APPENDIX D TO TIB NO 9, MARCH 1990
THE ACCRUAL TAX ACCOUNTING REGIME AND GOVERNMENT STOCK TRANSACTIONS

1. Introduction

1.1 This item deals with the calculation of income and expenditure in respect of Government stock under the accrual tax accounting regime.

1.2 New Zealand Government stock purchased from the Reserve Bank or anyone else on or after 8.30 pm on 31 July 1986 (the "Implementation date") is a financial arrangement in terms of section 64B(1) of the Income Tax Act 1976. The tax consequences for a taxpayer arise from a taxpayer being a holder or an issuer in respect of that financial arrangement. Government stock purchased after the implementation date is subject to the accruals legislation. This also applies to mortgage bonds, local authority stock and similar debt instruments.

2. What is Govemment Stock?

2.1 Government stock is a fixed interest security offered by the Reserve Bank at a fixed coupon (i.e. interest payment) paid semi-annually. Government stock is issued to the market by periodic tender every few weeks. Each tenderer for the stock must state the yield to maturity sought and the amount of Government stock they are tendering for. The yield required must be stated to 2 decimal places. All tenders are submitted to the Reserve Bank. After the tender closing date, allotment is made in ascending order of yields bid. Generally the interest rate received from Government Stock is lower than that received from other similar debt instruments as Government Stock is considered to be a relatively risk-free investment.

2.2 If the bidder is successful, the Government Stock will be issued to the taxpayer for the purchase or "settlement" price. Irrespective of the date of settlement, holders of Tender stock will receive a full semi-annual coupon payment on the first and subsequent coupon dates.

2.3 A secondary market exists where taxpayers may buy or sell Government Stock at below par (discounted) or above par (at a premium) value, depending on the movement of interest rates subsequent to the purchase of the Government Stock. Therefore the price paid on the secondary market for Government Stock will reflect current interest rates against the coupon rate applying to the stock held, plus the amount of interest which has accrued on the stock since the last coupon payment date. Thus secondary market dealings will almost always occur at a premium or a discount. The owner of the stock at the time the coupon payments are due is the person who will receive the coupon payment. Similarly the owner of the stock at the time of maturity will receive the redemption amount.

2.4 Where the yield required by an investor is greater than the coupon rate the stock will be issued or acquired at a price below its redemption (or par) value, i.e. at a discount.

2.5 Government stock is issued at a premium where the issue or acquisition price of the stock is greater than its redemption price i.e., the yield required is less than the coupon rate.

3. Accruals Treatment of Government Stock

3.1 Taxpayers investing in Government Stock are holders as defined in section 64B(1) of the Act. Holders (except cash basis holders) are required to return interest income in accordance with section 64C of the Act.

3.2 Where the taxpayer is in the business of dealing in Government stock, section 64C(4) allows calculation of income (or expenditure, i.e. loss due to market yield fluctuations) using a method that has regard to market valuation. Certain other conditions set out in section 64C(4) must also be satisfied. As section 64C(4) is available only to dealers, any unrealised loss under section 64C(4) will be deductible under section 106(1)(h).

3.3 Where section 64C(4) does not apply, income must be calculated -

(a) In accordance with section 64C(2) in every lncome year except the income year in which the Government stock matures, is sold, or otherwise transferred by the holder; or

(b) According to section 64F (i.e base price, or cash base price adjustment) in the income year in which the Government stock matures or is sold, or otherwise transferred by the holder.

If the Government stock is bought and sold within the same income year only the base price adjustment or cash base price adjustment is required.

3.4 Determination G3: Yield to Maturity Method, made by the Commissioner on 13 May 1987 and Determination G11: Present Value Based Yield to Maturity Method, made by the Commissioner on 21 November 1988 apply to Government stock (among other things).

Where section 64C(2) applies taxpayers must use

(i) Determination G3; or

(ii) Determination G11; or

(iii) An alternative method that has regard to the principles of accrual accounting, and

(a) Conforms with commercially acceptable practice; and

(b) Is adopted and applied by the person consistently in respect of all such financial arrangements; and

(c) Gives a result which is not materially different from Determinations G3 or G11:

The accrual rules for interest aim to spread income and expenditure over the term of the financial arrangement.

4. Treatment of Holders (not being cash basis holders)

4.1 During the life of the financial arrangement gains are deemed to be income derived under sections 64C(2) or 64C(4), and are assessable under section 65(2)(j). On sale, transfer, or maturity of the Government stock section 64F(4)(a)(i) deems a positive amount resulting from the base price adjustment to be income derived in that income year.

4.2 Any loss, calculated under the base price adjustment, resulting from the sale or transfer of Government stock for less than the acquisition price, is deemed to be an allowable deduction under section 64F(4)(a)(ii).

5. Cash Basis Holders

5.1 Where the stock is held by someone who is a cash basis holder (as defined in section 64D(1) of the Act), income from that stock will be recognised on a cash basis, except in the year in which the stock matures, is sold, or otherwise transferred by the holder. In that year a cash base price adjustment is required in terms of section 64F(3).

5.2 A cash basis holder may take into account interest income which has accrued on the Government stock before the stock was acquired by the cash basis holder. The proviso to section 65(2)(j) applies where any securities have been acquired by purchase or otherwise during the year and allows the Commissioner, where he considers it equitable to do so, to apportion between the transferor and the transferee any interest due or accruing at the date of the transfer.

5.3 However this provisioh is available only when the apportionment of the interest is indicated on the contract note, or where other evidence is available to support the apportionment. The apportionment on the contract note for the first periodic interest payment is to be treated on the basis that the coupon interest accrues evenly on a straight-line daily basis over the full period to which it relates (360 or 365 day basis is acceptable). This is the treatment followed prior to the introduction of the accrual tax accounting regime, and it is not intended to alter except in the year in which section 64F applies. The cash basis holder will be required to recognise as periodic interest only that proportion of the payment which accrued after the date of acquisition.

5.4 In the final year a cash base price adjustment is necessary. A positive amount calculated under the cash base price adjustment is deemed to be income derived by the cash basis holder in that income year under section 64F(5)(a) of the Act. A negative amount calculated under the cash base price adjustment is deemed to be an allowable deduction for the cash basis holder in that income year.

6. Withholding Tax

6.1 Where withholding tax deductions are withheld by the issuer of the debt, yield to maturity calculations are to be made as if the amount withheld was paid -

(a) To the person entitled to the credit of withholding tax; and

(b) On the day the payment from which the deduction is withheld is made.

7. Example

7.1 Between coupon payment dates a taxpayer purchases Government stock in the secondary market. The taxpayer has a 31 March balance date. The example below applies Determination G3.

Purchase price:	$9,700 (A)
Redemption value (face value):	$10,000 (D)

Coupon rate: 10% per annum paid semi-annually

Purchase date: 9 March 1991

Coupon payment dates: 15 April and 15 October

Redemption date: 15 April 1992

The dealers note shows the interest apportionment as:

Vendor	$398
Purchaser	$102

Payments (for the new holder)

9 March 1991	($ 9,700) (A)
15 April 1991 (coupon)	$ 500 (B1)
15 October 1991 (coupon)	$ 500 (B2)
15 April 1992 (coupon and redemption)	$10,500 (B3)

7.2 Income Position for a Cash Basis Holder

Year ending 31 March 1991:

No interest received or receivable, therefore none assessable.

Year ending 31 March 1992:

Interest received or receivable:

15/4/91	$ 500 (B1)
15/10/91	$ 500 (B2)
	$1,000
Less apportionment of first interest payment to vendor	$ 398
Income returned	$ 602 (C)

Year ending 31 March 1993:

Cash base price adjustment:

	a	-	(b	+	c)
(B1)	500	-	(A) 9,700	+	(C) 602
(B2)	500				
(B3)	10,500				
	$11,500	-	($9,700	+	$602)

= + $1,198. This is a positive amount and is therefore income derived in the year ending 31 March 1993.

7.3 Holders (Other than Cash Basis Holders)

The yield to maturity calculation in line with Determination G3 gives the following results:

IRR per period	.085688
IRR per annum	.171377

Period	Day	Month	Year	Cashflow	End of Period Balance	Period Inc/Exp	No. Days in period
0	9	3	1991	(9,700)	(9,700)		
1	15	4	1991	500	9,368.51	168.51	37
2	15	10	1991	500	9,671.28	802.77	183
3	15	4	1992	10,500	0	828.72	183

Income Calculation:

Allocating period income to income years (31 March balance) on a 365 Day basis in terms of Determination G1.

Year ending 31 March 1991:

	DR	CR	Income
Opening balance	0		
9/3/91 Price paid	$9,700		
31/3/91 22 days interest	$100.20		$ 100.20
Income for year ending 31/3/91			$ 100.20

Year ending 31 March 1992:

	DR	CR	Income
15/4/91 15 days interest	68.31 9,368.51	$500	$ 68.31
15/10/91 183 days interest	802.77 $9,671.28	$500	$ 802.77
31/3/92 168 days interest	760.79		$ 760.79
Income for year ending 31 March 1992			$1,631.87

Year ending 31 March 1993:

Base price adjustment

a - (b + c)

$11,500 - ($9,700 + $1,732.07)

= + $67.93 which is deemed to be income derived.

7.4 Total income returned under the two methods would be:

Income year ending	**Cash Basis Holder**	**Holder**
31 March 1991	Nil	$ 100.20
31 March 1992	$ 602	$1,631.87
31 March 1993	$1,198	$ 67.93
	$1,800	$1,800.00

8. Conclusion

8.1 Income from Government Stock is assessable for income tax purposes, and should be calculated on a yield to maturity basis (except in the final year, where a base price adjustment is required) in terms of section 64C of the Act unless the person is a cash basis holder. Losses are an allowable deduction for income tax purposes in terms of section 64F, or section 106(1)(h).