7. ACCOUNTING TREATMENT OF DEFERRED TAX

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PURPOSE OF REPORT

1. The purpose of this report is to recommend a change to the Council's current policy of not accounting for deferred tax. This recommendation has arisen from the Council's obligation to comply with NZ IAS 12, Income Tax.

EXECUTIVE SUMMARY

2. Paragraph 39 of NZ IAS 12 requires that an entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

   (a) The parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
   (b) It is probable that the temporary difference will not reverse in the foreseeable future.

3. Because a parent controls the dividend policy of its subsidiary, the parent is able to control the timing of the reversal of temporary differences associated with its investment in that subsidiary.

4. Therefore, if the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability.

5. The Council is able to control the dividend flow from its subsidiaries, however, special dividends in excess of current year's profits are anticipated, which will cause the temporary differences on the undistributed retained earnings to reverse.

6. Hence Council does not qualify for the exemption provided under paragraph 39 and must recognise a deferred tax liability on the undistributed retained earnings of its subsidiaries.

7. This liability is estimated to be around $280 million.

8. Although most of the liability will be offset by imputation credits, we have not yet been able to confirm that a contra-entry for these credits may be recognised.

9. The Council leases the Town Hall to Christchurch City Facilities, a Council Controlled Organisation, for Income Tax purposes. Therefore, it is required to pay Income Tax on the rental income it receives.

10. The Council revalues its Buildings and this results in depreciation being charged on different bases for accounting and Income Tax purposes. This has resulted in a taxable temporary difference of $39 million at 30 June 2005 and NZ IAS 12 requires that a deferred tax liability of $13 million be recognised at that date.

FINANCIAL AND LEGAL CONSIDERATIONS

11. An obligation to comply with NZ IFRS.

STAFF RECOMMENDATIONS

It is recommended that:

(a) The current accounting policy be amended to recognise a deferred tax liability on undistributed retained earnings within investments in subsidiaries and associates.

(b) Staff continue to work with their tax advisors to seek clarification regarding the contra-entry for imputation credits.

(c) The current accounting policy be amended to recognise a deferred tax liability on the taxable temporary differences on buildings rented to Council Controlled Organisations defined in the Income Tax Act 2004.

BACKGROUND ON ACCOUNTING TREATMENT OF DEFERRED TAX

12. The Council has resolved to adopt New Zealand International Financial Reporting Standards as from 1 July 2006 and in preparation for this staff have reviewed the existing accounting policies and procedures.

Analysis

13. An analysis is provided in Appendix 1, Issue Paper 20, (attached), which was adopted by the IFRS Steering Committee on 3 February 2006.

OPTIONS

14. Continue with the current dividend policy and calculate the resulting deferred tax liability each year.

15. Cease receiving dividends from CCHL. This is not realistic as the funds are required for Council activities and to help to reduce rates.

16. There is no realistic options with respect to the recognition of the deferred tax liability on the taxable temporary differences on buildings rented to Council Controlled Organisations defined in the Income Tax Act 2004 as the Council is required by the Local Government Act 2002 to comply with the New Zealand equivalents of International Financial Reporting Standards and the sale of the Town Hall is not achievable in the short term and is an option that is unlikely to find sufficient support for it to be achieved.