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Funding and Hedging Arrangements Denominated in Foreign Currency in Respect of the Forward Purchase of a Commodity and Payment in Full at the Date of Agreement

Issued: 8 December 1992

S1

Income Tax (Determinations (Regulations) 1987

This anonymous version appears in substitution for the full version of Determination S1: Funding and Hedging Arrangements Denominated in a Foreign Currency in Respect of the Forward Purchase of a Commodity and Payment in Full at the Date of Agreement. The determination is made pursuant to regulations 8 and 10 of the Income Tax (Determinations) Regulations 1987. The determination was signed by R.D. Adair, Deputy Commissioner, on 8 December 1992.

This determination may be cited as "Determination S1: Funding and Hedging Arrangements Denominated in a Foreign Currency in Respect of the Forward Purchase of Commodity and Payment in Full at the Date of Agreement".

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

1. A has entered into an agreement to purchase a commodity in order to pay a cash sum to B. This sum has had to be funded from C, who has provided a loan to A. A is a wholly owned subsidiary of C, and has entered into hedging arrangements with its parent in order to minimise its exposure to commodity price movements. As A and C are able functionally to be treated as one person when characterising this transaction, all financial arrangements within the scope of this determination can be treated as one financial arrangement. That financial arrangement consists of the following. An agreement whereby a holder sells a commodity to be delivered in instalments over a period of time, and the issuer pays the full purchase price at the time of entering into the agreement for those deliveries. An agreement whereby the issuer under the agreement for the sale and purchase of a commodity borrows the amount of purchase price required to pay the holder under the former agreement. The issuer under the agreement for sale and purchase of the commodity enters into an a commodity price swapping agreement in order to hedge the risk of price movements in the commodity in the period during which the agreement for the sale and purchase of that commodity operates.

2. This determination applies to all these financial arrangements, together with any consequential financial arrangements arising as a result of deferred settlement of payment obligations under these financial arrangements (as more fully described in this determination) being in all cases financial arrangements denominated in a base currency.

   This determination allows an issuer under the agreement for sale and purchase of the commodity to calculate income or expenditure in relation to all of these financial arrangements.

3. A has agreed to buy and B has agreed to sell quantities of a commodity for delivery over 36 months. The amounts of the commodity to be delivered each month are quantified by reference to a schedule of base quantities known at the time the agreement was entered into. The actual amount of commodity to be delivered each month may vary from the agreed base quantities, but only by reference to movements between two commodity indices relative to each other. The actual value of the commodity to be delivered each month expressed in a Base Currency will not change by reason of the fact that there is a movement between these two commodity indices. A will pay a sum certain on the day of entering into the agreement to B for all future

deliveries. No further adjustment to the price is contemplated in the agreement for the sale and purchase of the commodity.

4. A will borrow from C the full amount of the purchase price to be paid to B. This loan to A will be denominated in a Base Currency, as will the purchase price paid by A to B. The loan will provide for repayment of principal and interest each month according to a schedule under which the amount to be paid by A every month is equivalent to the value of the base quantity of the commodity B has agreed to deliver to A each month, calculated by reference to the commodity price prevailing in the month the agreement for sale and purchase of the commodity was entered into.

5. A will enter into hedging arrangements at the time the agreement for sale and purchase of the commodity from B to A, the "Forward Commodity Purchase agreement", is executed. The hedging arrangements will be in the nature of commodity price swaps, under which A will receive from C, each month for 36 months, an amount equal to the price of the commodity, expressed in the base currency, as prevailing at the date the Forward Commodity Purchase agreement was entered into. This is calculated by reference to the base quantity of commodity to be delivered in respect of each month of payment, and in any event being an amount equal to the loan repayment to be made by A to C under the Base Currency Loan to A to enable it to pay the purchase price of the commodity to B. The other party to the swap will pay to A, each month for 36 months, an amount calculated by reference to the base quantity of the commodity to be delivered by B to A in that month and by reference to the commodity price prevailing on a recognised market for that commodity in that month expressed in Base Currency. The amount to be paid by each party in respect of any month under this swap agreement is calculated on the last day of the month, although actual payment is not required until 35 days thereafter.

6. A and B have applied for a determination pursuant to section 64E(1) of the Act.

7. Income or expenditure under the Forward Commodity Purchase agreement will be recognised using a methodology identical to that applied to the income or expenditure arising under the Base Currency Loan between A and C, after taking into account commodity price increases in each month, if any.

8. The income or expenditure shall, in respect of the Forward Commodity Purchase agreement be recognised on the basis of the lowest price agreed by the parties pursuant to section 64BA(1)(c)(i) of the Act being the market price in the month each respective delivery is made in that month.

9. The parties have entered into this arrangement in order to provide a cash sum to B, in circumstances in which C will not be a direct funder. C has accordingly purchased

forward commodity, and taken the commodity risk on price movements which it has hedged.

2 Reference

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

3 Scope of the Determination

This determination shall apply to the Forward Commodity Purchase agreement and the funding and hedging arrangements denominated in a Base Currency in respect of the forward purchase and forward payment for commodity entered into between A and B on 7 December 1992 under which the purchase price will be paid in full in that month, and shall bind both A and B.

4 Principle

1. The Forward Commodity Purchase agreement is an arrangement transferring the commodity pursuant to a financial arrangement expressed in a Base Currency. The Commissioner accepts that the lowest price the parties have agreed and would have agreed for the purposes of section 64BA(1)(c)(i) is the market price in the month of each delivery in respect of deliveries made in that month. To the extent that the market price exceeds that part of the payment attributable to those deliveries, it shall contain both an element of capital (being part payment of the purchase price), and an element of interest. To the extent to which the market price of the commodity delivered in any month is less than that part of the purchase price attributable to the commodity delivered, B as the holder under the financial arrangement would have derived income to the extent of the difference in value, and correspondingly A as issuer would have incurred expenditure. As the commodity or the consideration given for the commodity is relevant under provisions of the Act other than sections 64B to 64M, and as the price at which the commodity is transferred pursuant to the Forward Commodity Purchase agreement includes an amount deemed to be income derived or expenditure incurred by the issuer or the holder, section 64L(2) of the Act will apply to determine the amount to be taken into account as the price or cost price or selling price of or capital expenditure incurred in respect of the commodity. This determination provides the method for recognising income derived or expenditure incurred in any year in respect of this financial arrangement, and allocates that income derived or expenditure incurred to the relevant monthly periods.

2. The Base Currency Loan from C to A is a financial arrangement under which C is the holder and A is the issuer. Schedulised monthly repayments by A to C will contain elements of both capital and interest. This determination provides the method for recognising the income derived and expenditure incurred in any year under this financial arrangement.

3. The Commodity Price Swap agreement entered into between A and C contains two notional arrangements. One financial arrangement consists of the obligation of A to pay an amount equal to the prevailing market price for the commodity in each of 36 months, and the other arrangement consists of a right in A to receive a fixed amount in respect of the same 36 months. This determination provides the method for recognising income or expenditure under these financial arrangements.

4. It is assumed that the financial arrangements described above will be performed without amendment in accordance with the terms of the documents disclosed to the Commissioner prior to the issuing of this determination.

5. It is assumed that the amount of income derived or expenditure incurred as calculated pursuant to this determination and under section 64B to 64M of the Act in relation to the commodity price swap agreement, will be equivalent to the net expenditure incurred or income derived (as the case may be), calculated in accordance with this determination and sections 64B to 64M of the Act, arising under the Forward Commodity Purchase agreement and the Base Currency Loan. The overall net effect should, in the absence of the other income arising otherwise than under these financial arrangements, result in A being in a tax neutral position in respect of these financial arrangements in each year.

5 Interpretation

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

   words and expressions shall have the same meaning as in the Act, except that, where there is a conflict between the meaning of an expression in sections 64B to 64M of the Act and the meaning of the expression elsewhere in the Act, the expression shall have the same meaning as in the said sections 64B to 64M;

   "the Act" means the Income Tax Act 1976;

   "Base Currency" in relation to a financial arrangement means the currency in which the rights and obligations under the financial arrangement are fixed;

"Base Currency Loan" refers to a Base Currency Loan entered into between A and C to the extent of an amount equal to the purchase price payable on 8 December 1992 by A to B under the Forward Commodity Purchase agreement;

"Commodity Price Swap agreement" means the commodity price swap agreement executed between A and C on 7 December 1992 in the form disclosed to the Commissioner prior to the issuing of this determination;

"Exchange Rate" means the price of one currency expressed in another currency;

"Forward Commodity Purchase agreement" means a document entered into between A and B for the forward purchase of commodity where payment is received in full at the time and the contract is entered into;

"Market Price" means the index price for commodity in a recognised market calculated as the average of the spot prices for any month in which it is necessary during that month to fix a market value;

"NZD" means the currency of New Zealand;

"Separate Agreement" means an agreement between A and B entered into on 7 December 1992 containing schedules of delivery;

"Spot Rate" means the Exchange Rate for a spot contract as defined in Determination G6D: Foreign Currency Rates; and

"Value" in respect of any obligation expressed in a Base Currency means the amount outstanding in respect of any obligation to pay or right to receive any amount of that Base Currency; and in respect of any outstanding obligation to deliver commodity, or to pay an amount equal to or calculated by reference to an outstanding obligation to deliver commodity, or the right to receive outstanding deliveries of commodity, or an amount calculated by reference to an outstanding obligation to deliver commodities, the value of those rights or obligations shall be determined by applying the market rate at the relevant time to the base quantities of commodity outstanding undelivered at that time.

2. Any reference in this determination to another determination made by the Commissioner shall be construed as referring 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, but the absence of a capital letter shall not alone imply that the word or phrases are used with a meaning different from that given by its definition.

6 Method

1. In respect of the Forward Commodity Purchase agreement, the purchase price shall be apportioned to each monthly delivery of commodity by determining the proportion of the scheduled amounts to be delivered in each month in accordance with a schedule to the Separate Agreement to the total base quantities of the commodity to be delivered over the 36 months and applying those proportions to the purchase price paid for those commodities in December 1992.

2. The amount of the core acquisition price of the Forward Commodity Purchase agreement, is to be determined in accordance with sub-paragraph 64BA(1)(c)(i). In relation to the Forward Commodity Purchase agreement the lowest price agreed and which would be agreed by the parties in accordance with that sub-paragraph is the Market Price in a recognised market for any month. That price is determined monthly in relation to the deliveries made in that month.

3. The amount of income derived or expenditure incurred by A as issuer and B as holder under the Forward Commodity Purchase agreement shall be calculated in accordance with the following formula:

   $a + b + c - d - e - f$

   Where:

   a = the value in NZD of the amount of the commodity, calculated by reference to the Market Price in the month the Forward Commodity Purchase agreement was entered into, which is yet to be delivered as at the beginning of any year; and

   b = the value in NZD of the amount of the commodity calculated by reference to the Market Price in the last month of any year in respect of commodity that is yet to be delivered as at the end of any year; and

   c = the value in NZD of the amount of commodity delivered by reference to the Market Price in the month of delivery in respect of deliveries that month and converted into NZD as at the last day of that month; and

   d = the value in NZD of the amount of the commodity undelivered calculated by reference to the Market Price at the beginning of any year;

   e = the value in NZD of the amount of the commodity undelivered as at the end of any year calculated by reference to the Market Price in the month the Forward Commodity Purchase agreement was entered into; and

f = the proportion of the purchase price apportioned to the deliveries made during any month of the year converted into NZD at the last day of any month in which deliveries are made

and the amount so calculated shall:

a) where it is a positive amount be deemed to be expenditure incurred by the holder and income derived by the issuer in the income year;

b) where it is a negative amount be deemed to be income derived by the holder and expenditure incurred by the issuer in the income year.

4. Where —

a) any amount at any time is expressed in a currency other than NZD in relation to the financial arrangement; and

b) it is necessary to convert the amount of NZD or the base currency or otherwise to calculate the value of the amount in NZD or the Base Currency—

the Exchange Rate for the purposes of the calculation shall be in accordance with Determination G6D.

5. Determination G2: Requirements as to Precision shall apply to the calculation of income and expenditure under this determination.

6. The amount of income or expenditure incurred by A under the Base Currency Loan agreement shall be calculated in accordance with the following formula:

$c - f$

Where:

c = the value in NZD of the amount of the principal borrowed allocated to the month of payment as at the month of payment.

f = the value in NZD as at the month of payment of the amount of consideration paid by A;

The principal borrowed is allowed to any month of payment by determining the amount of commodity to be delivered in any month as a percentage of the total commodity to be delivered, and applying that percentage to the total principal borrowed.

7. The price at which the commodity is transferred pursuant to the Forward Commodity Purchase agreement, shall include an amount deemed to be income derived or expenditure incurred by the issuer or the holder. The amount of any income or

expenditure recognised in any year in respect of the Forward Commodity Purchase agreement, shall be allocated to each month in that year in respect to which the commodity has been delivered, in the same proportion as the value of the commodity delivered in that month expressed in the base currency bears to the value of the commodity delivered in that year expressed in the base currency. Where the value of the commodity delivered in that month expressed in the Base Currency (being the amount allocated above together with the proportion of the purchase price paid under that agreement referrable to that month), exceeds that proportion of the purchase price, an amount of assessable income shall be deemed to have arisen under section 64B to 64M for the purposes of section 64L(2) for the issuer and an amount of expenditure incurred shall be deemed to have arisen under section 64B to 64M for the purposes of section 64L(2) for the holder. Where the value of commodity delivered in that month expressed in the Base Currency is less than the purchase price paid under the agreement attributable to that month, an amount of expenditure incurred shall be deemed to have arisen under section 64B to 64M for the purposes of the section 64L(2) for the issuer, and an amount of assessable income shall be deemed to have arisen under section 64B to 64M for the purposes of section 64L(2) for the holder.

8. Where any repayments under the Base Currency Loan would be unable to be made as a result of delays in A receiving amounts payable under the Commodity Price Swap agreement, any loan to A expressed in the Base Currency on a fully fluctuating basis for the purpose of meeting the loan repayments under the Base Currency Loan will be a financial arrangement and subject, as far as possible, to the provisions of subclause 6(9) hereof.

9. The Commodity Price Swap agreement shall be treated as consisting of two notional arrangements as follows:

    i) the obligation of A to pay in each of 36 months an amount equal to an calculated by reference to the market price for the commodity in each of those months shall be treated as a notional sale of the commodity to A at market value for that month. Because the commodity to be delivered in any month and the amount to be received in respect of it is in both cases the market value, there is no income or expenditure to be recognised under this notional financial arrangement, other than in respect of income or expenditure to be recognised as the result of any delay in payment of any amounts owing under this financial arrangement expressed in a currency other than NZD, in respect of which the provisions of this clause shall as far as possible apply.

    ii) The right of A to receive under the Commodity Price Swap agreement a sum of money in each of 36 months calculated by reference a fixed price, itself calculated by reference to the base quantities and the prevailing market price of the

commodity (in the month in which the Commodity Price Swap agreement was entered into), shall be treated as a notional financial arrangement under which A on-sells the base quantities of commodity to be delivered during that month by B to A to the other party to the Commodity Price Swap agreement. The income or expenditure arising under this financial arrangement to A shall be calculated in accordance with the following formula:

$a + b + c - d - e - f$

where:

a = the future consideration payable in respect of the financial arrangement as at the beginning of the year, converted into NZD as at the beginning of the year;

b = the future consideration receivable in respect of the financial arrangement as at the end of the year, converted into NZD as at the end of the year;

c = consideration received in respect of the financial arrangement in the year, converted into NZD as at the date of the receipt;

d = the future consideration receivable in respect of the financial arrangement as at the beginning of the year, converted into NZD as at the beginning of the year;

e = the future consideration payable in respect of the financial arrangement as at the end of the year, converted into NZD as at the end of the year;

f = the consideration paid in respect of the financial arrangement in the year, converted into NZD as at the date of payment.

excepting that at the end of any year where a right to receive a sum of money has arisen and that money has not yet been paid, then for the purposes of calculating the value of any rights and obligations or of any consideration given, that value shall be ascertained at the time at which the right or obligation to payment arose. In such circumstances the delay in payment shall be regarded as a further financial arrangement and treated in accordance with this clause.

7 Example

The scheduled delivery quantities and timing of such deliveries under the Forward Commodity Purchase agreement is as follows:

1 January 1993	1,000	units
1 July 1993	750	units
1 January 1994	500	units
1 July 1994	250	units
	2,500	units

This schedule is also used to determine the notional delivery quantities and times under the Commodity Price Swap agreement.

Under the Forward Commodity Purchase agreement, A has paid $2,000 to B on 1 January 1993, as full payment for the abovementioned deliveries. A funded this $2,000 through a Base Currency Loan from C, which is repayable in instalments due on the abovementioned dates.

Under the Commodity Price Swap agreement, A agrees to pay a sum equal to the market value of the commodity on the abovementioned quantity as at the abovementioned delivery dates (the Floating Price Swap). Another party agrees to pay A $1.00 per unit on the same dates and for the same quantities (the Fixed Price Swap).

Although payment obligations under the Commodity Price Swap agreement are fixed and incurred on the above dates, payment may not be made until 6 months later.

When A receives the commodity on the delivery date, it then on-sells. Again, payment for this on-sale may be not be made until 6 months later.

For the relevant period, the following assumptions are made:

a) the commodity price was increased at a uniform rate, being:

1 January 1993	$1.00
1 July 1993	$1.20
1 January 1994	$1.40
1 July 1994	$1.60
1 January 1995	$1.80

b) the Base Currency $ rate to NZD has moved at a constant rate, being:

1 January 1993	1.00
1 July 1993	0.95
1 January 1994	0.90
1 July 1994	0.85
1 January 1995	0.80

A shall have the following income/expenditure.

In respect of the Forward Commodity Purchase Agreement

At first balance date — 31 December 1993

a = $2,500

b = 750 x $1.40 = $1,050

c = 1000 x $1 + 750 x $1.20

= $1,000 + $900

d = $2,500

e = $750

f = $\frac{1,000}{2,500}$ x $2,000 + $\frac{750}{2,500}$ x $2,000

= $800 + $600

Income/expenditure is:

$$\frac{2,500}{1.0} + \frac{1,050}{0.9} + \frac{1,000}{1.0} + \frac{900}{0.95} - \frac{2,500}{1.0}$$

$$- \frac{750}{0.9} - \frac{800}{1.0} - \frac{600}{0.95}$$

Base currency = $800

NZD = $849

At the second balance date – 31 December 1994

a = $750

b = 0

c = 500 x $1.40 + 250 x $1.60

= $700 + $400

d = $750 x $1.40

= $1,050

e = 0

$$f = \frac{500}{2{,}500} \times \$2{,}000 + \frac{250}{2{,}500} \times \$2{,}000$$

= $400 + $200

Income/expenditure is:

$$\frac{750}{0.9} + 0 + \frac{700}{0.9} + \frac{400}{0.85} - \frac{1{,}050}{0.9} - 0 - \frac{400}{0.9} - \frac{200}{0.85}$$

Base currency = $200

NZD = $235

In respect of the Base Currency Loan Agreement

At the first balance date – 31 December 1993

$$c = \frac{1{,}500}{2{,}500} \times \$2{,}000 + \frac{750}{2{,}500} \times \$2{,}000$$

= $800 + $600

f = $1,000 + $750

Income/expenditure is:

$$\frac{800}{1.0} - \frac{1{,}000}{1.0} + \frac{600}{0.95} - \frac{750}{0.95}$$

Base Currency = ($350)

NZD = ($358)

At the second balance date – 31 December 1994

c = $\frac{500}{2,500} \times \$2,000 + \frac{250}{2,500} \times \$2,000$

= $400 + $200

f = $500 + $250

Income/expenditure is:

$\frac{400}{0.9} - \frac{500}{0.9} + \frac{200}{0.85} - \frac{250}{0.85}$

Base Currency = ($150)

NZD = ($170)

In respect of the Floating Price Swap

Under subclause 6(9) there is no income or expenditure in either income year.

In respect of the Swap

At the first balance date – 31 December 1993

a = $2,500

b = $750

c = $1,000 + $750

d = $2,500

e = 750 x $1.40

= $1,050

f = $1,000 x $1 + 750 x $1.20

= $1,000 + $900

Income/expenditure is:

$\frac{2,500}{1.0} + \frac{750}{0.9} + \frac{1,000}{1.0} + \frac{750}{0.95} - \frac{2,500}{1.0}$

$$- \frac{1,050}{0.9} - \frac{1,000}{1.0} - \frac{900}{0.95}$$

Base Currency = ($450)

NZD = ($491)

At the second balance date – 31 December 1994

a	=	$750 x $1.40
	=	$1,050
b	=	0
c	=	$500 + $250
d	=	$750
e	=	0
f	=	$500 x $1.40 + 250 x $1.60
	=	$700 + $400

Income/expenditure is:

$$\frac{1,050}{0.9} + 0 + \frac{500}{0.9} + \frac{250}{0.85} - \frac{750}{0.9} - 0 - \frac{700}{0.9} - \frac{400}{0.85}$$

Base Currency (BCD) = ($50)

NZD = ($65)

Adding all 3 =

At the first balance date – 31 December 1993

NZD = $849 - $358 - $491 = 0

BCD = $800 - $350 - $450 = 0

At the second balance date – 31 December 1994

NZD = $235 - $170 - $65 = 0

BCD = $200 - $150 - $50 = 0