

**Note (not part of the Rulings):**

These rulings deal with the payment of a break fee by a landlord to exit early from, or vary the interest rate of, a fixed interest rate loan. It was considered appropriate to issue two separate rulings to deal with the two scenarios. However, a single commentary applies to both rulings.

**DEDUCTIBILITY OF BREAK FEE PAID BY A LANDLORD TO EXIT EARLY FROM A FIXED INTEREST RATE LOAN****PUBLIC RULING – BR PUB 09/09**

This is a public ruling made under section 91D of the Tax Administration Act 1994.

**Taxation Laws**

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

This ruling applies in respect of sections DA 1, DB 6, DB 7, and EW 31 and the definition of “interest” in section YA 1.

**The Arrangement to which this Ruling applies**

The Arrangement is where a person has entered into a fixed interest rate loan and the money has been used to acquire a property from which rental income is derived or to refinance another loan used for that purpose. The person subsequently pays a break fee to the lender to repay in full and terminate that loan earlier than its agreed repayment date. It does not matter whether the loan is replaced by further borrowing from either the same or a different lender.

This Ruling will not apply where the loan is not used solely for the deriving of rental income, or where the loan is part of or connected with one or more other financial arrangements between the lender and the borrower.

This Ruling will also not apply if the taxpayer has adopted the IFRS financial reporting method in section EW 15D.

**How the Taxation Laws apply to the Arrangement**

The Taxation Laws apply to the arrangement as follows:

- A base price adjustment will be required.
- The amount of any break fee will be included in the “consideration” element of the base price adjustment formula for a borrower and will increase the overall negative figure that the base price adjustment provides.
- The negative amount under the base price adjustment will be expenditure incurred under the financial arrangements rules and will be interest.
- An automatic deduction will be available for companies (other than qualifying companies) for the negative base price adjustment amount as interest under section DB 7.
- A deduction will be available for other taxpayers under section DB 6, provided the general permission in section DA 1 is satisfied.

- Where the money was borrowed to purchase a property from which rental income is derived, the general permission will be satisfied.

**The period or income year for which this Ruling applies**

This ruling will apply from the first day of the 2008/09 income year to the last day of the 2011/12 income year.

This ruling is signed by me on the 16<sup>th</sup> day of December 2009.

**Martin Smith**

Chief Tax Counsel

## **DEDUCTIBILITY OF BREAK FEE PAID BY LANDLORD TO VARY THE INTEREST RATE OF AN EXISTING FIXED INTEREST RATE LOAN**

### **PUBLIC RULING – BR PUB 09/10**

This is a public ruling made under section 91D of the Tax Administration Act 1994.

### **Taxation Laws**

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

This ruling applies in respect of sections DA 1, DB 6, DB 7, and EW 31 and the definition of “interest” in section YA 1.

### **The Arrangement to which this Ruling applies**

The Arrangement is where a person has entered into a fixed interest rate loan and the money has been used to acquire a property from which rental income is derived or to refinance another loan used for that purpose. The person then subsequently pays a break fee to the lender for a variation of that loan to adjust the interest rate.

This Ruling will not apply where the loan is not used solely for the deriving of rental income, or where the loan is part of or connected with one or more other financial arrangements between the lender and the borrower.

This Ruling will also not apply if the taxpayer has adopted the IFRS financial reporting method in section EW 15D.

### **How the Taxation Laws apply to the Arrangement**

The Taxation Laws apply to the arrangement as follows:

- No base price adjustment will be required.
- Taxpayers who are not cash basis persons, and cash basis persons who have chosen to adopt a spreading method, will be required to apply Determination G25 in relation to the variation to the terms of the loan. The amount of the break fee will be included in the calculation under the determination. This means an adjustment will be made in the year of variation and the deduction of the break fee will effectively be spread over the term of the loan.
- Cash basis persons will be able to deduct the amount of the break fee when it is incurred under the general permission, provided the money was borrowed to purchase a property from which rental income is derived.

### **The period or income year for which this Ruling applies**

This ruling will apply from the first day of the 2008/09 income year to the last day of the 2011/12 income year.

This ruling is signed by me on the 16<sup>th</sup> day of December 2009.

**Martin Smith**

Chief Tax Counsel

## COMMENTARY ON PUBLIC RULINGS – BR PUB 09/09 AND BR PUB 09/10

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 09/09 and Public Ruling BR Pub 09/10 (“the Rulings”).

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

### Background

The Rulings deal with the deductibility of fees charged by banks to permit landlords to repay a fixed interest rate loan early or to vary the existing terms of such a loan. These fees are variously referred to by terms such as “early repayment fees”, “early repayment adjustment charge”, “early exit fees” or “mortgage break fees”. In these Rulings, the term “break fee” is used to refer to all such charges.

The amount of the fee and the circumstances that trigger the charging of the fee vary from lender to lender. The fee is generally seen as compensation for the loss the lender may have suffered if their current interest rate for a similar loan for a fixed interest rate period closest to the borrower’s unexpired fixed interest period is lower than the fixed interest rate applying to the borrower’s loan. A break fee is charged in two primary scenarios:

- the loan is repaid early (whether replaced by further borrowing from the same or another financial institution or not); and
- the interest rate of the loan is simply renegotiated during the term of the loan and the existing loan continues.

### Legislation

Note that the Income Tax Act 2007 was amended by the Taxation (Business Tax Measures) Act 2009 with effect from the 2009/10 income year. The amendments allow non-individuals to return income tax for financial arrangements on a cash accounting basis. Where necessary, the following legislation includes the relevant provisions for the 2008/09 income year and the 2009/10 and later income years.

Section DA 1(1) and (2) reads as follows:

#### **DA 1 General permission**

##### *Nexus with income*

- (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
  - (a) incurred by them in deriving—
    - (i) their assessable income; or
    - (ii) their excluded income; or
    - (iii) a combination of their assessable income and excluded income; or
  - (b) incurred by them in the course of carrying on a business for the purpose of deriving—
    - (i) their assessable income; or
    - (ii) their excluded income; or
    - (iii) a combination of their assessable income and excluded income.

*General permission*

- (2) Subsection (1) is called the **general permission**.

Section DA 2(1) and (2) reads as follows:

**DA 2 General limitations**

*Capital limitation*

- (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

*Private limitation*

- (2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the **private limitation**.

Section DB 6(1) and (4) reads as follows:

**DB 6 Interest: Not capital expenditure**

*Deduction*

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

...

*Link with subpart DA*

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

Section DB 7(1), (2) and (8) reads as follows:

**DB 7 Interest: Most companies need no nexus with income**

*Deduction*

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

*Exclusion: Qualifying company*

- (2) Subsection (1) does not apply to a qualifying company.

...

*Link with subpart DA*

- (8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

Section DB 11 reads as follows:

**DB 11 Negative base price adjustment**

*Deduction*

- (1) A person who has a negative base price adjustment under section EW 31(4) (Base price adjustment formula) is allowed a deduction for the expenditure to the extent to which it arises from assessable income, under section CC 3 (Financial arrangements), derived by the person under the financial arrangement in earlier income years.

*Link with subpart DA*

- (2) This section supplements the general permission and overrides all the general limitations.

Section EW 3(2) and (3) reads as follows:

**EW 3 What is a financial arrangement?**

*Money received for money provided*

- (2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—  
(a) at a future time; or

- (b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

*Examples of money received for money provided*

- (3) Without limiting subsection (2), each of the following is a financial arrangement—
  - (a) a debt, including a debt that arises by law:
  - (b) a debt instrument:
  - (c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:
  - (d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

Section EW 29(3) reads as follows:

**EW 29 When calculation of base price adjustment required**

*Maturity*

- (3) A party to a financial arrangement must calculate a base price adjustment as at the date on which the arrangement matures.

Section EW 31 reads as follows:

**EW 31 Base price adjustment formula**

*Calculation of base price adjustment*

- (1) A person calculates a base price adjustment using the formula in subsection (5).

*When formula applies*

- (2) The person calculates the base price adjustment for the income year in which section EW 29 applies to them.

*Positive base price adjustment*

- (3) A base price adjustment, if positive, is income, under section CC 3 (Financial arrangements), derived by the person in the income year for which the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred by the person under the financial arrangement in earlier income years and for which a deduction was denied in those income years.

*Negative base price adjustment*

- (4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under section DB 11 (Negative base price adjustment).

*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, ignoring non-contingent fees, 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 method in section EW 15D:
  - (b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

*Consideration in particular cases*

- (8) If any of sections EW 32 to EW 48 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** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—
- (a) by the person; or
  - (b) by law.

For the 2008/09 income year, section EW 54 reads as follows:

**EW 54 Meaning of cash basis person**

*Who is cash basis person*

- (1) A **cash basis person** is—
- (a) a natural person who meets the criteria in section EW 56:
  - (b) a trustee of a deceased's estate, whether or not a natural person, in the circumstances described in section EW 60.

*Natural persons excluded by Commissioner*

- (2) A natural person may be excluded under section EW 59 from being a cash basis person for a class of financial arrangements.

For the 2009/10 and later income years, section EW 54 reads as follows:

**EW 54 Meaning of cash basis person**

*Who is cash basis person*

- (1) A person is a **cash basis person** for an income year if—
- (a) 1 of the following applies in the person's case for the income year:
    - (i) section EW 57(1); or
    - (ii) section EW 57(2); and
  - (b) section EW 57(3) applies in the person's case for the income year.

*Persons excluded by Commissioner*

- (2) A person may be excluded under section EW 59 from being a cash basis person for a class of financial arrangements.

Section EW 55 reads as follows:

**EW 55 Effect of being cash basis person**

*Use of spreading method*

- (1) A cash basis person is not required to apply any of the spreading methods to any of their financial arrangements, but may choose to do so under section EW 61.

*Calculation of base price adjustment*

- (2) The fact that a cash basis person does not use any of the spreading methods for the financial arrangement does not excuse them from the requirement to calculate a base price adjustment when any of section EW 29(1) to (12) applies to them.

For the 2008/09 income year, section EW 56 reads as follows:

### **EW 56 Natural person**

#### *Criteria for natural person as cash basis person*

- (1) A natural person is a *cash basis person* for an income year if—
  - (a) 1 of the following applies in the person's case for the income year:
    - (i) section EW 57(1); or
    - (ii) section EW 57(2); and
  - (b) section EW 57(3) applies in the person's case for the income year; and
  - (c) the person is not a trustee.

#### *Financial arrangements, income, and expenditure relevant to application of criteria*

- (2) The calculations required by section EW 57(1) to (3) are done for the financial arrangements, or the income and expenditure, described in section EW 58.

#### *Increase in specified sums*

- (3) The Governor-General may make an Order in Council increasing a sum specified in any of sections EW 57(1) to (3).

Section EW 56 was repealed with effect from the 2009/10 income year.

For the 2009/10 and later income years, section EW 57(1)–(9) reads as follows:

### **EW 57 Thresholds**

#### *Income and expenditure threshold*

- (1) For the purposes of section EW 54(1)(a)(i), this subsection applies if the absolute value of the person's income and expenditure in the income year under all financial arrangements to which the person is a party is \$100,000 or less.

#### *Absolute value threshold*

- (2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is \$1,000,000 or less. The value of each arrangement is,—
  - (a) for a fixed principal financial arrangement, its face value;
  - (b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement;
  - (c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

#### *Deferral threshold*

- (3) For the purposes of section EW 54(1)(b), this subsection applies if the result of applying the formula in subsection (4) to each financial arrangement to which the person is a party at the end of the income year and adding the outcomes together is \$40,000 or less.

#### *Formula*

- (4) The formula is—
$$(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure})$$

#### *Definition of items in formula*

- (5) The items in the formula are defined in subsections (6) to (9).

#### *Accrual income*

- (6) **Accrual income** is the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:
  - (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

- (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
- (c) an alternative method approved by the Commissioner.

*Cash basis income*

- (7) **Cash basis income** is the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

*Cash basis expenditure*

- (8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

*Accrual expenditure*

- (9) **Accrual expenditure** is the amount that would have been expenditure incurred under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:
- (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
  - (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
  - (c) an alternative method approved by the Commissioner.

*Increase in specified sums*

- (10) The Governor-General may make an Order in Council increasing a sum specified in any of subsections (1) to (3).

For the 2008/09 income year, sections EW 57(1), (2) and (3) referred to sections EW 56(1)(a)(i), EW 56(1)(a)(ii) and EW 56(1)(b) respectively.

In section YA 1, the definitions of "interest", "maturity", "non-contingent fee", and "non-integral fee" read as follows:

**YA 1 Definitions**

**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

...

**maturity,—**

- (a) in the financial arrangements rules, means,—
  - (i) for an agreement for the sale and purchase of property or services or an option, the date on which the agreement or option ends:
  - (ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:

...

**non-contingent fee** means a fee that—

- (a) is for services provided for a person becoming a party to a financial arrangement; and
- (b) is payable whether or not the financial arrangement proceeds

**non-integral fee** means a fee or transaction cost that, for the purposes of financial reporting under IFRSs, is not an integral part of the effective interest rate of a financial arrangement

In Determination G25: Variations in the Terms of a Financial Arrangement, the definition of "Variable Rate Financial Arrangement" reads as follows:

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

- (a) the interest rate is determined by a fixed relationship to economic, commodity, industrial or financial indices or prices, or banking or general commercial rates; or
- (b) the interest rate is set periodically by reference to market interest rates.

## Application of the legislation

The application of the legislation depends on whether the loan is repaid in full and terminated or the loan remains in existence and there is simply a variation of the interest rate.

### *Loan repaid in full*

A fixed interest rate loan is a financial arrangement pursuant to section EW 3. The financial arrangements rules ("FA rules") will therefore apply. When a loan is repaid in full, a base price adjustment ("BPA") is required under section EW 29.

Although many landlords are likely to be cash basis persons under the FA rules and not required to use a spreading method, they are still subject to the FA rules and will be required to do a BPA if the loan is repaid in full.

The formula for calculating a BPA is in section EW 31(5). The formula for a borrower is:

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

A break fee charged by a bank in respect of the early repayment of the loan will fall within the definition of "consideration" in section EW 31(7) as "consideration that has been paid ... by the person for or under the financial arrangement". The break fee will not be ignored as a "non-contingent fee" because the fee is not "for services provided for the taxpayer **becoming a party** to the financial arrangement and payable whether or not the financial arrangement proceeds". The fee is payable to allow the taxpayer to cease being a party to the financial arrangement. As the scope of these rulings excludes landlords who have adopted the International Financial Reporting Standard ("IFRS") financial reporting method under section EW 15D, it is unnecessary to consider whether the break fee constitutes a non-integral fee.

As part of the consideration paid by a borrower, the amount of the break fee will increase the overall negative figure that the BPA provides in this scenario (see Example 1 below).

A negative BPA is expenditure incurred under the FA rules pursuant to section EW 31(4). In the case of taxpayers who have previously returned income under a financial arrangement (such as lenders), an automatic deduction is allowed for the negative BPA expenditure under section DB 11 to the extent of that previously returned income. However, as landlords are generally borrowers who will not have derived income from their loans, section DB 11 will have no application in those circumstances.

Negative BPA expenditure is also “interest” for the purposes of sections DB 6 and DB 7 (see the definition of “interest” in section YA 1). An individual taxpayer or qualifying company will be able to deduct the amount of the negative BPA as interest under section DB 6, provided the general permission in section DA 1 is satisfied and none of the general limitations (excluding the capital limitation) apply. Section DB 6 specifically provides that the capital limitation will not apply, so it is unnecessary to consider whether the amount is of a capital or revenue nature.

Where the borrowed money was used to purchase property from which rental income is derived, the Commissioner’s view is that the general permission will be satisfied and the amount of the negative BPA will be deductible under section DB 6. Note that if the borrowing was used for a private or domestic purpose, a deduction would be denied under the private limitation in section DA 2(2).

In the case of a company (other than a qualifying company), the amount of the negative BPA will be automatically deductible under section DB 7 without any requirement to consider the general permission.

The Commissioner notes that some commentators have suggested section DB 5 may have application when the loan amount is refinanced. Section DB 5 provides a deduction for expenditure incurred in borrowing money used as capital in deriving income. The Commissioner’s view is that section DB 5 has no application where the FA rules apply. The amount of the break fee is dealt with under the BPA on repayment of the original loan, as set out above. This will be the case whether or not the amount of the loan is refinanced.

### ***Interest rate varied***

Instead of repaying a loan in full and then refinancing with a new loan, a borrower may negotiate with their lender to vary the rate of interest on an existing loan. This is sometimes referred to as an “interest rate switch”. A break fee will often be charged in these circumstances.

Where the renegotiation of the interest rate is simply a variation of the loan and that same loan continues in existence, a BPA is not required. In these circumstances, the deductibility of the break fee depends on whether or not the taxpayer is a cash basis person. Note that if the change in the interest rate is effected by way of the existing loan being discharged and a new loan agreement being entered into, a BPA will be required as discussed above.

A taxpayer who is not a cash basis person will have been required to adopt a spreading method in relation to the loan under the FA rules. As the loan is a fixed interest rate loan at the time of the variation, it will not be a variable rate financial arrangement (as defined in Determination G25: Variations in the terms of a financial arrangement). Therefore, the taxpayer will need to apply Determination G25 when the loan is varied, rather than Determination G26: Variable rate financial arrangements. The break fee will be brought into the Determination G25 calculation. This means an adjustment is made in the year of variation and the deduction of the break fee is effectively spread over the term of the loan (see Example 2 below).

A cash basis person is not required to adopt a spreading method, although they may choose to do so. A person will be a cash basis person if:

- the income and expenditure under all the person’s financial arrangements for the income year does not exceed \$100,000, or

- the value of all the person's financial arrangements on every day of the income year does not exceed \$1 million.

In addition, the difference between the accrual treatment and the cash treatment of all the person's financial arrangements cannot exceed \$40,000 for the income year. Where a significant break fee is paid, it is possible that these thresholds may be breached and a person may cease to be a cash basis person. In those circumstances the treatment of the break fee set out above for a non-cash basis person will apply.

Note that as a result of the changes made by the Taxation (Business Tax Measures) Act 2009 (referred to in Legislation above) with effect from the 2009/10 income year a non-natural person may be a cash basis person.

Where a cash basis person does not adopt a spreading method, the deductibility of the break fee is determined outside the FA rules.

The break fee will be incurred whether it is actually paid or simply added to the balance of the loan: *King v CIR* (1973) 1 NZTC 61,107.

The break fee will be deductible if it satisfies the general permission and none of the general limitations apply. Where the borrowed money was used to purchase property from which rental income is derived, the Commissioner's view is that the general permission will be satisfied. Note that if the borrowing was used for a private or domestic purpose, a deduction would be denied under the private limitation in section DA 2(2).

Note that section DB 5 will also have no application in these circumstances. Where all that occurs is a variation of the interest rate applicable to a loan, the break fee cannot be said to have been incurred in borrowing money.

## Examples

### ***Example 1 – Loan repaid in full***

At the beginning of year 1, B borrows \$200,000 at a flat 10% per annum fixed interest rate to purchase a rental property from which rental income is derived. The loan is interest only. At the end of year 2, B breaks the loan in order to refinance at a lower interest rate with another bank. B repays the loan and pays an additional \$10,000 break fee.

B will have to calculate a BPA in relation to the loan as follows:

consideration – income + expenditure + amount remitted

The consideration received by B is the original loan amount of \$200,000. The consideration paid by B is the return of the principal, two instalments of interest at \$20,000 each, and the break fee of \$10,000, or \$250,000:

(\$200,000 + \$20,000 + \$20,000 + \$10,000).

There is no income amount or amount remitted. The expenditure amount is the \$20,000 interest incurred under the loan in year 1.

The BPA is thus:

(\$200,000 – \$250,000) – \$0 + \$20,000 + \$0  
= –\$50,000 + \$20,000

$$= -\$30,000$$

The negative BPA amount of \$30,000 represents the \$20,000 interest expense for year 2 and the amount of the break fee.

The negative BPA amount is expenditure incurred under the FA rules and is deemed to be interest. It will be deductible to B in the year in which it is incurred under section DB 7 (if B is a company) or section DB 6 and the general permission (if B is a non-corporate or qualifying company).

### ***Example 2 – Interest rate varied***

A and B are the shareholders in S Ltd. S Ltd owns two residential rental properties. S Ltd borrows \$100,000 for three years. Interest is fixed at 10% payable annually in arrears. S Ltd is not a cash basis person. Assuming a straight-line spreading method, the total annual expenditure incurred under the FA rules would be:

$$(\$100,000 + \$30,000 - \$100,000)/3 = \$30,000/3 = \$10,000 \text{ per annum}$$

In year 2 the loan is renegotiated to an 8% interest rate. A break fee of \$2,500 is charged. The revised annual finance charges are:

$$(\$100,000 + \$26,000 + \$2,500 - \$100,000)/3 = \$28,500/3 = \$9,500 \text{ pa}$$

Determination G25 will apply. The formula is:

$$a - b - c + d$$

where

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

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

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

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

Applying the Determination G25 formula, the adjustment in year 2 is:

$$\$0 - \$19,000 - \$0 + \$10,000 = -\$9,000$$

This gives total expenditure for years 1 and 2 of \$19,000 (\$10,000 + \$9,000), the equivalent position by the end of year 2 had the revised annual expenditure of \$9,500 been claimed from the outset of the financial arrangement. This means the deduction for the break fee is effectively spread over the term of the loan.