DETERMINATION > FINANCIAL ARRANGEMENTS > GENERAL

Variations in the Terms of a Financial Arrangement

Issued: 28 May 1992

G25

This Determination may be cited as "Determination G25: Variations in the Terms of a Financial Arrangement".

1 Explanation (which does not form part of the determination)

1. A financial arrangement may be varied for many reasons. It may be varied by mutual agreement between the parties, by operation of the terms of the arrangement (such as an option), or by a partial remission of debt. One way of effecting a change is by terminating the existing financial arrangement and issuing a new one. That situation is straight forward and does not need a specific determination. A base price adjustment is calculated and income or expenditure under the new financial arrangement is calculated using the yield to maturity method or an appropriate alternative.

2. This determination applies where the variation is effected by changes to the original financial arrangement. Such changes may have been contemplated or anticipated in the original financial arrangement, for example:

   (a) where there are options in the financial arrangement exercisable by either party, or

   (b) where the original financial arrangement contains an intent that it will be altered in certain prescribed ways (or at the agreement of the parties) on the happening of some event.

   In both these cases, at the date of acquisition, an accrual method can not be applied that will last unaltered until the maturity or other sale of the financial arrangement. This determination applies in such cases, even though the financial arrangement may set out quite clearly how it is to be altered. The determination does not apply where the terms of the financial arrangement are unequivocal as to the nature, time and amount of the changes made.

3. At the most basic level, a variation will involve a change to the cash flows or the dates upon which they are payable.

4. The method requires an adjustment to be made in the year of variation. The effect of the variation is that the total income or expenditure up to the end of the year of variation is equal to what it would have been had the timing and exact details of the variations been known at the date of issue or acquisition.

5. The method is similar to that used in section 64D(4) of the Act where a taxpayer becomes a cash basis holder.

   It is also similar to section 64C(2B) that gives a method of changing to the straight line method of accounting for financial arrangements from another method used.

6. This determination does not apply to variable rate financial arrangements, where the only variation is a change in the index, price, or rate (these will be dealt with by a subsequent determination entitled Variable Rate Financial Arrangements). It does apply where a variation occurs that does not result from a change in the indicator rate. For example when the amount of principal is varied without a corresponding payment or the margin above the indicator rate is varied.

2 Reference

This determination is made pursuant to section 64E(1) of the Income Tax Act 1976.

3 Scope of Determination

This determination applies to any financial arrangement where the amounts payable, or the dates on which they are payable, are varied after the date of issue or acquisition, but it does not apply:

(a) To a Variable Rate Financial Arrangement (as defined in this determination) under which the only variation is a change in the economic, commodity, industrial or financial indices or prices, or banking rates or general commercial rates, or

(b) Where the variation is effected by the maturity or other termination of the financial arrangement and the issue of a new financial arrangement, or

(c) Where the variation is made according to the terms of the financial arrangement, which terms are unequivocal as to the nature, time and amount of the changes made.

4 Principle

The adjustment in this determination is made in the year of variation. The result is that the total accumulated income or expenditure up to the end of the year of variation is equal to that that would have applied had the changes been known at the date of issue or acquisition.

5 Interpretation

1. In this determination, unless the context otherwise requires:

Expressions used have the same meaning as in the Act and where a word or expression is given a particular meaning for the purposes of sections 64B to 64M of the Act it shall have the same meaning as in the said sections 64B to 64M;

"the Act" means the Income Tax Act 1976;

"Variable Rate Financial Arrangement" means a financial arrangement under which:

(a) the interest rate is determined by a fixed relationship to economic, commodity, industrial or financial indices or prices, or banking or general commercial rates; or

(b) the interest rate is set periodically by reference to market interest rates.

2. Any reference in this determination to another determination made by the Commissioner shall be construed as including a reference to any fresh determination made by the Commissioner to vary, rescind, restrict, or extend that determination.

3. For convenience, words and phrases defined in this determination are indicated by initial capital letters. However, in the absence of a capital letter shall not alone imply that the word or phrase is used with a meaning different from that given by its definition.

6 Method

1. In the income year in which a financial arrangement is varied, a person who is the issuer or holder of the financial arrangement shall include, in calculating assessable income for the income year, an amount in respect of the financial arrangement calculated in accordance with the following formula:

$$a - b - c + d, \text{ where:}$$

a is the sum of all amounts that would have been income derived by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued;

b is the sum of all amounts that would have been expenditure incurred by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued;

c is the sum of all amounts treated as income derived of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year; and d is the sum of all amounts treated as expenditure incurred of the person in respect of the financial arrangement since it wc vas acquired or issued to the end of the previous income year.

The amount so calculated shall:

(a) Where it is a positive amount, be deemed to be income derived by the holder or the issuer as the case may be:

(b) Where it is a negative amount, be deemed to be expenditure incurred by the holder or issuer as the case may be:

Provided that expenditure incurred by the holder, in the year in which the financial arrangement is varied, using this method shall not exceed total income derived by the holder in previous income years.

2. In income years after the income year in which the financial arrangement is varied, income deemed to be derived or expenditure deemed to be incurred shall be calculated using the terms of the financial arrangement as varied and the provisions of the Act.

7 Examples

1. **Example A (A straight line method)**

A New Zealand taxpayer issues (borrows) $8,800 on 10 July 1991 for 3 years with interest at 10% pa payable half-yearly in arrears. The loan is made by issuing $10,000 of notes at a discount. There are no fees.

The issuer is a New Zealand taxpayer eligible to use the straight line method (Determination G24), and chooses to do so. The issuer has a balance date of 31 March.

The total finance charges are:

+	10,000	principal payable
+	3,000	interest payable
–	8,800	principal received
+	4,200	

Since the principal outstanding is fixed throughout, and all time units are of the same length, Method A of Determination G24: Straight Line Method was used to calculate expenditure incurred.

Accordingly, an amount of 4,200/6 = 700 would be expenditure incurred in each half year period.

On 10 July 1993, in consideration of the issuer's circumstances, the holder agrees to forgive the 5th and 6th interest payments but not the principal amount due. The treatment of the loan in the 1994 and following years is set out below.

If the actual cashflows had been known at the outset, namely:

10 July 1991	+	8,800	principal received
10 January 1992	–	500	interest
10 July 1992	–	500	interest
10 January 1993	–	500	interest
10 July 1993	–	500	interest
10 July 1994	–	10,000	principal paid
	–	3,200	expenditure incurred

then Method B of Determination G24: Straight Line Method would have applied because the length of the periods between payments are unequal. Under that method the Total Finance Charges of 3,200 would be spread over the term of the loan in proportion to the principal outstanding and length of each period. Using the formula in Method B of Determination G24 expenditure of 533.33 would have been incurred for each period.

Then using Determination G1A: Apportionment of Income and Expenditure on a Daily Basis, (on a 365 day basis) the position of the lender before and after the variation would be as follows:

Year Ending 31 March	Expenditure Incurred Original (1)	Expenditure Incurred Changed (2)	Actual Expenditure Incurred
1992	1,016	774	1,016
1993	1,400 (3)	1,067	1,400
1994	1,400	1,067	492 (4)
1995	384	292	292
Totals	4,200	3,200	3,200

(1) Expenditure calculated using Method A of Determination G24: Straight Line Method.

(2) Expenditure calculated using Method B of Determination G24: Straight Line Method.

(3) The number of actual days was used to arrive at the 1992 figure (a broken period plus a leap year), whilst the annual payments were used for the 1993 and 1994 years.

(4) Expenditure calculated using this determination where:

a = 0

b = 774 + 1,067 + 1,067 = 2,908

c = 0

d = 1,016 + 1,400 = 2,416

so a − b − c + d = −492 which being a negative amount is deemed to be expenditure incurred in the year.

In the 1995 income year the expenditure incurred would be calculated using the base price adjustment in section 64F where:

a = all consideration paid = 12,000

b = acquisition price = 8,000

c = expenditure incurred in previous years = 2,908

so a − (b + c) = 292, which because it is a positive amount is deemed to be expenditure incurred in terms of section 64F(4)(b)(i).

2. **Example B (a zero coupon loan)**

On 15 April 1991 a 5 year zero coupon bond with a face value of $1,000,000 is issued for $500,000. The lender is a New Zealand taxpayer who balances on 31 March, and uses the yield to maturity method of accounting for financial arrangements.

By mutual agreement the debt is varied on 15 April 1993: the borrower repays $250,000, and the face value of the bond is reduced to $600,000.

The original yield to maturity is 14.870% pa, so that the income of the lender (the holder) would be as follows:

Year Ending 15 April	Opening Principal Outstanding	Accrual Income (1)	Closing Principal Outstanding
1992	500,000	74,350	574,350
1993	574,350	85,406	659,756
1994	659,756	98,106	757,862
1995	757,862	112,694	870,556
1996	870,556	129,444	0
		500,000	

(1) Calculated using the yield to maturity method and a rate of 14.870%.

If the changed cash flows had been known at 15 April 1991, namely:

15 April 1991	500,000 by lender
15 April 1993	250,000 by borrower
15 April 1996	600,000 by borrower

the yield to maturity would have been 14.235% pa and the income would have been as follows:

Year Ending 15 April	Opening Principal Outstanding	Accrual Income (1)	Principal Payments	Closing Principal Outstanding
1992	500,000	71,175	0	571,175
1993	571,175	81,307	250,000	402,482 (2)
1994	402,482	57,293	0	459,775
1995	459,775	65,449	0	525,224
1996	525,224	74,776	600,000	0
		350,000	850,000	

(1) using the yield to maturity method and a rate of 14.235%.

(2) 571,175 + 81,307 − 250,000 = 402,482

Then using Determination G1A: Apportionment of Income and Expenditure on a Daily Basis the position of the lender after the variation would be as follows:

Year Ending 31 March	Income Derived Original (1)	Income Derived Actual (2)	Expenditure Incurred
1992	71,303	68,258	71,303
1993	84,867	80,883	84,867
1994	97,584 (3)	58,279 (4)	51,250 (5)
1995	112,095	65,114	65,114
1996	128,770	74,401	74,401
1997	5,381	3,065	3,065
Total	500,000	350,000	350,000

Notes:

(1) Calculated using the Yield to Maturity Method and original cash flows.

(2) Calculated using the Yield to Maturity Method and changed cash flows.

(3) There are 350 days from 15 April 1993 to 31 March 1994 and 85,406 × 15/365 + 98,106 × 350/365 = 97,584

(4) Similarly, 81,307 × 15/365 + 57,293 × 350/365 = 58,279

(5) Expenditure calculated using this determination where:

a = 68,258 + 80,883 + 58,279 = 207,420

b = 0

c = 71,303 + 84,867 = 156,170

d = 0

so a − b − c + d = 51,250 which being a positive amount is deemed to be income derived for the 1994 income year.

In the 1997 income year the income derived would be calculated using the base price adjustment in section 64F where:

a = all consideration paid to the person = 850,000

b = acquisition price = 500,000

c = income derived in previous income years = 346,935

a − (b + c) = 3,065 which is a positive amount therefore in terms of section 64F(4)(a)(i) it is deemed to be income derived by the holder (lender).

About this document

General determinations set out the Commissioner's view on how the financial arrangements rules apply to a specific type of financial arrangement. All general determinations are binding on the Commissioner and some are also binding on taxpayers.