules are applied. It should be noted that the legislation does provide alternative methods for the measurement of total group assets, including the use of net current value.¹² Presumably net current value is another term for market value as it is not defined in the Act.

IFRS provides preparers of financial statements with a range of options and in many cases, professional judgment is required when determining both when to recognise an item and how to value or measure it. Therefore, the potential to manipulate financial statements to find the most advantageous outcome for the entity is without doubt.

Motivation to manipulate?

The preparation of financial statements usually takes place in-house, overseen by the Finance Director who is often a member of the Board of Directors. The Board of Directors authorise the financial statements before they are issued to the general public.

It is generally accepted that these groups are incentivised to ensure the financial statements reflect:

- Assets at their highest value;
- Debts at their lowest value;
- Revenue and profits at their highest value;
- Expenditure at its lowest value.

These are generalised statements but executive and Board members are usually incentivised in many ways to produce financial results that reflect the above features. This is due to direct incentivisation such as bonuses and share options and other less direct incentives such as job preservation.

These same objectives will apply to produce the most favourable results to the entity when applying the thin capitalisation restrictions. Higher assets, lower debt will reduce the risk of breaching the 60% maximum debt level in s FE 5 of the Income Tax Act 2007. This is important as it the antithesis to the motivating factors when preparing tax returns – minimising revenues, maximising interest and other expenditures, minimising expenditure required to be capitalised as an

¹¹ Income Tax Act 2007, s FE 15(1)

¹² Income Tax Act 2007, s FE 16(1)(b)

asset etc. Usually the rules applying under the Income Tax Act 2007 for calculation of an entity's income tax liability are highly prescribed with little choice and judgment allowed. In the area of thin capitalisation, more flexibility is available given the reliance on IFRS as the basis for calculating assets for the debt percentage ratio. Most notable is that the incentive to maximise asset values is consistent when reporting the financial position to shareholders and when calculating the debt percentage for thin capitalisation purposes.

If we accept the premise that management are encouraged to use the flexibility and judgment availed under the IFRS measurement criteria to maximise asset values, then the tax policy question is whether this is acceptable for thin capitalisation purposes.

Or perhaps another way of looking at the application of the thin capitalisation rules is whether interest deductions should be allowed where debt is installed for strategic reasons rather than to fund new investment. Those strategic reasons might be to maximise New Zealand's interest deductions or to comply with the worldwide group's debt policy.

Should the New Zealand taxpayer fund the worldwide group's debt policy?

One view might be that interest deductions should only be allowed where the debt is being used to make investment that is expected to produce taxable income. This view sees debt in a functional light – it is taken on to undertake a specific project or to acquire a specific asset.

Another view is that debt is an actively managed function of the treasury department in an organisation. This view would see an entity as being funded by an optimal level of debt and equity investment. As debt is usually cheaper than equity, optimal use of debt funding will maximise shareholder value. Also, maximising the interest deduction in the country where the highest tax liability falls benefits the group.

Most multinational organisations benefit from a treasury function to actively manage the debt to equity balance. The reasons for this are at least twofold as outlined above: to maintain an optimal debt:equity ratio for shareholder wealth maximisation; and to optimise the global tax position. The issue is how much of this active management should be funded by the New Zealand taxpayer.

An example of active management may occur where shareholders choose to exchange equity for intra-group debt. This may be enabled by increasing property valuations within the entity, resulting in increased assets and increased equity levels. This equity may be exchanged for unsecured intra-group debt, bearing high rates of interest. This in turn will reduce the taxable income of the New Zealand entity by increasing the interest deductions allowed. The interest income will invariably fall in a country with little or no tax liability. However, in the financial statements on a worldwide group level, the debt will be eliminated as it is intra-group and the interest costs in New Zealand are eliminated against the interest revenues in the group lender. Therefore, the debt will have no

negative impact on the worldwide financial statements. In the case where a foreign investment company with tax losses (or in a jurisdiction that doesn't tax foreign income), has an investment in a New Zealand subsidiary, the subsidiary may always carry the maximum debt allowed under the thin capitalisation rules, regardless of its debt requirements for funding assets as the interest income will not be subject to tax in the home jurisdiction.

Parliamentary contemplation?

The purpose of the thin capitalisation rules is indicated in s FE 1 of the Income Tax Act 2007 where it states the interest deduction restrictions apply if "the level of debt in New Zealandis disproportionately high". We know the legislation then continues to determine disproportionately high is higher than 60% of the New Zealand group's total assets and more than 110% of the worldwide group's debt percentage.

However, there is little guidance as to exactly what sort of behaviour is being counteracted by these measures. A somewhat blunt tool is used to cap interest deductions where interest bearing debt gets beyond a pre-determined level – allowing enterprises with the resources to manage debt up to this level. Whether active debt management was envisaged by legislators is difficult to judge.

Introducing an alternative for comparative purposes

At this point, an alternative measurement tool is introduced to provide a comparative measure. This alternative is the "tax base".

The *tax base* is a term that derives directly from IFRS. Reporting standard IAS 12 Income Taxes¹³ requires a reporting entity to compare asset and liability values measured under IFRS to the "tax base" of each asset and liability. The differences between these two measures represent the difference between the value of assets and liabilities for accounting purposes and for income tax purposes with a resulting recognition of a deferred tax asset or liability. Put another way, the tax base measures the assets and liabilities on the basis used to prepare the income tax liability payable to the revenue authority.

The tax base of an entity's assets is the amount that will be deductible for tax purposes in the future. So for example, if the entity purchases an item of plant in order to produce inventory for sale, the cost of the plant will be depreciated (and therefore tax deductible) over its useful life. So the tax base will always be the cost less any accumulated tax depreciation.

The potential advantage of using the tax base measure for calculating assets in the debt percentage is that it is less open to manipulation and judgment. For many assets, the measurement under the tax base is restricted to the asset's cost. Under basic business principles, debt is obtained to fund the cost of the assets used to produce revenue. As business has grown into multi-entity, multinational

¹³ IASB "IAS 12 Income Taxes" (IASB, 1996)

Thin capitalisation: an alternative model for calculating debt percentage.

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groups, debt has become subject to active management by a global treasury function. Therefore, using the tax base as the valuation basis for assets restricts interest deductibility to the debt associated with funding the cost of assets and may reduce the imposition of debt for artificial reasons.

Appendix 1 provides an analysis of a variety of common assets: cash; accounts receivable; loans receivable and bonds; inventory; equity investments; property, plants and equipment; intangible assets; derivative financial assets and biological assets. The measurement of the value of these asset classifications is examined by comparing the *tax base* with the *IFRS* measurement.

For many of these asset groups, the difference between the two measurement bases is of little consequence. However, for other assets there could be a significantly different value. Probably the most significant differences may arise when measuring property plant and equipment (especially land).

Property, plant and equipment is measured based on cost for the purposes of calculating the tax base, less any tax depreciation allowed by determination of the Commissioner of Inland Revenue. The IFRS measurement could be based upon cost or fair value, less any accumulated depreciation as determined by management. Significant judgment is allowed to be exercised when determining the value of property, plant and equipment for financial reporting purposes. A multinational group will be motivated to maximise the carrying value of its property, plant and equipment if it is inclined to maximise the volume of interest bearing debt planted into the New Zealand subsidiary.

The calculation of the tax base of every asset is required by every entity reporting under IFRS so from a compliance perspective, no additional work is required.

Downsides of using the tax base for calculating the debt percentage

There are some potential downsides from using the tax base as the measurement of assets in the debt percentage.

First, goodwill does not have a tax base at all – it is measured at nil. If a New Zealand entity invests in a business, it may pay an amount over and above the fair value of the net assets as it perceives value in the business's goodwill. This is a real cash outlay so not including this in the value of assets in the debt percentage may be unduly harsh.

Another downside is that some assets are measured at fair value using the tax base measurement as well, such as some financial assets like financial derivatives. Using the tax base would have no impact on the inclusion of these assets within the debt percentage.

Another downside is that the legislation specifically allows taxpayers to use “net current value” to measure assets in the debt percentage.¹⁴ Assuming this is a variation of market value, then the use of revalued amounts is available in the legislation in addition to IFRS.

Is tax base a better measurement of assets for debt percentage?

The question of whether the tax base would be a better measurement for total group debt when calculating the debt percentage really relies on whether legislators intended to allow for debt to be increased where asset values increase with rising market values. The instalment of the option to use “net current value” as an alternative to the IFRS measurement would tend to indicate that increased debt with increasing asset values would be tolerated.

Whether this is ideal from the perspective of the New Zealand taxpayer is another question again.

Conclusion

New Zealand’s thin capitalisation regime is designed to restrict interest deductions for New Zealand entities with foreign investors and foreign investments. The restrictions are made to interest payments that are made to foreign lenders.

The restrictions are imposed where debt levels in the New Zealand group entities breach the “safe-harbour” debt percentage thresholds set in legislation. The safe-harbour thresholds rely on the calculation of the debt percentage which measures the level of debt compared with total assets.

New Zealand’s tax legislation allows for total assets to be measured using the values used under IFRS reporting. IFRS is inherently subject to management judgment and discretion, being based upon principles rather than rigid rules. While financial information reported under IFRS is required to meet certain levels of quality (including being relevant, reliable and useful), significant flexibility is allowed. Also given management are usually motivated by incentive schemes, bonuses and job preservation to maximise value to shareholders, the desire to maximise asset values and maintain an optimal debt and asset portfolio will impact decision making in the financial reporting arena.

This research study considers the use of an alternative basis for measuring total group assets for the purpose of calculating the debt percentage. The tax base derives from IFRS reporting and is used under IAS 12 for the purpose of calculating the deferred tax asset or liability – being the difference between the financial reporting values of the reporting entity’s assets and liabilities and the tax values of the group assets and liabilities. The tax base of an asset typically represents the cost of that asset that will be deductible in future years. This is usually not subject to revaluations.

¹⁴ Income Tax Act 2007, s FE 5.

Using the tax base measure for determining the total group assets would limit interest deductions to debt that is incurred in relation to new investment. This would reduce the ability of an entity to restructure debt into a New Zealand entity based upon revaluations of assets – especially land.

Using the tax base is not the perfect measure as it excludes any value for acquired goodwill and some asset values can be equally as variable as their IFRS compliant counterpart. However, the tax base is subject to less judgment and in the area of property, plant and equipment, the tax base reflects a tighter representation of the cost of the asset to the entity.

In the current global business environment, debt is actively managed to ensure optimal tax outcomes across the worldwide group and to maximise shareholder value. This often involves engineering situations to include additional debt in higher taxed countries even where additional investment is not being made.

Whether this alternative basis is desirable is highly dependent on the views of policy makers. Should New Zealand taxpayers allow profits attributable to New Zealand to be reduced by interest deductions for optional debt? Or should interest deductions be restricted to that debt that funds new investment?

DRAFT

Appendix 1 Analysis of assets using IFRS and Tax Base

Cash

Cash is categorised as a financial asset under IFRS.¹⁵ Financial assets cover a whole range of assets including accounts receivable, loans receivable, investments in bonds and shares, derivatives and cash. IFRS 9 Financial Instruments prescribes the standard for accounting for financial assets and the default measurement basis for cash is “fair value” with any gains or losses flowing through the profit and loss account.¹⁶ IFRS further defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.¹⁷

While cash is in New Zealand dollars, its market value is effectively equivalent to its cost. Cash in its local currency is the basis of measurement for all assets and liabilities and therefore its fair value does not fluctuate.

Cash will fluctuate where it is held in a foreign currency. Foreign currency cash amounts will be translated at the “closing rate” on the reporting date. For example, if \$A50,000 is held in a bank account in Australia and the reporting date is 31 December 2016, the amount reported in the New Zealand financial statements will be translated using the exchange rate at close of business on 31 December 2016. If the rate was NZD1:AUD0.95, the New Zealand financial statements would report the amount as \$NZ52,750.43.

Essentially the same treatment should be applied for tax purposes. The Income Tax Act 2007 allows income or deductions for revaluing financial instruments such as cash and specifies the methods that must be used to spread the income or deduction across the life of the arrangement. Entities that use IFRS reporting for their financial statements can apply the same method for tax purposes.¹⁸

Is there room to manipulate the value of the asset? It may be possible to utilise the range of exchange rates available to best advantage given the lack of specification of an exact source of exchange rates. However, the same manipulation could arise in applying the tax rules. Applying the most advantageous exchange rate is unlikely to result in large scale manipulation of the value of assets on the balance sheet.

Use of the tax base or IFRS should not result in significantly different values for cash.

Accounts receivable

Accounts receivable, loans receivable and bonds are all financial assets and are therefore also subject to the measurement rules found in IFRS 9. Generally

¹⁵ IAS 32, para. 11.

¹⁶ IFRS 9, para. 4.1.4.

¹⁷ IFRS 13, para. 9.

¹⁸ Income Tax Act 2007, s EW 15C.

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accounts receivable will be valued at fair value with all gains or losses passing through the annual profit or loss account.¹⁹ Usually debtors and accounts receivable will remain valued at cost in the financial statements as this is most commonly the collectable amount. Inherent in the measurement of accounts receivable at *fair value* is that where a receivable is considered uncollectable, the carrying value will reflect the fact the amount is not expected to be received. In other words, the fair value of an uncollectable receivable is nil. IFRS 9 specifically mandates that a reporting entity will allow for any “lifetime expected credit losses” on accounts receivable.²⁰ Typically, this may be implemented as a policy to always provide for a certain amount of bad debts, measured based upon experience of the entity in the past. For example, this may look like a matrix of potential credit losses depending upon the age of the debtor – 10% of the accounts receivable that are 3 months overdue may be provided for. This provision for expected credit losses is not the same as writing off a debt as “bad”. As stated in the application notes of IFRS 9:²¹

“Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs.”

This differs from the treatment under the Income Tax Act 2007. Accounts receivable can only be written down to a recoverable amount where a specific debtor is identified and the receivable is written down as irrecoverable in the debtors’ ledger prior to the entity’s balance date.²²

So what does this mean in terms of the likely measurement of accounts receivable for financial reporting purposes compared with the measurement for tax purposes? Write downs of accounts receivable for financial reporting purposes are more likely to be expedited compared with tax – resulting in lower asset measurements for financial reporting purposes than the tax base.

Loans receivable and investment in bonds

Loans receivable and investments in bond instruments are also classified as financial assets for financial reporting purposes and governed by the measurement requirements in IFRS 9. However, unlike cash and accounts receivable, loans receivable and bonds are usually measured at “amortised cost” – that is the cost of the asset, amortised over the life of the asset. It is essential that to be measured at “amortised cost”, the financial asset must be held for the purpose of collecting cashflows including interest and principal as agreed under the contractual terms of the arrangement.²³ The method used to measure these types of financial assets is also known as the “effective interest method” – that is, a method that discounts the value of the financial asset to its present value, taking into account the expected future cash receipts calculated at the effective

¹⁹ IFRS 9, para. 4.1.4.

²⁰ IFRS 9, para. 5.5.15.

²¹ IFRS 9, B5.5.7.

²² Income Tax Act 2007, s DB 31.

²³ IFRS 9, para. 4.1.1, 4.1.2.

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interest rate inherent in the asset.²⁴ The value of the financial asset will also be adjusted for any expected credit losses – this is known as impairment.²⁵

The tax treatment of loans receivable and investments in bonds is determined under subpart EW of the Income Tax Act 2007 - the financial arrangement rules. Usually, an entity that reports under IFRS will also be able to use the same method to calculate income and deductions of the loan receivable or bond. However, the Act will not allow a deduction for impairment or expected credit losses.²⁶ In this case, the value of an asset for tax purposes would be higher than that in the financial statements. An alternative method for valuing financial assets such as bonds and loans receivable for tax purposes would be to use the yield to maturity method found in Determination G3 (NZD denominated) or G9C (foreign currency denominated). This method is likely to reach a similar valuation for the financial asset as the financial reporting methodology in IFRS 9, other than the inability to deduct expected credit losses for tax purposes.

Inventory

The measurement rules for inventory or trading stock are given in IAS 2 Inventories.²⁷ The standard provides the choice of valuing inventory at cost or, if lower, the net realisable value. Net realisable value is used when after all the costs of selling and getting the stock ready to sell are taken into account, the amount realised is expected to be less than the inventory's cost. Likewise, the tax rules provide for inventory to be valued at the lesser of cost or market selling price.²⁸ Similarly to the “net realisable value” method allowed under IAS 2, the market selling price takes into account the costs of getting the stock ready for sale and the costs of selling.

Therefore, for IFRS reporting entities, the measurement of inventory for financial reporting and the tax base should be broadly the same.

Equity investments < 20%

Investments in equity instruments where the investor has an interest of less than 20% are treated differently under IFRS to other investments.²⁹ This is due to the lack of opportunity to participate in the management and control of the investee in an influential way.

²⁴ Definition of “effective interest method” found in IFRS 9 Appendix A.

²⁵ IFRS 9, para. 5.5.1.

²⁶ Income Tax Act 2007, s EW 15D.

²⁷ IASB “IAS 2 Inventories” (IASB, 2003)

²⁸ Income Tax Act 2007, s EB 6 and 11. Note that the other valuation methods provided in ss EB 9 and 10 only apply if allowed under financial reporting so they are not relevant for entity's complying with IFRS.

²⁹ IFRS 9, 2.1(a) excludes investments in entities that are classified as subsidiaries, associates or joint ventures.

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Under IFRS, these investments are measured at *fair value* like other financial assets.³⁰ This fair value can of course fluctuate up or down depending upon the market value of the investment.

The tax base of equity investments is their cost.

Therefore, differences between the measurement of investments using IFRS or the tax base will arise. However, the differences may produce higher or lower values under IFRS depending upon the market value of the investment.

Equity investments 20%-50%

Investments in equity instruments where the investor has a voting interest somewhere between 20% and 50% is accounted for under IFRS using the *equity method* of accounting.³¹ These investors are deemed to have significant influence over the investee.³²

The equity method of accounting involves the investor measuring their investment at cost plus or minus any share of profits/losses and dividends (with some adjustments possible for transactions between the investor and investee). If an investee is doing well, it is most likely the financial statements of the investor will reflect a value in the investment that is higher than its cost. However, if an investee is making losses, over time the investee will be reflected in the investor's financial statements at amounts below its cost (potentially reduced to zero).

Gains and losses in equity investments are not taken into account when calculating taxable income (unless they come under the FIF or CFC rules). Therefore, the tax base of these assets will be cost.

For equity investments with voting interest between 20% and 50%, the accounting and tax treatments are fairly prescribed with little ability to manipulate. Therefore, the chance of an entity utilising the valuation of these investments to manage the debt percentage to their advantage is unlikely.

In a situation where the investee is doing well, the debt percentage will be more advantageous to the investor as the asset value will rise while there is no reason for the associated debt to rise in value. However, equally, an investor's debt percentage will be adversely affected if the reported value of the investment declines due to poor performance while the real associated debt remains.

Investments in equity instruments > 50%

The financial reporting treatment of investments where the investor has control of the investee is to consolidate **all** of the assets and liabilities of the investee into

³⁰ IFRS 9, 4.1. The investment could be recognised at fair value with the gains or losses flowing either through the profit or loss account or through the other comprehensive income.

³¹ IASB "IAS 28 Investments in Associates and Joint Ventures" (2003, IASB)

³² IAS 28, para.5.

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the investor's group financial statements. Although the investor may not have 100% control of the investee, all the assets and liabilities are included in the consolidated statement of financial position as the investor has *control* of the assets.³³

In calculating the debt percentage for an entity that is part of a New Zealand group, the assets of the New Zealand group are used. This is different to the financial reporting requirements that include all assets and liabilities controlled by the New Zealand investor. Under the tax rules for calculating the New Zealand group debt percentage, only those assets that are used in the New Zealand businesses will be included.³⁴

Where an investment is greater than 50%, the issues for calculating debt percentage really involve the underlying values attributed to the assets under IFRS. No "new" issues of value arises as the investment itself is excluded from the assets of the New Zealand group under the consolidation rules.

Property, plant and equipment

For many businesses, the acquisition of property, plant and equipment is the most significant investment in order to produce revenue. It is often because of the purchase of property, plant and equipment that the need for debt arises. So there is a direct link between the debt acquired and the cost of the property, plant or equipment acquired.

For tax purposes, property, plant and equipment is always valued at cost, less any depreciation or amortisation allowed by statutory determination.³⁵ The rules around valuation of property, plant and equipment and the tax deductions allowed in respect of depreciation and amortisation are prescribed in detail with little flexibility allowed. The tax base is the cost of the property, plant and equipment, less any accumulated depreciation deducted in calculating income tax liabilities.

On the other hand, significant variability may occur when valuing property, plant and equipment for the purposes of IFRS reporting. The standard that regulates accounting for property, plant and equipment is IAS 16.³⁶ The measurement of property, plant and equipment values are determined by the following:

- The values may be determined using either the cost or the fair value of the asset;³⁷
- All assets that are expected to decline in value over time are depreciated over their "useful life";³⁸

³³ IASB "IFRS 3 Business Combinations" (2008, IASB)

³⁴ Income Tax Act 2007, s FE 14.

³⁵ Income Tax Act 2007, s EE 27(3).

³⁶ IASB "IAS 16 Property, plant and equipment" (IASB, 2003)

³⁷ IAS 16, para 29.

³⁸ IAS 16, para 50.

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- Useful life is dependent upon the asset and determined by the management;³⁹
- Useful life should broadly match the consumption of the asset's economic benefits by the entity;⁴⁰
- All assets should be evaluated for indications of impairment;⁴¹
- Any impairment results in the write down of the asset value;⁴²
- Assets may be revalued upward to a fair value;⁴³
- Fair value may be determined by a quoted price in an actively traded market through to management judgment where more objective data is not available.⁴⁴

All of this appears a lot more complex than the reality. The standards do provide for significant flexibility. There is requirement to write down property, plant and equipment where there is indication of impairment, but equally there is the ability to increase the reported value of an asset. Depreciation rates are flexible and variable. Useful lives are discretionary.

Property, plant and equipment may have a significantly different value in the entity's financial statements compared with its tax base. This is often the area that produces the most significant deferred tax assets and liabilities due to the different measurement.

Intangible assets

Intangible assets is a varied group of assets with variable issues. This asset group will be broken down into research and development, goodwill and brands, and acquired intellectual property rights such as patents, licences and trademarks.

Research and development

The treatment of research and development is aligned under the financial reporting and taxation rules. This is because the Income Tax Act 2007 allows entities reporting under IFRS to apply to the treatment of its research and development expenditure to the calculation of the entity's income tax liability. So any tax base should align with the carrying value of an asset arising through research and development expenditure.

Goodwill and brands

Goodwill and brands arise either through internal generation or through acquisition from external sources. Costs associated with the internal development of goodwill and brands will be expensed for financial reporting

³⁹ IAS 16, para 57.

⁴⁰ IAS 16, para 57.

⁴¹ IASB "IAS 36 Impairment" (IASB, 2004), para 9.

⁴² IAS 16, paras 31 and 32.

⁴³ IAS 16, para 32.

⁴⁴ IASB "IFRS 13 Fair Value Measurement" (IASB, 2011), paras 72-90.

Appendix 1 Analysis of assets using IFRS and Tax Base

purposes and never accumulated and recognised as an asset.⁴⁵ This is because recognition of internally generated brands and goodwill as assets is denied by the financial reporting standard. This can produce some particularly anomalous results. Take Apple Inc. for example.⁴⁶ Apple's brand is estimated to be valued at US\$178b.⁴⁷ This is not recognised in the financial statements of Apple Inc.⁴⁸ even though it would represent a more than 50% increase in the company's asset value.

The treatment of internally generated goodwill and brands is aligned with the tax treatment which may allow a tax deduction at the time of the expenditure but would not allow an entity to capitalise the costs and deduct at a later date.

On the other hand, the tax treatment and accounting treatment of externally acquired brands and goodwill is different. The financial reporting standards allow an entity to recognise these assets when they have been purchased. They are measured at cost and cannot be revalued upward. However, the cost of acquired goodwill and brands must be tested for impairment on an annual basis and written down if necessary.⁴⁹

Externally acquired brands and goodwill have a tax base of nil.⁵⁰ The basis for this being that the cost of goodwill is never tax deductible in New Zealand.

Returning to the issue of determining whether the difference in measurement impacts the debt percentage – the answer is, of course, yes. An asset is recognised in the financial statements and is able to be included in the calculation of the debt percentage. However, this amount is not subject to manipulation or optimism as it is limited to the higher of cost or the impaired amount. It should also be noted that the cost of the brand or goodwill that has been acquired may have relied on direct debt funding and therefore it would seem appropriate it should be included in the entity's calculation of its debt percentage.

Patents, licences, trademarks etc.

An entity will often acquire legal or contractual rights such as a licence or a patent or a trademark or a consent. The financial reporting standards allow the entity to recognise as asset and where it has a fixed life, the cost should be amortised over that life.⁵¹ The Income Tax Act 2007 requires the same treatment. This type of asset is referred to as fixed life intangible property and is depreciated for tax purposes on a straight line basis over the life of the asset.⁵²

⁴⁵ IASB "IAS 38 Intangible assets" (IASB, 2004), paras 48 and 63.

⁴⁶ The U.S. FASB also denies the recognition of internally generated brands and goodwill.

⁴⁷ Interbrand Best Global Brands 2016 Rankings.

⁴⁸ See Apple Inc. Form 10K as filed with the SEC.

⁴⁹ IAS 36, para 10.

⁵⁰ IAS 12, para 21.

⁵¹ IAS 38, para 97.

⁵² Income Tax Act 2007, s EE 33(2).

Appendix 1 Analysis of assets using IFRS and Tax Base

The measurement of the intangible asset in the financial statements should be the same as the tax base. Therefore, there should be no impact on the debt percentage calculation. Also, the maximum asset value is always cost and any borrowing in relation to this asset will be based on the cost.

Derivative Financial Assets

Like intangible assets, this group of assets is wide ranging including forward exchange contracts, options, swaps, futures, credit default swaps and collateralised debt obligations. However, for financial reporting purposes, they are all valued at fair value. Determining the fair value depends upon the availability of an active market. Forward exchange contracts are usually easy to value as they rely on the spot exchange rate and the cost of borrowing at any point in time. These prices are all readily available on an active market. Swaps are also readily valued based on actively traded interest rates and futures contracts are also traded in active markets. Options are more difficult to value and the financial reporting standard allows any number of models to be used. The value of an option is less readily discernible by reference to an active market – however, there are accepted option pricing models available that will give a valuation credibility in the market.

The tax treatment of futures, forward exchange contracts, swaps and options is similar for tax purposes. The Income Tax Act 2007 allows entities that prepare their financial statements under IFRS to apply the same values for income tax purposes.⁵³ There are other methods available to be used for tax purposes. However, these methods are market value based methods so should not produce vastly different values to the IFRS compliant valuation.

Where more variance between tax and financial reporting values may appear is in relation to the more bespoke derivative financial assets such as collateralised debt obligations and credit default swaps.

Under IFRS, collateralised debt obligations and credit default swaps are valued at the end of the reporting period at fair value. Several methods are available to the entity under the tax rules, including compliance with the IFRS method. However, these types of financial assets are less likely to appear in non-financial institutions in New Zealand.

Biological assets

Livestock and crops (biological assets) are valued at fair value for financial reporting purposes.⁵⁴ Under the Income Tax Act 2007, livestock are valued at national standard cost or a market value estimate (herd scheme method). Crops and forestry are valued at cost. Therefore, there will usually be a difference between the tax base value and the value used for financial reporting purposes.

⁵³ Income Tax Act 2007, s EW 15C.

⁵⁴ IASB "IAS 41 Agriculture" (IASB, 2000), para 12.

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Usually, the financial reporting value will be higher (except perhaps in some cases where the herd scheme is being utilised).

Using the financial reporting value for the calculation of the debt percentage will usually produce a higher asset value, therefore reducing the risk of the entity breaching the safe harbour ratio.

Appendix 2 Table of differences between IFRS and tax base for common asset classifications

Asset type	IFRS reporting	Tax base	Impact
Cash	Market value	Market value	None
Debtors and bonds	Market value - provide for expected losses Lower of cost or NRV (including retail method)	Cost - write off irrecoverable amounts	Tax base may be higher
Inventory	Market value	Cost or NRV or discounted selling price	None
Investments - shareholdings < 20%	Market value	Cost	Financial statements may be higher
Investments - shareholdings 20-50%	Cost plus share of profits	Cost	Financial statements may be higher or lower
Investments - shareholdings > 50%	Cost	Cost	None
Livestock	Market value	Herd scheme or national standard cost or cost	Financial statements may be higher
Forestry/crops	Market value	Cost	Financial statements may be higher
Bearer plants	Market value or cost	Cost	Financial statements may be higher
Land	Market value or cost	Cost	Financial statements may be higher
PPE	Cost or market value less accounting depreciation and impairment	Cost less tax depreciation	Financial statements subject to significant judgment
Intangible - r&d	Cost when recognised as an asset	Cost when treated as an asset	None
Intangible - brands	Not recognised as an asset	Not recognised as an asset	None
Intangible - patents, licenses, trademarks	Cost less amortisation and impairment	Cost less amortisation	Tax base may be higher
Financial assets	Fair value	Market value	Usually no difference