DEDUCTIBILITY OF BREAK FEE PAID BY A LANDLORD TO EXIT EARLY FROM A FIXED INTEREST RATE LOAN ON SALE OF RENTAL PROPERTY

PUBLIC RULING – BR PUB 10/20

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. The person subsequently pays a break fee to the lender to repay in full and terminate that loan earlier than its agreed repayment date in order to sell the rental property. Therefore, the person ceases to derive rental income from the property.

This Ruling will not apply when 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 is required in the income year the loan is repaid.
- The amount of any break fee is included in the "consideration" element of the base price adjustment formula and will increase the overall negative figure that the base price adjustment provides.
- The negative amount under the base price adjustment is expenditure incurred under the financial arrangements rules and constitutes interest.
- An automatic deduction is available for companies (other than qualifying companies) for the negative base price adjustment amount as interest under section DB 7.
- A deduction is available for other taxpayers under section DB 6 and the general permission in section DA 1.

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 28th day of October 2010.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING – BR PUB 10/20

This commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 10/20 ("the Ruling"). The commentary is not a legally binding statement.

All legislative references are to the Income Tax Act 2007 unless otherwise stated. The relevant legislative provisions are reproduced in the Appendix to this commentary.

Background

This Ruling deals with the deductibility of a fee charged by banks to permit landlords to repay a fixed interest rate loan early in order to sell a rental property. These fees are variously referred to by terms such as "early repayment fees", "early repayment adjustment charge", "early exit fees" and "mortgage break fees". In this Ruling, the term "break fee" is used to refer to all such charges.

The amount of the break 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.

Public rulings BR Pub 09/09 'Deductibility of break fee paid by a landlord to exit early from a fixed interest rate loan' and BR Pub 09/10 'Deductibility of break fee paid by landlord to vary the interest rate of an existing fixed interest rate loan' deal with the deductibility of the break fee in two scenarios. These are when:

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

This Ruling considers the additional scenario where the break fee is paid in order to sell the rental property, so the landlord ceases to derive assessable income from the property.

Application of the legislation

Financial arrangements rules and base price adjustment

A fixed interest rate loan is a financial arrangement under 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 when the loan is repaid in full.

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

consideration – income + expenditure + 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".

"Consideration" is defined to exclude "non-contingent fees" and "non-integral fees". The break fee will not be excluded 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" (emphasis added). The fee is payable to allow the taxpayer to cease being a party to the financial arrangement. The scope of these rulings excludes landlords who have adopted the IFRS financial reporting method under section EW 15D, so it is unnecessary to consider whether the break fee constitutes a non-integral fee.

As part of the consideration paid by the borrower, the amount of the break fee will increase the overall negative figure that the BPA provides in this scenario.

Deductibility of negative base price adjustment amount

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

Negative BPA expenditure is "interest" for the purposes of sections DB 6 and DB 7 (see the definition of "interest" in section YA 1). 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.

An individual taxpayer or a 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 the capital limitation will not apply, so it is unnecessary to consider whether the amount is of a capital or revenue nature.

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. The borrowed money was used to purchase a property from which rental income is derived. The BPA is being carried out at the time the rental property is sold and the deriving of rental income ceases. The negative BPA amount is deductible as interest as it has a sufficient relationship with the derivation of the rental income. 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).

Alternative view – general permission not satisfied

The Commissioner notes that some commentators have suggested that because the break fee is paid to allow the taxpayer to dispose of the property, and therefore to cease deriving assessable rental income, the break fee does not have a sufficient relationship with the derivation of assessable income and the general permission is not satisfied to the extent of the amount of the break fee. The Commissioner's view is that the break fee amount is an indivisible part of the negative BPA amount produced by the application of the BPA formula. The BPA provides a net figure at the end of the financial arrangement. This net figure is treated as interest, and it is the deductibility of that interest net figure that must be considered. The individual amounts that go into the BPA formula are not considered separately to determine assessability or deductibility.

Relevance of post-cessation business cases

It has also been suggested that relevant here is the line of reasoning in the post-cessation of business cases, such as *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295, *Case U29* (2000) 19 NZTC 9,273 and *Inglis v CIR* (2001) 20 NZTC 17,379.

The post-cessation cases look at the deductibility of expenditure incurred after a business has ceased. These cases are concerned with how long after a business has ceased that expenditure may be claimed. However, under the present arrangement, the BPA is being performed at the same time as the rental property is sold and the deriving of rental income from it ceases. Therefore, the post-cessation cases are not relevant.

Example

At the beginning of year 1, B borrows $200,000 at a flat 10% per year 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 sell the property. B repays the loan and pays an additional $10,000 break fee.

B must 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:

($200,000 + $20,000 + $20,000 + $10,000) = $250,000.

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

Therefore, the BPA is:

($200,000 – $250,000) – $0 + $20,000 + $0

= –$50,000 + $20,000

= –$30,000

The negative BPA amount of $30,000 effectively 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. If B is a company, B will obtain an automatic deduction for the $30,000 in the year in which it is incurred under section DB 7. If B is a non-corporate or a qualifying company, the $30,000 will be deductible under section DB 6 and the general permission. The general permission is satisfied because the borrowed money was used to purchase the rental property from which assessable income was derived.

APPENDIX: LEGISLATION

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

Section DA 1(1) and (2) states:

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) states:

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**.

Section DB 6(1) and (4) states:

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) states:

Deduction

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

Exclusion: Qualifying company

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

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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 states:

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) states:

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) states:

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 states:

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, 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.

Section YA 1 states:

IFRS means a **New Zealand** Equivalent to International Financial Reporting Standard, approved by the Accounting Standards Review Board, and as amended from time to time or an equivalent standard issued in its place

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