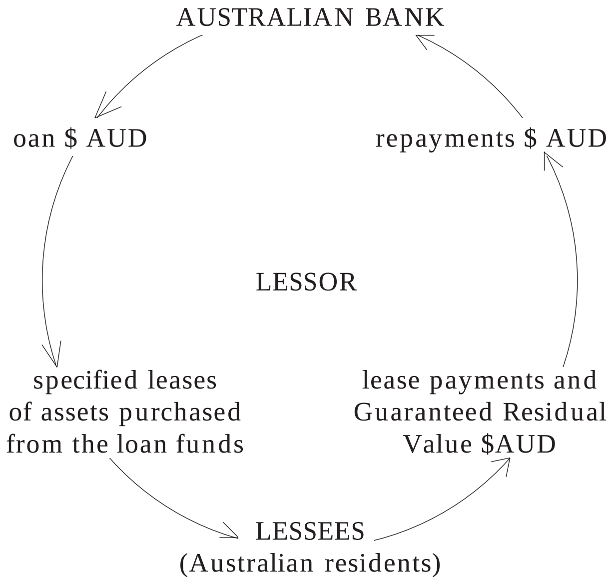
THE ACCRUAL TAX ACCOUNTING REGIME AND SPECIFIED LEASES

1. An inquiry was received about calculating a lessor's income under a specified lease. The lessor was involved in transactions with an overseas bank and overseas lessees:



The lessor was a New Zealand company. It borrowed Australian dollars from an Australian bank, used the funds to buy lease assets in Australia, and leased the assets under specified leases to Australian residents, from whom the lessor received instalments in Australian dollars.

2. It appeared that the transactions involved no exposure to a foreign exchange variation. The lessor was repaying the Australian bank in Australian dollars and was receiving instalments under the specified leases in the same currency.

3. However, the lessor was concerned that a timing mismatch could occur in accounting for any exchange variation for tax purposes. This mismatch could arise as follows:

4. The loan to the lessor by the Australian bank was a financial arrangement to which Section 64B to 64M of the Income Tax Act 1976 ("the Act") applied.

   The lessor was required to account for any exchange variation *on an unrealised basis as it accrued over the term of the loan.* (Section 64C(3)(a) and Determination G9A: *Financial Arrangements That Are Denominated In Currency Or Commodity Other Than New Zealand Dollars* refer).

5. The specified leases were an excepted financial arrangement and not part of a financial arrangement. Sections 64B to 64M did not apply to them. Section 222C(2)(b) provides that the lessor's income over the term of a specified lease equals the sum of the lease payments plus the residual value of the lease asset, reduced by the cost price of the lease asset. All these amounts would be expressed in Australian dollars in the present lessor's case, and none of them provided for an exchange variation to be taken into account. In this particular case, it is doubtful whether any gain or loss due to an exchange variation could be brought to account under Section 71 of the Act as the loan deemed to have been made by the lessor under the specified leases was not made in the course of carrying on business in New Zealand as required by Section 71(3). In other cases, even if an exchange variation could be brought to account under section 71, this would be done *in the income year when the deemed loan was repaid,* taking into account the gain or loss from an exchange variation *only when it was realised.*

6. Section 222C(1) deems the income derived by the lessor under the specified leases to be income derived from interest.

7. There are alternative methods for allocating this interest to each instalment paid under the specified lease. Section 222C(2)(a)(i) calculates the deemed interest on the balance of capital outstanding at the time each instalment is paid, so that the interest content of each instalment reduces as the capital outstanding diminishes.

8. Pursuant to Section 222C(2)(a)(ii) a method which satisfies the following criteria may be used:

   the method is other than that prescribed in Section 222C(2)(a)(i), i.e., other than a method whereby amounts are calculated on the outstanding balance in each instalment period where the total of the amounts equals the sum of the lease payments; and

   the method is commonly applied in commercial usage; and the method, in the Commissioner's opinion, having regard to:

- the lease term, and
- frequency of payments

results in

- allocation of a fair and reasonable amount to each l instalment period, and

- the sum of all amounts so allocated being equal to the sum of the lease payments.

9. To avoid the mismatch described in paragraphs 3 to 5 above, the lessor wished to account for instalments paid to the lessor under the specified leases on an accrual basis, recognising any foreign exchange variation on an unrealised basis over the term of the specified leases.

10. In the Commissioner's opinion, Section 222C(2)(a)(ii) allows a lessor to use any method of calculation provided for in sections 64C(2) or 64C(3)(a) of the Act to account for instalments paid to the lessor under a specified lease, including any exchange variation in respect of those instalments.

Example

The facts used in the example first appeared in March 1983 as Appendix E to Public Information Bulletin No 120. It also appears in *CCH New Zealand Income Tax Law and Practice* (Vol.2, p.20, 421). This example applies a method of calculation provided for in sections 64C(2) and 64C(3)(a) to payments expressed in a foreign currency made to a lessor under a specified lease.

As Australian company, A T Limited (the lessee) leases a computer (the lease asset) from a New Zealand company, B K Limited (the lessor), the cost price of which is AUD 1,100,000, installation costs are AUD 100,507.65, and the guaranteed residual value (GRV) is AUD 200,000. The lease term is five years, from 1 September 1988, and provides for 10 rental payments of AUD 191,801.48 paid every six months on 1 March and 1 September each year. B K Limited's balance date is 30 June.

For the purposes of this example "AUD" refers to Australian dollars, and "NZD" to New Zealand dollars. Assume the following spot exchange rates applied:

Date	Rate (1 NZD = AUD)
1 September 1988	0.8410
1 March 1989	0.8695
30 June 1989	0.8560
1 September 1989	0.8370
1 March 1990	0.8210
30 June 1990	0.7980
1 September 1990	0.8360
1 March 1991	0.8470
30 June 1991	0.8430
1 September 1991	0.8230
1 March 1992	0.8180
30 June 1992	0.8010
1 September 1992	0.7850
1 March 1993	0.7750
30 June 1993	0.7690
1 September 1993	0.7840
1 March 1994	0.7420
30 June 1994	0.7960

The accrued income in AUD associated with the rental payments is given in the following table - this is calculated in accordance with Determination G9A: *Financial Arrangements that are Denominated in a Currency or Comodity other than New Zealand Dollars*, and Determination G3 : *Yield to Maturity Method*, and allocated to each income year in accordance with Determination G1A: *Apportionment of Daily Income and Expenditure.*

Date	Cashflows	Income	Year Ending	Accrued Income
1.9.88	-1,200,507.65			
1.3.89	191,801.48	131,942.48	30.6.89	214,382.70
1.9.89	191,801.48	125,363.64		
1.3.90	191,801.48	118,061.75		
1.9.90	191,801.48	109,957.35	30.6.90	233,294.08
1.3.91	191,801.48	100,962.22		
1.9.91	191,801.48	90,978.48	30.6.91	198,438.90
1.3.92	191,801.48	79,897.47		
1.9.92	191,801.48	67,598.60	30.6.92	155,501.14
1.3.93	191,801.48	53,948.01		
1.9.93	391,801.48	38,797.14	30.6.93	102,606.52
30.6.94	13,283.80			
	917,507.15	917,507.15		917,507.15

At the first balance date - 30.6.89

The closing tax book value ("CTBV") is calculated as:

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

e is nil since the lessor was not a party to this financial arrangement at the beginning of the income year.

f is AUD 1,200,507.65 - the price paid for the computer on 1 September 1988, being the sum of all consideration given by the lessor during the income year.

g is AUD 214,382.70 - the base currency income accruing to the person in this income year, calculated in accordance with the provisions of section 64B to 64M of the Act.

h is AUD 191,801.48 - the sum of all consideration given to the person in the income year (the rental payment of 1 March 1989)

i is nil as there is no expenditure incurred by the lessor.

This formula gives a CTBV of:

0 + 1200507.65 + 214382.70 - 191,801.48 - 0
= 1223088.87

The income or expenditure in respect of the rentals for the income year is calculated as

a + b - c - d

where:

a is the NZD value of the CTBV

= 1223088.87 / 0.8560
= 1428842.14

b is the NZD value of all consideration given to the person during the income year.

= 191801.48 / 0.8695
= 220588.25

c is the opening tax book value and has a nil value.

d is the NZD value of all consideration given by the person during the income year

= 1200507.65 / 0.8410
= 1427476.40

The income or expenditure is thus NZD 221953.99. This positive amount is income derived by the lessor.

At the second balance date 30.6.90

The CTBV is:

1223088.87 + 0 + 233294.08 - 383602.96 - 0
= AUD 1072779.99

The income derived / expenditure incurred in NZD is therefore:

1,072,779.99 / 0.7980 + (191,801.48 / 0.8370 + 191,801.48 / 0.8210) - 1,223,088.87 / 0.8560 + 0
= NZD 378,266.53

As this is positive amount it is income derived by the lessor.

At the third balance date 30.6.91

The CTBV is:

1072779.99 + 0 + 198438.90 - 383602.96 - 0
= AUD 887615.93

The income derived / expenditure incurred in NZD is therefore:

887615.93 / 0.8480 + (191801.48 / 0.8360 + 191801.48 / 0.8470) - 1072779.99 / 0.7980 + 0
= NZD 158256.71

As this is a positive amount it is income derived by the lessor.

At the fourth balance date 30.6.92

The CTBV is:

887615.93 + 0 + 155501.14 - 383602.96 - 0
= AUD 659514.11

The income derived / expenditure incurred in NZD is therefore

659514.11 / 0.8010 + (191801.48 / 0.8230 + 191801.48 / 0.8180) - 887615.93 / 0.8480 + 0
= NZD 244174.28

As this is a positive amount it is income derived by the lessor.

At the fifth balance date 30.6.93

The CTBV is:

659514.11 + 0 + 102606.52 - 383602.96 - 0
= AUD 378517.67

The income derived / expenditure incurred in NZD is therefore

378517.67 / 0.7690 + (191801.48 / 0.7850 + 191801.48 / 0.7750) - 659514.11 / 0.8010 + 0
= NZD 160676.09

As this is a positive amount it is income derived by the lessor.

At the sixth balance date 30.6.94

At this date the lessor must calculate the base price adjustment in Section 64F(2):

a - (b + c)

Where:

a is all consideration that has been paid to the lessor

= 191,801.48 / 0.8695 + 191,801.48 / 0.8370 + 191,801.48 / 0.8210 + 191,801.48 / 0.8360 + 191,801.48 / 0.8470 + 191,801.48 / 0.8230 + 191,801.48 / 0.8180 + 191,801.48 / 0.7850 + 191,801.48 / 0.7750 + 391,801.48 / 0.7840*
= 2,598,330.16

* 391,801.48 = rental payment (191,801.48) + the guaranteed residual rate (200,000)

b is the acquisition price of the lease asset (complete)

= 1,200,507.65 / 0.8410
= 1,427,476.40

c is all amounts of income derived under section 64C

= 221,953.99 + 378,266.53 + 158,256.71 + 244,174.28 + 160,676.09 (as calculated above)
= 1,163,327.60

The Base Price Adjustment is

a - (b + c)

= 2,598,330.16 - (1,427,476.40 + 1,163,327.60)
= 7,526.16

Since this is a positive amount it is income derived by the lessor in the income year.

Lease terminated and asset sold for AUD 500,000

Assume that the lease was cancelled after instalment 7, the lessee paying a penalty of AUD 210,000. The lessor then sells the asset to an Australian buyer for AUD 500,000.

Date	Rental Payments	Income	Capital (AUD)	Rate	Capital (NZD)
1.3.89	191,801.48	131,942.48	59,859.00	0.8695	68,843.01
1.9.89	191,801.48	125,363.64	66,437.84	0.8370	79,376.15
1.3.90	191,801.48	118,061.75	73,739.73	0.8210	89,816.97
1.9.90	191,801.48	109,957.38	81,844.33	0.8360	97,899.92
1.3.91	191,801,48	100,962.22	90,839.26	0.8470	107,248.24
1.9.91	191,801.48	90,978.48	100,823.00	0.8230	122,506.68
1.3.92	191,801.48	79,897.47	111,904.01	0.8180	136,801.97
1.9.92	191,801.48	67,598.60	124,202.88	0.7850	158,220.23
1.3.93	191,801.48	53,948.01	137,853.47	0.7750	177,875.45
1.9.93	391,801.48	38,797.14	353,004.34	0.7480	450,260.64

The deemed sale price to the lessor is

Cost price - capital repayments - payment to cancel

Cost price = 1,200,807.65 / 0.8410
= 1,427,476.40

Capital repayments =

68,843.01 + 79,376.15 + 89,816.97 + 97,899.92 + 107,248.24 + 122,506.68 + 136,801.97
= 702,492.94

Payment to cancel = 210,000 / 0.8180
= 256723.72

The deemed sale price is:

1,427,476.40 - 702,492.94 - 256,723.72
= NZD 468,259.74

The lessor on the sale of the asset for AUD500,000 (NZ 611,246.94 at the exchange rate 0.8180) would have assessable income of NZD 142,987.20, that is:

NZD 611,246.94 received
\- NZD 468,259.74 less the deemed sale price
NZD 142,987.20