

INTERPRETATION STATEMENT: IS 20/07

Income tax – Application of the financial arrangements rules to foreign currency loans used to finance foreign residential rental property

All legislative references are to the Income Tax Act 2007 (the Act) unless otherwise stated.

Contents

| | |
|--|----|
| Summary | 1 |
| Introduction | 2 |
| Scope of the financial arrangements rules..... | 2 |
| Excepted financial arrangements | 2 |
| Transitional residents’ arrangements (s EW 5(17)) | 3 |
| Variable principal debt instruments | 4 |
| Excepted financial arrangements – summary | 5 |
| Arrangements subject to the financial arrangements rules..... | 5 |
| Cash basis and non-cash basis persons | 5 |
| First step in the cash basis person test..... | 5 |
| Second step in the cash basis person test – deferral threshold | 6 |
| Annual monitoring of cash basis status important | 6 |
| Cash basis person may use a spreading method | 6 |
| Cash basis adjustment required if status changes | 7 |
| Non-cash basis persons | 7 |
| Closing tax book value | 8 |
| Currency conversion | 9 |
| Applying Determination G9A | 9 |
| Calculating a base price adjustment..... | 9 |
| When a base price adjustment calculation is triggered..... | 9 |
| Ceasing to be a New Zealand tax resident..... | 9 |
| Base price adjustment on maturity of financial arrangement..... | 10 |
| Base price adjustment formula | 11 |
| Income under the financial arrangements rules | 12 |
| Expenditure under the financial arrangements rules | 12 |
| References..... | 19 |

Summary

1. If you are a New Zealand tax resident who has a foreign currency loan, you need to consider whether the loan is subject to the financial arrangements rules (FA rules). If the FA rules apply, they may affect the amount of expenditure you are deemed to incur, and you may be required to pay tax on deemed financial arrangement income as a result of an increase in the value of the New Zealand dollar.

Introduction

2. This Interpretation Statement explains when and how the FA rules apply to a foreign currency loan that is used by a New Zealand resident individual to finance foreign residential rental property. This statement does not discuss situations involving foreign property owned by non-residents, partnerships, trusts, or entities such as companies. Nor does it deal with foreign currency loans used exclusively for a private or domestic purpose such as a private holiday home.
3. Although people often use the terms "loan" and "mortgage" interchangeably, especially in the context of real estate purchases, a loan (or loan agreement) is not technically a mortgage. A mortgage is the name of the type of security the borrower gives to the lender in case the loan is not repaid as agreed. For this reason, we use the term 'foreign currency loans' throughout this statement.

Scope of the financial arrangements rules

4. The FA rules apply only to financial arrangements as that term is defined in s EW 3. A foreign currency loan meets the initial definition of financial arrangement because it is an arrangement under which a person (the borrower) receives money (the loan advanced) in return for the borrower providing money (the principal borrowed together with interest) to another person at a future time or on a future event occurring (or not occurring, as the case may be). Foreign currency loans are also a "debt", which is given as an example of a financial arrangement in s EW 3(3)(a).
5. Despite foreign currency loans being covered by the initial definition of financial arrangement, certain financial arrangements are excluded from the scope of the FA rules. These arrangements are referred to as "excepted financial arrangements" (ss EW 4 and EW 5). In certain circumstances, discussed from [6], a foreign currency loan may be an excepted financial arrangement.

Excepted financial arrangements

6. Section EW 4 provides that excepted financial arrangements are not financial arrangements for the purposes of the FA rules. Section EW 5 describes the types of financial arrangements that are excepted financial arrangements.
7. A foreign currency loan used to finance a foreign residential rental property may be an excepted financial arrangement if the:
 - borrower is a transitional resident (s EW 5(17)); or
 - loan is a variable principal debt instrument (s EW 5(25)).
8. A foreign currency loan that is used to finance a foreign residential rental property cannot be an excepted financial arrangement under s EW 5(18). Section EW 5(18) requires, among other things, that the loan be used for a private or domestic purpose. The Commissioner considers that s EW 5(18) requires that the property be used exclusively for a private or domestic purpose. Renting a foreign property to third parties is not a private or domestic purpose (even if the property is used privately on occasion).

Transitional residents' arrangements (s EW 5(17))

9. The first situation in which a foreign currency loan could be an excepted financial arrangement is if you are a transitional resident. In this case, you may not be required to apply the FA rules on the basis that the loan is an excepted financial arrangement under s EW 5(17).
10. Section EW 5(17) provides:
- Certain arrangements to which transitional resident is party*
- (17) An arrangement to which a transitional resident is a party is an excepted financial arrangement for the transitional resident if—
- (a) no other party to the arrangement is a New Zealand resident; and
 - (b) the arrangement is not for a purpose of a business carried on in New Zealand by a party to the arrangement.
11. A transitional resident is a special category of New Zealand tax residents, which will include people who are new migrants to New Zealand or former New Zealand tax residents returning to New Zealand after an extended period overseas.
12. To qualify as a transitional resident, you must:
- be a New Zealand tax resident;
 - have not been a New Zealand tax resident in the preceding 10 years before becoming a New Zealand tax resident; and
 - have not been a transitional resident before.
13. The transitional residency period is generally four years, but can sometimes last up to five years, depending on how you became a New Zealand tax resident.
14. This means that most foreign currency loans held by transitional residents will be excepted financial arrangements and not subject to the FA rules. Section EW 5(17) does not distinguish between financial arrangements entered into before or during the transitional residency period, with both being excepted financial arrangements during the transitional residency period.
15. A foreign currency loan to a transitional resident will not be an excepted financial arrangement under s EW 5(17), if:
- another party to that loan is a New Zealand tax resident; and
 - the loan is for a purpose of a business carried on in New Zealand by any party to the loan.
16. While it is conceivable the above two criteria might arise for some foreign currency loans to transitional residents, it is not considered to be a common situation in the context of foreign rental properties.
17. When a person ceases to be a transitional resident, and continues to be a New Zealand tax resident, any foreign currency loans they may be a party to will no longer be excepted financial arrangements under s EW 5(17). Such loans will revert to being financial arrangements, and therefore subject to the FA rules, on the day after the taxpayer ceased to be a transitional resident.
18. For the purposes of applying the FA rules to such financial arrangements, the taxpayer is treated as becoming a party to the foreign currency loan on the day after they cease to be a transitional resident (s EW 37). The initial consideration

paid to the taxpayer will, for the purposes of the FA rules, be the outstanding balance of the loan (including accrued amounts) on that day.

Example 1: Change in tax residency status

Davina is a tax resident of Australia and owns her own home there. She moves to New Zealand after accepting a job with a New Zealand-based company. Davina becomes a New Zealand tax resident on 31 July 2019. She has not been a New Zealand tax resident before and is eligible to be a transitional resident.

Davina keeps her Australian home to rent it out. She has a fixed-term table loan of AUD400,000 with an Australian registered bank with a branch in New Zealand. Davina is a cash basis person for the purposes of the FA rules. (Whether a person is a cash basis or non-cash basis person is discussed from [27].)

For the 48-month period (beginning on 31 July 2019) that Davina is a transitional resident, her AUD400,000 loan is an excepted financial arrangement under s EW 5(17), so is not subject to the FA rules.

After Davina's transitional residency period ends, her Australian currency loan ceases to be an excepted financial arrangement under s EW 5(17). Because Davina rents out her Australian home, her Australian loan cannot be an excepted financial arrangement under s EW 5(18) as this provision requires that the loan be used for a private or domestic purpose.

The Australian loan will not be an excepted financial arrangement under s EW 5(20) because it is not a variable principal debt instrument. Therefore, the Australian loan will be subject to the FA rules once Davina's transitional residency period ends. The initial consideration paid to Davina for the purposes of the FA rules will be the loan balance outstanding when her transitional residency period ends, including accrued amounts as at that time (s EW 37).

Davina will not be required to withhold non-resident withholding tax on interest she pays to the lender because it is registered bank with a branch in New Zealand (s RF 2(2B)). Non-resident withholding tax obligations are explained in Interpretation Statement "IS 20/06: Income tax – Tax issues arising from ownership of foreign residential rental property".

Variable principal debt instruments

19. The second situation in which a foreign currency loan could be an excepted financial arrangement is if the:
 - loan is a "variable principal debt instrument" (VPDI); and
 - total value of **all** VPDI to which the taxpayer is a party, does not exceed NZD50,000 at any point in the year (s EW 5(25)).

A VPDI might be a revolving credit facility where the borrower can borrow or repay principal at any time, a credit card account or an everyday banking cheque account.

20. Because the threshold for the VPDI is relatively low and takes into account all of the VPDI to which a person is party to, including bank accounts and credit cards, it would seem unusual that a foreign currency loan would qualify as an excepted financial arrangement under s EW 5(25).

21. If you have a foreign currency loan that is an excepted financial arrangement under s EW 5, you are still able to elect for it to be treated as a financial arrangement under s EW 8.

Excepted financial arrangements – summary

22. If your foreign currency loan is an excepted financial arrangement, you are not required to apply the FA rules to it. However, you should regularly check to confirm that your foreign currency loan remains an excepted financial arrangement. For example, if you previously used the loan to finance a foreign property that was used exclusively for private or domestic use (s EW 5(18)), but you later rent the property out, your foreign currency loan will cease to be an excepted financial arrangement and will become subject to the FA rules. Other events, such as your ceasing to be a transitional resident, will also affect the status of your foreign currency loan.
23. Even if your foreign currency loan is an excepted financial arrangement, you may still need to withhold non-resident withholding tax or pay approved issuer levy. This is explained in Interpretation Statement "IS 20/06: Income tax – Tax issues arising from ownership of foreign residential rental property".

Arrangements subject to the financial arrangements rules

24. If your foreign currency loan is not an excepted financial arrangement under s EW 5, it will be a financial arrangement and subject to the FA rules. However, the calculations required under the FA rules and when you need to make those calculations, depend on whether you are a non-cash basis person or a cash basis person.
25. If you are a non-cash basis person, you are required to apply a spreading method every year for the term of the arrangement, except for the income year in which you are required to make a base price adjustment (BPA). BPAs and the events that trigger them are discussed from [52].
26. While you are a cash basis person, you are not required to apply a spreading method and may account for interest on a cash basis over the term of your loan. However, you must calculate a BPA for the year in which the loan matures or the year in which you cease to be a New Zealand tax resident.

Cash basis and non-cash basis persons

27. The test for determining whether you are a cash basis person or a non-cash basis person has two steps (s EW 57).

First step in the cash basis person test

28. The first step of the cash basis person test requires you to meet at least one of the following thresholds:
 - (a) The absolute value of your financial arrangement income and expenditure for the income year under all your financial arrangements is NZD100,000 or less (the income and expenditure threshold (s EW 57(1)));
 - (b) On every day in the income year, the total absolute value of all your financial arrangements is NZD1m or less (the absolute value threshold (s EW 57(2))).

29. "Absolute value" is defined in s YA 1 as "the value irrespective of whether the value's sign is positive or negative". This means that the absolute values for a \$100,000 loan and a \$100,000 cash term deposit are both \$100,000 even though one is a liability (-\$100,000) and the other is an asset (+\$100,000).
30. When applying the above two thresholds, you must include **all** financial arrangements (excluding excepted financial arrangements) that you are a party to, whether as a borrower or a lender. For example, any New Zealand dollar (NZD) home loans and NZD term deposits will generally be financial arrangements, so you need to include them when applying the above thresholds.
31. You do not need to include excepted financial arrangements when applying the above two thresholds, because they are not treated as financial arrangements for the purposes of the FA rules.
32. If you **exceed** the income and expenditure threshold, **and** the absolute value threshold, you will be a non-cash basis person for that income year. The implications of being a non-cash basis person are discussed from [40].
33. If you are under the income and expenditure threshold and/or the absolute value threshold, you then need to apply the second step of the cash basis person test.

Second step in the cash basis person test – deferral threshold

34. The second step of the cash basis person test requires you to consider the deferral threshold (s EW 57(3)). The deferral threshold involves a comparison of your financial arrangement income and expenditure from all your financial arrangements, when calculated on a cash basis, with what your financial arrangement income and expenditure would be from all your financial arrangements, when calculated on a non-cash basis. The following formula at s EW 57(4) is used:

$$(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure})$$

35. You must apply this formula to each financial arrangement you are a party to at the end of the income year, and add the outcomes together. If the total is more than NZD40,000 you will be a non-cash basis person for that income year. Otherwise, you remain a cash basis person.

Annual monitoring of cash basis status important

36. If you have a large foreign currency loan, then even small changes in foreign exchange rates could result in you exceeding the deferral threshold. Alternatively, significant changes in the value of the New Zealand dollar, as seen during the Global Financial Crisis, could result in the threshold being exceeded on smaller loan amounts. Therefore, it is important that you monitor annually whether you still meet the requirements to be a cash basis person.

Cash basis person may use a spreading method

37. A cash basis person may elect to calculate their financial arrangement income or expenditure for each income year of their foreign currency loan term using a spreading method.
38. If you are a cash basis person and you make this election, then the FA rules discussed from [40] will apply as if you were a non-cash basis person.

Cash basis adjustment required if status changes

39. If your status changes from cash basis to non-cash basis or from non-cash basis to a cash basis, you must make a cash basis adjustment under s EW 63. The details of this calculation are beyond the scope of this item.

Example 2: Cash basis person

Xavier is a New Zealand tax resident. He recently purchased a property in southern France that he uses as a holiday home six months of the year. For the other six months of the year, the property is listed for rent on a short-stay accommodation website.

Xavier financed the purchase of the property with a €300,000 loan from a French bank. When converted, the value of the loan is less than NZD550,000. Xavier also has a NZD100,000 loan for his New Zealand home. Xavier is not party to any other financial arrangements and is under the deferral threshold (s EW 57(3)) at all relevant times. Therefore, Xavier is a cash basis person, and is required only to calculate a base price adjustment if an event triggering such a calculation occurs. In Xavier's case, the repayment of his French loan (whether by Xavier directly or through refinancing) is the most likely event that would trigger a base price adjustment. Base price adjustments are discussed from[51].

Non-cash basis persons

40. If you are a non-cash basis person with a foreign currency loan, the FA rules require you to apply a spreading method to calculate the income or expenditure derived or incurred in relation to the loan. A spreading method must be applied for each income year for the term of the arrangement, except for the income year in which a BPA is required.
41. The relevant spreading method to be applied to foreign currency loans is the determination method (s EW 20). The determination we are focusing on in this item is *Determination G9A: Financial arrangements that are denominated in a currency or commodity other than New Zealand dollar* (Inland Revenue, 1990). Instead of *Determination G9A*, it is possible to apply *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach* (Inland Revenue, 2004). However, practical issues around obtaining suitable forward currency rates as required under *Determination G9C* mean the determination is not ordinarily used in relation to long-term home loans. For this reason, we do not cover *Determination G9C* in this item.
42. *Determination G9A* applies:
- where it is necessary to calculate the income or expenditure of a person in respect of a financial arrangement and any right or obligation of the person in relation to the financial arrangement is fixed or otherwise determined in a currency or commodity other than New Zealand dollars (NZD) and is not fixed in NZD.
43. A cash-basis person does not have to use *Determination G9A* (or any other determination) unless they have elected to calculate their financial arrangement income or expenditure for each income year of their foreign currency loan term using a spreading method.
44. *Determination G9A* provides:

The income or expenditure of the person in respect of a financial arrangement and an income year shall be calculated in accordance with the following formula:

$$a + b - c - d$$

where—

a = the value in NZD of the closing tax book value; and

b = the sum of the value in NZD of all consideration given during the income year to or for the benefit of the person in relation to the financial arrangement; and

c = the value in NZD of the opening tax book value; and

d = the sum of the value in NZD of all consideration given during the income year by or on behalf of the person in relation to the financial arrangement—

and the amount so calculated shall,—

- (a) Where it is a positive amount be deemed to be income derived by the person in the income year:
- (b) Where it is a negative amount be deemed to be expenditure incurred by the person in the income year.

Closing tax book value

45. To calculate the above formula, it is necessary to work out the closing tax book value. Determination G9A provides a second formula to do so:

“Closing tax book value”, in relation to an income year means the value of a person's rights and obligations under a financial arrangement, calculated in accordance with the following formula:

$$e + f + g - h - i$$

where—

e is—

- (i) Where the person was a party to the financial arrangement at the beginning of the income year, the opening tax book value of the person's rights and obligations under the financial arrangement; and
- (ii) In every other case, nil; and

f is the sum of the value (expressed in the base currency in relation to the financial arrangement) of all consideration given during the income year by or on behalf of the person in relation to the financial arrangement; and

g is the base currency income of the person in respect of the financial arrangement; and

h is the sum of the value (expressed in the base currency in relation to the financial arrangement) of all consideration given during the income year to or for the benefit of the person in relation to the financial arrangement; and

i is the base currency expenditure of the person in relation to the financial arrangement:

46. The opening tax book value referred to in the explanation of “e”, is defined in Determination G9A as:

“Opening tax book value”, in relation to an income year and the rights and obligations of a person under a financial arrangement, means the closing tax book value of the person's rights and obligations under the financial arrangement at the end of the last preceding income year:

47. Accordingly, the first year in which you apply Determination G9A, the opening tax book value will always be zero. For all following years, the opening tax book value will be the same as the closing tax book value from the previous year.

Currency conversion

48. Note that the amounts in the formula "a + b – c – d" are expressed in New Zealand dollars and the amounts in the formula "e + f + g – h – i" are expressed in the foreign currency the loan is denominated in (the "base currency"). Therefore, it is necessary to convert the foreign currency amounts borrowed and repaid into New Zealand dollars.
49. For the purposes of Determination G9A, *Determination G6D: Foreign currency rates* (Inland Revenue, 1990) sets out the relevant methods and sources of rates information to be used when converting foreign currency amounts into New Zealand dollars.

Applying Determination G9A

50. The simplest way to understand how Determination G9A applies to a foreign currency loan is by way of a worked example. This is done in Example 4 after [73], which applies Determination G9A and includes a BPA calculation.

Calculating a base price adjustment

51. Regardless of whether you are a cash basis person or a non-cash basis person, if you have a foreign currency loan that is a financial arrangement, you will likely be required to calculate a BPA if certain events occur.

When a base price adjustment calculation is triggered

52. Section EW 29 sets out when BPA calculations are required. Common events that will trigger a BPA for your foreign currency loan are that:
- you cease to be a New Zealand tax resident; or
 - your foreign currency loan "matures".

Ceasing to be a New Zealand tax resident

53. If you cease to be a New Zealand tax resident, you will generally be required to make a BPA calculation for your foreign currency loan (s EW 29(1)). An exception to this is where you are a "temporary" New Zealand tax resident. Section EW 30(1) provides:

EW 30 When calculation of base price adjustment not required

Cash basis person who ceases to be temporary New Zealand resident

- (1) A cash basis person who ceases to be a New Zealand resident before the first day of the fourth income year following the income year in which they first became a New Zealand resident does not calculate a base price adjustment for a financial arrangement to which they—
- (a) were a party before first becoming a New Zealand resident; and
 - (b) are a party on the date on which they cease to be a New Zealand resident.

54. To be a temporary New Zealand tax resident under s EW 30, you must:
- (a) be a cash basis person; and

- (b) cease to be a New Zealand tax resident before the first day of the fourth income year (1 April under a standard balance date) in which you became a New Zealand tax resident.
55. Effectively, this allows for a maximum temporary tax residency period of four years, assuming a person became a New Zealand tax resident on 1 April of a particular income year and ceased to be a tax resident on 31 March of the fourth income year after the income year they became a tax resident.
56. A temporary resident, other than a transitional resident, who enters into a financial arrangement during the temporary residency period, is required to calculate a BPA when they cease to be a New Zealand tax resident, even if they continued to hold the arrangement on that date.
57. Similarly, a temporary resident, other than a transitional resident, who entered into a financial arrangement before the temporary residency period, but who exited that arrangement before the end of the temporary residency period will also be required to calculate a BPA on the date they end the arrangement (the date of maturity).

Example 3: Temporary resident

Peter is a cash basis person who became a New Zealand tax resident on 28 August 2016. He has a foreign currency loan that he took out on 27 June 2015.

Peter ceases to be a New Zealand tax resident on 20 February 2020. He still has the foreign currency loan on that date.

Under s EW 30, Peter is a temporary resident because he had the loan before becoming a New Zealand tax resident and he still had it on the date he ceased to be a New Zealand tax resident. Therefore, Peter is not required to calculate a base price adjustment on the loan on 20 February 2020, as he would otherwise need to do under s EW 29(1).

Base price adjustment on maturity of financial arrangement

58. The other common event that will require you to calculate a BPA on your foreign currency loan is the loan reaching maturity (s EW 29(3)).
59. Section YA 1 defines "maturity" in relation to loans as follows:
- maturity,—**
- (a) in the financial arrangements rules, means,—
- ...
- (ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:
60. In the ordinary course of a fixed-term loan, the final payment may not be required for up to 30 years after the initial borrowing is advanced. However, a foreign currency loan will mature earlier if the full amount owing under the loan is paid off. Therefore, it is important to be aware that routine refinancing can result in a foreign currency loan maturing, triggering a BPA. For example, if you have a foreign currency loan from Lender A and you refinance with Lender B, your original loan from Lender A will be repaid in full and will mature for the purposes of the FA rules.
61. So that you can calculate a BPA you may need to keep records for longer than the seven-year record keeping period that ordinarily applies for tax purposes.

Base price adjustment formula

62. When a BPA event occurs, s EW 31 sets out how the required BPA is to be calculated:

EW 31 Base price adjustment formula

...

Formula

(5) The formula is—

consideration – income + expenditure + amount remitted.

Definition of items in formula

(6) The items in the formula are defined in subsections (7) to (11).

Consideration

(7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:

- (a) non-contingent fees, if the relevant method is not the IFRS financial reporting method¹ in section EW 15D:
- (b) non-integral fees, if the relevant method is—
 - (i) the IFRS financial reporting method in section EW 15D:
 - (ii) the modified fair value method in section EW 15G.

Consideration in particular cases

(8) If any of sections EW 32 to EW 48, or EZ 52D applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

Income

(9) **Income** is—

- (a) income derived by the person under the financial arrangement in earlier income years; and
- (b) dividends derived by the person from the release of the obligation to repay the amount lent; and
- (c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

Expenditure

(10) **Expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

Amount remitted

(11) **Amount remitted**—

- (a) is an amount (a **remission**) that is not included in the consideration paid or payable to the person because it has been remitted—
 - (i) by the person; or
 - (ii) by law; but
- (b) does not include a remission that is self-remission.

¹ IFRS means a New Zealand equivalent to an International Financial Reporting Standard

63. From the perspective of a borrower, the consideration paid or payable "to the person" is everything the borrower has received from the lender; that is, the loan amount advanced by the bank. The consideration paid or payable "by the person" is everything paid to the lender; that is, the principal and interest repayments made to the bank. It may also include fees the borrower is required to pay.
64. As noted above, the simplest way to explain the BPA calculation is by way of a worked example. Example 4 after [73] illustrates both a BPA calculation and the application of Determination G9A.

Income under the financial arrangements rules

65. If applying Determination G9A or making a base price adjustment results in a positive figure, that figure represents an amount of income deemed to have been derived in the relevant income year (ss CC 3, EW 14(3) and EW 31(3)).
66. In the context of a foreign currency loan, if an amount of income is deemed to have been derived by the borrower under the FA rules, it will likely be as a result of a significant increase in the value of the New Zealand dollar.

Expenditure under the financial arrangements rules

67. If applying Determination G9A or making a BPA results in a negative figure, that figure represents an amount of financial arrangement expenditure deemed to have been incurred in the relevant income year. Your deemed expenditure under the FA rules may be more or less than your actual expenditure on the loan, depending on the movement of foreign exchange rates.
68. Where there is a foreign exchange gain, your deemed financial arrangement expenditure will likely be less than your actual expenditure. Where there has been a foreign exchange loss, your deemed financial arrangement expenditure will likely be more than your actual expenditure.
69. Even though this financial arrangement expenditure is deemed to have been incurred under ss EW 13 and EW 31, it is still necessary to consider whether that expenditure is deductible. The relevant deductibility provision is s DB 6.
70. Section DB 6(1)–(3) provides:

DB 6 Interest: not capital expenditure

Deduction

- (1) A person is allowed a deduction for interest incurred.

Exclusion

- (2) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

...

Link with subpart DA

- (3) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

71. For the purposes of s DB 6, financial arrangement expenditure is treated as "interest" under the definition in s YA 1, which states:

interest,—

...

- (c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—
 - (i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules; and
 - (ii) does not include interest to which section DB 1(1)(e) (Taxes, other than GST, and penalties) applies:

- 72. Under s DB 6, it is still necessary for the deemed interest expenditure to satisfy the general permission for deductibility (s DA 1). Where the financial arrangement in question is a foreign currency loan used to finance a foreign rental property, the general permission will likely be satisfied because of the nexus between the financial arrangement expenditure incurred and the rental income derived from the property that the loan finances.
- 73. Residential property deductions are generally “ring-fenced”, meaning they can be used only against income from residential property, with any deductions in excess of the income being carried forward to the next income year the taxpayer derives income from residential property. For further information on the residential ring-fencing rules, see “Ring-fencing of residential property deductions”, *Tax Information Bulletin* Vol 31, No 8 (September 2019): 53.

Example 4: Base price adjustment calculation and application of Determination G9A

Tim is a New Zealand tax resident, who is not a transitional resident. He has an Australian dollar loan that he uses to finance a residential rental property in Australia. Tim is also a non-cash basis person.

The relevant loan and exchange rate information for Tim's loan is as follows:

| | |
|-------------------|-----------|
| Loan amount | AUD1m |
| Interest rate | 6% |
| Term in years | 20 |
| Payments per year | 12 |
| Drawdown date | 5/04/2018 |

Tim's loan repayment schedule for year 1 (the 2018/2019 income year) in Australian dollars (AUD) is as follows:

| Payment date | Payment AUD | Principal AUD | Interest AUD | Loan balance AUD |
|---------------|------------------|------------------|------------------|------------------|
| 5/05/18 | 7,164.31 | 2,164.31 | 5,000.00 | 997,835.69 |
| 5/06/18 | 7,164.31 | 2,175.13 | 4,989.18 | 995,660.56 |
| 5/07/18 | 7,164.31 | 2,186.01 | 4,978.30 | 993,474.55 |
| 5/08/18 | 7,164.31 | 2,196.94 | 4,967.37 | 991,277.61 |
| 5/09/18 | 7,164.31 | 2,207.92 | 4,956.39 | 989,069.69 |
| 5/10/18 | 7,164.31 | 2,218.96 | 4,945.35 | 986,850.73 |
| 5/11/18 | 7,164.31 | 2,230.06 | 4,934.25 | 984,620.67 |
| 5/12/18 | 7,164.31 | 2,241.21 | 4,923.10 | 982,379.46 |
| 5/01/19 | 7,164.31 | 2,252.41 | 4,911.90 | 980,127.05 |
| 5/02/19 | 7,164.31 | 2,263.68 | 4,900.64 | 977,863.37 |
| 5/03/19 | 7,164.31 | 2,274.99 | 4,889.32 | 975,588.38 |
| TOTALS | 78,807.41 | 24,411.62 | 54,395.80 | |

The AUD54,395.80 total interest shown in the loan repayment schedule is calculated on a monthly basis and does not include interest accrued for the 26 days from 6/03/2019 to 31/03/19 which Tim paid on 5/04/19. Determination G9A requires interest to be calculated on a daily basis. Interest calculated on a daily basis for the period 5/04/2018 to 31/03/19 is AUD58,478.41.

Year 1 calculations

First, Tim calculates the closing tax book value (CTBV) of the loan for year 1. The formula in Determination G9A for calculating the CTBV is:

$$e + f + g - h - i = \text{CTBV}$$

When calculating CTBV, all amounts are in AUD (the base currency).

The variables in the CTBV formula are:

- e = Opening tax book value (which is always zero in the first year)
- f = Consideration paid by the person
- g = Accrual income calculated on a default method basis
- h = Consideration paid to the person
- i = Accrual expenditure calculated on a default method basis

Using the above loan amounts, Tim calculates the CTBV as follows:

- e = AUD0.00
- f = AUD78,807.41
- g = AUD0.00
- h = AUD1m
- i = AUD58,478.41

$$0 + 78,807.41 + 0 - 1\text{m} - 58,478.41 = -979,671.00$$

Therefore, the CTBV is -AUD979,671.00.

Having calculated the CTBV for year 1, Tim can calculate the accrued foreign exchange income or loss under Determination G9A. To do this Tim uses the second formula set out in Determination G9A:

$$a + b - c - d = \text{accrued foreign exchange gain/loss}$$

The variables in the above formula are:

- a = CTBV
- b = Consideration paid to the person
- c = Opening tax book value (which is always zero in the first year)
- d = Consideration paid by the person

When applying the second formula, all amounts must be converted into NZD in accordance with Determination G6D. Tim obtains the AUD–NZD spot rates for the dates on which each loan payment was made.

Tim obtained the following rates from the Reserve Bank of New Zealand website and converts the loan repayment schedule for year 1 into NZD as follows.

| Payment date | AUD–NZD foreign exchange rate | Payment NZD | Principal NZD | Interest NZD |
|---------------------|--------------------------------------|--------------------|----------------------|---------------------|
| 5/05/18 | 0.9337 | 7,673.03 | 2,317.99 | 5,355.04 |
| 5/06/18 | 0.9188 | 7,797.46 | 2,367.36 | 5,430.10 |
| 5/07/18 | 0.9163 | 7,818.74 | 2,385.69 | 5,433.05 |
| 5/08/18 | 0.9122 | 7,853.88 | 2,408.39 | 5,445.49 |
| 5/09/18 | 0.9095 | 7,877.20 | 2,427.62 | 5,449.57 |
| 5/10/18 | 0.9164 | 7,817.89 | 2,421.39 | 5,396.50 |
| 5/11/18 | 0.9245 | 7,749.39 | 2,412.18 | 5,337.21 |
| 5/12/18 | 0.9498 | 7,542.97 | 2,359.66 | 5,183.31 |
| 5/01/19 | 0.9463 | 7,570.87 | 2,380.23 | 5,190.63 |
| 5/02/19 | 0.9549 | 7,502.68 | 2,370.59 | 5,132.09 |
| 5/03/19 | 0.9628 | 7,441.12 | 2,362.89 | 5,078.23 |
| Total | | 84,645.23 | 26,214.01 | 58,431.22 |

Tim also obtains the AUD–NZD spot rate for two additional dates:

- 5/04/2018, being the date on which the loan was drawn down, which is used to calculate the NZD equivalent of the loan amount advanced (consideration paid to the person); and
- 31/3/2019, being the last day of the relevant income year, which is used to calculate the NZD equivalent of the CTBV that Tim calculated in AUD earlier.

Tim uses these additional rates to calculate the NZD equivalent of the loan amount advanced and the NZD equivalent of the CTBV for year 1 as follows.

| Date | AUD–NZD foreign exchange rate | NZD amount |
|-------------|--------------------------------------|------------------------------|
| 5/04/2018 | 0.9482 | 1,054,629.82 (AUD1m) |
| 1/3/2019 | 0.9574 | 1,023,261.96 (AUD979,671.00) |

Using the above amounts that he converted from AUD to NZD, Tim applies the second formula under Determination G9A as follows:

- a = -NZD1,023,261.96
- b = NZD1,054,629.82
- c = NZD0.00
- d = NZD84,645.23 (being total loan payments during income year)

Using these amounts, and the second formula under Determination G9A gives:

$$-1,023,261.96 + 1,054,629.82 - 0 - 84,645.23 = -53,277.37$$

The -NZD53,277.37 amount includes interest paid and accrued from 5/04/18 to 31/03/19 and foreign exchange gains and losses.

Because -NZD53,277.37 is a negative amount, Tim is deemed to have financial arrangement expenditure under Determination G9A. This expenditure is treated as interest for the purposes of s DB 6. Because the loan is used to finance Tim's foreign residential rental property, this deemed interest amount satisfies the general permission for deductibility under s DA 1. Therefore, Tim is allowed a deduction of NZD53,277.37 in year 1 (the 2018/19 income year).

Base price adjustment calculation in year 2

In year 2 (the 2019/20 tax year), Tim makes two further loan payments on 5/4/2019 and 5/5/2019.

On 5/5/2019, Tim also repays the remaining balance of the loan after refinancing with a new lender at a more favourable interest rate. Because the loan is paid back in full on 5/5/2019, the loan is considered to have matured and a BPA calculation is required. The formula for this calculation is:

$$\text{consideration} - \text{income} + \text{expenditure} + \text{amount remitted}$$

When applying the BPA formula, Tim must convert all AUD amounts into NZD amounts. The variables in the above formula are:

| | | |
|-----------------|---|--|
| Consideration | = | All amounts paid to the borrower - all amounts paid by the borrower |
| Income | = | All income derived by the borrower under the loan in earlier income years |
| Expenditure | = | All expenditure incurred under the loan in earlier income years |
| Amount remitted | = | An amount, not included in the consideration because it has been remitted by the person, or by law, but not a self-remission |

The additional loan repayments Tim makes in year 2 are as follows (including the conversion of these amounts into NZD amounts):

| Payment date | Payment AUD | Principal AUD | Interest AUD | Balance AUD | AUD–NZD foreign exchange rate | Payment NZD |
|--------------|-------------|---------------|--------------|-------------|-------------------------------|--------------|
| 5/04/19 | 7,164.31 | 2,286.37 | 4,877.94 | 973,302.01 | 0.9486 | 7,552.51 |
| 5/05/19 | 7,164.31 | 2,297.80 | 4,866.51 | 971,004.21 | 0.9471 | 7,564.47 |
| 5/05/19 | 971,004.21 | 971,004.21 | - | 0.00 | 0.9471 | 1,025,239.37 |

Using NZD amounts, Tim calculates the BPA on his loan as:

| | | |
|-----------------|---|---|
| Consideration | = | 1,054,629.82 (original loan amount) – (84,645.23 (repayments in year 1) + 15,116.98 (repayments in year 2) + 1,025,239.37 (outstanding principal balance repaid)) |
| Income | = | 0.00 |
| Expenditure | = | 53,277.37 (year 1 deemed financial arrangement expenditure calculated under Determination G9A) |
| Amount remitted | = | 0.00 |

Therefore:

$$-70,371.76 - 0 + 53,277.37 + 0 = -17,094.39$$

Because -NZD17,094.39 is a negative amount, Tim is treated as having financial arrangement expenditure of NZD17,094.39.

As was the case for his financial arrangement expenditure calculated for year 1 of his loan, Tim is allowed a deduction of NZD17,094.39 in year 2 (the 2019/20 tax year).

References

Subject references

Cash basis person

Financial arrangements rules

Foreign currency loans

Legislative references

Income Tax Act 2007, ss CC 3, DA 1,
DB 6, EW 3, EW 4, EW 5, EW 13,
EW 14, EW 20, EW 29, EW 30, EW 31,
EW 57, EW 63, YA 1 ("absolute value",
"interest", "maturity")

Related rulings/statements

Determination G9A: Financial arrangements that are denominated in a currency or commodity other than New Zealand dollar (Inland Revenue, 1989).

Determination G9C: Financial arrangements that are denominated in

a currency other than New Zealand dollars: an expected value approach (Inland Revenue, 2004).

Determination G6D: Foreign currency rates (Inland Revenue, 1990).

"Ring-fencing of residential property deductions", *Tax Information Bulletin* Vol 31, No 8 (September 2019): 53.

Interpretation Statement "IS 20/06: Income tax – Tax issues arising from ownership of foreign residential rental property" (July 2020).