TIB Appendices

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Appendix A: Accrual Determinations Recently Signed by the Commissioner

Determination G17B: Deferred Property Settlements Denominated in New Zealand Currency

This determination may be cited as "Determination G17B: Deferred Property Settlements Denominated in New Zealand Currency".

1. Explanation (which does not form part of the determination)

(1) This determination rescinds and replaces Determination G17A: *Discounted value of Amounts Payable in Relation to Deferred Property Settlements Denominated in New Zealand Currency* made by the Commissioner on 9 February 1990. This determination differs from Determination G17A:

(a) by expanding the scope of the determination to ensure the acquisition price, for the purposes of the base price adjustment, must be determined in all circumstances;

(b) making it clear that if all the amounts Payable and the dates on which those amounts are Payable are known at the first balance date after the Transfer Date, the yield to maturity method must be applied to calculate income derived or expenditure incurred during the term of the Deferred Property Settlement;

(c) providing a method of calculating income derived or expenditure incurred during the term of a Deferred Property Settlement where the amounts Payable or the dates on which those amounts are Payable are not known with certainty at the first balance date after the Transfer Date; and

(d) in the use of the Specified Rate. This determination uses the method prescribed in Determination G23: *Specified Rate*. Determination G17A used the market yield ascertained in accordance with Determination G13: *Prices or Yields.*

(2) In this determination an agreement for the sale and purchase of property or a specified option, where Payment in full is not made at the time at which the first right in the Specified Property is to be transferred, will be called a "Deferred Property Settlement".

(3) This determination does not apply -

(a) To short term agreements for the sale and purchase of property; or

(b) To short term options; or

(c) To private or domestic agreements for the sale and purchase of property; or

(d) To deferred property settlements where any amount Payable is denominated in foreign currency; or

(e) To deferred property settlements where the total deposits and other amounts Payable more than 31 days prior to the Transfer Date exceed 20% of the total purchase price.

(4) Short term agreements for the sale and purchase of property and short term options are agreements or options under which settlement is required within -

(a) 93 days of entry into the contract in the case of real property; or

(b) 63 days of entry into the contract in the case of other property. Such short term agreements or options are excepted from the accruals provisions of the Act. A private or domestic agreement for the sale and purchase of property as defined in section 64B(1) is also an excepted financial arrangement.

(5) For all deferred property settlements, a core acquisition price must be determined as at the date on which the first right in the property is transferred; for ease of reference, this date is called the "Transfer Date" in this determination. Sections 64BA(2) and(3) of the Act define "acquisition price" in terms of the "core acquisition price", which is itself defined in section 64BA(1). In section 64BA(1)(c)(i) an amount "w" is defined as the lowest price that the buyer and seller would have agreed upon for the property on the basis of Payment in full at the time at which the first right in the Specified Property is to be transferred. If there is no such lowest price, then paragraph (c)(ii) provides that "w" shall be "the discounted

value of the amounts Payable for the Specified Property as determined pursuant to a determination made by the Commissioner under section 64E(1)(f) of this Act".

(6) As indicated in subclause 1(1) above, this determination requires the discounted value of the amounts Payable to be calculated at an interest rate ascertained in accordance with Determination G23: *Specified Rate*, as at the Transfer Date of the Specified Property. The Specified Rate is the market yield applying to Bank Bills of a similar term to the Credit Term; if the Credit Term is longer than twelve months the market yield on New Zealand Government Securities must be used.

(7) The amounts Payable are then discounted to the Transfer Date, using the yield so ascertained and the present value calculation Method A in Determination G10B: *Present Value Calculation Methods*, or an alternative method producing not materially different results. The sum of the discounted amounts and any deposit or other amounts Paid on or before the Transfer Date is the amount of "w" to be used for calculating the core acquisition price.

(8) The core acquisition price is used to determine the acquisition price of a Deferred Property Settlement in accordance with sections 64BA(2) or (3) of the Act.

(9) Once the acquisition price is known, income derived or expenditure incurred in relation to a Deferred Property Settlement shall be calculated as if the value of the Specified Property was equal to the amount of the core acquisition price using the yield to maturity method, which could be that determined in Determination G3: *Yield to Maturity Method* or Determination G11A: *Present Value Based Yield to Maturity Method*, or an alternative method producing a result which is not materially different.

(10) For the purposes of determining the income derived or expenditure incurred of a Deferred Property Settlement the yield to maturity method (or an alternative method producing not materially different results) will not apply:

(a) Where in relation to the Deferred Property Settlement any amount Payable or the date on which any amount is Payable is not known at the first balance date after Transfer Date; or

(b) Where the Credit Term of the Deferred Property Settlement is not known at the date of entry into the Deferred Property Settlement.

(11) Where the yield to maturity method can not be applied as the amounts Payable or the dates on which those amounts are Payable are not known, the "best estimate method" of determining income derived or expenditure incurred is to be used. The method requires each party to the arrangement to estimate the unknown variables (the Credit Term or the amounts Payable or dates on which amounts are Payable) in relation to the Deferred Property Settlement. The estimates should be fair and reasonable given the facts known in relation to the arrangement. The discounted value of the amounts estimated may be used as the basis for a yield to maturity accrual to determine income derived or expenditure incurred over the term of the Deferred Property Settlement.

(12) If estimates of the credit term of cash flows or the dates on which amounts are Payable change an adjustment must be made using the method specified in Determination G26: *Variations in the Terms of a Financial Arrangement* in the income year in which the change occurs.

That method requires an adjustment to be made in the year the estimates change. The effect of the adjustment is that the total income or expenditure up to the end of the year in which the estimates change is equal to what it would have been had the timing and exact details of the new estimates been known at the first balance date after the Transfer Date.

The adjustment must be made on the basis of fair and reasonable re-estimates of the unknown variables, which re-estimates are required to be undertaken by the parties for these purposes at the end of any year when actual cashflows and / or factual circumstances have rendered the original estimate (or previous re-estimate) no longer fair and reasonable.

(13) Where any party to a Deferred Property Settlement fails to undertake any such estimate or re-estimate or to communicate such estimate or re-estimate to the Commissioner in the income tax return for the relevant year, or where any party adopts an estimate or re-estimate which is in the Commissioner's opinion not or no longer fair and reasonable,

the Commissioner shall determine his own estimates and the method below shall be applied. Such estimates or re-estimates by the Commissioner may also be subject to change, so as to reflect different actual cashflows and / or factual circumstances, in the manner contemplated in subclause 1(12) and this subclause 1(13) of this determination.

(14) When settlement takes place the acquisition price should be recalculated using the discounting provisions of this determination for the purposes of the base price adjustment.

2. Reference

(1) This determination is made pursuant to sections 64E(1)(a), 64E(1)(f), and 64E(6) of the Income Tax Act 1976.

(2) Determination G17A: *Discounted Value of Amounts Payable in Relation to a Deferred Property Settlement Denominated in New Zealand Currency* is hereby rescinded with effect from the day on which this determination is signed.

3. Scope of Determination

(1) This determination shall apply to any deferred property settlement in relation to which a person is a holder or issuer, but shall not apply -

(a) To any Deferred Property Settlement where any amount Payable (other than the property that is the subject of the Deferred Property Settlement) is not denominated in New Zealand dollars; or

(b) To any Deferred Property Settlement where more than 20% of the amount Payable is required to be Paid more than 31 days prior to the Transfer Date.

4. Principle

(1) The discounted value of amounts Payable for the Specified Property is calculated as at the Transfer Date using -

(a) The Specified Rate; and

(b) Present value calculation Method A provided in subclause 6(2) of Determination G10B: *Present Value Calculation Methods*, or an alternative method producing not materially different results.

(2) The discounted value of the amounts Payable for the Specified Property enables the acquisition price for a Deferred Property Settlement to be ascertained for the purposes of determining income derived or expenditure incurred in any period and the base price adjustment.

(3) Where any amounts Payable or the dates on which any amounts are Payable are not known with certainty reasonable estimates of the unknown variables must be made to enable an estimate of income derived or expenditure incurred in any income year.

5. Interpretation

(1) In this determination, unless the context otherwise requires -

Expressions used have the same meanings as in the Act and where a word or expression is given a particular meaning for the purposes of sections 64B to 64M of the Act it shall have the same meaning as in the said sections 64B to 64M:

"the Act" means the Income Tax Act 1976:

"Bank Bill" means an order to Pay, denominated in New Zealand currency and drawn upon and accepted by a person who is a registered bank for the purposes of the Reserve Bank Act, 1989:

"Credit Term" means the period commencing on the day after the Transfer Date and ending on the day on which the Final Payment is required to be made:

"Deferred Property Settlement" means an agreement for the sale and purchase of property or a specified option under which any amount is Payable after the date on which the first right in the Specified Property is transferred:

"Final Payment" in relation to a Deferred Property Settlement means the last Payment required to be made by the issuer of a Deferred Property Settlement under the agreement, other than any amount that is not material in relation to the total value of consideration required to be given by the issuer under the financial arrangement:

"Paid", in relation to any amount Paid to or Paid by any person, includes distributed, credited, or dealt with in the interests of or on behalf of or to the order of the person; and, in relation to any amount, "Pay", "Payable" and "Payment" have corresponding meanings:

"Specified Property" in relation to a Deferred Property Settlement means the property that is the subject of the Deferred Property Settlement:

"Specified Rate" at any date shall be calculated pursuant to Determination G23: *Specified Rate*:

"Transfer Date" in relation to a Deferred Property Settlement means the day on which the first right in the Specified Property is transferred.

(2) Any reference in this determination to another determination made by the Commissioner shall be construed as including a reference to any fresh determination made by the Commissioner to vary, rescind, restrict, or extend that determination.

(3) For convenience, words and phrases defined in this determination are indicated by initial capital letters, but the absence of a capital letter shall not alone imply that the word or phrase is used with a meaning different from that given by its definition.

6. Method

Calculating the Acquisition Price for the Base Price Adjustment

(1) For the purposes of subparagraph (ii) of the definition of "w" in section 64BA(1)(c) of the Act, the discounted value of the amounts Payable for the Specified Property in relation to any person shall be calculated by summing -

(a) Every amount Payable to or, as the case may be, by the person for the Specified Property on or before the Transfer Date; and

(b) The present value as at the Transfer Date of amounts Payable to or, as the case may be, by the person for the Specified Property after the Transfer Date. Where the amounts Payable and the dates those amounts are Payable are not known at the first balance date after the Transfer Date, the acquisition price shall be calculated for the purposes of the base price adjustment when the financial arrangement matures.

(2) For the purposes of this determination, the present value as at the Transfer Date of the amounts Payable shall be calculated, subject to subclause (3) of this clause, using Method A provided in clause 6(2) of Determination G10B: *Present Value Calculation Methods*, or an alternative method producing not materially different results.

(3) For the purposes of subclause (2) of this clause the annual rate of interest at which the present value of the amounts Payable is required to be calculated shall be the Specified Rate determined as at the Transfer Date of the Specified Property and according to Determination G23: *Specified Rate*.

(4) The present value of the amounts Payable together with any deposit or amounts Paid on or before the Transfer Date is the amount "w" to be used to calculate the core acquisition price in accordance with section 64BA(1) of the Act.

(5) The core acquisition price is used to determine the acquisition price of a Deferred Property Settlement in accordance with section 64BA(2) or (3) of the Act. The acquisition price used will be used as variable "b" of the base price adjustment.

Calculating the Present Value of the Amounts Payable for the Purposes of Determining Income Derived or Expenditure Incurred During the Term of a Deferred Property Settlement

(6) Where the amounts Payable and the dates on which those amounts are Payable are known by the first balance date after the Transfer Date, the income derived or expenditure incurred in relation to a Deferred Property Settlement shall be calculated as if the value of the Specified Property were equal to the core acquisition price calculated in accordance with the Act and subclauses (1) to (5) of this clause, using the yield to maturity method or an alternative method producing not materially different results.

(7) Where the amounts Payable and the dates on which those amounts are Payable are not known by the first balance date after the Transfer Date, fair and reasonable estimates of the amounts Payable and the dates on which those amounts are Payable are to be used for the purposes of calculating the core acquisition price. The income derived or expenditure incurred in relation to a Deferred Property Settlement shall be calculated as if the value of the Specified Property were equal to the core acquisition price calculated in accordance with the Act and subclauses (1) to (5) of this clause, using the yield to maturity method or an alternative method producing not materially different results.

(8) If estimates of the credit term or amounts Payable or receivable or the dates on which amounts are Payable or receivable change, an adjustment must be made using the method specified in Determination G25: *Variations in the Terms of a Financial Arrangement* in the income year in which the change occurs.

That method requires an adjustment to be made in the year the estimates change. The effect of the adjustment is that the total income or expenditure up to the end of the year in which the estimates change is equal to what it would have been had the timing and exact details of the new estimates been known at the first balance date after the Transfer Date.

(9) Where any party to a Deferred Property Settlement fails to undertake any such estimate or re-estimate or to communicate such estimate or re-estimate to the Commissioner in the income tax return for the relevant year, or where any party adopts an estimate or re-estimate which is in the Commissioner's opinion not or no longer fair and reasonable, the Commissioner may determine his own estimates or re-estimates and the method used in this determination shall be applied. Such estimates or re-estimates by the Commissioner may also be subject to change, so as to reflect different actual cashflows and / or factual circumstances, in the manner contemplated in subclause 6(8) and this subclause 6(9) of this determination.

7. Examples

(1) A commercial property is sold for $1,500,000 under a sale and purchase agreement, subject to certain planning consents being obtained.

A deposit of $150,000 is Paid on 20 December 1988, when the agreement is entered into. The balance of $1,350,000 is Payable in two equal instalments due 3 and 6 months after the date of possession.

Under the agreement, possession passes to the purchaser on the date the sale becomes unconditional; the purchaser has no other prior rights.

The purchaser's balance date is 31 March.

On 3 March 1989 the planning consents are obtained and the sale becomes unconditional.

The Credit Term of the agreement (3 March 1989 to 4 September 1989) is 185 days (or 2 quarters). As this is under twelve months the yield on Bank Bills must be ascertained.

The yield on Bank Bills of a similar term to the Credit Term ascertained on 20 December 1988 pursuant to Determination G23: *Specified Rate*, is 13.2%.

In this case, the purchaser is the "issuer" for purposes of the accruals regime.

Method A of Determination G10: *Present Value Calculation Methods*, is applied to calculate the present value as at 3 March 1989 ("the specified date") as follows -

R = 13.2% (the Specified Rate)

N = 4 (since the Payments are at quarterly intervals)

$$F = \frac{R}{100 \times N}$$

$$= 0.03300$$

At 3 June 1989:

A = 0

B = $675,000 (Payable by the issuer or receivable by the holder on 4 September 1989)

C = 0 (Payable by the holder or receivable by the issuer)

thus the present value at 3 June 1989 =

$$\frac{A + B - C}{1 + F}$$

= $653,437

At 3 March 1989:

A = $653,437, B = $675,000, C = 0

therefore the present value at 3 March 1989 =

$$\frac{A + B - C}{1 + F}$$

= $1,285,999

To this must be added the $150,000 deposit, giving a total present value of $1,435,999 which is the item "w" used in calculating the core acquisition price.

For the purposes of recognising the expenditure incurred in the1989 and 1990 income year Determination G3 is used (alternatively, G11A could be used), where -

R = 13.2%

N = 4

F = 0.0330

The expenditure incurred for the first 3 months is -

$1,285,999 x 0.0330 = $42,437.96

This expenditure is allocated to the 1989 income year in accordance with Determination G1A -

1989 income year - 28 days = $12,915.90

On the maturity of the financial arrangement, in the 1990 income year, a base price adjustment is calculated to arrive at the expenditure deemed to be incurred.

Base Price Adjustment = a - (b + c) where -

a = all consideration Paid = $1,500,000

b = the acquisition price = $1,435,999

c = expenditure incurred in previous income years = $12,915.90

bpa = $51,085.10 which is deemed to be expenditure incurred in the 1990 income year.

As this is a positive amount it is deemed to be income derived by the holder in that income year.

(2) An agreement for the sale and purchase of a rural property (which is to be subdivided) was entered into on 10 September 1990. The terms of the agreement are:

Price: $525,000 (including the deposit)

Deposit: $25,000 Paid on 10 September 1990

Possession: 1 February 1991

Settlement: On the later of 1 August 1991 or 14 days after deposit of the subdivision plan in the land office

The lowest price, at the time the agreement for the sale and purchase of property was entered into on the basis of Payment in full on the date the property is transferred, has not been agreed between the parties.

This determination requires the buyer and seller to make a fair and reasonable estimate of the anticipated settlement date in order to calculate income or expenditure accruing at balance date.

The acquisition price for the purposes of the base price adjustments will be recalculated if the facts change from those which are estimated.

It would be appropriate in this case to expect settlement on 1 August 1991, the last day for settlement under the terms of the agreement for the sale and purchase of property. The appropriate calculations to determine income derived or expenditure incurred for the purchaser are shown below. The purchaser has a 31 March balance date and is the "issuer" for purposes of the accruals legislation.

The Credit Term of the agreement (1 February 1991 to 1 August 1991) is 181 days. As this is under twelve months the yield on bank bills must be ascertained in order to discount the purchase price.

The yield on bank bills of a similar term to the Credit Term on 20 December 1988 pursuant to Determination G23: *Specified Rate*, is 11.5%.

Method A of Determination G10B: *Present Value Calculation Methods*, is applied to calculate the present value as at 1 February 1991 ("the specified date") as follows-

R = 11.5% (the Specified Rate)

N = 2 (since the Payments are at half yearly intervals)

$$F = \frac{R}{100 \times N}$$

$$= 0.0575$$

At 1 February 1991:

A = 0

B = $500,000 (Payable by the issuer or receivable by the holder, estimated to occur on 1 August 1991)

C = 0 (Payable by the holder or receivable by the issuer)

whence present value at 1 February 1991 =

$$\frac{A + B - C}{1 + F}$$

$$= \$472,813$$

To this must be added the $25,000 deposit, giving a total present value of $497,813. This amount is used as the basis for an accrual calculation.

For the purposes of recognising the expenditure incurred in the 1991 and 1992 income years, Determination G3 or Determination G11A or an alternative method producing not materially different results may be used. (Note: As there is only one period of less than a year and no discount or premium a yield to maturity accrual method will produce the same result as spreading the difference between the present value and the total amount Payable on a daily basis over the term of the arrangement).

The amount allocated to each day in the period is:

$$\frac{\$(525{,}000 - 497{,}813)}{181} = \$150.20$$

There are 58 days between 1 February and 31 March therefore expenditure incurred in the 1991 financial year is:

$150.20 x 58 = $8,711.60

If settlement occurs as expected on 1 August 1991, a base price adjustment is calculated to determine income derived or expenditure incurred. The acquisition price for the purposes of the base price adjustment will be as calculated above.

Base Price Adjustment = a - (b + c) where:

a = all consideration Paid = $525,000

b = the acquisition price = $497,813

c = expenditure incurred in previous income years = $8,711.60

bpa = $18,475.40, which is deemed to be expenditure incurred in the 1992 income year.

If, however, the settlement date differs from 1 August 1991, the acquisition price for the purposes of the base price adjustment should be recalculated using the method provided in this determination.

(3) The assets of a company are sold on a deferred Payment basis for a price which is in part to be determined by the profitability of the company over the next 36 months.

The terms of the arrangement are as follows:

Price: $1,300,000 plus 10% of profits for the next three years

Deposit: $100,000 Paid on 10 September 1990

Possession: 1 February 1991

Settlement: Half-yearly instalments of $200,000 on 1 August and 1 February plus 10% of profits on 1 February each year.

The cashflows in relation to the arrangement, including the profits forecast (based on previous company data and forecast trends in the business, costs, capital expenditures, etc.) by the buyer, are:

Date	Amount	Profit	Total
Deposit	100,000		100,000
1/8/91	200,000		200,000
1/2/92	200,000	25,000	225,000
1/8/92	200,000		200,000
1/2/93	200,000	30,000	230,000
1/8/93	200,000		200,000
1/2/94	200,000	40,000	240,000

The buyer and the seller were unable to agree on a lowest price which is why the percentage of profits option was adopted. An interest element has been capitalised into the cost of sale.

The seller (holder) is obliged to return accrual income associated with the transaction. The buyer (issuer) will seek a deduction for accrual expenditure incurred. As the lowest price was not agreed the discounted value method applies. This example looks at the calculations made by the buyer.

The Credit Term of the agreement (1 February 1991 to 1 February 1994) is 1,096 days (or 6 half year periods). As this is over twelve months the yield on New Zealand Government Stock of a similar term must be ascertained. The yield on Government Stock of a term similar to the Credit Term on 1 February 1991 pursuant to Determination G23: *Specified Rate* is 10.0%.

In this case, the purchaser is the "issuer".

Method A of Determination G10: *Present Value Calculation Methods,* is applied to calculate the present value as at 1 February 1991 (the "specified date") as follows:

R = 10.0% (the Specified Rate)

N = 2 (since the Payments are at half- yearly intervals)

$$F = \frac{R}{100 \times N}$$
$$= 0.05$$

At 1 August 1993:

A =0

B = $200,000 + (0.10 x $400,000) (Payable by the issuer or receivable by the holder as at 1 February 1994)

C =0 (Payable by the holder or receivable by the issuer) therefore the present value at 1 February 1991 =

$$\frac{A + B - C}{1 + F}$$

= $228,571

At 1 February 1993:

A = $228,571

B = $200,000

C = 0

therefore the present value at 1 February 1991 =

$$\frac{A + B - C}{1 + F}$$

= $408,163

It will be found that the present value of the cashflows, by continuing to discount as shown above and in accordance with Determination G10B, is $1,192,343 (which figure is arrived at as demonstrated in the table below). This amount is the value of the property for the purposes of a yield to maturity accrual.

Date	Amount	Profit	Total	Present Value
Deposit	100,000		100,000	100,000
1/8/91	200,000		200,000	190,476
1/2/92	200,000	25,000	225,000	204,082
1/8/92	200,000		200,000	172,768
1/2/93	200,000	30,000	230,000	189,222
1/8/93	200,000		200,000	156,705
1/2/94	200,000	40,000	240,000	179,092
				1,192,345

The amounts calculated using the yield to maturity method in Determination G3: *Yield to Maturity Method* will be expenditure incurred by the buyer of the property. The results are shown in the following table. These amounts are spread on a daily basis between income years using Determination G1A as follows:

This amount can be used as the basis of a yield to maturity accrual. The cashflows and expenditure incurred in each period are:

	Cashflows	Cumulative Discounted Cashflows at Period End	Cumulative Discounted Cashflows at Period Beginning	Expenditure Incurred
		(y)	(z)	(y - z)
1/2/95	(240,000)	240,000	228,571	11,429
1/8/94	(200,000)	428,571	408,162	20,409
1/2/94	(230,000)	638,162	607,773	30,389
1/8/93	(200,000)	807,773	769,308	38,465
1/2/93	(225,000)	994,308	946,960	47,348
1/8/92	(200,000)	1,146,960	1,092,343	54,617
1/2/92	1,192,345			
	(100,000)			
				202,657

The yield to maturity rate (note that it is assumed no fees or other Payments are made in relation to the financial arrangement) is 10.0%.

Period Ending	Expenditure in Respect of Period	Days in Period	Allocation to Income Year	Days	Amount	Total Amount
1/2/95	11,428	184	1994/95	184	11,428	25,297
			1994/95	123	13,869	
1/8/94	20,408	181	1993/94	58	6,539	63,068
1/2/94	30,389	184	1993/94	123	30,389	
			1993/94	123	26,140	
1/8/93	38,466	181	1992/93	58	12,326	96,586
1/2/93	47,348	184	1992/93	184	47,348	
			1992/93	123	36,912	
1/8/92	54,618	182	1991/92	59	17,706	17,706
1/2/92						
	202,657	1,096		1,096	202,657	202,657

Note: The yield to maturity method will enable the calculation of an amount of income or expenditure for the final year to which a financial arrangement relates. However for the purposes of calculating the amount deemed to be income derived or expenditure incurred in the final income year, it is necessary to apply section 64F of the Act - the base price adjustment.

On 1 February 1993 the profits of the company are $500,000. The buyer therefore Pays $50,000 to the purchaser. The buyer's forecast of future Payments remains as originally estimated. The method in Determination G25: *Variations to the Terms of a Financial Arrangement* is used to calculate expenditure incurred in the period and future income years

That is, if the changed cashflows had been known at the beginning of the arrangement the present value would be $1,215,019 and the yield to maturity rate is 10.0%.

The cashflows and expenditure incurred in each period are:

	Cashflows		Expenditure Incurred
1/2/95	(240,000)	payment	11,427
1/8/94	(200,000)	payment	20,408
1/2/94	(230,000)	payment	30,389
1/8/93	(200,000)	payment	38,466
1/2/93	(250,000)	payment	48,539
1/8/92	(200,000)	payment	55,752
1/2/92	1,215,019	value of property	
	(100,000)	deposit	
			204,981

The amounts would be spread between income years as follows:

Period Ending	Expenditure in Respect of Period	Days in Period	Allocation to Income Year	Days	Amount	Total Amount
1/2/92						
1/8/92	55,752	182	1991/92	59	18,073	18,073
			1992/93	123	37,679	
1/2/93	48,539	184	1992/93	184	48,539	
1/8/93	38,466	181	1992/93	58	12,326	98,544
			1993/94	123	26,140	
1/2/94	30,389	184	1993/94	184	30,389	
1/8/94	20,408	181	1993/94	58	6,539	63,068
			1994/95	123	13,869	
1/2/95	11,427	184	1994/95	184	11,427	25,296
		1,096		1,096	204,981	

Using the formula in Determination G25, expenditure incurred in the 1993 income year is:

a = 0

b = expenditure incurred in the current and previous income years had the changes been known as at the Transfer Date.

= 18,073 + 98,544

= 116,617

c = 0

d = expenditure incurred in previous income years

= 17,706

Thus, a - b - c + d = -98,911

This amount is expenditure incurred by the issuer in the 1993 income year. If the remaining estimates are accurate the expenditure incurred in the respective income years would be as follows:

1992	17,706
1993	98,911
1994	63,068
1995	25,296
	204,981

A party will be required to change an estimate or re-estimate at the end of any year where the actual cashflows and / or factual circumstances are such that the applicable estimate or re-estimate is no longer “fair and reasonable”. In default of any such estimate or re-estimate, the Commissioner may adopt or substitute his own estimates.

Thus, if the cashflows change from estimates in the 1994 year to an extent that the re-estimates are no longer fair and reasonable, the method in Determination G25 may again be used to calculate expenditure incurred.

This determination is signed by me on the 28th day of May in the year 1992.

R D Adair
Deputy Commissioner of Inland Revenue

Determination G25: Variations in the Terms of a Financial Arrangement

This determination may be cited as "Determination G25: Variations in the Terms of a Financial Arrangement".

1. Explanation

(1) A financial arrangement may be varied for many reasons. It may be varied by mutual agreement between the parties, by operation of the terms of the arrangement (such as an option), or by a partial remission of debt. One way of effecting a change is by terminating the existing financial arrangement and issuing a new one. That situation is straight forward and does not need a specific determination. A base price adjustment is calculated and income or expenditure under the new financial arrangement is calculated using the yield to maturity method or an appropriate alternative.

(2) This determination applies where the variation is effected by changes to the original financial arrangement. Such changes may have been contemplated or anticipated in the original financial arrangement, for example:

(a) where there are options in the financial arrangement exercisable by either party, or

(b) where the original financial arrangement contains an intent that it will be altered in certain prescribed ways (or at the agreement of the parties) on the happening of some event.

In both these cases, at the date of acquisition, an accrual method can not be applied that will last unaltered until the maturity or other sale of the financial arrangement. This determination applies in such cases, even though the financial arrangement may set out quite clearly how it is to be altered. The determination does not apply where the terms of the financial arrangement are unequivocal as to the nature, time and amount of the changes made.

(3) At the most basic level, a variation will involve a change to the cash flows or the dates upon which they are payable.

(4) The method requires an adjustment to be made in the year of variation. The effect of the variation is that the total income or expenditure up to the end of the year of variation is equal to what it would have been had the timing and exact details of the variations been known at the date of issue or acquisition.

(5) The method is similar to that used in section 64D(4) of the Act where a taxpayer becomes a cash basis holder.

It is also similar to section 64C(2B) that gives a method of changing to the straight line method of accounting for financial arrangements from another method used.

(6) This determination does not apply to variable rate financial arrangements, where the only variation is a change in the index, price, or rate (these will be dealt with by a subsequent determination entitled *Variable Rate Financial Arrangements*). It does apply where a variation occurs that does not result from a change in the indicator rate. For example when the amount of principal is varied without a corresponding payment or the margin above the indicator rate is varied.

2. References

This determination is made pursuant to section 64E(1) of the Income Tax Act 1976.

3. Scope of Determination

This determination applies to any financial arrangement where the amounts payable, or the dates on which they are payable, are varied after the date of issue or acquisition, but it does not apply:

(a) To a Variable Rate Financial Arrangement (as defined in this determination) under which the only variation is a change in the economic, commodity, industrial or financial indices or prices, or banking rates or general commercial rates, or

(b) Where the variation is effected by the maturity or other termination of the financial arrangement and the issue of a new financial arrangement, or

(c) Where the variation is made according to the terms of the financial arrangement, which terms are unequivocal as to the nature, time and amount of the changes made.

4. Principle

The adjustment in this determination is made in the year of variation. The result is that the total accumulated income or expenditure up to the end of the year of variation is equal to that that would have applied had the changes been known at the date of issue or acquisition.

5. Interpretation

(1) In this determination, unless the context otherwise requires:

Expressions used have the same meaning as in the Act and where a word or expression is given a particular meaning for the purposes of sections 64B to 64M of the Act it shall have the same meaning as in the said sections 64B to 64M;

the "Act" means the Income Tax Act 1976;

"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.

(2) Any reference in this determination to another determination made by the Commissioner shall be construed as including a reference to any fresh determination made by the Commissioner to vary, rescind, restrict, or extend that determination.

(3) For convenience, words and phrases defined in this determination are indicated by initial capital letters. However, the absence of a capital letter shall not alone imply that the word or phrase is used with a meaning different from that given by its definition.

6. Method

(1) In the income year in which a financial arrangement is varied, a person who is the issuer or holder of the financial arrangement shall include, in calculating assessable income for the income year, an amount in respect of the financial arrangement calculated in accordance with the following formula:

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.

The amount so calculated shall:

(a) Where it is a positive amount, be deemed to be income derived by the holder or the issuer as the case may be:

(b) Where it is a negative amount, be deemed to be expenditure incurred by the holder or issuer as the case may be:

Provided that expenditure incurred by the holder, in the year in which the financial arrangement is varied, using this method shall not exceed total income derived by the holder in previous income years.

(2) In income years after the income year in which the financial arrangement is varied, income deemed to be derived or expenditure deemed to be incurred shall be calculated using the terms of the financial arrangement as varied and the provisions of the Act.

7. Examples

(1) Example A (a straight line method)

A New Zealand taxpayer issues (borrows) $8,800 on 10 July 1991 for 3 years with interest at 10% pa payable half-yearly in arrears. The loan is made by issuing $10,000 of notes at a discount. There are no fees.

The issuer is a New Zealand taxpayer eligible to use the straight line method (Determination G24), and chooses to do so. The issuer has a balance date of 31 March.

The total finance charges are:

+ 10,000	principal payable
+ 3,000	interest payable
- 8,800	principal received
+ 4,200	

Since the principal outstanding is fixed throughout, and all time units are of the same length, Method A of Determination G24: *Straight Line Method* was used to calculate expenditure incurred.

Accordingly, an amount of 4,200 / 6 = 700 would be expenditure incurred in each half year period.

On 10 July 1993, in consideration of the issuer's circumstances, the holder agrees to forgive the 5th and 6th interest payments but not the principal amount due. The treatment of the loan in the 1994 and following years is set out below.

If the actual cashflows had been known at the outset, namely:

10 July 1991	+ 8,800	principal received
10 January 1992	- 500	interest
10 July 1992	- 500	interest
10 January 1993	- 500	interest
10 July 1993	- 500	interest
10 July 1994	-10,000	principal paid
	- 3,200	expenditure incurred

then Method B of Determination G24: *Straight Line Method* would have applied because the length of the periods between payments are unequal. Under that method the Total Finance Charges of $3,200 would be spread over the term of the loan in proportion to the principal outstanding and length of each period. Using the formula in Method B of Determination G24, expenditure of $533.33 would have been incurred for each period.

Then using Determination G1A: *Apportionment of Income and Expenditure on a Daily Basis*, (on a 365 day basis) the position of the lender before and after the variation would be as follows:

Year Ending 31 March	Expenditure Incurred Original (1)	Changed (2)	Actual Expenditure Incurred
1992	1,016	774	1,016
1993	1,400 (3)	1,067	1,400
1994	1,400	1,067	492 (4)
1995	384	292	292
Totals	4,200	3,200	3,200

(1) Expenditure calculated using Method A of Determination G24: *Straight Line Method.*

(2) Expenditure calculated using Method B of Determination G24: *Straight Line Method.*

(3) The number of actual days was used to arrive at the 1992 figure (a broken period plus a leap year), whilst the annual payments were used for the 1993 and 1994 years.

(4) Expenditure calculated using this determination where:

a = 0
b = 774 + 1,067 + 1,067 = 2,908
c = 0
d = 1,016 + 1,400 = 2,416
so a - b - c + d = - 492 which being a negative amount is deemed to be expenditure incurred in the year.

In the 1995 income year the expenditure incurred would be calculated using the base price adjustment in section 64F where:

a = all consideration paid = 12,000
b = acquisition price = 8,800
c = expenditure incurred in previous years = 2,908

so a - (b + c) = 292, which because it is a positive amount is deemed to be expenditure incurred in terms of section 64F(4)(b)(i).

(2) Example B (a zero coupon loan)

On 15 April 1991 a 5 year zero coupon bond with a face value of $1,000,000 is issued for $500,000. The lender is a New Zealand taxpayer who balances on 31 March, and uses the yield to maturity method of accounting for financial arrangements.

By mutual agreement the debt is varied on 15 April 1993: the borrower repays $250,000, and the face value of the bond is reduced to $600,000.

The original yield to maturity is 14.870% pa, so that the income of the lender (the holder) would be as follows:

Year Ending 15 April	Opening Principal Outstanding	Accrual Income (1)	Closing Principal Outstanding
1992	500,000	74,350	574,350
1993	574,350	85,406	659,756
1994	659,756	98,106	757,862
1995	757,862	112,694	870,556
1996	870,556	129,444	0
		500,000	

(1) Calculated using the yield to maturity method and a rate of 14.870%.

If the changed cash flows had been known at 15 April 1991, namely:

15 April 1991	500,000 by lender
15 April 1993	250,000 by borrower
15 April 1996	600,000 by borrower

the yield to maturity would have been 14.235% pa and the income would have been as follows:

Year Ending 15 April	Opening Principal Outstanding	Accrual Income (1)	Principal Payments	Closing Principal Outstanding
1992	500,000	71,175	0	571,175
1993	571,175	81,307	250,000	402,482 (2)
1994	402,482	57,293	0	459,775
1995	459,775	65,449	0	525,224
1996	525,224	74,776	600,000	0
		350,000	850,000	

(1) using the yield to maturity method and a rate of 14.235%.

(2) 571,175 + 81,307 - 250,000 = 402,482

Then using Determination G1A: *Apportionment of Income and Expenditure on a Daily Basis* the position of the lender after the variation would be as follows:

Year Ending 31 March	Income Derived Original (1)	Income Derived Changed (2)	Expenditure Incurred
1992	71,303	68,258	71,303
1993	84,867	80,883	84,867
1994	97,584 (3)	58,279 (4)	51,250 (5)
1995	112,095	65,114	65,114
1996	128,770	74,401	74,401
1997	5,381	3,065	3,065
Total	500,000	350,000	350,000

Notes:

(1) Calculated using the Yield to Maturity Method and original cash flows.

(2) Calculated using the Yield to Maturity Method and changed cash flows.

(3) There are 350 days from 15 April 1993 to 31 March 1994, and 85,406 x 15 / 365 + 98,106 x 350 / 365 = 97,584

(4) Similarly, 81,307 x 15 / 365 + 57,293 x 350 / 365 = 58,279

(5) Expenditure calculated using this determination where:

a = 68,258 + 80,883 + 58,279 = 207,420

b = 0

c = 71,303 + 84,867 = 156,170

d = 0

so a - b - c + d = 51,250 which being a positive amount is deemed to be income derived for the 1994 income year.

In the 1997 income year the income derived would be calculated using the base price adjustment in section 64F where:

a = all consideration paid to the person = 850,000

b = acquisition price = 500,000

c = income derived in previous income years = 346,935

a - (b + c) = 3,065 which is a positive amount therefore in terms of section 64F(4)(a)(i) it is deemed to be income derived by the holder (lender).

This determination is signed by me on the 28th day of May in the year 1992.

R D Adair
Deputy Commissioner of Inland Revenue

Appendix B: Interest Deductibility - Leading Cases

Section 106(1)(h)(i) and (ia), Income Tax Act 1976

This appendix sets out in some detail the Commissioner's interpretation on several of the leading cases on interest deductibility which form the basis of the statement.

The change in wording of Section 106(1)(h)

All the previous cases on the deductibility of interest on borrowed capital related to section 106(1)(h)(i) in its old form. Interest under that section was deductible in so far as the Commissioner was satisfied that it was paid on capital employed in the production of assessable income.

The Income Tax Amendment Act (No.2) 1987 enacted the current form of section 106(1)(h) with effect from the income year commencing 1 April 1985. The amendment aligned the tests of deductibility in section 104 and 106(1)(h) so that any deemed interest under the accrual rules could satisfy the test for deductibility. This applied particularly to deemed interest from financial arrangements where there is no underlying principal (such as interest rate swaps). The amendment was not intended to change the existing law, but to extend it to include this category of interest.

In *Pacific Rendezvous*, the Court of Appeal stated that the test in section 104 is no more restrictive than the test in the (then) section 106(1)(h). The Court of Appeal added that the considerations under both the provisions would be the same. Implicit in this view is that the result under either test would be the same.

The Commissioner views the current law on interest deductibility on borrowed capital as governed by the principles laid down in *Public Trustee*, *Pacific Rendezvous*, *Eggers* and *Brierley*. Each of these cases is outlined below.

The Case Law on Interest Deductibility on Borrowed Capital

Public Trustee

The *Public Trustee* case involved the trustee of an estate that consisted partly of assets producing assessable income but principally of assets producing non-assessable income. The trustee did not have sufficient cash to meet the death duties. Rather than realise assets producing assessable income, the trustee borrowed money to meet the duties. The issue before the court was whether the interest on the borrowed capital was deductible.

The majority of the Court of Appeal held that the capital was employed in the production of both assessable and non-assessable income. Further, the amount of the interest deduction was a matter for the Commissioner. Apportionment of interest was not an issue in this case as the parties had agreed on a method. This case is examined in more detail under "Deductibility of Interest Incurred to Retain Assets Producing Assessable Income" below.

Pacific Rendezvous

The next case was *Pacific Rendezvous*. It involved capital borrowed to expand a motel business by adding additional units. The question was whether the interest on the capital was deductible. The taxpayer acknowledged that the dominant purpose of the borrowing was to increase the capital value of the motel before selling it, although the completed units were rented out until the business was sold, and did produce assessable income.

The Court of Appeal held that all the capital was used in the production of assessable income and the interest was fully deductible. The court approved the use of the capital as the appropriate test to determine the deductibility of the interest.

Eggers

The *Eggers* case involved capital borrowed to acquire a property which was to be farmed. The farm property was leased during development and pending substantial farming operations.

The Court of Appeal held that the leasing of the land was part of a wider income earning process. The court concluded that the borrowed capital was fully committed to the income earning process and there was no other use to which the land could be put. This meant the interest expenditure was fully deductible.

The court also considered the further issue of whether assessable income needed to be produced in the same income year in which the deduction was claimed. The court held that there was no such requirement and that the term "assessable income" used in section 106(1)(h) meant the assessable income of the taxpayer generally.

Brierley

The *Brierley* case is the most recent Court of Appeal decision on this issue. It is clear that the Court saw the decision as an application of the principles set out in the earlier cases of *Public Trustee*, *Pacific Rendezvous* and *Eggers*. These are the facts:

The taxpayer borrowed money to subscribe for shares in BIL cash issues. In the income tax returns for the years ended 31 March 1978 to 1981, the taxpayer claimed a deduction for the interest on the money borrowed to acquire the shares. The taxpayer received assessable dividend income from BIL shares in the 1979 income year only. In all other material income years the taxpayer received only non-taxable distributions from the BIL shares. The Commissioner's assessments apportioned the interest in the ratio of taxable dividends derived to the sum of taxable dividends plus cash distributions from capital sources in the relevant income years. The Taxation Review Authority allowed the deduction in full. The Commissioner appealed.

The Court of Appeal dismissed the appeal and held that:

(i) the interest was fully deductible as the capital was used in the production of assessable income in the material income years or future income years, and no identifiable part of the capital was used for the whole or part of the year in other ways;

(ii) the taxpayer's purpose in incurring the expenditure was not the test to be applied in determining whether the interest expenditure was deductible;

(iii) the taxpayer does not have to earn assessable income in the period to deduct the interest. The term "assessable income" as used in the section meant assessable income of the taxpayer generally rather than income in a particular accounting period; and

(iv) section 106(1)(h) provided a test for deductibility of interest independent of section 104.

Note: in the earlier case of *Pacific Rendezvous* Richardson J in his judgment did recognize that in some circumstances the income derived from the capital on which the interest is paid is so modest, if not inconsequential, that it might well have a bearing on the question of whether the funds can fairly be characterized as being employed in the production of assessable income. His Honour suggested that *Harley* v *CIR*; *Jenkins* v *CIR* [1971] NZLR 482 may have been such a case.

Deductibility of Interest Incurred to Retain Assets producing Assessable Income

The leading case on the deductibility of interest where the borrowed capital is indirectly used in the production of assessable income (for example, capital borrowed to retain assets producing assessable income) is *Public Trustee.*

The facts of the case are outlined under "Public Trustee" above. The issue was whether the interest on capital borrowed to pay death duties by the trustee of an estate was deductible.

The majority of the Court of Appeal held that part of the interest was deductible because the capital was used to produce assessable income. Their Honours could see no distinction between interest on capital used to acquire assets for producing assessable income (which is clearly deductible) and interest on capital borrowed to retain such assets. The court added that the amount of the interest that could be deducted was for the Commissioner to determine, since the capital was employed to produce both assessable and non-assessable income. The court recognised that there should be apportionment of interest in this type of situation.

In the leading judgment of the court, Myers C.J. acknowledged that the debt had to be incurred for the purpose of maintaining the income of the estate and preventing its reduction if the interest was to be deductible. If the debt was incurred for a purpose wholly unconnected with the production of the assessable income of the estate, then by inference the interest would not have been deductible. His Honour also distinguished between voluntary and involuntary expenditure. He held that interest on capital borrowed to meet death duties was deductible because the death duties were an involuntary expenditure that the trustee was compelled to pay.

That case establishes that interest is deductible to the extent that the taxpayer establishes that capital has been borrowed to meet involuntary expenditure to retain assets producing assessable income. However, if the capital is borrowed for purposes quite alien to the income producing asset (such as to meet a personal obligation), the interest would not be deductible.

Where the interest expenditure is also incurred to retain assets which do not produce assessable income, the interest will have to be apportioned. Only the interest which relates to retaining the assets which produce assessable income will be deductible.

For example, if a taxpayer who owns a farm borrows to meet obligations under a Matrimonial Property Act settlement instead of selling assets which produce assessable income to raise the funds, the interest on the borrowed capital will be deductible. The taxpayer must make the payment under statute, and in terms of *Public Trustee* the interest has sufficient nexus to the income producing activity.

If the interest is payable in preserving an asset which is used both for a private and domestic use (e.g., a homestead on the farm in which the taxpayer resides), and an income producing use, the interest must be apportioned. This is consistent with the decision in *Public Trustee* which accepted that interest is only deductible to the extent it is used in the production of assessable income.

This view is not precluded by the more recent decision in *Williams* v *CIR* (1988) 10 NZTC 5078. In that case the taxpayer was allowed an interest deduction in full on capital borrowed to meet a Matrimonial Property Act settlement. However, the issue of apportionment was not addressed by the court as it was not raised in the case.

The *Public Trustee* case considered a provision in the same form as the previous section 106(1)(h)(i). The principles in that case are applicable to section 106(1)(h)(i). and 106(1)(h)(ia).

The tests under both subparagraphs applying *Public Trustee* will be the same. Interest will be deductible under either subparagraph to the extent the taxpayer establishes that the capital is used to meet an involuntary expenditure in order to preserve an asset producing assessable income.

The onus will always be on the taxpayer to establish that the interest is deductible and what proportion of it is deductible. If there is no factual basis for the claim the interest is not deductible.