

## QUESTIONS WE'VE BEEN ASKED

# Can a close company deduct interest on a shareholder loan account where the amount is not known until after balance date?

Issued: 13 December 2022

QB 22/10

This Question We've Been Asked sets out when a close company can deduct interest payable on a shareholder loan account in its tax return where the exact amount is not known until after balance date (usually 31 March).

### Key provisions

Income Tax Act 2007 – ss BD 3, BD 4, DB 7, EA 4, RE 3, RE 4, RE 10, YA 1, YB 1, YB 3 – YB 14 and subpart EW

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## Question

Can a close company deduct interest on a shareholder loan account in its tax return if the exact amount of interest is not known until after balance date?

## Answer

Yes – a close company can do so if it has a legal obligation to pay the interest on the shareholder loan account based on a previously agreed formula or method. The company must have the legal obligation, including a method of calculating the liability, before its balance date, which is usually 31 March. The financial arrangements rules (FA rules) may apply to determine the timing of the deduction.

Companies need to keep records of the method they used to determine the amount of interest owing and of the legal obligation to pay the interest.

## Key terms

**Close company** means a company with 5 or fewer natural persons or trustees who hold more than 50% of the voting interests or market value interests in the company. All natural persons associated at the time are treated as one person (s YA 1 and s YB 3). Close companies are often small businesses owned and operated by family members.

**FA rules** means the rules in subpart EW that require parties to a financial arrangement to spread income or expenditure from the arrangement over its term. The key purpose of the FA rules is to prevent deductions for expenditure being accelerated and income recognition being deferred.

## Explanation

1. *Public Information Bulletin* No. 130 on “Deductibility of interest, the quantum of which has not been determined at balance date” (September 1984:7) (**the PIB**)<sup>1</sup> discussed post-balance date adjustments by a company for interest on shareholders’ loan accounts. The PIB stated that such adjustments must be subject to a contractual obligation showing how to calculate the interest to be paid or credited to the shareholder. This QWBA updates the PIB to reflect changes in case law on when

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<sup>1</sup> This item is set out in full at the end of this document.

expenditure is incurred. It also sets out the resident withholding tax consequences of interest payments made to shareholder loan accounts.

## Background

2. Most close companies are automatically allowed a deduction for interest incurred on a loan although some interest is not deductible (s DB 7). However, not all companies get an automatic deduction. Qualifying companies, some non-resident companies and companies that derive exempt income (except in certain circumstances) are some of the excluded companies.
3. Usually a company knows how much interest it owes on any money it has borrowed and how much it can deduct as an expense. However, where a company borrows money from its shareholders, it may not be able to calculate the amount of interest payable until after its balance date.
4. This is often the case for close companies who have only a few shareholders. Amounts owing to shareholders such as interest or a salary may be credited to a shareholder's loan account, but the amount owing may depend on the company's profitability. Such amounts may not therefore be determined until after balance date. For example, a company has an extended period in which to pay shareholder-employees their salary (s EA 4(3)). Once the company has determined its result for the year and calculated the shareholder-employees' salaries, it will know the final balance of those shareholders' loan accounts and can calculate any interest owing to shareholders.
5. Interest is normally paid on shareholder loan accounts at a market rate. If interest is paid at above market rates, it may give rise to FBT or a non-cash dividend.<sup>2</sup>
6. To deduct interest at balance date, where the exact amount owing is not known until after that date, a company must show that:
  - it has incurred the interest on or before balance date, and
  - the amount is calculated based on a previously agreed formula or method.
7. A shareholder loan account is a loan between a company and a shareholder. Loans are generally subject to the FA rules. The FA rules will therefore determine when interest income from a loan is derived and when a deduction for the interest payment can be taken. Under the FA rules, shareholders that are associated with a company, for example, through family or trust relationships, may have to account for interest on the same basis as the company (s EW 59). This will usually be on an accrual basis.

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<sup>2</sup> See "[IS 21/10 Non-cash dividends](#)" (2 July 2021) *Tax Information Bulletin* Vol 33 No 7 (August 2021): 16.

## Incurring interest

8. Interest is deductible in the year in which it is incurred, unless other tax laws, such as the FA rules, apply (s BD 4(2)).<sup>3</sup> A company incurs interest when it pays, agrees to pay or becomes definitively committed to the interest.<sup>4</sup> This means that a company must have an existing legal obligation to pay the interest. A legal obligation can exist even if the obligation to pay the interest has a condition attached or the obligation can be changed.<sup>5</sup> For example, a company would still have a legal obligation to pay interest if the company and its shareholders agreed that interest would only be paid on the shareholders' loan accounts if the company made a profit.
9. If there is just a possibility that interest might be payable, the company will have no legal obligation to pay it. This situation might occur where directors have discussed the payment of interest and agreed to see if the company has made enough profit before deciding whether interest should be paid. In that case, the company has no legal obligation to pay on or before balance date.
10. For close companies (like other companies), the obligation to manage the business and affairs of the company rests with the board of directors.<sup>6</sup> Therefore, whether a close company has an existing legal obligation to pay interest on a shareholder loan account should be reflected in a decision of the directors of the close company (who may also be shareholders of the company).<sup>7</sup>
11. For example, there may be written agreements, meeting minutes, director resolutions, correspondence with shareholders or other written confirmation that the company agrees to pay interest on shareholders' loan accounts. The legal obligation must be to pay interest, not just to repay the loan.

### Example 1: Interest has not been incurred

Upkwick NZ Limited has three shareholders who are also directors – Miley, Miriana and Taylor. Each shareholder has a shareholder's loan account. The company is newly incorporated and unsure whether it will make a profit in its first year of operation (to

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<sup>3</sup> For more detail on financial arrangements, see "[IS 22/05](#): Cash basis persons under the financial arrangements rules", *Tax Information Bulletin* Vol 34, No 8 (September 2022): 38, or "[IS 20/07](#): Income tax – Application of the financial arrangements rules to foreign currency loans used to finance foreign residential rental property", *Tax Information Bulletin* Vol 32, No 7 (August 2020): 110.

<sup>4</sup> *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351.

<sup>5</sup> *FCT v James Flood Pty Ltd* (1953) 88 CLR 492.

<sup>6</sup> Section 128 of the Companies Act 1993.

<sup>7</sup> *A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082.

31 March 2022) as a housebuilder. In July 2022, the accountant confirms that the company has made a small profit. The directors did not discuss whether interest would be paid on any shareholders' loan accounts until their accountant contacted them to ask whether interest was to be paid. In August 2022, the directors agreed at a company meeting that interest should be charged on the balances of the shareholders' loan accounts at the end of every income year as long as the company makes a sufficient profit. The company agrees that the rate of interest should be the same rate as the 1-year fixed term deposit rate at Milton Bank on 31 March each year. On the same day, Miriana emails the company accountant to relay the company's decision. The accountant includes this in the August 2022 company minutes.

Upkwick NZ Limited has not incurred any interest in its first year of operation. The directors did not determine whether any interest was to be charged on the shareholder loan accounts until after the end of the income year. The interest is therefore not deductible in the income year ended 31 March 2022.

### **Example 2: Interest has not been incurred**

Snazzy Sox Limited has two shareholders who are also directors – Aroha and her grandfather Hemi. In setting up the company in May 2021, Hemi provided 95% of the funding required to manufacture merino socks for dogs. Before 31 March 2022, the directors discuss whether the company should pay interest on Hemi's shareholder loan account. Hemi tells Aroha that there's no need for the company to pay him interest for the first couple of years, but that he might need some interest to be paid on the loan in 2024, depending on the company's financial situation, because his grandson Etera is getting married in that year. The directors agree that the company will discuss paying interest on any shareholder loan accounts in 2023.

Snazzy Sox Limited has not incurred a legal obligation to pay Hemi interest in any of the 2022-24 income years, as any payments are no more than pending, threatened or expected in those years.

### **Example 3: Interest has been incurred**

Spurred on by its success in 2022, Upkwick NZ Limited from

Example 1 continues to build houses in the 2023 income year. In July 2023, the company's accountant confirms that the company has made a sufficient profit to pay interest on the shareholder loan accounts. The accountant determines the interest

payable on each shareholder loan account based on the company minutes from August 2022 which show the company's agreement to pay interest and how to calculate the interest payable.

Because the company agreed to charge interest before 31 March 2023, identified a method of calculation and emailed the company's accountant with this information, Upkwick NZ Limited can demonstrate that it has a legal obligation to pay interest to its shareholders on their loan accounts in the income year. Upkwick NZ Limited has therefore incurred interest in the income year ending 31 March 2023.

## Method of determining the amount payable

12. Part of having a legal obligation to pay interest is being able to work out how much interest is owed. With shareholder loan accounts, this calculation may not be possible until after balance date.
13. However, if before balance date a company and its shareholders have agreed how to calculate the amount of interest that will be payable once the company's accounts are finalised, the company can deduct the interest in its tax return.<sup>8</sup> The method of calculation must be agreed in the year for which the deduction is sought, that is, before balance date. There must be a method of calculation and it must be certain. Guessing how much interest should be paid is not a method of calculation.
14. Methods of calculating the amount of interest payable could be based on:
  - the terms of an agreement that provides a method of calculating the interest,
  - a bank rate at a given date, or
  - interest rates used in previous years.
15. A company must keep documents to show the method it has agreed to use to calculate the interest. These could include written agreements, meeting minutes, directors' resolutions, correspondence with shareholders or other written confirmation as to how the amount is calculated.

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<sup>8</sup> *RACV Insurance Pty Ltd v FCT* 74 ATC 4169; *Commercial Union Assurance Company of Australia Ltd v FC of T* 77 ATC 4186.

#### Example 4: Method of calculation is certain

The Closet Company Limited has a business offering home storage solutions. Its five shareholders are all family members. Two of the shareholders are also directors. When the company was first established in July 2021, the directors discussed the payment of interest on shareholder loan accounts at a board meeting. They agreed that an interest rate of 1% more than the interest rate on balance date, on a 1-year fixed term deposit at Milton Bank, will be applied to the balance of the individual shareholder loan accounts at balance date. This decision is recorded in the minutes kept by the Closet Company Limited.

The Closet Company Limited has incurred an interest expense in the income year. The amount of interest payable can be calculated using the current Milton Bank interest rate at balance date. The company can also rely on the board meeting minutes to demonstrate its obligation to make payment and the method it used to calculate the interest amount.

### Paying the interest

16. When a company pays interest owing to a shareholder, it may have to deduct resident withholding tax (RWT) from the payment and pay that amount to Inland Revenue. Generally, this requirement will apply if the company is resident in New Zealand and carrying on a taxable activity or is a non-resident carrying on a taxable activity in New Zealand through a fixed establishment (ss RE 3 and RE 4). However, the company may not be required to deduct RWT if it pays less than \$5,000 in interest in the year (s RE 10).
17. For RWT purposes, a company will pay interest to a person when it:
  - gives the interest to them, for example, by bank transfer,
  - credits the amount to a shareholder's loan account, or
  - deals with the amount in their interest, or on their behalf, in some other way such as when it pays a bill to a third party for them (s YA 1 – definition of "pay").
18. The way that a company pays interest to shareholders determines whether payment has been made for RWT purposes. A company may pay interest to a shareholder for RWT purposes before transferring the funds to a bank account or crediting it to a shareholder's loan account. This situation could occur when directors make an unconditional resolution to pay the interest, or they approve the financial statements as shown in *Example 5*.

19. A company with non-resident shareholders may have to deduct non-resident withholding tax (NRWT) from a payment of interest. For more detail on when companies must deduct RWT and NRWT, see [Resident withholding tax \(RWT\)](#) and *Resident withholding tax on interest (RWT) payer's guide IR 283* (June 2020), [Non-resident withholding tax](#) and *NRWT Payer's guide IR 291* (September 2020).

### Example 5: Payment of interest has been made

In late May 2023, the Closet Company Limited's accountant quantifies the interest due on the shareholder loan accounts and prepares the journal entries for the interest payments. The Closet Company Limited finalises its 2023 year-end accounts at an Annual General Meeting on 8 June 2023. The ratified accounts include the journal entries crediting the shareholder loan accounts of three of the shareholders with the interest payable. On 15 June 2023, the Closet Company Limited pays the other two shareholders their interest by bank transfer as requested.

The date of payment for RWT purposes for three of the shareholders is 8 June 2023 as this is the date that the directors of the Closet Company Limited ratified the accounts crediting the interest to the shareholder loan accounts. The date of payment for the other two shareholders is 15 June 2023, when the bank transfers were made. The Closet Company Limited should deduct RWT from the interest it pays to all its shareholders on these dates and return it to Inland Revenue by 20 July 2023.

## Taking the deduction

20. Under the FA rules, parties to a financial arrangement must spread interest over the period of the arrangement. Where interest is accrued on shareholder loan accounts on a daily basis and paid on an annual basis, there will be no income or expenditure to spread. This means deductions can be taken when the company incurs the interest expense, and the interest income will need to be returned by the shareholders when they derive it.
21. If interest is not paid annually, Inland Revenue expects companies to apply the FA rules to determine when a deduction for the interest expense can be taken.

## Receiving the interest

22. A shareholder will be treated as receiving interest in the year that they derive it. Which year this is will depend on whether the shareholder returns their income as they



receive it or as they earn it (even if they haven't received payment) (s BD 3(3)). If the FA rules apply to spread any income, those rules will determine the time of derivation.

23. As noted at [7], under the FA rules, shareholders that are associated with a company may have to account for interest on the same basis as the company (s EW 59). A company and a shareholder (who is not a company) will be associated persons if the shareholder has a voting interest in the company of 25% or more. However, if a shareholder is an associated person of another shareholder, their interests are combined and treated as one interest. With close companies usually being family-owned companies, shareholders are very likely to be associated with one another because they are related by blood, by family trust relationships or other relationships (ss YB 4 – YB 14). This means that both the company and its shareholders will have to account for interest on the same basis. This will usually be on an accrual basis.
24. A shareholder will still derive interest income if they do not receive it but the amount is credited to their account or they direct the company to use the money in another way for the shareholder's benefit (s BD 3(4)). For example, the shareholder may direct the company to pay the interest amount directly to satisfy the shareholder's debt with a third party.
25. A shareholder can claim a credit for any RWT deducted and paid in their tax return for the year that they derive the interest.

### Example 6: Use of RWT credit

The Closet Company Limited in Example 5 pays interest to its shareholders on 8 June and 15 June 2023. It also deducts an amount of RWT on these dates. On 18 July 2023, the company's accountant reports the required information to Inland Revenue. This includes the interest paid, the RWT deducted and the names, contact details, IRD numbers and tax rates of the shareholders. At the same time, the accountant pays the RWT deducted to Inland Revenue.

The next day, the accountant prepares and files tax returns for the year ending 31 March 2023 for both the company and the shareholders. The company returns its income on an accrual basis. The shareholder loan accounts are financial arrangements and the company and the shareholders are associated persons. The accountant therefore returns the interest income of the shareholders on the same basis as the company and includes the interest income in the shareholders' tax returns for 31 March 2023. The shareholders' tax returns include a tax credit for the RWT deducted.

The shareholders can claim the amount of RWT withheld by the Closet Company Limited in their tax returns for the year ending 31 March 2023 because the RWT has been deducted and paid to Inland Revenue.

## References

### Legislative References

Income Tax Act 2007 – ss BD 3, BD 4, DB 7, EA 4, RE 3, RE 4, RE 10, YA 1, YB 1, YB 3 – YB 14 and subpart EW

### Case References

*A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082

*C of IR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351

*Commercial Union Assurance Company of Australia Ltd v FC of T* 77 ATC 4186

*FC of T v James Flood Pty Ltd* (1953) 88 CLR 492

*RACV Insurance Pty Ltd v FC of T* 74 ATC 4169

### Other References

"Deductibility of interest, the quantum of which has not been determined at balance date", *Public Information Bulletin, Vol 130* (September 1984): 7.

"IS 20/07: Income tax – Application of the financial arrangements rules to foreign currency loans used to finance foreign residential rental property", *Tax Information Bulletin Vol 32, No 7* (August 2020): 110. <https://www.taxtechnical.ird.govt.nz/tib/volume-32---2020/tib-vol32-no7>

"IS 21/10: Non-cash dividends" (2 July 2021) *Tax Information Bulletin Vol 33 No 7* (August 2021) 16. <https://www.taxtechnical.ird.govt.nz/interpretation-statements/2021/is-21-05>

"IS 22/05: Cash basis persons under the financial arrangements rules", *Tax Information Bulletin Vol 34, No 8* (September 2022): 38. <https://www.taxtechnical.ird.govt.nz/interpretation-statements/2022/is-22-05>

*Resident withholding tax on interest (RWT) payer's guide* IR 283 (June 2020).

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*NRWT payer's guide* IR 291 (September 2020). [https://www.ird.govt.nz/-](https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir200---ir299/ir291/ir291-2020.pdf?modified=20201016022401&modified=20201016022401)

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## The PIB item

### **Deductibility of Interest, the Quantum of which has not been Determined at Balance Date**

The Department is concerned at transactions of a retrospective nature. The area of concern is the practice of creating and claiming deductions for interest for which no liability existed at balance date. A typical example is the post-balance date adjustments by a company for interest on the shareholders' advances. Unless there is a contractual obligation at balance date to pay the interest it is the Department's view that the interest has not been incurred in the relevant income year. This view is well supported by case law.

While the actual quantum of the interest need not be determined by balance date, the interest adjustments must be subject to a contractual obligation (resolution or separate agreement) which shows how the interest to be paid or credited is to be calculated. The rate of interest payable, (e.g., 11 percent) need not necessarily be specified but some basis or measure for calculation would be expected, e.g., the average bank overdraft rate for the period. It is acknowledged that there will be circumstances, e.g., insufficient profits, where a lesser amount will actually be paid or credited and this generally will be acceptable.

In essence it is necessary that a contractual obligation, evidenced in writing, exists in the year of claim.

Where rates and amounts are not specified, or are subject to modification in certain circumstances, the method of determining the amount and/or the relevant circumstances, should be given.

## About this document

Questions We've Been Asked (QWBAs) are issued by the Tax Counsel Office. QWBAs answer specific tax questions we have been asked that may be of general interest to taxpayers. While they set out the Commissioner's considered views, QWBAs are not binding on the Commissioner. However, taxpayers can generally rely on them in determining their tax affairs. See further [Status of Commissioner's advice \(December 2012\)](#). It is important to note that a general similarity between a taxpayer's circumstances and an example in a QWBA will not necessarily lead to the same tax result. Each case must be considered on its own facts.