

THE TAXATION OF FINANCIAL ARRANGEMENTS

***A discussion document on
proposed changes to the accrual rules***

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Deputy Prime Minister
and Treasurer**

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FOREWORD

We are issuing this discussion document as part of a post-implementation review of the accrual rules contained in Part EH of the Income Tax Act 1994. It examines the problems and anomalies of the accrual rules and puts forward proposals to resolve them.

The accrual rules govern the taxation of financial arrangements. The scope of the rules is very wide, as they cover a broad range of transactions from straightforward loans to some extremely complex financing arrangements.

New Zealand has been a leader internationally in accrual legislation, having introduced the accrual rules in 1986 as a comprehensive set of rules for the taxation of financial arrangements. This review is therefore based on over ten years' experience of the rules for taxpayers, practitioners and administrators.

While the rules have been working reasonably well for straightforward debt instruments, and have proven to be sufficiently robust to deal with most financial innovation, application of the rules has not always been easy for those required to use them. Our aim in this review, therefore, is to simplify the rules wherever this is compatible with the basic policy underlying them, and with protection of the tax base.

This document raises the issues we know to be problematic, and invites discussion from interested parties on the policy solutions we have proposed. We look forward to receiving your submissions.

Hon Winston Peters
Deputy Prime Minister and
Treasurer

Rt Hon Bill Birch
Minister of Finance and
Minister of Revenue

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CHAPTER 1

THE ACCRUAL RULES

1.1 The accrual rules in Part EH of the Income Tax Act 1994 govern the tax treatment of financial arrangements.

1.2 The purpose of the accrual rules is:

- to bring to tax all returns on financial arrangements on an accrual basis over the term of the arrangement, including the returns on instruments that can alter the incidence of those returns, such as derivatives;
- to overcome deferral of tax by spreading income and expenditure over the term of the arrangement; and
- to set out the methods by which expected income and expenditure are calculated and allocated to an income year.

1.3 This was discussed by Gault J in *CIR v Dewavrin Segard (NZ) Limited*:

The broad object or purpose to be inferred from the provisions is to bring in as assessable for tax income and to allow deduction of expenditure across the term of financial arrangements in which they are earned or incurred. This would overcome avoidance by the loading of expenditure at the commencement of the arrangement and deferring or capitalising income.¹

What is within the rules

1.4 Financial arrangements are very broadly defined in the Income Tax Act 1994. They encompass virtually any arrangement in which there is an exchange of consideration with an element of deferral or futurity.

1.5 Examples of a financial arrangement include:

- loans including those evidenced by mortgages and debentures;
- credit card accounts;
- forward contracts;
- agreements for sale and purchase of property with deferred payment.

¹ (1994) 16 NZTC 11,048 (CA).

1.6 Excepted financial arrangements are specifically excluded from the definition of financial arrangements and are thereby excluded from the ambit of the accrual rules. Excepted financial arrangements fall into three categories:

- equity instruments, such as shares;
- those excluded for compliance costs reasons, for example, short-term trade credits and short-term agreements for the sale and purchase of property; and
- those arrangements already subject to a specific tax regime such as life insurance, superannuation schemes and farm-out arrangements.

How the rules apply

1.7 The core of the accrual rules comprises the two basic requirements that:

- income from a financial arrangement is brought to tax regardless of whether that gain is of an income or capital nature; and
- income or expenditure in relation to a financial arrangement is spread over the term of that financial arrangement.

1.8 All income is taxable. Expenditure may or may not be deductible, depending upon the general deductibility provisions within the Act. An automatic deduction is currently available to holders for expenditure arising from a base price adjustment.

1.9 When the financial arrangement is entered into, the expected cashflows (and other consideration) are used in determining what amounts of income or expenditure will be spread. Thus expected income or expenditure is spread over the term of the financial arrangement, but all income or expenditure, expected or unexpected, is taken into account on maturity or disposal. The exception to this is where a market valuation method of spreading is used, because this brings unexpected income or expenditure to account at each balance date.

1.10 The rules provide the methods by which the income and expenditure are spread over the term of the arrangement. The primary method is the yield to maturity method. Other methods are acceptable if they produce a result which is not materially different from yield to maturity, are commercially acceptable, and are used by the taxpayer in its financial reporting. Other spreading methods, including an annual market valuation, are permissible provided certain criteria are met.

- 1.11 When taxpayers sell or dispose of their interest in a financial arrangement, or the financial arrangement matures, the base price adjustment is calculated. This is a wash-up provision that calculates all remaining income and expenditure in relation to the financial arrangement that have not been brought to tax under the spreading provisions.
- 1.12 The determinations procedure in section 90 of the Tax Administration Act 1994 gives the Commissioner of Inland Revenue power to issue determinations in relation to the accrual rules. They cover matters such as the application of the yield to maturity method to particular financial arrangements and acceptable alternative methods of spreading income and expenditure where the yield to maturity method cannot be used. Such determinations are legally binding on both the taxpayer and the Commissioner.
- 1.13 In order to reduce compliance costs, taxpayers who fall below appropriate thresholds are not required to spread their gains over the term of the financial arrangement; instead, they are permitted to continue to recognise income under normal principles. However, they are still required to recognise all gains from a financial arrangement, whether income or capital, and to carry out a base price adjustment to ensure that all such gains have been brought to tax.

Historical background to the accrual rules

- 1.14 The origins of the present accrual rules lie in the announcement of the Government in the 1986 Budget of the introduction of new timing rules for the recognition of interest income and expenditure.
- 1.15 The introduction of the accrual rules was considered necessary to curb tax avoidance and to protect the tax base. The law prior to the introduction of the accrual rules permitted taxpayers to defer or effectively eliminate their income tax liabilities by bringing forward deductions or deferring income. This was especially evident when one party to a transaction was able to advance deductions for expenditure and the other was able to delay recognition of income.
- 1.16 The consultative process on the proposals began with the release of the Government's *Consultative Document on Accrual Tax Treatment of Income and Expenditure* in October 1986.
- 1.17 Following the release of the consultative document, the Government appointed a consultative committee of tax practitioners and financial experts to hear submissions on the proposals and prepare the draft legislation necessary to implement the accrual rules. The committee widened the scope of the original scheme proposed in the consultative document.

- 1.18 The consultative document envisaged accrual rules redressing anomalies in the taxation of debt and debt instruments. The committee, however, was aware of the ease of substitution of such instruments by derivatives and combinations of transactions that were not traditional debt instruments, and the consequent opportunity for tax avoidance. Therefore, primarily owing to anti-avoidance concerns, the resulting legislation encompassed a wide range of commercial dealings.
- 1.19 The accrual rules, having been subjected to further refinements through the legislative process, were passed into law on 31 March 1987 in the form of the Income Tax Amendment Act 1987. The rules were radically different from previous tax law. They departed from the traditional recognition of the distinction between capital and revenue, and the requirement to spread income was much wider than was previously the case.

Previous reform

- 1.20 Not surprisingly for such a radical and complex piece of fiscal legislation, the accrual rules have not been problem free. In 1988 the Government appointed another committee of consultants in response to growing concern about the effect of the accrual rules on property transactions and, in particular, the effect of the abolition of the distinction between capital and revenue. The recommendations in the subsequent report of the committee led to legislative changes in 1988. Inland Revenue commissioned a report in 1989 on the effect of the accrual rules on trusts and estates as a result of uncertainty over the application of the rules in this area.
- 1.21 Some aspects of the accrual rules were also considered by the Tax Simplification Consultative Committee. Following recommendations made by this committee in its final report in July 1990, the accrual rules were amended to allow for simplified accrual calculations for certain taxpayers and to increase the thresholds for qualification as a cash basis holder.
- 1.22 The Consultative Committee on the Taxation of Income from Capital (the Valabh Committee) was appointed in December 1989 to hear public submissions on matters concerning the design and implementation of reforms outlined in the *Consultative Document on the Taxation of Income from Capital*.
- 1.23 The Valabh Committee highlighted the accrual rules as an area of taxation law requiring review. Following the release of the committee's final report in July 1992, legislation was introduced to deal with hire purchase agreements and bad debts.
- 1.24 In this document we have drawn on the excellent work of that committee, as well as that of other commentators.

CHAPTER 2

THE REVIEW AND SUMMARY OF PROPOSALS

The purpose of this discussion document

- 2.1 This discussion document is part of a post-implementation review of the accrual rules. It examines the problems and anomalies of the accrual rules and puts forward proposals to resolve them. Notwithstanding those problems, the basic policy objectives underlying the rules are sound and they are essential to the protection of the tax base.
- 2.2 We seek submissions from the public on these proposals in order to develop simplified, more coherent and workable accruals legislation for Part E of the Act.

The main issues

- 2.3 In its report *The Operational Aspects of the Accruals Regime*, published in October 1991, the Valabh Committee noted that relatively few problems existed with the accrual rules in relation to the central areas on which they were originally focused, namely debts. However, the rules were ultimately applied across a wide range of financial transactions. It is in these other areas that practical problems and uncertainties most frequently arise.
- 2.4 We agree with the Valabh Committee that the major problem behind most of the criticisms is the lack of clear statutory guidance on the boundaries of the accrual rules and, in particular, in the definition of the term “financial arrangement”. A clearer definition of this term would assist in the application of the rules. In the interests of certainty, taxpayers need to know whether particular transactions fall within the rules. It is generally acknowledged that the present definition is too wide, including within its scope some commercial transactions that were not originally anticipated as being subject to the rules.
- 2.5 Two other areas that have attracted criticism are the accrual treatment of foreign exchange gains and losses, and remission income. As regards the former, criticism was founded on hedging arrangements, where there is a mismatch between a taxpayer’s economic income arising from a hedged position and the taxable income from the same hedged position. Criticism of the debt remission rules has been largely based on opposition to the idea that such economic income should be subject to tax at all.

2.6 Other boundary issues that have arisen are:

- The definition of the term “excepted financial arrangement”. This term contains the specific statutory exclusions to the wide definition of financial arrangement and thus can govern whether or not the accrual rules apply in a particular situation.
- The application of the rules to assignments of income and debt defeasances, which can take a variety of forms. The present rules give no clear guidance as to which forms should be included and which should be excluded from their ambit.
- The application of the rules to wider transactions, elements of which are financial arrangements and elements of which are not.

2.7 Uncertainties arising from difficulties of application of the rules include:

- The distinction between “holders” and “issuers”. The rules depend on this distinction for, amongst other things, the calculation of the base price adjustment at maturity of the financial arrangement. In some circumstances it may not be clear which party to a financial arrangement is the holder and which is the issuer.
- The application of the rules on the death of a taxpayer who is a party to a financial arrangement. At present, there is uncertainty as to when a base price adjustment is required.
- The application of the rules to security arrangements.

2.8 Problems arise in many areas from the failure of the legislation to reflect the policy intent, including:

- the confusion that exists over the relationship between the accrual rules and other provisions in the Act, as set out in section EH 8;
- the lack of clarity in the distinction between agreements for sale and purchase of property, forward contracts and futures contracts as they are used in the rules;
- the overlap that can be found between the definitions of trade credit, short-term trade credit and short-term agreement for the sale and purchase of property.

The generic tax policy process

2.9 This review of the accrual rules is one of the elements of the generic tax policy process adopted by the Government for the development of tax policy in New Zealand. It requires the Government to review legislation after its introduction, to identify remedial issues and provide the opportunity for public comment.

- 2.10 The adoption of this process is one of a number of initiatives taken by the Government over recent years to ensure that the New Zealand tax system is effective and efficient.
- 2.11 This Government is committed to the clarification of tax legislation. This should bring about more logical, coherent and understandable legislation in which the policy intent is more apparent.
- 2.12 The policy review of the accrual rules outlined in this discussion document will form an important part of this process. It is timed to coincide with the rewrite of parts C, D and E of the Act.

Benefits of the review

- 2.13 The expected benefits of the review of the accrual rules include:
- improving the clarity of the rules to make them more workable for taxpayers, their advisers and Inland Revenue;
 - removing uncertainty by the resolution of questions of application of the accrual rules to specific areas; and
 - reducing administrative and compliance costs.

SUMMARY OF MAIN PROPOSALS

Definition of financial arrangement

The first two limbs of the definition of financial arrangement will be retained in principle. The reference to wider financial arrangements will be made more explicit.

Definition of excepted financial arrangement

The list of excepted financial arrangements will be expanded to exclude more arrangements from the ambit of the rules, such as some prepayments for goods and services, and employment contracts.

Wider financial arrangements

The concept of wider financial arrangements will be retained and the meaning of “solely attributable” in section EH 2 clarified.

Distinction between holder and issuer

The distinction will be removed leading to a rewriting of the base price adjustment formula, and alignment of the deductibility and the low compliance cost provisions for all parties to a financial arrangement.

Spreading provisions

The spreading provisions will apply to expected returns except where the market value provisions are applied. The requirement that Inland Revenue approve markets before a market valuation method can be applied will be removed. Taxpayers unable to use the yield to maturity method or determinations will be required to take into account the scheme of the accrual rules in choosing an allocation method. They must apply that method consistently to the same class of financial arrangements across income years.

Taxation of foreign exchange loans and forward contracts

All foreign exchange gains and losses will continue to be brought to tax under the accrual rules on the base price adjustment. Only expected foreign exchange gains and losses will be spread over the life of the arrangement. Forward rates will be used to measure expected foreign exchange gains and losses.

Assignments of income and debt defeasances

Absolute assignments of income and legal defeasances of debt will not create a new financial arrangement; an assignment or legal defeasance (novation) which absolutely disposes of the rights/obligations of an assignor/defeasor under an arrangement will terminate that financial arrangement for the assignor/defeasor. Arrangements other than novations or absolute assignments will create a new financial arrangement.

Partial assignments and defeasances

Partial assignments and defeasances of the cashflows under a financial arrangement will be required to be accounted for as a variation to a financial arrangement.

Debt remission

Amounts forgiven under a financial arrangement will continue to be treated as income. In certain circumstances, the sale of a debt to an associate of the debtor will be deemed to be settlement of the debt.

Specified or finance leases

Leases with financing characteristics entered into on or after 1 April 1999 will be included within the scope of the accrual rules. To avoid confusion with those leases entered into before 1 April 1999, leases that fall within the accrual rules will be referred to as “finance leases”. In line with the Valabh Committee recommendations, the definition of “finance lease” will be narrower than the current definition of “specified lease”.

Security arrangements

Guarantees, security arrangements and insurance contracts will be excluded from the accrual rules, except when they are substitutes for derivative transactions such as forward contracts.

Trusts and estates

A transfer of a financial arrangement, necessitating a base price adjustment, will be deemed to occur on the death of any party to a financial arrangement and on the distribution of a financial arrangement to a beneficiary under a will or on intestacy. Section EH 4(6) (natural love and affection) will be extended to cover debts owing by a trust to the settlor in some circumstances.

Deferred settlements

The rules applying to trade credits and agreements for the sale and purchase of property will be integrated. The rules for these agreements will be extended to include services.

Definitions

The definition of agreements for the sale and purchase of property, forward contracts and futures contracts will be clarified.

Miscellaneous issues

- Section 60 of the Tax Administration Act 1994 relating to disclosure of interrelated arrangements will be repealed.
- The scope of section GD 11(1) will be broadened to remove the limitation on Inland Revenue powers to set independent or market related prices.
- A distribution *in specie* by a company in liquidation will necessitate a base price adjustment.
- Temporary residents will be exempted from the requirement to calculate a base price adjustment under section EH 4(9)(d) if they become non-resident for tax purposes within three years of initially obtaining tax residence.

Relationship between the accrual rules and other provisions of the Act

Section EH 8(1) will be retained and will clarify the position that while the accrual rules govern timing and amount of gross income and expenditure, the core provisions determine assessability and deductibility.

Draft legislation

- 2.14 We have included at the end of some chapters indicative draft amendments to the existing legislation where we consider this will assist discussion. This is to illustrate the policy intent of the proposals in this document. The draft amendments are not, however, draft legislative proposals. Only when the policy has been finalised (after consultation) will legislation be drafted in bill form.
- 2.15 The draft amendments build on existing legislation. The final bill may propose a greater change in drafting style to create clearer legislation in plain English.

Submissions

- 2.16 We invite submissions on the matters set out in this discussion document, including the draft legislation, and any other aspect of the accrual rules not specifically referred to in this discussion document. When we consider there are specific issues on which we would appreciate comment, we have indicated this at the end of the relevant chapter. When this occurs, it is not intended to limit the scope of submissions.
- 2.17 All submissions should be addressed to:
- The Accruals Review
C/o General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington
- Facsimile: (04) 474 7215
- 2.18 Submissions should be made by 27 February 1998. They should contain a brief summary of their main points and recommendations. Submissions received by the due date will be acknowledged.

CHAPTER 3

THE DEFINITION OF FINANCIAL ARRANGEMENT

Proposed policy

- Retain the concept of a broad definition of financial arrangement as contained in subparagraphs (i) and (ii) of paragraph (a) of the current definition to ensure that debts, debt substitutes and derivatives are within the rules.
- Remove references to “promises” in subparagraph (ii).
- Include debts created by operation of law in subparagraph (i).
- Repeal subparagraph (iii) and replace it with a more targeted reference to wider financial arrangements.

The accrual rules and the definition of financial arrangement

- 3.1 The definition of financial arrangement sets the outer boundary of the accrual rules.
- 3.2 The accrual rules apply to every arrangement that is a financial arrangement within the definition in section OB 1. The only exceptions to this are:
- Certain arrangements that are *prima facie* within the definition of financial arrangement are explicitly excluded from the operation of the rules (excepted financial arrangements).
 - The status of certain parties to a financial arrangement may affect the application of the rules (non-residents and cash basis holders).
- 3.3 The definition is very wide and the boundaries are not precise. This is because the definition attempts to describe the characteristics of the transactions intended to be covered, rather than listing certain classes of transactions.

Practical difficulties

- 3.4 The current definition was deliberately cast very widely to minimise avoidance opportunities and to include both traditional debt and derivative instruments. However, it has proven to be insufficiently targeted. The broad definition gives rise to several problems.

Mutual promises

- 3.5 The current definition describes an arrangement in which one person provides money in consideration of a promise by another person to pay money in the future. “Money”, by definition, includes money’s worth, so should include the value of a future right. However, the second reference to “money” in the definition is to a promise to provide money in the future. This implies that when “money” is first referred to, that (first) consideration must be more immediate than a promise.
- 3.6 The resulting implication is that if the consideration to be provided by both parties is not to be provided until some time in the future (for example, deferred settlement agreement for the sale and purchase of property), the arrangement will not be a financial arrangement. If, on the other hand, promises were treated as consideration for accrual rules purposes, this lends weight to the argument that both the promise (the future right) and the actual consideration (the exercise of that right) would have to be valued.

Prepayments for goods and services, such as employment contracts, bus tickets and magazine subscriptions

- 3.7 Prepayments for goods and services, such as employment contracts, bus tickets and magazine subscriptions fall within the definition of financial arrangement. Any discount for prepayment is income for the purchaser which, in theory, should be accounted for on an accrual basis. To enforce this would give rise to unacceptably high compliance costs for taxpayers and administrative costs for the Government.

The relationships between paragraphs (i) and (ii) of the definition, and between paragraphs (ii) and (iii)

- 3.8 It is possible for a debt to be created by operation of law, rather than by agreement between the parties. Thus that part of the definition contained in paragraph (i) is potentially wider than (ii), in respect of debts and yet, the term “financial arrangement” itself implies some consensual agreement.
- 3.9 It is not clear whether paragraph (iii) is limited by reference to paragraph (ii) – that is, is an element of futurity required before an assignment is a financial arrangement?

Proposed reform

- 3.10 The Government has explored ways of limiting the definition of financial arrangement while still achieving the aim of the rules.

3.11 We consider that the core definition should be wide enough to include all transactions which could result in a return for any party. Our proposal, therefore, is to:

- retain in principle paragraphs (i) and (ii) of the current definition of financial arrangement;
- redraft paragraph (ii) to deal with mutual promises; and
- make it clear that debts arising by operation of law are included.

3.12 Because we have retained a wide definition of financial arrangement, we propose to expand the definition of excepted financial arrangement to deal with the issues such as small prepayments (see chapter 4).

The concept of a return

3.13 Some instruments that are not financing transactions *per se* are still within the scope of the accrual rules, but do not give rise to accrual income or expenditure. This is currently achieved under the accrual rules because the non-financing element of those financial arrangements is excluded from the income or expenditure calculation in the base price adjustment. Examples of these instruments are an agreement for sale and purchase where delivery and payment occur contemporaneously, and a New Zealand dollar denominated interest-free loan. In each of these cases, the transaction is a financial arrangement and a base price adjustment is required, but the base price adjustment will give a nil result.

3.14 We looked at several ways of excluding these arrangements from the scope of the rules without success. The alternative approaches we considered, and the reasons we rejected them, are set out later in this chapter.

Consideration

3.15 We have reviewed the terminology used throughout the accrual rules to describe payments and other consideration. As discussed above, if paragraph (ii) distinguishes between money, and a promise to pay money in the future, this implies that “money” must refer to immediate payment. However, the definition of money uses the term “right to money”. This reference to “promises” in the definition of financial arrangement can therefore be removed.

Absolute assignments

3.16 Chapter 9 deals with assignments and defeasances. For the reasons discussed there, we consider that an absolute assignment of a financial arrangement should not itself be a financial arrangement. Similar rules should be applied to assignments and defeasances of excepted financial arrangements. The reference to assignments and defeasances should be removed from the definition of financial arrangement.

Relationships between paragraphs (i) and (ii), and between paragraphs (ii) and (iii) of the definition.

- 3.17 Various commentators have considered paragraph (i) of the definition to be redundant because a debt falls within paragraph (ii). This is not necessarily the case. A debt can be created by operation of law, as well as by agreement between the parties. When such a debt carries a return, that return should be subject to the accrual rules. A debt created by operation of law is still a debt within subparagraph (i) of the definition, even though it is not a consensual arrangement within subparagraph (ii). Therefore subparagraph (i) is not redundant. We do not see any conflict between subparagraphs (i) and (ii) except where “arrangement” in the term of “financial arrangement” implies a consensual arrangement, and paragraph (ii) overrides the specific word “debt” in subparagraph (i). However, for certainty we propose that debts arising by operation of law be specified in the legislation.
- 3.18 The relationship between subparagraphs (ii) and (iii) is more complex. Subparagraph (iii) refers to arrangements that are of a substantially similar nature to those in (i) and (ii). It is not clear what substantially similar means in this context. Subparagraph (iii) seems to be operating as a general catch-all provision, and we do not believe this is appropriate. Such a provision is useful at the end of a list, but here a broad unfocused provision follows a very widely drafted definition.
- 3.19 It may need to be made explicit that tripartite arrangements and composite arrangements are within the definition in subparagraph (ii). If so, it should be stated explicitly. Therefore we recommend that subparagraph (iii) be repealed and replaced with a more targeted reference to wider financial arrangements.

Other options considered

Valabh Committee proposal

- 3.20 The main feature of the Valabh Committee proposal was to limit subparagraph (ii) of the definition to arrangements in which there is a reasonable expectation of a return. This proposal is problematic because it does not bring within the main definition transactions for which there is no certainty of a return, such as forward rate agreements and swaps. These types of transactions would have to be listed in a third part of the definition and would have to be continually amended to keep up with innovation in the financial markets. We consider this would eventually lead to the problems that prompted the introduction of the broad inclusive definition – namely, the definition would not encompass innovative debt substitutes.
- 3.21 We agree with the Valabh Committee that there should be a more extensive definition of excepted financial arrangement.

Modified Valabh proposal – equality of consideration

- 3.22 These difficulties with the Valabh Committee proposal could be remedied by excluding from paragraph (ii) of the definition, arrangements in which there is a reasonable expectation of equality of consideration.² This approach would mean that all arrangements in which there is an expectation of movement in value of the subject of the arrangement would come within the definition. The extent to which this movement in value might be taxed is limited by specific valuation rules. An example is the lowest price concept, which takes out of the calculation of income any movement in the value of property which is the subject of an agreement for the sale and purchase of property.
- 3.23 On closer investigation, however, this proposal would achieve little. A deferred settlement agreement for the sale and purchase of property, even with no implicit interest charge, would still be within the rules because the value of the property transferred might move. The taxpayer would still have to go through the base price adjustment calculation to find that, in that case, there was no accrual income or expenditure because of the valuation rules. An interest-free loan would still be a financial arrangement under this analysis, because it is a debt within paragraph (i) of the definition. A foreign currency denominated arrangement would also still be within the rules, because currency movements are always likely to occur.

Draft legislation**“Financial arrangement” – means**

- (a) Any debt (including any debt arising by operation of law);
- (b) Any arrangement under which a person obtains money in exchange for money provided by any person to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice);
- (c) An arrangement that meets the criteria of paragraph (b) and that includes or is comprised of any combination of financial arrangements or excepted financial arrangements or both;

other than an excepted financial arrangement that is not part of a financial arrangement.

² Certainty would be a better test in theory, but in practice this can never be achieved. For example, there might be an unpredictable default under a loan.

CHAPTER 4

THE DEFINITION OF EXCEPTED FINANCIAL ARRANGEMENT

Proposed policy

Expand the definition of excepted financial arrangement to clarify the boundaries of the accrual rules. The main expansions are:

- travellers' cheques;
- interests in a group investment fund, partnership or joint venture;
- security arrangements relating to credit risk;
- small variable principal debt instruments;
- employment contracts;
- small prepayments for goods and services; and
- warranties.

The accrual rules and the definition of excepted financial arrangements

- 4.1 A definition of excepted financial arrangement is needed to deal with arrangements that are financial arrangements within the core definition, but which for policy reasons should not be subject to the accrual rules. Those policy reasons are high compliance costs (as in short-term agreements for the sale and purchase of property); equity (as in shares); or when the arrangement is subject to its own rules (as in farm-out arrangements).

Practical difficulties and proposed reform

- 4.2 The current definition of excepted financial arrangement is too narrow. This means that the rules may be applied to arrangements that in policy terms are not intended to fall within their scope. The Valabh Committee recommended specific additions to the proposed definition of excepted financial arrangement if exclusion from the rules could not be achieved through contracting the definition of financial arrangement.³ We have reviewed the Valabh Committee recommendations and other proposals and detail our list of proposed exclusions below, from paragraph 4.5.

³ *Operational Aspects of the Accrual Regime: Discussion Paper*, October 1991, page 14.

Other options considered

- 4.3 We considered defining excepted financial arrangements by feature, such as describing equity as an excepted financial arrangement, and listing the features of equity in order to assist identification. However, we concluded that this would only create another uncertain boundary within the accrual rules, and that taxpayers are better served by a definitive list of arrangements that are specifically excluded. A similar idea was tried unsuccessfully in the United States in the 1980s,⁴ but the regulations defining the debt/equity boundary were withdrawn as they proved to be no more helpful than the case law.
- 4.4 Narrowing by detail implies that everything not on the list is a financial arrangement, and generally this is considered to be bad drafting style. However, when these exclusions are made for compliance cost reasons, the boundaries can be justified and they do not necessarily create pressure to extend them on other policy grounds.

Proposed changes to arrangements currently falling within the definition of excepted financial arrangement*A debenture to which sections FC 1 or FC 2 applies*

- 4.5 Debentures within sections FC 1 and FC 2 have the characteristics of an equity instrument. A share is defined in section OB 1 to include an interest in the capital of a company and any debenture to which section FC 1 or section FC 2 applies. This exclusion should therefore be repealed because it is covered by the general exclusion for shares.

Leases

- 4.6 Specified leases were excluded from the accrual rules because they had their own rules. Other leases were excluded because they are not financing transactions. Prepayments under a lease are dealt with under the accrual expenditure provisions in section EF1.
- 4.7 The Valabh Committee recommended bringing specified leases within the accrual rules. We agree with that proposal (see chapter 12). Finance leases entered into on or after 1 April 1999 will be financial arrangements. Other leases will continue to be excepted financial arrangements.

⁴ Treasury regulations proposed under section 385 of the Internal Revenue Code - first proposed in 1980 and withdrawn in 1983.

Short-term agreements

- 4.8 Trade credits will be integrated with the rules governing agreements for the sale and purchase of property. Short-term agreements for the sale and purchase of property will continue to be excepted financial arrangements but, as is now the case for short-term trade credits, will be able to be treated as financial arrangements on an elective basis. The short-term trade credit exclusion will be repealed, therefore, because it will be redundant.
- 4.9 Short-term agreements for the sale and purchase of property will also cover agreements for the provision of services (see chapter 15).

Proposed additions to the definition of excepted financial arrangement

Travellers' cheques

- 4.10 Currently, travellers' cheques are financial arrangements. Excluding them from the accrual rules will reduce compliance costs of accounting for changes in exchange rate movements between the date of purchasing travellers' cheques and the date they are presented.

Interest in a group investment fund

- 4.11 An interest in a group investment fund (GIF) is a type of equity interest. A group investment fund allows a trustee company to gather the funds of small investors into an administratively efficient entity. Although some aspects of the company taxation rules can apply to GIFs, an interest in a GIF is not an interest in a company (and therefore not a share) for the purposes of the Act.
- 4.12 The intention of the legislation is that equity instruments should not be included in the rules. In practice, Inland Revenue has taken the position that GIFs are not financial arrangements.⁵ The proposed amendment clarifies the intent of the legislation.

Interests in a partnership or joint venture

- 4.13 The Valabh Committee considered that partnership and joint venture interests were the major addition to the excepted financial arrangement definition in the "equity" category. It was never intended that such interests were financial arrangements and they will be added to the excepted financial arrangement list to make this clear. The exclusion does not extend to financial arrangements held or issued by the partnership or joint venture.

⁵ *Tax Information Bulletin*, No. 6, December 1989, page 1.

Security arrangements

- 4.14 Security arrangements will be included in the definition of excepted financial arrangement to the extent they relate to credit risk (see chapter 13). The exclusion will not extend to arrangements that secure a person against various price fluctuations, such as foreign exchange and interest rate movement, since these arrangements could be used as substitutes for derivative contracts. Insurance contracts that indemnify a person against foreign exchange movements should also be included in the accrual rules on the same basis.

VPDIs and promissory notes issued at par (including cheques) if the accounts or VPDIs do not exceed \$20,000

- 4.15 A variable principal debt instrument (VPDI) is defined in section OB 1 as a bank deposit account or other financial arrangement for which it is contemplated that the holder may advance further sums to the issuer upon demand. This would include most credit card facilities.
- 4.16 The rationale for excluding these small VPDIs is based on compliance costs, since record keeping for such an instrument over an extended period is onerous and there are no substantial deferral opportunities with these kinds of instruments. The exclusion will apply to New Zealand dollar as well as foreign currency denominated VPDIs. The limit of NZD20,000 per person is appropriate. It is the same threshold we have suggested for small prepayments of goods and services.

Employment contracts

- 4.17 An employment contract can be a financial arrangement because a person (employer) obtains money (in this case money's worth is represented by work) in consideration for a promise by any person (the employer) to provide money (wages or salary) to any person (the employee) at some future time or times.
- 4.18 We believe these would usually be excluded as short-term agreements for the sale and purchase of property (assuming these rules apply to services) based on a continuous supply. However, the matter is not beyond doubt, in our view. We therefore propose to add them to the excepted financial arrangement list.

Cash basis persons providing on demand loans without interest, discount or premium

- 4.19 Where a cash basis person provides a loan that is denominated in New Zealand currency, repayable on demand, and does not carry a premium, discount or right to receive interest, no accrual income or remission income can arise. For this reason the holder's interest in these loans will not be subject to the accrual rules.

Small prepayments for goods and services

- 4.20 The Valabh Committee recommended excluding contracts that are exclusively for the provision of services (except financial services). This was to make it clear that bus tickets and the like cannot be interpreted as falling within the definition of financial arrangement.⁶
- 4.21 This proposal conflicts with the committee's alternative proposal to include services in the definition of property and would be difficult to implement, as it requires a detailed definition of financial services.
- 4.22 Instead, we propose a \$20,000 threshold for prepayments for goods and services. This will avoid the unacceptably high compliance and administrative costs associated with small prepayments.

Arrangements in which the amount lent is denominated in a foreign currency

- 4.23 Any arrangement in which the rights acquired by a cash basis person are to obtain money lent, the money is expressed in a currency other than New Zealand dollars, and the person applies the money for private and domestic purposes is to be excluded from the accrual rules.
- 4.24 This exception is designed to cover private or domestic borrowings in a foreign currency, such as an overseas mortgage. The rationale for the exclusion is removal of the compliance costs of calculating foreign exchange gains and losses for relatively small transactions.
- 4.25 A transitional provision will apply when funds cease to be used for private and domestic purposes. It will operate by deeming the issuer to have issued a financial arrangement for an arm's length price at the time the borrowed money ceases to be used for private and domestic purposes.

Warranties

- 4.26 The Court of Appeal in *CIR v Mitsubishi Motors New Zealand Ltd*⁷ made it clear that a warranty and a sale and purchase agreement were one inseparable financial arrangement that was an excepted financial arrangement (a short-term agreement for the sale and purchase of property). However, there is a wider issue of whether warranties that are less well integrated with a sale and purchase agreement should be included in the accrual rules.
- 4.27 Warranties should not be accounted for under the accrual rules if the arrangements are not debt or debts substitutes. These should be treated consistently with other contingent contracts such as guarantees and insurance contracts.

⁶ *Operational Aspects of the Accruals Regime: Discussion Paper*, October 1991, page 22.

⁷ (1994) 16 NZTC, 11,099.

Draft legislation

“Excepted financial arrangement” – means:

- (a) An annuity for a term contingent upon human life or an annuity to which section CM 2 applies:
- (b) Membership of a superannuation scheme:
- (c) A specified preference share to which section FZ 1 applies:
- (d) Shares, or an option to acquire or to dispose of shares (other than withdrawable shares, as defined in section OB 1 of this Act) where those shares were or that option was acquired or issued by the person before 8.00 p.m. New Zealand Standard Time on 18 June 1987:
- (f) A lease other than a finance lease:
- (g) A bet on any –
 - (i) Race (as defined in section 2 of the Racing Act 1971):
 - (ia) Sporting event under a sports-betting system established under Part VB of the Racing Act 1971:
 - (ii) Game of chance, lottery, or prize competition (as those terms are defined in section 2 of the Gaming and Lotteries Act 1977):
 - (iii) New Zealand lottery or New Zealand prize competition (as those terms are defined in section 71 of the Gaming and Lotteries Act 1977):
- (h) An option to acquire or to sell or otherwise dispose of property (other than an interest in a financial arrangement) where the option was issued or acquired by the person after 8.00 p.m. New Zealand Standard Time on 18 June 1987 for private or domestic purposes only:
 - (i) A short-term agreement for the sale and purchase of property or services:
 - (j) A short-term option:
 - (k) A private or domestic agreement for the sale and purchase of property or services:
 - (l) A farm-out arrangement:
- (m) A hire purchase agreement (as defined in section 2 of the Hire Purchase Act 1971) entered into before 1 April 1993, or any assignment of such an agreement:

- (n) Travellers' cheques:
- (o) An interest as an investor in any group investment fund:
- (p) An interest as a partner in any partnership or an interest as a joint venturer in any joint venture but for the avoidance of doubt, this does not include financial arrangements held or issued by the partnership or joint venture:
- (q) A contract of insurance, a guarantee or indemnity unless that contract insures against risk of loss associated with movements in exchange rates, interest or commodity prices.
- (r) A warranty over goods or services:
- (s) In relation to any cash basis person, any arrangement where –
 - (i) The only rights acquired by the person are to obtain money lent; and
 - (ii) The money lent is expressed in a currency other than New Zealand currency; and
 - (iii) The money lent is applied, and continues to be applied, by the person wholly for private and domestic purposes:
- (t) In relation to any cash basis person, any New Zealand currency denominated arrangement involving money lent by that person under which the only rights acquired by the person are to the repayment on demand, without interest premium or discount, of the money lent:
- (u) Bank accounts, variable principal debt instruments and promissory notes issued at par (including cheque accounts) where the accounts or variable principal debt instruments to which the taxpayer is a party do not at any time during the year exceed in aggregate \$20,000:
- (v) Contracts of employment as defined in the Employment Contracts Act 1991:
- (w) Prepayments under an agreement for the sale and purchase of property or services, where the aggregate value of such prepayments made by the person at any time in the income year is less than \$20,000:

CHAPTER 5

WIDER FINANCIAL ARRANGEMENTS

Proposed policy

- Refer explicitly in the definition of financial arrangement to an arrangement that comprises a combination of financial arrangements, excepted financial arrangements, or both.
- Preserve the debt/equity boundary.
- Amend section EH 2 to clarify that gross income or expenditure will only be “solely attributable” to an excepted financial arrangement to the extent the gross income or expenditure could have been expected to arise, or be incurred, without the support of the wider financial arrangement.
- Exclude from wider financial arrangements the valuation rules for agreements for the sale and purchase of property and other arrangements.

Wider financial arrangements and the accrual rules

- 5.1 The current definition of financial arrangement can apply to a series of subordinate arrangements.
- 5.2 The concept of a wider financial arrangement is necessary because without it, the intent of the rules could be defeated. A wider financial arrangement can be constructed from a combination of financial arrangements or excepted financial arrangements to create the same return as a financial arrangement.
- 5.3 The return on a wider financial arrangement that is solely attributable to an excepted financial arrangement is excluded from the operation of the rules. The statutory provision giving effect to this is section EH 2:

The amount of the gross income deemed to be derived or the expenditure deemed to be incurred by a person in respect of a financial arrangement under the qualified accrual rules shall not include the amount of any income, gain or loss, or expenditure, that is solely attributable to an excepted financial arrangement that is part of the financial arrangement.

Practical difficulties

If the wider financial arrangement includes one or more excepted financial arrangements

- 5.4 The distinction between financial arrangement and excepted financial arrangement is reflected in the current rules in that any part of the income from a wider financial arrangement that is *solely attributable* to an excepted financial arrangement, is excluded by section EH 2. The confusion in this area arises from the fact that the accrual rules cover some debt substitutes, such as the loan element in a deferred settlement agreement for sale and purchase of property, and yet many equity instruments that on the surface appear to be debt substitutes are excluded by section EH 2. Thus the relationship between section EH 2 and the stated policy intent of the rules is not clear.
- 5.5 In practical terms, this means that it is not always clear whether a particular part of a wider financial arrangement should be excluded under section EH 2, and if so, how the amount to be excluded should be calculated.
- 5.6 Section EH 2 purports to exclude from the rules an amount of income that is solely attributable to an excepted financial arrangement, but gives no guidance as to how this amount is to be calculated. It is not clear what “solely” means in this context.
- 5.7 There are two extreme approaches to the interpretation of “solely attributable” in section EH 2:
- If the excepted financial arrangement would not have been entered into without the wider financial arrangement, none of the income from the wider financial arrangement is solely attributable to the excepted financial arrangement.
 - If part of the wider financial arrangement is an excepted financial arrangement, any income attributed to it by the arrangement is excluded from the accrual rules.
- 5.8 The first approach would render section EH 2 redundant, as it could never achieve its purpose of preserving the distinction between financial arrangement and excepted financial arrangement.
- 5.9 The second approach may be too simplistic. It should be clear that the parties to a financial arrangement cannot defeat the purpose of the rules by attributing income to an excepted financial arrangement that is part of a wider financial arrangement.

If all of the subordinate arrangements are financial arrangements

- 5.10 A wider financial arrangement can be a combination of arrangements that are financial arrangements in themselves. An example is a foreign currency denominated agreement to purchase several trucks over a three-year period, with different delivery and settlement dates for each truck.
- 5.11 There are currently no specific rules to guide taxpayers in the treatment of these arrangements. The wider financial arrangement could be broken down into its component parts (arrangement to purchase each truck) and each subordinate arrangement taxed as if it were a stand-alone financial arrangement. Alternatively, the entire agreement could be treated as one wider financial arrangement. If all the subordinate arrangements are subject to the same set of rules (for example, the consideration for each subordinate arrangement is valued in the same way) this would yield a result not materially different from the result achieved by breaking the arrangement down.
- 5.12 If the wider financial arrangement comprises financial arrangements that are subject to different valuation rules, the two approaches described above could give materially different results, and it is not clear which valuation rules should be used.

Options for change

- 5.13 The concept of a wider financial arrangement is necessary to counter the construction of financial arrangements to defeat the intention of the accrual rules.
- 5.14 Amalgamating the components into a wider financial arrangement is referred to as “integration”. Our rules do not adopt a full integration approach, as this is sustainable only where there is no distinction between financial arrangement and excepted financial arrangement to be preserved. Breaking a wider financial arrangement down into component parts is referred to as “bifurcation”. This is what section EH 2 aims to achieve.

If the wider financial arrangement includes one or more excepted financial arrangements*How should the amount to be excluded be calculated?*

- 5.15 Difficulties arise in determining the extent to which it is appropriate to separate out any part of the return on a wider financial arrangement that is properly attributable to an excepted financial arrangement, and in determining the best method for calculating any amount to be excluded. The excepted financial arrangement component of a wider financial arrangement should be separated out by using pricing or valuation rules. We propose that if the terms and conditions (including the consideration paid for the excepted financial arrangement) on which the excepted

financial arrangement are issued are such that it would stand alone on those terms and conditions, it can properly be said that the return on that excepted financial arrangement is solely attributable to the excepted financial arrangement. However, if those terms are dependent on the issue of the wider financial arrangement, the return cannot be said to be solely attributable to the excepted financial arrangement.

Convertible notes

- 5.16 This valuation approach is consistent with that adopted by the determinations dealing with convertible notes. Determination G22: *Optional Conversion Convertible Notes* sets out a method for determining that part of the acquisition price, and that part of the consideration, that is attributable to the excepted financial arrangement. The method involves taking the expected cashflows under the arrangement and discounting them back.⁸ This discounted amount gives the acquisition price for the debt component.

What excepted financial arrangements should be excluded?

- 5.17 Some financial arrangements are excluded from the accrual rules as a concession where the costs of complying would be onerous and there is little scope for defeating the intent of the rules. Short-term agreements that provide little scope for deferral are a good example of this. Unless the wider arrangement as a whole is an excepted financial arrangement, that concession need not apply. We consider that section EH 2 should not exclude those arrangements that are excepted financial arrangements on compliance cost grounds only. Examples of these are short-term agreements for the sale and purchase of property, travellers' cheques and some foreign currency denominated borrowings.

If all the subordinate arrangements are financial arrangements

- 5.18 If the wider financial arrangement comprises more than one financial arrangement, the consideration passing under that wider financial arrangement should be measured according to the value of that consideration on the day it passes under paragraph (e) of the definition of core acquisition price. There are special rules governing the value of consideration that passes under an agreement for the sale and purchase of property, hire purchase agreement and trade credit. These rules were developed to deal with transactions where the main purpose of the arrangement is to transfer property between the parties. Where property is being used as a vehicle for transferring some other benefit, those rules should not apply. In chapter 15 we discuss the definition of an agreement for the sale and purchase of property, and note that the special rules for valuing consideration under an agreement for the sale and purchase of property should not apply where the agreement contemplates settlement by

⁸ Using rates provided in Determination G10B: *Present Value Calculation Methods*, which are essentially market rates.

any means other than the delivery of the property. Our proposal here, that parties to a wider financial arrangement should not be able to take advantage of those rules, is consistent with that approach.

Other options considered

5.19 The boundary between financial arrangements and excepted financial arrangements is most marked in the cases of the debt/equity boundary. Many commentators have come to the view that the only solution to the difficulty with this boundary in the context of financial arrangements, is to remove the distinction altogether and tax all equity on an accrual basis.

5.20 We do not consider this to be a viable proposition. As discussed in chapters 3 and 4, there are valid reasons for preserving the distinction between financial arrangement and excepted financial arrangement:

- From the taxpayer's point of view, the debt/equity boundary could be undermined if merely by aggregating arrangements into a wider financial arrangement, equity was subject to the accrual rules. This would place more pressure on the definition of financial arrangement.
- It would not necessarily be clear to taxpayers whether various arrangements subject to their own regime (farm-out arrangements, insurance, shares) would be subject to the accrual rules or to their own regime.
- We have a well developed dividend imputation system for the taxation of equity and do not propose to interfere with that.

Specific issue for consultation

This chapter sets out the principles under which paragraph (c) of the proposed definition of financial arrangement and section EH 2 should be applied. We would like comment on any problems that might arise from the practical application of these principles.

CHAPTER 6

THE DISTINCTION BETWEEN HOLDER AND ISSUER

Proposed policy

Remove the distinction between holders and issuers and apply the same rules to any party to a financial arrangement. This will result in:

- The removal of the acquisition price terminology and the rewriting of the base price adjustment formula.
- The alignment of the deductibility rules for all parties to a financial arrangement so that expenditure arising on a base price adjustment will give rise to a deduction if the core deductibility tests are satisfied. If those deductibility requirements are not met, taxpayers who have been overtaxed in previous years may be entitled to a deduction. The maximum deduction will be equal to the amount of overtaxation in previous years.
- The cash basis concession (subject to certain thresholds) being extended to all parties to a financial arrangement who are natural persons. This will be optional.
- The repeal of the discretionary powers of the Commissioner in sections EH 1(9) and EH 3(2)(a).

The distinction between holder and issuer and the accrual rules

- 6.1 The accrual rules distinguish between holders and issuers of financial arrangements. The holder is generally the person who will receive a pecuniary benefit from the arrangement. The issuer is the person who is not the holder.
- 6.2 The distinction has evolved from the traditional concept of a debt instrument where a lender (the holder of the instrument) lends a principal amount to the borrower (the issuer of the instrument acknowledging the debt).

Practical difficulties

- 6.3 This terminology is not always appropriate. Financial risk management instruments such as options, forward exchange contracts, futures, swaps, and forward rate agreements incorporate risk and return concepts that are expressed differently from the lending of a principal amount. Some financial arrangements may not have any principal cashflows: they may simply contain a mechanism whereby it is agreed to settle in cash any difference arising under the arrangement.

6.4 Other problems with the distinction between holder and issuer are:

- A party to a financial arrangement can be a holder at times and an issuer at others. For example, as in a credit card account, where one can be in debit or credit.
- A party may be defined as the holder but in economic substance should be an issuer. An example of this is a property agreement in which the seller (defined as the holder) receives payment in advance of the delivery of the property.
- It is not always obvious which party is the holder and which party is the issuer. For example, under the pecuniary benefit test both parties may be a holder under a forward contract for foreign exchange.

Proposed reform

6.5 We propose to remove the distinction between holders and issuers and apply the same rules to any party to a financial arrangement.

6.6 This means we will have to deal with a number of issues where the current rules depend on that distinction, such as the base price adjustment formula, the concept of acquisition price, automatic deductibility for holders, and the cash basis holder's concession. These issues are dealt with in this chapter.

The base price adjustment

6.7 At present, for the purposes of the base price adjustment calculation, the amount of consideration paid to the holder is compared with the acquisition price paid by the holder in relation to the financial arrangement. The amount of consideration paid by the issuer is compared with the acquisition price paid to the issuer.

Example

With a loan of \$100 at 10% for one year, for the lender (holder) the base price adjustment would be "a" consideration of \$110, less "b" the acquisition price of \$100. This gives a result of \$10, which, because it is positive, is income for the holder.

The base price adjustment for the borrower (issuer) is "a" consideration paid of \$110 less "b" the acquisition price of \$100. This gives a result of \$10, which, because it is positive, is expenditure of the issuer.

6.8 Another way of expressing this relationship, but without distinguishing between holders and issuers, is to compare the amount of consideration paid to and by a person. Using this approach, a positive outcome is always income and a negative outcome always expenditure.

6.9 Our proposal is that the base price adjustment be changed to:

$$a - b - c + d + e$$

where:

- a = all consideration paid to the person (everything received)
- b = all consideration paid by the person (everything paid)
- c = income derived in all previous income years
- d = expenditure incurred in all previous income years
- e = any amounts that have been remitted by the person.

6.10 A positive amount would be gross income derived and a negative amount would be expenditure incurred. The expenditure would be subject to the core provisions of the Act to determine deductibility.

Example

Using the previous example, for the lender, the base price adjustment would be “a” consideration received of \$110, less “b” consideration paid of \$100, giving \$10, which, being positive, is income.

For the borrower, the base price adjustment would be “a” consideration received of \$100, less “b” consideration paid of \$110, giving (\$10), which, being negative, is expenditure.⁹

The acquisition price and consideration

6.11 With the removal of the distinction between holder and issuer, the concept of acquisition price no longer works for the base price adjustment. This is because the acquisition price would be item “a” for one party to the financial arrangement, and item “b” for the other.

6.12 However, the acquisition price concept contains the rules that have been developed to determine the amount deemed to be consideration for certain types of financial arrangements. Apart from the general market valuation rule (in paragraph (e) of the definition of core acquisition price), valuation rules apply to:

⁹ Other examples of the application of the new base price adjustment can be found in chapters 8, 9 and 12.

- non-market value transfers subject to the anti-avoidance section;
- trade credits;
- agreements for the sale and purchase of property or specified options; and
- hire purchase agreements.

6.13 Our proposed base price adjustment formula does not use the acquisition price terminology, but refers only to “consideration”. Although the acquisition price terminology will be removed, those same valuation rules will be retained. It may be possible to rationalise some of those rules. The indicative draft legislation at the end of this chapter shows one way in which this might be achieved. Section 90 of the Tax Administration Act 1994 would have to be amended to give specific authority for the Commissioner to determine a price for finance leases, and for prepayments. Prepayments are discussed in chapter 15.

Fees

6.14 The acquisition price concept discussed in the preceding paragraphs is the core acquisition price adjusted for non-contingent fees that exceed 2% of the core acquisition price.

6.15 Since we propose that this 2% threshold be removed, and that only contingent fees be spread, there is no need for a distinction between the acquisition price and the core acquisition price (see chapter 17).

Automatic deductibility

6.16 There are different consequences for holders and issuers under the base price adjustment. A negative adjustment for a holder is currently automatically deductible without having regard to the core provisions.

6.17 These rules reflect, in part, the initial thrust of the 1986 reforms, which proposed that the accrual rules tax all economic gains and allow deductions for all losses for both holders and issuers. This approach, however, would have enabled deductions for capital losses for both holders and issuers. This would have been a significant extension of the deductibility rules and was thus later modified, because such an approach is not appropriate in an income tax system which does not tax all sources of income.

6.18 Even so, holders of financial arrangements could be disadvantaged if they were not entitled to a deduction for negative amounts on a base price adjustment. This is because in some cases they might have paid tax on gains over the life of the financial arrangement (for example, on foreign exchange gains) that were not eventually realised. An entitlement to an automatic deduction for these overstatements is appropriate.

6.19 However, the automatic deduction as it currently applies is problematic for two reasons:

- It extends deductibility to one group (holders) when there is not always a rational reason for the distinction between holders and issuers.
- It provides an incentive for taxpayers to create financial arrangements to take advantage of the provision.

6.20 We propose that for any party to a financial arrangement, a negative base price adjustment will give rise to a deduction if either:

- the core deductibility tests are satisfied; or
- the loss arises because of an overstatement of amounts deemed to be income derived in previous income years.

6.21 This will better reflect the original policy intent and can be calculated relatively simply by reference to the base price adjustment. Amounts of income derived and expenditure incurred in previous years appear as items “c” and “d” in the proposed base price adjustment formula.¹⁰ A negative base price adjustment result can then be deductible up to a specified maximum amount. That maximum will be equal to income previously returned, less expenditure previously deducted, represented as item “c” less item “d” of the formula.

Cash basis method

6.22 If there is no longer a distinction between holders and issuers, the cash basis method of accounting for income and expenditure under a financial arrangement (currently available only to natural persons who are holders) will have to be either removed or extended. The policy objective behind the cash basis method is to reduce compliance costs for individual taxpayers. This is recognised as being appropriate for parties other than holders, as is evidenced by Determination G15: *Exemption from section 64C for Small Debtors*, which allows a cash basis for some debtors with low levels of borrowing.

6.23 We intend, therefore, to extend availability of the cash basis method to any natural person who is a party to a financial arrangement. The Commissioner will then rescind Determination G15.

¹⁰ Both items are incorporated in item “c” in the current formula.

- 6.24 The threshold for the cash basis method will also be amended. The cash basis method will be available to a natural person who is party to financial arrangements with a face value in total of not more than a certain dollar value. The current level is \$600,000 for holders, and \$200,000 for qualifying small debtors under Determination G15. We suggest \$1,000,000 as an appropriate threshold. This conforms with the threshold for availability of the straight-line method – another low compliance cost option.
- 6.25 We consider the income test should also be retained because it allows more scope for people to come within the provision. For example, some financial arrangements may not be easy to value, or arrangements with a value of more than \$1,000,000 may not generate significant amounts of income. The income test threshold could be raised to \$100,000.
- 6.26 Currently if the difference between income calculated on a yield to maturity (or straight-line) basis and on a cash basis is more than \$20,000, the cash basis method is not available. We appreciate that this test imposes compliance costs on taxpayers who have significant interests in financial arrangements which are issued at a large discount or premium. Those taxpayers are required to calculate and apply both accrual and cash methods to determine whether they are eligible to use the cash basis method. However, we propose to retain this test because removal of it could lead to an unacceptably high level of deferral.

Cash base price adjustment

- 6.27 Removal of the holder and issuer distinction means that the cash base price adjustment in section EH 4, which currently applies only to holders, must be changed. We consider that the new base price adjustment can be applied to both accrual and cash basis taxpayers.

Commissioner's discretionary powers

- 6.28 A discretionary power is difficult to justify in the self-assessment environment. Our starting point, therefore, is that these powers should be repealed, unless there is good reason to retain them.
- 6.29 Section EH 1(9) gives the Commissioner the discretion not to require issuers to comply with the spreading requirements of section EH 1. This is effectively allowing a cash basis method for issuers and, as noted above, the Commissioner has already issued one determination in respect of qualifying small debtors. Section EH 3(2) gives the Commissioner the discretion either to deem individuals to be cash basis holders (paragraph (a)) or not (paragraph (b)).
- 6.30 If the distinction between holder and issuer is removed, the cash basis method will be extended to issuers, which will render the discretion in section EH 1(9) redundant. Therefore we consider that the Commissioner's discretion in section EH 1(9) can be repealed.

- 6.31 The discretion in section EH 3(2)(a) should also be repealed. It would seem to be useful only when the threshold for the cash basis method has been breached. Although thresholds are arbitrary, if each such threshold in the Act were subject to a Commissioner's discretion, it would create uncertainty for taxpayers.
- 6.32 We propose, however, that the discretion in section EH 3(2)(b), which allows the Commissioner to deem persons not to be cash basis holders for certain classes of financial arrangement, be retained. This is aimed at schemes promoted to exploit the ability to defer tax by using the cash basis method. Scheme promoters in any particular case can apply for a binding product ruling to ensure that the Commissioner will not use his discretion.

Election not to use the cash basis method

- 6.33 The cash basis method is currently mandatory, and there is no scope for a person below the cash basis threshold to account on an accrual basis. We consider that an accrual method should be available to any taxpayer wishing to use it.
- 6.34 Our proposal is that natural persons below the cash basis threshold will be required to use the cash basis method, unless they elect to use an accrual method. This election should be given a year in advance. The rules introduced in 1996¹¹ for electing to treat short-term trade credits as financial arrangements are similar, and to adopt them will provide consistency within the accrual rules. Following notification, the accrual method would apply from the beginning of the next income year. Any such election will apply to all financial arrangements held or issued by that taxpayer.
- 6.35 Taxpayers becoming eligible to use the cash basis method will automatically be required to use this method. The exception is that when moving from an accrual basis to a cash basis, taxpayers can continue to treat financial arrangements held at that time on an accrual basis. If they wish to continue using an accrual method, they will have to notify the Commissioner in that year.

Specific issues for consultation

Are there occasions when the removal of the automatic deduction for holders would deny a deduction that ought, on policy grounds, to be available?

¹¹ Section EH 10.

Draft legislation

EH 4 GROSS INCOME AND EXPENDITURE WHERE FINANCIAL ARRANGEMENT REDEEMED OR DISPOSED OF

EH 4 (1) Where, in relation to any person, a financial arrangement matures, is remitted (other than by way of being written off as a bad debt), sold, or otherwise transferred by the person in any income year, the amount of the base price adjustment in relation to that income year and that person, and that financial arrangement, shall be the amount calculated in accordance with the following formula:

$$a - b - c + d + e$$

where –

- a is the amount of all consideration that has been paid, and all further consideration that has or will become payable, to the person in relation to the financial arrangement; and
- b is the amount of all consideration that has been paid, and all further consideration that has or will become payable, by the person in relation to the financial arrangement; and
- c is the aggregate of –
 - (A) all amounts, except non-contingent fees, that are gross income derived by the person in respect of the financial arrangement in all previous income years since the acquisition of the financial arrangement; and
 - (B) all amounts that are dividends within the meaning of section CF 2(1)(b) (being dividends which, if the transaction giving rise to the dividend had been effected with a shareholder of the relevant company, would have been dividends within the meaning of section CF 2(1)(b)) within the meaning of section CF 2(1)(k), that are derived by the person in respect of the financial arrangement; and
 - (C) all amounts that are gross income of the person under section DC 2(1) in respect of the financial arrangement;
- d is all amounts, except non-contingent fees, that are expenditure of the person in respect of the financial arrangement in all previous income years since the acquisition of the financial arrangement; and
- e all amounts that have been remitted by the person in relation to the financial arrangement.

EH 4(3) The amount of the base price adjustment in relation to any financial arrangement and any income year shall be:

- (a) Where it is a positive amount, be deemed to be gross income derived by the person in the income year; and
- (b) Where it is a negative amount, be deemed to be expenditure incurred by the person in the income year.

“Amount of all consideration” in the qualified accrual rules means the aggregate of the amounts, not including non-contingent fees, determined in accordance with the following rules –

- (a) Where neither paragraph (b) or (c) apply to a financial arrangement, the value of all consideration:
- (b) If the consideration is property or services transferred under an agreement for the sale and purchase of property or services (not being an agreement for the sale and purchase of property or services that has lapsed or otherwise does not proceed), a specified option (not being a specified option that has lapsed or otherwise does not proceed), a hire purchase asset transferred under a hire purchase agreement, in accordance with section FC10(1), or a lease asset transferred under a finance lease, for an original party to that agreement, an amount calculated in accordance with the following formula:

$w + x$

where –

w is –

- (i) Where the disclosure provisions of the Credit Contracts Act 1981 apply, the cash price determined by section 2(1) of that Act; or
- (ii) The price (determined in accordance with section OB 7, if the consideration payable under the relevant financial arrangement is denominated in a foreign currency) that the parties would have agreed upon at the time at which the arrangement was entered into on the basis of payment in full at the time at which the first right in the property that is the subject of the arrangement is to be transferred or the first services are to be performed; or
- (iii) If subparagraph (i) is not applicable and there is insufficient information available to determine a price under subparagraph (ii), an amount calculated under a determination made by the Commissioner under section 90(1) of the Tax Administration Act 1994:

x is the value of all consideration provided in relation to the financial arrangement other than the property or services that is the subject of the arrangement, including the amount of all expenditure or loss incurred by the lessor in preparing and installing a hire purchase asset or lease asset for use to the extent to which any such expenditure or loss is not taken into account in determining the amount of item w:

(c) Where section GD 11 applies an amount calculated under that section:

“Non-contingent fee” means money paid to or by a party in relation to the issue or acquisition of the financial arrangement by way of fees for services which are not contingent on the implementation of the financial arrangement:

CHAPTER 7

THE SPREADING PROVISIONS

Proposed policy

- Apply the spreading provisions to expected cashflows except when the market valuation method applies.
- Remove the requirement that Inland Revenue approve markets before a market valuation method can be applied by taxpayers.
- Require taxpayers unable to use the yield to maturity method or determinations to take into account the tenor of the spreading provisions in choosing an allocation method.
- Require taxpayers to apply a method consistently to all financial arrangements in a class and across income years. The requirement for consistency will apply unless there are sound commercial reasons for change. The taxpayer, in this event, must notify Inland Revenue of the change.

The spreading provisions and the accrual rules

- 7.1 Debt instruments can have expected and unexpected returns. The accrual rules, in order to tax debt instruments and debt substitutes consistently, bring to account all gains and losses, both expected and unexpected, by way of the base price adjustment on maturity or transfer of financial arrangements. The total amount of gross income or expenditure associated with a financial arrangement is determined by reference to all consideration paid to and by a person.
- 7.2 In order to minimise opportunities to defer gains or accelerate losses that would, under a realisation-based system, be taxed only on maturity, gains and losses that are expected to arise are spread over the term of financial arrangement. The spreading provisions provide methods that allocate this income or expenditure to income years.
- 7.3 Subsection EH 1(1) establishes a link between the base price adjustment and the spreading provisions. This is because section EH 1, like section EH 4, refers to consideration paid to or by a person. This indicates that amounts that will not be included in the base price adjustment should not be subject to the spreading provisions.

- 7.4 One exception to the rule that only expected gains or losses are spread, is where a market valuation method is used. Market valuation accrues expected and unexpected gains or losses by valuing arrangements periodically and taxing the change in value over the period. Methods provided by determination may be another exception to the general rule.

Practical difficulties

- 7.5 Problems and criticisms have arisen regarding the application of the spreading provisions. These include:
- uncertainty over the relationship between the different accrual methods;
 - the restrictive nature of the market valuation method;
 - in the absence of a determination and if the yield to maturity method cannot be used, uncertainty whether a taxpayer is entitled to use a market valuation method under a general provision; and
 - the robustness of the consistency requirements.

Proposed reform

- 7.6 The main accrual methods are yield to maturity, market valuation, and methods set out in determinations. These methods are to be retained, although the relationship between them will be clarified. Yield to maturity is the primary method, and when this cannot be used, either a determination must be followed, or an alternative method within the provisos to section EH 1(2) or EH (1)(5)(a), must be followed. The alternative method in section EH (1)(5)(b) can be used only when there is no determination. A market value method can be used in the circumstances described below. Straight-line and cash basis methods are available for certain taxpayers.

Yield to maturity method

- 7.7 The yield to maturity method is applied if cashflows can be estimated with reasonable accuracy. Increases or decreases in value of the financial arrangement associated with changes in market prices, such as interest rates, are brought to account on realisation through the base price adjustment. No changes are proposed to this section.

Market valuation

- 7.8 Market valuation provides the best comprehensive measure of income.

- 7.9 However, the approach can cause problems including:
- valuation problems if there is no active secondary market for an instrument; and
 - potential deductions for doubtful or bad debts.
- 7.10 Its use is limited, therefore, to dealers in financial arrangements who are entitled to deductions for losses on those traded instruments, and to certain markets (futures and foreign exchange market) where the risk of default is low and a market valuation basis is the easiest way of calculating accrued income or expenditure.
- 7.11 The requirement that the Commissioner approve the market before a market valuation method is applied is to be amended. Taxpayers will be able to continue to use a price from a market approved by the Commissioner, which will provide certainty for taxpayers. Alternatively, taxpayers may use prices from non-approved markets provided they can show the Commissioner that the prices obtained are reliable arm's length prices on which market participants are prepared to act. The objective criteria that should be considered in determining whether markets are reliable include:
- the number of participants in the market or having access to the market;
 - the frequency of trading in the market;
 - the existence of an appropriate regulatory body;
 - the existence of industry standards regulating trading practices; and
 - the accessibility of sources of information to market participants.
- 7.12 Taxpayers will be allowed to mark to related markets if there is no, or an inadequate, direct market in the instrument. Examples are over the counter traded options marked to a futures market, and swaps marked to the market in the indicator rates. This will allow taxpayers to use methods which have regard to such factors as volatility.
- 7.13 The valuation methods will not be prescribed, although the general conditions in section EH 1(6) must be met: the person must be a dealer and must consistently apply the method for tax and financial accounting, and the method must be commercially acceptable.

Determinations

- 7.14 When the yield to maturity method does not apply, the Commissioner may issue determinations setting out the appropriate tax treatment of the financial arrangement. Methods prescribed in determinations are currently required to result in an allocation of income or expenditure to income years in a way that has regard to the tenor of section EH 1(2), that is, yield to maturity.¹²
- 7.15 This requirement is too narrow. Determinations should have regard to the broader spreading requirements of the accrual rules. This means determinations based on yield to maturity, market valuation or another appropriate allocation method can be issued.

Alternative methods

- 7.16 The purpose of providing alternative spreading methods to those set out in legislation or determinations is to reduce compliance costs by enabling taxpayers to use the same methods of accounting for tax and financial reporting purposes.
- 7.17 Alternative methods are acceptable if they have regard to the principles of accrual accounting and:
- are consistent with the method used for financial reporting;
 - are consistent with commercially acceptable practice; and
 - provide results that are not materially different to yield to maturity or the relevant determination.
- 7.18 We do not propose changing these criteria. They are flexible enough to enable changing practice to be taken into account, while ensuring that alternative methods of accrual do not have significant tax base effects.

In the absence of a determination

- 7.19 Where the yield to maturity, straight-line or market value method cannot be applied and there is no relevant determination, section EH 1(5)(b) provides that a taxpayer may use another method if it is commercially acceptable practice and applied consistently for financial reporting purposes. In addition, the method must result in an allocation to each income year that is fair and reasonable and has regard to the tenor of the yield to maturity method.

¹² Section 90(1)(c) of the Tax Administration Act 1994.

- 7.20 There are two problems with this provision. First, the reference to yield to maturity is too restrictive. A method should be acceptable if it has regard to the tenor of the spreading provisions. Where financial reporting is inconsistent with the tenor of the spreading provisions, the spreading provisions should take precedence. Another method, such as market valuation, should then be allowed.
- 7.21 The reference to financial reporting in section EH 1(5)(b) also means that where a taxpayer does not prepare financial reports, such as an issuer who is a natural person, the provision does not apply. Determination G12: *Accounting for a Financial Arrangement in the Absence of a Determination* attempts to fill this gap in the legislation. It is better to legislate for this situation, and we propose that a taxpayer who does not prepare financial accounts should use a method which is fair and reasonable, having regard to the tenor of the accrual rules.

Consistency criteria

- 7.22 The purpose of consistency requirements is to minimise the ability to manipulate income or expenditure by changing the method used to calculate gains and losses from a financial arrangement. Consistency requirements are most important where different methods of accounting may produce materially different results – for example, market valuation compared with a spreading method that brings only expected income and expenditure to tax.
- 7.23 Our proposed policy is that:
- Taxpayers will use the same method for all financial arrangements of the same class, unless Inland Revenue approves otherwise.
 - The same method will be consistently applied across income years unless there is a valid commercial reason for change.
- 7.24 Taxpayers who wish to change methods for commercial reasons will have to give notice, together with details of the reason for change, to Inland Revenue by the end of the filing period for their income year before that in which the change is to take effect. These proposals will not affect the taxpayer's ability to use different methods under section EH 1 (7).

CHAPTER 8

THE TAXATION OF FOREIGN EXCHANGE LOANS AND FORWARD CONTRACTS

Proposed policy

- Continue to bring to tax all foreign exchange gains and losses under the accrual rules on the base price adjustment.
- Spread only expected foreign exchange gains and losses over the life of the arrangement.
- Use forward rates to measure expected foreign exchange gains and losses.
- Allow taxpayers to continue to use market value based spreading if they meet the requirements of the Act.

Treatment of foreign exchange under the accrual rules

8.1 The objective of the accrual rules is to treat all forms of debt as consistently as possible, so as to minimise the impact of tax on the structuring of debt instruments. This means that all gains to a financial arrangement should be taxed, and the expected or anticipated gains should be spread over the life of the arrangement.

8.2 This objective was put simply in relation to foreign currency denominated instruments in the report of the Consultative Committee, which said:

Accrued gains and losses on [foreign currency denominated] instruments are measurable and clearly alter the wealth of the business; it is consistent over time to provide the same income tax treatment in this context as is provided for other debt instruments denominated in New Zealand dollars, where domestic interest rates move.¹³

8.3 In the case of foreign currency denominated instruments, it is necessary, therefore, to take into account expected movements in exchange rates, since they form as much a part of the return as do interest payments. For example, if a taxpayer purchases a yen denominated security which pays interest at a rate of, say, 3%, the taxpayer will generally expect the yen to appreciate over the term of the security so that the overall risk-adjusted yield is equivalent to what could have been earned on a New Zealand dollar denominated security. If the anticipated exchange gain is not accrued, the true interest income derived by the taxpayer would be understated, which would create incentives to hold financial assets denominated in “hard” currencies.

¹³ *Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure*, April 1987, page 12.

- 8.4 Similarly, if a taxpayer issues a debt denominated in a currency where the domestic interest rate is 25%, that currency will be expected to depreciate over the term of the loan so that the cost of borrowing does not exceed the rate at which the taxpayer could borrow in New Zealand dollars. In this case the true interest expense (and taxpayer's deductions) would be overstated if the anticipated foreign exchange gain were not accrued for tax purposes.

Valabh Committee recommendations

- 8.5 The Valabh Committee noted taxpayer concerns over the fact that foreign exchange was the only area of the accrual rules where unexpected and unrealised gains were brought to tax on a mandatory basis. The Committee said that accruing only anticipated gains using forward rates seemed an attractive compromise to overcome these concerns, although it noted two flaws in the approach. We consider these problems can be addressed.
- 8.6 The first problem was that forward rates are available only a few years in advance. We believe that advances in financial markets and information technology mean this is no longer a constraint. Quoted forward rates are now more accessible, and where a rate is not quoted, ready access to spreadsheet software makes their calculation from interest rate information reasonably straightforward.
- 8.7 The second problem, which was first raised in the 1986 consultative document, is the potential for investors to realise losses and defer gains. We share this concern, especially in relation to forward contracts for foreign currency, but note that taxpayers currently have the opportunity to realise losses on domestic debt instruments without bringing to tax unexpected increases in value. We believe similar treatment for foreign currency denominated arrangements should not pose a greater problem so long as all the *expected* gains are spread.

Treatment of foreign currency loans

- 8.8 The treatment of foreign currency denominated loans is governed by Determination G9A: *Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars*. It broadly follows the accounting treatment of foreign exchange loans in that changes in the spot value of the loan are brought to tax on each balance date. This is done by returning as income or expenditure the difference between the opening and closing book value of the loan in New Zealand dollars, and any consideration given or received over the course of the year at the spot exchange rate on the relevant day.

Problems with the current treatment

- 8.9 The current treatment of foreign currency loans causes problems for some taxpayers, where gains from changes in the spot exchange rate are reversed in the future and therefore never realised.
- 8.10 In most situations, a market value based approach provides the best measure of income. We recognise, however, that the current treatment is causing some difficulties because of the volatile nature of spot exchange rates. It is possible in this case to overcome these problems by deferring the tax on unexpected gains until realisation, without distorting taxpayer's investment decisions.
- 8.11 This approach would be more consistent with the scheme of the accrual rules – that is, to spread only the anticipated gain or loss on an arrangement.
- 8.12 This can be compared to the tax treatment of a domestic bond. The anticipated yield is taxed over the life of the arrangement, while any unexpected gains or losses, say from a change in the market interest rate affecting the price of the bond, are captured by the base price adjustment when the bond matures or is transferred.

Options for change

- 8.13 Our proposal is to spread the anticipated yield of a foreign currency denominated loan over the term of the arrangement and to tax any unexpected gains or losses when they are realised. This would overcome the present problems with foreign currency denominated loans and align the treatment of foreign currency debt with New Zealand dollar denominated arrangements.
- 8.14 It is worth noting that the proposed changes will not restrict access to market valuation methods of spreading. Taxpayers can continue to use mark-to-market if they are dealers in such financial arrangements and they meet the other conditions set out in the Act.

Measuring the anticipated gains

- 8.15 What is the best way to measure the expected foreign exchange gain or loss on a financial arrangement? As recognised in the original consultative document¹⁴, the best objective measure we have of expected exchange rate movements is the set of forward exchange rates. This is not because forward rates are always equal to, or even close to, actual future spot rates, but because they do not systematically err on the high or low side of actual spot rates. Although changes in the spot exchange rate may be erratic in the short term, over the longer term they tend to reflect differences in inflation rates between countries. These differences will in turn be reflected in the interest differential between countries. It is these interest differentials that

¹⁴ Pages 119 - 120

are the basis for calculating forward rates (along with other factors such as credit risk and dealers' margins).

- 8.16 Under our proposal the anticipated gain on a foreign currency loan would be calculated by using forward exchange rates to determine the expected New Zealand dollar value of foreign currency cashflows. These amounts would then be spread on a yield to maturity basis. Any realised amounts would be converted into New Zealand dollars using the appropriate spot exchange rate.

Example

Taxpayer A buys a US dollar bond at its face value of US\$10,000.00. It pays a 5% coupon and is redeemed in 3 years. The New Zealand interest rate is 10%. The relevant exchange rates and cashflows are:

Exchange rates

Year	spot rate (USD/NZD)	forward rate (USD/NZD)	
0	0.5000		
1	0.4700	$f_{(0,1)}$	0.4773
2	0.4500	$f_{(0,2)}$	0.4556
3	0.4400	$f_{(0,3)}$	0.4349

where $f_{(0,1)}$ is the forward rate at year 0 for delivery in year 1

Cashflows

Year	USD cashflows	anticipated NZD cashflows ¹	actual NZD cashflows ²
0	-10000.00	-20000.00	-20000.00
1	500.00	1047.56	1063.83
2	500.00	1097.45	1111.11
3	10500.00	24143.48	23863.64

The anticipated New Zealand dollar income is spread over the term of the arrangement on a yield to maturity (YTM) basis following the methodology set out in Determination G3. In addition, the difference between the spot rate value of the cashflows and their expected value (as measured by the forward rate from year 0) is a realised foreign exchange gain or loss when the cashflows are received. These realised gains or losses are to be brought to tax as the "realisation adjustment".

Yield to maturity

The yield on the cashflows converted into New Zealand dollars using the forward rates is 10.0%. This yield is used to calculate the New Zealand dollar income.

<i>Period ended</i>	<i>Opening principal</i>	<i>Accrual income</i> ³	<i>Anticipated payments</i> ⁴	<i>Realisation adjustment</i> ⁵	<i>Total income</i> ⁶
1	20000.00	2000.00	1047.56	16.27	2016.27
2	20952.44 ⁷	2095.24	1097.45	13.66	2108.90
3	21950.23	2195.02	24143.48	-279.84	1915.18
		6290.27	26288.49	-249.92	6040.35

Alternatively, using the Base Price Adjustment in Year 3 we have:

a - b - c + d + e

a = all consideration paid to the person	\$26040.35
b = all consideration paid by the person	\$20000.00
c = income derived in all previous income years	\$4125.17 ⁸
d = expenditure incurred in all previous income years	\$0.00
e = any amounts remitted by the person	<u>\$0.00</u>
<i>Income</i>	<u>\$1915.18</u>

Notes

1. USD cashflow/forward exchange rate (or spot rate for the initial payment)
2. USD cashflow/spot rate
3. Opening principal x NZD yield.
4. Contracted cashflows converted using the forward rate.
5. Cashflows converted at forward rate less cashflow converted at spot rate, brings to tax realised gains or losses.
6. Accrual income plus realisation adjustment.
7. Opening principal in year 2 = opening principal in year 1 + accrual income – anticipated payments
8. Total income in year 1 (\$2016.27) + total income in year 2 (\$2108.90)

8.17 It may be necessary to maintain the current “mark-to-spot” treatment of Determination G9A in limited circumstances, for example, for trade credits or where there are no scheduled repayment dates on the loan.

Forward contracts and the accrual rules

8.18 The treatment of forward contracts is currently dealt with by Determination G14: *Forward Contracts for Foreign Exchange and Commodities*. The scheme of the determination is to treat the difference between the forward value and the spot value of the commodity or currency at the start of the contract as a premium or discount. This is spread over the term of the contract. At subsequent balance dates, the change in the spot value of the commodity or currency is brought to tax as a gain or a loss.

8.19 This treatment is largely driven by the tax treatment of foreign currency denominated loans. It was because of the need to ensure a match between a fully hedged foreign loan and a domestic loan that the treatment of foreign currency forward contracts brings to tax spot changes in the currency. Changing the treatment of foreign exchange loans to spread anticipated gains as measured by the forward rate will mean this “mark-to-spot” treatment of forward contracts is no longer necessary.

- 8.20 We agree that a fully hedged foreign currency loan should be treated in the same way as a domestic loan. However, Determination G14 will not necessarily provide a match between the tax treatment of the loan and the forward contract because some taxpayers may use a mark-to-market approach.

Practical difficulties

- 8.21 The expected gain or loss on a forward contract is the difference between the expected spot rate when the contract is to be settled and the rate specified in the contract. For most forward contracts, the expected gain or loss at the time they are written is zero. This is why most forward contracts change hands for no consideration.
- 8.22 We consider that the current treatment under Determination G14 is inappropriate. The spot value of the currency on balance date does not represent a gain or loss to the holder of a forward contract since the contract could only be settled by entering an equal and opposite forward contract, not a spot transaction.

Options for change

- 8.23 The taxation of forward contracts for commodities and foreign currency should be consistent with the overall scheme of the accrual rules. All gains and losses should be taxable, with the anticipated yield spread over the life of the arrangement.
- 8.24 We propose that forward contracts for foreign exchange that are written at an arm's length rate should have any gains or losses taxed on realisation. This is because there is no anticipated yield on this type of arrangement. This arm's length rate is likely to be the rate quoted by Reuters or Telerate with some allowance for dealers' margins, credit risk and so on. If a rate is not quoted and cannot be calculated from cross-rates, it will be the rate calculated using a commercially acceptable method and verifiable interest rates. The exchange of consideration at the outset of the arrangement is likely to indicate a non-market rate.
- 8.25 Where a forward contract is not written at the market rate or is later sold when forward rates have changed, the contract contains an embedded debt instrument. Consideration is likely be paid for such an arrangement. The expected gain or loss on this embedded debt will be spread over the life of the arrangement in a manner consistent with other debt instruments.
- 8.26 Just as with foreign exchange loans, those taxpayers who meet the requirements of the Act can continue to spread gains and losses using a market valuation approach.

Examples*Example 1*

Taxpayer A enters into a forward contract to sell US\$100,000.00 in 90 days at the “market” forward rate of 0.6367 (call this rate $f_{(0,90)}$). This means the taxpayer will exchange US\$100,000.00 for NZ\$157,059.84 in 90 days.

No consideration changes hands when Taxpayer A enters the contract since the right to buy or sell something at the market rate has no value, and at the time it enters the contract it has no expectation that US\$100,000.00 will be worth any more or less than the NZ\$157,059.84 it will receive under the contract. There is no expected gain or loss to be spread under the contract.

In 90 days the spot rate turns out to be 0.6407. This means US\$100,000.00 is worth only NZ\$156,079.29. The difference between this amount and the rate in the forward contract (NZ\$980.55) is a foreign exchange gain to Taxpayer A and will be income under the BPA.

Example 2

Consider the case where Taxpayer A sells the forward contract set out in Example 1 to Taxpayer B on day 45.

The market forward rate for delivery on day 90 ($f_{(45,90)}$) has changed to 0.6592. This means US\$100,000.00 will be exchanged for NZ\$151,699.03. The contract held by Taxpayer A, however, will guarantee payment of NZ\$157,059.84. The contract is equivalent to a zero coupon bond paying \$5,360.81 (being the difference between NZ\$157,059.84 and NZ\$151,699.03) on day 90 and a forward contract to sell US\$100,000.00 at **today’s** forward rate.

With a 10% p.a. yield over 45 days the market price of the contract would be NZ\$5,295.52.¹ The anticipated gain on this “bond” (NZ\$65.29) should be spread by Taxpayer B over the term of the arrangement. The NZ\$5,298.19 will be income to Taxpayer A under the BPA.

Taxpayer B has paid NZ\$5,295.52 at the start of the arrangement plus US\$100,000.00 at the end (worth NZ\$156,079.29 at the spot rate of .6407) for a total of NZ\$161,374.81. In return Taxpayer B has received the NZ\$157,059.84 set out in the contact for a total loss of NZ\$4,314.97.

¹ Since $\$5,295.52(1+0.0123) = \$5,360.81$

8.27 One of the consequences of these changes is that where a forward contract is being used to hedge a risk that is not subject to the accrual rules, the tax effect will more closely reflect the economic reality.

Specific issues for consultation

- What criteria should be considered in determining whether a forward exchange rate is “arm’s length”?
- Will it be necessary to maintain the current “mark-to-spot” treatment described in Determination G9A for some arrangements?

Draft legislation

These changes should not require legislative amendment and can be achieved through Determinations issued by the Commissioner. The Commissioner expects to issue drafts for discussion shortly.

CHAPTER 9

ASSIGNMENTS OF INCOME AND DEBT DEFEASANCES

Proposed policy

- Recognise that absolute assignments and legal defeasances of financial arrangements do not create a new financial arrangement for the assignor or defeasor and that an absolute assignment of a financial arrangement will terminate that financial arrangement for the assignor. Similarly, a legal defeasance of obligations under an arrangement will terminate that financial arrangement for the defeasor.
- Treat arrangements other than legal defeasances or absolute assignments as creating new financial arrangements subject to the accrual rules, including the situation where the underlying arrangement is an excepted financial arrangement.
- Treat absolute assignments or legal defeasances of excepted financial arrangements as having no accrual consequences. Payments in relation to such transactions will be taxable under ordinary income tax rules.
- Amend section DJ 1(c) to ensure that deductions for “insubstance” defeasances that may be characterised as an indemnity are not restricted.

Assignments of income and defeasances of debt and the accrual rules

9.1 A debt defeasance is an arrangement whereby one party pays another money in return for the promise to repay over time the obligations of the first party under a particular agreement. A debt defeasance can be a legal defeasance (or novation) or an economic or “insubstance” defeasance, the difference being:

- Under a legal defeasance the debtor is released by the creditor from the obligation to repay the debt.
- An economic, or insubstance, defeasance is a process of extinguishing debt by, for example, setting aside sufficient risk-free investments to cover all remaining debt repayments. The debtor is not released from the principal obligation to repay the creditor.

9.2 An assignment of income, on the other hand, occurs when persons receive money in consideration of relinquishing a future income stream to which they are otherwise entitled.

- 9.3 Debt defeasances and assignments of income are included explicitly in subparagraph (iii) of the current definition of financial arrangement, as arrangements of a substantially similar nature to those identified by the core definition.

Practical difficulties

- 9.4 The accrual rules fail to distinguish adequately between assignments and defeasances that are essentially financing arrangements which should be subject to the accrual rules, and those that are merely absolute transfers, which should not. This leads to uncertainty in the application of the law and to compliance and administrative costs.

Proposed reform

- 9.5 Arrangements with similar effects should be treated consistently under the accrual rules. Arrangements that create new financial arrangements should be subject to the accrual rules. Arrangements that merely transfer existing rights and obligations and do not create new financial arrangements should not.¹⁵
- 9.6 There are four types of arrangements to be considered:
- absolute assignments;
 - non-absolute assignments;
 - legal defeasances;
 - insubstance defeasances.
- 9.7 Under an absolute assignment or legal defeasance, the assignor or defeasor has completely transferred all of its rights or obligations in relation to the underlying arrangement. The assignor or defeasor has no continuing rights or obligations to the assignee or defeasance counterparty. Because of this, an absolute assignment or legal defeasance should not be a financial arrangement.
- 9.8 Under a non-absolute assignment or insubstance defeasance, the assignor or defeasor will continue to have rights or obligations in relation to the underlying arrangement. A consequence of this is that the assignor or defeasor will have continuing rights or obligations to the assignee or defeasance counterparty. Thus a non-absolute assignment or insubstance defeasance creates a new financial arrangement between the assignor or defeasor and the assignee or defeasance counterparty.

¹⁵ This approach was recommended by the Valabh Committee, *Operational Aspects of the Accruals Regime: Discussion Paper*, October 1991, pages 22 – 25.

Debt defeasances

- 9.9 A taxpayer can extinguish a liability in several ways. These include maturity and repayment of the debt, repurchasing debt in the market, refinancing, or legal defeasance of a debt to a third party. These events terminate a taxpayer's obligation in relation to an arrangement and should be treated on a consistent basis under the accrual rules as dispositions of financial arrangements.
- 9.10 An insubstance defeasance is a means by which the taxpayer reduces the risk associated with a liability and is similar, in effect, to a taxpayer investing funds to generate sufficient income to offset payment obligations as they arise. An insubstance defeasance will not be treated as a disposition of a financial arrangement. This is because at law the original obligation of the defensor is not terminated, and the defeasance in fact creates a new financial arrangement, which is an asset that offsets the original obligation.
- 9.11 Further, insubstance defeasances should be accounted for under the accrual rules because they could be used to create arrangements that can be substituted for debt or affect the return on debt instruments. An example is an interest rate swap, the effect of which can be replicated using defeasances.
- 9.12 We consider the appropriate boundary between insubstance and legal defeasance is determined by the legal arrangements entered into. An arrangement will be treated as having been terminated only if a person's obligations under an arrangement are legally extinguished.
- 9.13 Financial Reporting Standard 26 defines a legal defeasance as an arrangement in which it is virtually certain that the debtor will not be required to assume the primary obligation or satisfy secondary obligations for the debt servicing requirement.¹⁶ Extinguishments of liabilities also occur under those rules if a risk-free entity assumes responsibility for debt servicing.
- 9.14 Although harmonisation of tax and financial accounting rules is desirable in terms of compliance costs, it is inappropriate in this case. The concept of virtual certainty would be a less clear boundary than the jurisprudential concept of an absolute release from obligations under an arrangement. In addition, the treatment of insubstance defeasances for accounting purposes is not a settled issue. In contrast to FRS 26, a recent US Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*,¹⁷ allows a liability to be extinguished only if the debtor repays the creditor and is relieved of the obligation for the liability, or the debtor is legally released from being the primary obligor, either judicially or by the creditor.

¹⁶ *Accounting for the Defeasance of Debt, Financial Reporting Standard No 26*, 1995.

¹⁷ *Statement of Financial Accounting Standards No. 125*, Financial Accounting Standards Board, June 1996.

Assignments of income

- 9.15 An assignment of income occurs when an assignee pays money in order to receive a cashflow stream in the future.
- 9.16 Transfers of the benefits of contracts or other arrangements can be any of legal, equitable or statutory assignments. Historically, legal assignments relate to those choses in action (including debts and other financial arrangements) which were enforceable in the common law courts; equitable assignments (such as transfers of interests in a trust fund) were enforceable in the courts of equity.
- 9.17 Statutory assignments are those for which the transfer mechanism is specified in legislation (for example, by section 130 of the Property Law Act 1952). Statutory rules arose in order to overcome problems of enforcement. Even if an assignment is not made according to the statute, it may still be valid as an equitable assignment. However, for the purposes of determining the effects of assignments under the accrual rules, the distinctions between legal, equitable and statutory assignments are not necessarily helpful.
- 9.18 We agree with the Valabh Committee's view that anything other than an absolute assignment should be treated as a financial arrangement. This is because the assignor has continuing rights in relation to the underlying arrangement, and the other parties to the underlying arrangement will continue to have obligations to the assignor.

Assignments and defeasances of excepted financial arrangements

- 9.19 The Act contains a list of excepted financial arrangements, and only those transactions that fall within the definition can be excluded from the accrual rules. Therefore while excepted financial arrangements are excluded, an assignment or defeasance of an excepted financial arrangement is not.
- 9.20 The same problem in determining whether an assignment or defeasance creates a new financial arrangement applies equally if the original asset or liability is an excepted financial arrangement.
- 9.21 If an assignment or defeasance of cashflows from an excepted financial arrangement constitutes a termination of legal rights or obligations of the transferor, no accrual implications should arise. There will be no base price adjustment because there is no underlying financial arrangement to terminate. The assessability and deductibility of payments will be subject to general income tax rules.
- 9.22 If an assignment or defeasance does not result in an absolute termination of rights or obligations, the analogy with a loan is more convincing. The accrual rules should apply to such transactions.

Practical application of these proposals

9.23 The following section provides examples of the application of the proposals to different types of arrangements.

Legal defeasance of a debt

9.24 A legal defeasance effects a disposal of the liabilities arising under a financial arrangement. A base price adjustment will be required, therefore, for the defeasor of the debt (borrower). The total expenditure arising as a result of the defeasance will be the difference between what was received under the loan and what was paid by the defeasor to the creditor and the defeasance counterparty.

9.25 The defeasance counterparty will receive consideration in exchange for its agreement to assume the obligations of the defeasor. The difference between the amount received and the amount payable in the future to the original creditor will be accounted for on an accrual basis.

9.26 The creditor will be treated as a party to a continuing arrangement and will continue to calculate income under the financial arrangement as if the defeasance had not occurred. This minimises compliance costs associated with terminating the liability and entering into a new financial arrangement on similar terms. This approach accords with the substance of the transaction because, from the creditor’s point of view, the only change is in the party making the payments.

Example: Legal defeasance

On 3 May 1993 Company A issued a debenture for \$7000. It has a face value of \$7000, a term of 5 years, pays interest annually in arrears (coupon rate 10%) and requires the repayment of principal in one lump sum together with the final interest payment.

Cashflows and accrual expenditure under the debenture for Company A are:

Date	Cashflow	Tax year	Expenditure	Total Expenditure
3/5/93	7,000.00	31/3/94	636.37	636.37
3/5/94	- 700.00	31/3/95	699.58	1335.95
3/5/95	- 700.00	31/3/96	701.46	2037.41
3/5/96	- 700.00	31/3/97	699.66	2737.07
3/5/97	- 700.00	31/3/98	699.66	3436.73
3/5/98	-7,700.00	31/3/99	63.25	3499.98

On 4 May 1995, Company A enters into a legal defeasance of its obligation to pay interest and redeem the debenture. The cost to the defeasor of the defeasance is \$6,663.74 (the present value of the future cashflows at the interest rate at the time of the defeasance - 12%).

The defeasance terminates the original financial arrangement.

Step 1: Company A is obliged to perform a base price adjustment to determine the gain or loss on the financial arrangement.

- a = the amount of all consideration paid to the person = \$7000
- b = the amount of all consideration paid by the person = \$6,663.74 + 700 + 700 = \$8,063.74
- c = income derived in prior years = 0
- d = expenditure incurred in prior years = 1,335.95
- e = amounts remitted by the person = 0

a - b - c + d + e = 272.21 income derived.

Step 2: The defeasance counterparty becomes obligor under a financial arrangement as a result of the defeasance. The cashflows and accrual expenditure are:

Date	Cashflow	Tax year	Expenditure	Total Expenditure
3/5/95	6,663.74	31/3/96	728.81	728.81
3/5/96	- 700.00	31/3/97	809.86	1538.67
3/5/97	- 700.00	31/3/98	823.06	2361.73
3/5/98	-7,700.00	31/3/99	74.53	2436.26

Expenditure must be accrued over the term of the arrangement. At maturity the defeasance counterparty performs a base price adjustment.

- a = the amount of all consideration paid to the person = \$6,663.74
- b = the amount of all consideration paid by the person = \$7,700 + 700 + 700 = \$9,100
- c = income derived in prior years = 0
- d = expenditure incurred in prior years = \$2,361.73
- e = amount remitted by the person = 0

a - b - c + d + e = -74.53 expenditure incurred in the final year.

Step 3: The rights of the original creditor do not change. Income derived from the original financial arrangement is accrued over its term. Income derived is \$3500.

Step 4: Outcomes

Defeasor	Original arrangement	1,063.74	expenditure
Defeasance counterparty	New arrangement	2,436.26	expenditure
Creditor	Original arrangement	3,500.00	income
Overall tax outcome		Nil	

Insubstance defeasance of a debt

9.27 The creditor may not be involved with the arrangements made between the original debtor (the defeasor) and the counterparty. Since the obligations under the original financial arrangement do not change, the arrangement continues to be subject to the accrual rules. In order to put our proposal into operation, an amendment is required to make it clear that amounts paid on behalf of the defeasor to the original lender are included in accrual calculations for both the original financial arrangement and the defeasance.

9.28 The defeasance counterparty will receive consideration in exchange for its agreement to make payments to the original creditor. This arrangement is equivalent to a loan from the defesor to the defeasance counterparty. The income or expenditure arising from the loan between the defeasance counterparty and the defesor will be subject to the accrual rules.

9.29 The rights of the original creditor do not change. The creditor remains the holder of the financial arrangement and will continue to calculate gains and losses under it as if the defeasance had not occurred.

Section DJ (1)(c)

9.30 Section DJ 1(c) provides that no deduction is allowed for any expenditure or loss recoverable under any insurance or right of indemnity. Under an insubstance defeasance, the defesor may still be liable to make payments to the creditor. Payments made by the defeasance counterparty may be an indemnity for those payments made to the creditor. As a policy matter, section DJ 1(c) should not unnecessarily restrict the defesor’s deduction for those payments.

Example: Insubstance defeasance

On 3 May 1993 Company A issued a debenture for \$7000. It has a face value of \$7000, a term of 5 years, pays interest annually in arrears (coupon rate 10%) and requires the repayment of principal in one lump sum together with the final interest payment.

Cashflows and accrual expenditure under the debenture for Company A are:

Date	Cashflow	Tax year	Expenditure	Total Expenditure
3/5/93	7,000.00	31/3/94	636.37	636.37
3/5/94	- 700.00	31/3/95	699.58	1335.95
3/5/95	- 700.00	31/3/96	701.46	2037.41
3/5/96	- 700.00	31/3/97	699.66	2737.07
3/5/97	- 700.00	31/3/98	699.66	3436.73
3/5/98	-7,700.00	31/3/99	63.25	3499.98

On 4 May 1995, Company A enters into an insubstance defeasance of its obligation to pay interest and redeem the debenture. The cost to the defesor of the defeasance is \$6,663.74 (the present value of the future cashflows at the interest rate at the time of the defeasance - 12%).

Because the obligations of Company A still exist the defeasance does not terminate the original financial arrangement. Expenditure continues to accrue over the term of the arrangement. A new debt is created between Company A and the defeasance counterparty.

Step 1: Expenditure accrues on the original financial arrangement. The base price adjustment will be calculated when the debenture matures, 3/5/98.

- a = amount of all consideration paid to the person = \$7,000
- b = amount of all consideration paid by (or on behalf of) the person =
\$7,000 + \$3,500 = \$10,500
- c = income derived in prior years = 0
- d = expenditure incurred in prior years = 3436.73
- e = amounts remitted by the person = 0

$a - b - c + d + e = -63.25$ expenditure incurred.

Step 2: A new financial arrangement arises between Company A and the defeasance counterparty. The original creditor is not a party to the arrangement. The cashflows and accrual income and expenditure are:

Date	Cashflow	Tax year	Income/ Expenditure	Total Income/ Expenditure
3/5/95	6,663.74	31/3/96	728.81	728.81
3/5/96	- 700.00	31/3/97	809.86	1538.67
3/5/97	- 700.00	31/3/98	823.06	2361.73
3/5/98	-7,700.00	31/3/99	74.53	2436.26

Income (for Company A) and expenditure (for the defeasance counterparty) must be accrued over the term of the arrangement. At maturity a base price adjustment calculation occurs.

Company A

- a = amount of all consideration paid to the person = \$7,700 + 700 + 700 = \$9,100
- b = amount of all consideration paid by the person = \$6,663.74
- c = income derived in prior years = \$2,361.73
- d = expenditure incurred in prior years = 0
- e = amounts remitted by the person = 0

$a - b - c + d + e = +74.53$ income derived

The defeasance counterparty

- a = amount of all consideration paid to the person = \$6,663.74
- b = amount of all consideration paid by the person = \$7,700 + 700 + 700 = \$9,100
- c = income derived in prior years = 0
- d = expenditure incurred in prior years = \$2,361.73
- e = amounts remitted by the person = 0

$a - b - c + d + e = -74.53$ expenditure incurred.

Step 3: The rights of the original creditor do not change. Income derived from the original financial arrangement is accrued over its term. Income derived is \$3500.

Step 4: Outcomes

Defeasor	Original arrangement	3,500.00	expenditure
	New arrangement	2,436.26	income
Defeasance counterparty	New arrangement	2,436.26	expenditure
	Creditor	Original arrangement	3,500.00
Overall tax outcome		Nil	

Absolute assignment of book debts

9.31 If a trader held book debts (debts that are excepted financial arrangements because they arise out of short-term agreements for the sale and purchase of property), the effect of the assignment is that the debtor pays the assignee directly.

- 9.32 The tax consequences, given the model proposed for taxing assignments or defeasances, are that neither the assignor nor the assignee has accrual income or expenditure in relation to the assignment. Any amount received by the assignor or paid by the assignee for transfer of the debts is determined under general income tax principles.

Insubstance defeasance of rental payments

- 9.33 A person obliged to make rental payments may enter into an insubstance defeasance of its rental obligations. This arrangement would be treated as a financial arrangement. The tax consequences should be that the defeasor continues to be treated as paying rent. The amounts are deductible if the ordinary rules are satisfied.
- 9.34 The defeasor is treated as having lent an amount equal to the defeasance payments to the defeasance counterparty and receives over time an amount equal to the rental obligation. This will result in income under the accrual rules.
- 9.35 For the defeasance counterparty, expenditure will be deemed to be incurred under the accrual rules.

CHAPTER 10

PARTIAL ASSIGNMENTS AND DEFEASANCES

Proposed policy

Account for partial assignments and defeasances of the cashflows under a financial arrangement as a variation to a financial arrangement.

The accrual rules and partial assignments and defeasances

- 10.1 In some circumstances a party to a financial arrangement will assign or defease only part of its rights or obligations under a financial arrangement. For example, a holder of government stock may assign the coupon payment rights while retaining the principal repayment rights. There is no provision under the current legislation to allow recognition of income or expenditure from partial assignments or defeasances.

Practical difficulties

- 10.2 The lack of certainty about which rules apply can create difficulties for taxpayers who transfer part of a financial arrangement.

Options for change

Proposed treatment – Determination G25: Variations in the terms of a Financial Arrangement

- 10.3 If the original parties to a financial arrangement agree to vary the terms, Determination G25 requires them to recalculate income or expenditure from the beginning of the arrangement as if the varied cashflows had been known from inception. The calculation required in the year of variation is a catch-up adjustment for the prior years.
- 10.4 The application of Determination G25 could be extended to cover partial assignments and defeasances involving a third party. Under this option, a partial assignment or defeasance is treated as a variation in the terms of the financial arrangement.

- 10.5 The effect for the assignor or defeasor would be to spread the gain or loss realised on the relevant part of the financial arrangement, over the life of the financial arrangement. The one-off adjustment in the year in which the partial assignment or defeasance occurs would pick up this gain or loss for prior years. The remainder of the gain or loss is then spread over the remaining years of the financial arrangement. No adjustment would be required for the party to the financial arrangement not participating in the assignment or defeasance.
- 10.6 We prefer this method because it adequately reflects income measurement and avoids the need for further legislation to deal specifically with partial transfers of arrangements. The method is easy to apply and fits in with the current legislative framework.
- 10.7 The differences between this and the other methods discussed below are differences of timing. They reflect the extent to which the financial arrangement is effectively revalued in the year of partial assignment or defeasance, and the period over which any resulting income or expenditure is spread.

Other options considered

Partial base price adjustment

- 10.8 An alternative to using Determination G25 is to use the base price adjustment mechanism. The essence of this method is to split the original financial arrangement into two parts, and perform a base price adjustment on the part that is defeased or assigned. There are two possible approaches:
- splitting the original acquisition price and allocating any accrued income or expenditure from the beginning of the arrangement to the date of partial disposition; or
 - valuing the cashflows retained by the transferor at the rate inherent in the original financial arrangement for the purpose of the base price adjustment and determining the acquisition price of the “new” financial arrangement to which the transferor becomes a party.
- 10.9 We use the term “partial base price adjustment” to describe either method.
- 10.10 The partial base price adjustment treatment brings to tax the gain or loss resulting from changes in value on the part of the financial arrangement disposed of in the year of partial disposition. Changes in the value of the financial arrangement could result from, for example, changes in market interest rates. The part of the financial arrangement that has been retained is not revalued.

- 10.11 This method may give a more accurate measure of accrual income or expenditure in the event of an absolute transfer of part of a financial arrangement, but would mean introducing considerable additional complexity into the accrual rules.

Full base price adjustment

- 10.12 Another option we considered is to perform a full base price adjustment in the year of partial assignment or defeasance. This would require deeming a disposition of the entire financial arrangement and acquisition of a new financial arrangement. A market valuation would be required, both to carry out the base price adjustment on the original financial arrangement and to ascertain the acquisition price of the new financial arrangement.
- 10.13 The full base price adjustment approach can be compared to a full mark-to-market adjustment at the time of the partial assignment or defeasance. Our view is that this is not appropriate if the market valuation method is not the spreading method used for that financial arrangement. This is because a portion of the gain or loss will not have been realised and may never be realised (for example, when interest rate movements reverse before maturity). Further, such treatment could distort the market by encouraging partial transfers when a loss is triggered, and discouraging them when gains arise.

Accounting treatment

- 10.14 The method of accounting for partial defeasances required for financial accounting purposes is set out in Financial Reporting Standard (FRS) 26. Paragraph 5.8 of FRS 26 is consistent with the second partial base price adjustment method described in paragraph 10.6. That standard provides:

Where there is a partial extinguishment of a debt, the outstanding liability shall be determined by discounting the remaining debt servicing requirements at the original interest rate or original interest rates implicit in the original debt arrangement.

- 10.15 Although not our preferred option, the partial base price adjustment method available under FRS 26 may, in any event, be available to taxpayers as an alternative method under the proviso to section EH 1(5)(a).

Specific issues for consultation

Does the approach in Determination G25 involve lower compliance costs than the partial base price adjustment approach?

CHAPTER 11

DEBT REMISSION

Proposed policy

- Continue to tax income arising from the forgiveness of a debt under the accrual rules subject to the exclusion for natural love and affection.
- Treat amounts remitted on the winding up of a company as having been deemed to be remitted before the winding up to ensure the Commissioner is treated on the same footing as other creditors.
- Exempt amounts remitted amongst members of a consolidated group from remission income only if the arrangement was held by members of the same group at all times during the term of the arrangement.

Debt remission and the accrual rules

- 11.1 The accrual rules, through the operation of the base price adjustment, bring to tax as income for the holder any amounts forgiven under a financial arrangement.
- 11.2 A financial arrangement is deemed to be remitted under section EH 4(9)(c) if:
- (i) The issuer has been discharged from making all remaining payments under that financial arrangement without fully adequate consideration; or
 - (ii) The issuer has been released from making all remaining payments under that financial arrangement by the operation of the Insolvency Act 1967 or the Companies Act 1955 or the Companies Act 1993 or the laws of any country or territory other than New Zealand, or by any deed or agreement of composition with its creditors; or
 - (iii) All of the remaining payments under the financial arrangement have become irrecoverable or unenforceable by action through the lapse of time:
- 11.3 The purpose of the debt remission rules is to recognise the fact that the forgiveness of a debt increases the wealth of the debtor. This should, as with all other gains under a financial arrangement, be brought to tax. The accrual rules try to do this as consistently and comprehensively as possible to minimise the impact of the tax system on the way debt instruments are structured.

Criticisms of the current rules

- 11.4 Some argue that the economic income arising from debt forgiveness should not be assessable unless taxpayers are also able to claim a deduction for associated capital losses. The classic example cited is of a taxpayer who borrows to buy shares. The value of the shares subsequently falls to zero and the lender forgives the debt in recognition of the fact that the borrower is now unable to pay. In this case the taxpayer incurred a capital loss in the form of the fall in the value of the shares, and a gain in the form of the forgiven debt. Under the current tax rules, the gain resulting from debt forgiveness is assessable, whereas the loss on the shares is not generally deductible (unless the shares were bought for the purpose of resale). The argument is made that the gain should not be assessable unless the loss is deductible.
- 11.5 This argument ignores the fact that the deductibility of the loss on the shares is denied on the basis that gains on the shares would not have been assessable had they increased in value. The non-deductibility of the loss on the shares is not determined by whether gain on the loan is assessable. Such mismatches are an inevitable consequence of maintaining a capital-revenue boundary. As long as the income tax system continues to exclude certain capital gains from tax it is necessary to deny deductions for certain capital losses in order to reduce the extent to which these omissions influence business decisions.
- 11.6 A further criticism is that the rules discourage commercially desirable debt restructuring. In particular, concerns focus on the desirability of taxing debt remission in cases of insolvency or commercial restructuring. While we recognise this concern, we consider the distortions that would be built into the tax system if remission income were not taxed would be greater than the costs of the present regime.

The Valabh Committee proposal

- 11.7 Given the concerns of some taxpayers about the effect of the rules, the Valabh Committee recommended significant changes. The Committee presented two options:¹⁸
- Retain the present debt remission rules but allow a deduction for principal losses. This was rejected by the Committee on the grounds that it would encourage parent companies to finance subsidiaries through debt rather than equity, in the expectation that should the operations of the borrowing subsidiary not be profitable, the parent might obtain a deduction for loss of principal when no deduction for equity loss would be available.

¹⁸ *Operational Aspects of the Accruals Regime: Discussion Paper*, October 1991, pages 27-38.

- Abolish remission income (except in the limited cases where remission of principal could constitute assessable income under the general law) but claw back any deductions arising from the use of remitted funds. This is the approach preferred by the Valabh Committee, given the large expected revenue loss from a generally available deduction for principal losses.

11.8 The Committee accepted, however, that because money is fungible, it would be nearly impossible to trace the application of particular borrowed amounts. The general provision dealing with amounts remitted, section 78 of the 1976 Act, was based on such a claw-back principle, and it was the shortcomings of this approach that created the need for specific treatment under the accrual rules. As a proxy for complex tracing rules, the Committee proposed:

- There should be a claw-back of deductions where there was a link between borrowed funds and any deductible expenditure or depreciation deduction. If no deduction was obtained there would be no claw-back.
- If no clear link existed, current year losses, or losses carried forward to the year in which the remission of principal occurs would be forfeited to the extent of the principal remitted. No claw-back would generally occur if no losses were available (except for related party losses).

11.9 Taxpayers would be exempt from this claw-back:

- if the debt remission constitutes a gift;
- if the amount is taxable under another provision of the Act; or
- if the taxpayer can establish to the satisfaction of the Commissioner that the borrowed funds were used for private or domestic purposes or to acquire a non-depreciable capital asset.

Problems with the Valabh Committee approach

11.10 We see several problems with the approach recommended by the Valabh Committee.

11.11 First, the committee's proposals would both create a preference, and add complexity to the law:

- The timing of the recognition of any remission income would depend on previous tax losses and the amount and timing of future deductions. Linking the recognition of remission income to the timing of deductions would favour taxpayers who incur relatively few deductions as a proportion of total revenue over those whose deductions represent a high proportion of total revenue.

- The extent to which the amount remitted is subject to future tax depends on the extent and timing of future deductions by the borrower. This causes a lock-in distortion that would encourage taxpayers to defer transactions that would trigger the tax liability.
- Unlike existing rules that tax remission income directly, the committee's claw-back rules rely on complex tracing provisions. These would be difficult both to administer and comply with.

11.12 Second, we have concerns as to their impact on the integrity of the tax base, especially on the winding up of a company or where there are limited recourse loans.

11.13 Finally, the proposal does not appear to achieve the symmetry of treatment of non-business lenders and their debtors hoped for by the committee.

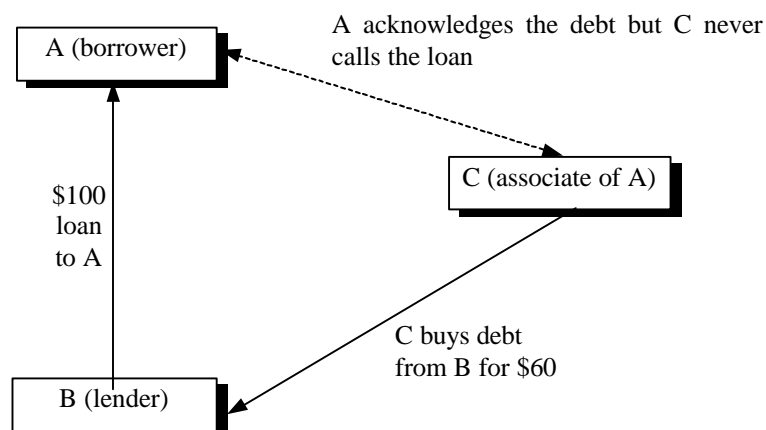
Options for change

11.14 We believe the best approach is to maintain the current treatment of amounts forgiven under a financial arrangement. We propose to address some issues that are causing concern, including the transfer of debts between associates (“debt parking”), and issues arising on insolvency and consolidation.

Debt parking

11.15 Figure 1 shows an example of how “debt parking” has been used in the past to circumvent the rules. A owes money to B which it cannot repay. Rather than forgiving the debt (which would give rise to remission income for A) B sells the debt, at a discount, to an associate of A (in this case C).

FIGURE 1: DEBT PARKING



- 11.16 B has received \$60 for A's debt and extinguished its rights under the arrangement. Had this money come direct from A (as full and final settlement of the debt) remission income of \$40 would have arisen to A. However, because C is an arm's length party from B, no remission income arises under current law. The difference between this type of arrangement and the sale or assignment of the debt from B to an unrelated third party is that, while A's debt under the arrangement is still outstanding, A no longer expects to have to repay the loan.
- 11.17 The \$40 loss to B will be deductible if B can account for the debt on a mark-to-market basis or obtain a deduction under section EH 4(5) as a dealer in this type of financial arrangement.
- 11.18 Because of the association between A and C this arrangement is, in effect, a settlement of the debt. We propose to treat it as such. This would mean that both A and B would carry out a base price adjustment. A would derive \$40 of remission income, since the arrangement has been settled on its behalf for \$60.
- 11.19 A new financial arrangement will be deemed to have been created between A and C. The consideration for this new debt will be the \$60 paid by C for the debt.
- 11.20 This approach relies on two thresholds: the extent of common ownership between the borrower and the purchaser of the debt, and the level of discount at which the debt is purchased. In Canada, similar rules apply if the debt is sold at a 20% or greater discount, and the two parties (in this case A and C) are under common control or the purchaser owns 25% or more of the debtor. A similar approach has been implemented in Australia. We propose a common ownership threshold in line with other associated persons tests in the Act. Broadly, this would mean 50% common ownership between companies covering arrangements sold at a discount of 20% or greater of their face value.

Technical issues

- 11.21 The remainder of this chapter is devoted to some technical problems in the current rules that are of concern to both the Government and taxpayers. We welcome comment from taxpayers on the practicality of our proposed solutions.

Company liquidations

- 11.22 Section EH 4(9)(c) deems an amount to be remitted if the issuer has been released from making all remaining payments under the financial arrangement by the operation of the Insolvency Act 1967, the Companies Act 1955 or the Companies Act 1993.

- 11.23 Taxpayers are released from all remaining payments only when they have been discharged from bankruptcy or on the winding up of the company. In the case of individuals, it was felt that it would be inconsistent with the aims of the bankruptcy rules if a taxpayer was discharged from bankruptcy only to face new debts to the Commissioner. With this in mind, section 64F(7C) [now section EH 4(7)] was enacted so that, on release from bankruptcy, an individual is deemed to have paid those amounts, and no remission income arises.
- 11.24 This change was not made in the case of companies. Since a company will be wound up, there is no need for it to emerge from bankruptcy with a “clean slate”. The problem, however, is that the tax liability for amounts forgiven arises only after the company is wound up. At this point it is not possible to collect the tax that is due on the amounts remitted
- 11.25 Amounts that are forgiven through the operation of the liquidation provisions could be treated as having been remitted immediately before the winding up of the company. This would put the Commissioner in the same position as other unsecured creditors. One concern we have with this is that the Commissioner’s debt arises only as a result of the liquidation. Unless the liquidation is part of a group restructuring this may not be appropriate.

Problem of circularity

- 11.26 Unless an arbitrary line is drawn, the calculation of the amount of remission income becomes circular: the imposition of tax reduces the amount that can be paid to other creditors, leading to further remission and an increase in the tax liability, which in turn requires further remission, and so on. The rules would require the remission of all debts, including the income tax liability, to occur only once, at the point of bankruptcy. Further amounts remitted to creditors because of this new liability to the Commissioner would not give rise to a tax liability.

Example	
<i>Assets</i>	<i>Liabilities</i>
Cash	Creditor A
100.00	30.00
	Creditor B
	30.00
	Creditor C
	30.00
	Creditor D
	30.00
\$100.00	\$120.00
Deem remission of \$20	
Tax liability = \$20 x 0.33 = \$6.60	
	Tax liability
	6.60
\$100.00	\$126.60
The taxpayer pays 78.9 cents in the dollar to all creditors, including the Commissioner (\$100.00/\$126.60). This means the Commissioner would receive \$6.60 x 0.789 = \$5.21.	

“Financial arrangement remitted” or “amounts remitted”?

- 11.27 Item “a” of the current base price adjustment formula in section EH 4(1) refers to “any amounts that have been remitted by the person”. This wording poses two problems. The first is that, if the debt has been forgiven by operation of statute, it has not been forgiven “by the person”. In this case the base price adjustment may not give the correct answer. This should be corrected.
- 11.28 The second problem is that the terminology is inconsistent with that of section EH 4(9)(c), which provides when “a financial arrangement shall be deemed remitted”. It is possible that there is a difference between a “financial arrangement” remitted and an “amount” remitted under a financial arrangement. Because of this inconsistent terminology, amounts that would otherwise be income under the base price adjustment could be excluded. An amendment to the definition of “remitted by the person” in section EH 4(9) should deal with both issues.

Remission income for consolidated groups

- 11.29 The treatment of remission income is inconsistent for corporate groups. For a wholly owned group, remission income is taxable.¹⁹ For a consolidated group, remission income is ignored.²⁰ On an amalgamation remission income is recognised if the issuer of the debt is insolvent.²¹ However, if amalgamating companies are members of a consolidated group prior to amalgamation, the income will not be recognised.
- 11.30 The amalgamation provisions for insolvent companies were introduced to buttress the accrual rules for remission income. In the absence of such provisions, the amalgamation rules could be used to avoid remission income.
- 11.31 The justification for providing a concession for remission income within a consolidated group is that the consolidation rules treat a group of companies comprehensively as one economic entity and one taxpayer. In effect, this means payments or receipts associated with financial arrangements between group members are offset and ignored for tax purposes. Applying the same logic, any economic gain such as remission income attributed to an issuer should be offset by an economic loss for the holder, resulting in neutral tax outcomes.
- 11.32 This treatment of remission income is a substantial concession to the general rule. The consolidation rules could be used to avoid remission income. Taxpayers seeking to restructure can benefit by consolidating before amalgamating companies.

¹⁹ Either under the accrual rules or as a dividend under section CF 2(1)(b). The dividend arising from remission income is excluded from the intercorporate dividend exemption.

²⁰ Section HB 2(1)(a).

²¹ Section FE 10(4).

11.33 Therefore we propose that the exception for remission income be more tightly targeted. Remission income will be disregarded within a consolidated group only if a financial arrangement has been issued and held by members of a consolidated group during the whole term of the arrangement. This will prevent taxpayers entering consolidated groups purely to benefit from the remission concession.

Specific issues for consultation

- To what extent will the proposed treatment of debt parking arrangements interfere with legitimate commercial sales of debt to associated persons?
- Should the remission rules for bankrupts and companies in liquidation be aligned? If the amounts were deemed to be remitted when a taxpayer was declared bankrupt the Commissioner could “join the queue” with other creditors, but any unpaid tax amounts would be forgiven when the taxpayer was discharged from bankruptcy. This would not disadvantage the insolvent taxpayer.
- Should the treatment of company liquidations be different if the liquidation is part of a group restructuring?

CHAPTER 12

SPECIFIED OR FINANCE LEASES

Proposed policy

- Include leases that are financing arrangements entered into on or after 1 April 1999 within the scope of the accrual rules.
- Refer to leases that fall within the accrual rules as “finance leases” to avoid confusion with those leases entered into before 1 April 1999.
- Define the term “finance lease” more narrowly than “specified lease”.

Specified leases and the accrual rules

- 12.1 At present, all leases are excepted financial arrangements. When the accrual rules were introduced, in 1987, those leases that are financing arrangements (specified leases) were included in the list of excepted financial arrangements because they already had their own “accrual type” rules.
- 12.2 A specified lease effectively transfers ownership of the lease asset to the lessee, and provides loan finance to the lessee to “buy” the asset. The Act recognises this, and treats a specified lease as a sale of the lease asset to the lessee at the beginning of the lease term. At the expiry of the lease term there is a deemed resale of the lease asset to the lessor for consideration equal to the guaranteed residual value, or if there is no guaranteed residual value, for no consideration. The Act specifically denies a deduction to the lessor for depreciation.

Practical difficulties

- 12.3 There are several problems with the application of the current specified lease rules as identified by the Valabh Committee.²² One is that many leases that neither transfer economic ownership nor provide finance fall into the definition of a specified lease. This happens, for example, when a lessee is responsible for the repairs and maintenance of a lease asset (and the title remains with the lessor).

²² *Operational Aspects of the Accruals Regime: Discussion Paper*, October 1991, pages 70-81.

12.4 Further, the current rules require the lessor to advise the lessee of the cost price of the lease asset. This is information that is often commercially sensitive, and may in any case be inappropriate because an asset can be used for many years by the lessor before it is leased. Compliance problems result, particularly in cases where the lessor is a non-resident, because it may be difficult to obtain information as to the cost price of the lease asset.

12.5 In addition, there are no clear statutory guidelines as to the method to be used by lessees to spread the interest component of lease payments.

Options for change

12.6 Leases that are financing arrangements are essentially similar to deferred property settlements and, therefore, should be within the accrual rules. In 1991 the Valabh Committee proposed that specified leases be brought within the scope of the accrual rules. It also proposed that amendments be made to the definition of specified lease to ensure that only those leases which are truly financing transactions are included in the accrual rules. We agree with the Valabh Committee's proposals on this matter, and set out in this chapter some specific rules showing how we consider the proposals could be applied in a practical sense.

Definitions

12.7 Under the current rules, a specified lease is a lease of personal property (excluding bloodstock and livestock) that effectively has one or more of the following features:

- It has a guaranteed residual value.
- The lease term is more than 36 months, and
 - the lessee has the option to acquire the lease asset at lower than market price at the end of the lease term; or
 - the sum of the lease payments and the guaranteed residual value is greater than the cost price of the leased asset; or
 - the lessee is liable for the repairs and maintenance of the leased asset.
- The lessee, or an associate of the lessee, becomes the owner of the leased asset at the expiry of the lease term.

12.8 The current definition of specified lease is too wide. The definition encompasses many operating leases such as leases of more than three years that place responsibility for repairs to and maintenance of the lease asset on the lessee.

12.9 We propose that the term “specified lease” be changed to “finance lease” and the definition be amended so that a lease would be a finance lease if it meets either of the following criteria:

- The lease provides for ownership of the lease asset to transfer to the lessee, or an associate of the lessee, whether at the option of the lessee or not, for no, or concessional, consideration at the expiry of the lease term. For example, a leased asset purchased by a lessee at the end of the lease term for no consideration would be a finance lease under the amended legislation.
- An asset is leased for a major portion, 75% or more of its economic life. The economic life of an asset would be determined using the “estimated useful life” used for depreciation purposes. For example, the estimated useful life of a personal computer is four years, so if the computer were leased for more than three years (being 75% of four years) the lease would be a finance lease.

12.10 The lease term would be the period from the beginning of the lease to the expiry of the lease. Expiry would be defined as the earlier of the date stated in the lease agreement or the date the lessee is entitled to terminate the lease without being required to pay the outstanding balance. The current provisions that treat consecutive leases as one lease will be retained.

12.11 The current definition of specified lease refers only to personal property. We consider that the definition of finance lease should include the lease of land, which would, by definition, include buildings, fixtures and fittings. It is appropriate that leases of fixtures and fittings be subject to the same rules as leases of other assets. We recognise that this may cause increased compliance costs for normal commercial or residential tenancies. However, because of the requirement in the definition that an asset be leased for at least 75% of its useful life, it is unlikely that normal commercial or residential tenancies would be classified as finance leases.

Consideration for the lease asset

12.12 A finance lease is in substance a sale of the lease asset to the lessee. Therefore the consideration for the lease asset should be close to the market value at the beginning of the lease term. In line with the rules for hire purchase agreements and agreements for the sale and purchase of property, we suggest that the consideration be set at one of the following:

- the cash price at which the property could have been purchased from the lessor;
- the lowest price at which the asset could be purchased under a short-term agreement for the sale or purchase of property;
- the discounted value of amounts payable under the lease calculated in accordance with a determination made by the Commissioner; or

- if the lessee or lessor apply for a specific determination, an amount determined by the Commissioner (the amount determined would apply to both the lessee and the lessor).

Application of proposals

- 12.13 A finance lease will be treated as a sale of the lease asset from the lessor to the lessee, possibly with a resale back at the end of the term. The lessor will be treated as having made a loan to the lessee of an amount equal to the consideration for the asset. The lessee will be treated as having used the loan to purchase the asset.
- 12.14 The lessor will account for any profit on that sale in the year of sale. The interest on the deemed loan will be recognised by both parties over the term of the loan on an accrual basis. The interest will be equal to the instalments and any guaranteed residual value, less the consideration for the asset.
- 12.15 A yield to maturity calculation will be applied to the cashflows of the lease transaction, with a base price adjustment at the end of the lease term. The yield to maturity calculation will be relatively straightforward, since the cashflows from the lease are usually set out in the lease agreement. If the cashflows are not known, the method to be used for spreading the interest will be dealt with under a determination.

Guaranteed residual value clauses

- 12.16 Many finance lease agreements contain a residual value clause. This is effectively a “guarantee” to the lessor that the lease asset will have a certain value at the end of the lease term. Some clauses require the lessor to sell the lease asset when it is returned. If the proceeds from the sale are less than the guaranteed residual value, the lessee must pay the lessor the shortfall. Depending on the terms of the lease agreement, the lessor may be required to return any excess to the lessee. The guaranteed residual value is another element of the consideration passing under the arrangement and, therefore, should be included as a cashflow in accrual calculations.

Depreciation and expiry of lease term

- 12.17 For depreciation purposes the lessee will be considered to have purchased the asset (and possibly to have sold it back to the lessor at the end of the lease term). As happens now for specified leases, the lessor will not be allowed a deduction for depreciation.
- 12.18 If there is a resale arrangement at the end of the lease term, the lessee will calculate any loss or gain on the sale of the lease asset, being the difference between the book value of the lease asset and the deemed sale price.

- 12.19 The deemed sale price on any sale back will be the guaranteed residual value or, if there is no guaranteed residual value, for no consideration. This deemed sale price may be adjusted for any payments required to be made to or from the lessee. That is, the deemed sale price would be increased by any payment to the lessee (for example, if the lease asset is sold to a third party for an amount greater than the guaranteed residual value and the lessor is required to pay the excess to the lessee). The price would be decreased by any payment from the lessee (for example, if the lease asset is sold to a third party for an amount less than the guaranteed residual value and the lessee is required to pay the shortfall to the lessor).

Termination of the lease before the end of the lease term

- 12.20 Sometimes finance leases are terminated before the lease term expires. If the lease asset is re-acquired by the lessor, it will be deemed to be sold back to the lessor for an amount equal to the outstanding balance and a base price adjustment performed. The outstanding balance is the amount of the principal outstanding and any interest due at the termination, adjusted for early termination payment to or from the lessee. For example, any early termination penalty paid by the lessee would be deducted.
- 12.21 If the payment from the lessee to the lessor exceeds the outstanding balance, the lease asset will be deemed to have been sold to the lessor for no consideration. Any payments to or from the lessee would be included in the base price adjustment calculations (see example 3).

Implementation

- 12.22 We propose that the new rules take effect for leases entered into on or after 1 April 1999. Thus the Act will deal with three types of lease: those within the current specified lease definition entered into before 1 April 1999, which will remain subject to the existing specified lease rules; those within the amended definition entered into on or after 1 April 1999 (“finance leases”), which will be subject to the accrual rules; and all others.
- 12.23 The following examples illustrate the proposed approach. The examples use the proposed base price adjustment formula as set out in chapter 6.

Example

On 6 December 1996 a taxpayer leases computer equipment. The cash price at which the equipment could have been purchased from the lessor is \$15,000. For the purposes of the example, assume there is no loading, and the equipment is depreciating at 40% diminishing value. The following table illustrates the amount of depreciation claimed by the lessee over the term of the lease.

Tax year	Opening book value	Depreciation	Closing book value
31/03/97	15,000.00	2,000.00	13,000.00
31/03/98	13,000.00	5,200.00	7,800.00
31/03/99	7,800.00	<u>3,120.00</u>	4,680.00
		10,320.00	

Instalments of \$6,032 are paid annually for three years (75% of the equipment's economic life), and the equipment has no guaranteed residual value. Using yield to maturity, the interest (being the three instalments of \$6,032 (\$18,096) and the guaranteed residual value (in this case 0) less the consideration of \$15,000) is allocated as follows:

Tax year	Lessor's Income/Lessee's expenditure
31/03/97	431.62
31/03/98	1,369.99
31/03/99	903.68
31/03/00	<u>390.71</u>
	3,096.00

Lessee

The lessee uses the computer for the three years and then returns it to the lessor. The base price adjustment would, therefore, be:

$$\begin{aligned}
 a &= 15,000 \\
 b &= 3 \times 6,032 = 18,096 \\
 c &= 0 \\
 d &= 431.62 + 1,369.99 + 903.68 = 2,705.29 \\
 e &= 0
 \end{aligned}$$

$$\text{Base price adjustment } 15,000 - 18,096 - 0 + 2,705.29 + 0 = (390.71)$$

The base price adjustment gives a negative result, making it accrual expenditure incurred by the lessee.

The lessee would also have a loss on sale of \$4,680, being the book value of the asset (\$4,680) and any guaranteed residual value payment (in this case zero) less the guaranteed residual value (in this case also zero).

The following table sets out the expenditure incurred by the lessee over the term of the lease. The expenditure incurred for tax purposes, \$18,096, equals the lease payments made of \$18,096 (item "b" in the base price adjustment calculation).

Expenditure for year 1	Interest	431.62	
	Depreciation	<u>2,000.00</u>	2,431.62
Expenditure for year 2	Interest	1,369.99	
	Depreciation	<u>5,200.00</u>	6,569.99
Expenditure for year 3	Interest	903.68	
	Depreciation	<u>3,120.00</u>	4,023.68
Expenditure for year 4	Base price adjustment	390.71	
	Loss on sale	<u>4,680.00</u>	<u>5,070.71</u>
			18,096.00

Lessor

The lessor would account for any income or loss on the sale in the year of sale. Interest from the loan is spread under the accrual rules on a yield to maturity basis, with a base price adjustment in the final year.

$$\begin{aligned}
 a &= 3 \times 6,032 = 18,096 \\
 b &= 15,000 \\
 c &= 431.62 + 1,369.99 + 903.68 = 2,705.29 \\
 d &= 0 \\
 e &= 0
 \end{aligned}$$

$$\text{Base price adjustment } 18,096 - 15,000 - 2,705.29 + 0 + 0 = 390.71$$

The base price adjustment gives a positive result, making it accrual income derived by the lessor.

The lessor is deemed to have purchased the lease asset for no consideration (that is, no guaranteed residual value was agreed between the lessor and the lessee). This table shows that interest and principal repaid under the deemed loan equal the lease payments.

Income for year 1	Interest	431.62
Income for year 2	Interest	1,369.99
Income for year 3	Interest	903.68
Income for year 4	Base price adjustment	390.71
Repayment of principal		<u>15,000.00</u>
		18,096.00

Example

This example uses the information from the previous example, but assumes there is now a guaranteed residual value of \$15,000 and the lease payments are now \$1,500 annually. At the end of the lease term the computer equipment is returned to the lessor, who then sells it for \$2,000. Under the terms of the lease the lessee is required to pay the lessor \$13,000. Using yield to maturity, the interest (being the three instalments of \$1,500 and the guaranteed residual value of \$15,000 less the consideration of \$15,000) is allocated as follows:

Tax year	Lessor's Income/Lessee's expenditure
31/03/97	431.51
31/03/98	1,500.00
31/03/99	1,500.00
31/03/00	<u>1,068.49</u>
	4,500.00

Lessee

Therefore the base price adjustment in the final year would be:

- a = 15,000
- b = (3 x 1,500) + 2,000 + 13,000 = 19,500
- c = 0
- d = 431.51 + 1,500.00 + 1,500.00 = 3,431.51
- e = 0

$$\text{Base price adjustment } 15,000 - 19,500 - 0 + 3,431.51 + 0 = (1,068.49)$$

The base price adjustment gives a negative result, making it accrual expenditure incurred by the lessee.

The lessee would also have a loss on sale of the lease asset of \$2,680 (\$4,680 + \$13,000 - \$15,000, being the book value and the guaranteed residual value payment less the guaranteed residual value). The following table shows that the expenditure incurred by the lessee for tax purposes, \$17,500, equals the lease payments of \$4,500 and the payment made under the guaranteed residual value clause of \$13,000.

Expenditure for year 1	Interest	431.51	
	Depreciation	<u>2,000.00</u>	2,431.51
Expenditure for year 2	Interest	1,500.00	
	Depreciation	<u>5,200.00</u>	6,700.00
Expenditure for year 3	Interest	1,500.00	
	Depreciation	<u>3,120.00</u>	4,620.00
Expenditure for year 4	Base price adjustment	1,068.49	
	Loss on sale	<u>2,680.00</u>	<u>3,748.49</u>
			17,500.00

Lessor

Interest from the deemed loan is spread under the accrual rules on a yield to maturity basis, with a base price adjustment in the final year.

$$\begin{aligned} a &= (3 \times 1,500) + 2,000 + 13,000 = 19,500 \\ b &= 15,000 \\ c &= 431.51 + 1,500 + 1,500 = 3,431.51 \\ d &= 0 \\ e &= 0 \end{aligned}$$

$$\text{Base price adjustment } 19,500 - 15,000 - 3,431.51 + 0 + 0 = 1,068.49$$

The base price adjustment gives a positive result, making it accrual income derived by the lessor.

In this example the sale price of \$15,000 would be reduced by the payment from the lessee of \$13,000, which means the lessor is treated as having purchased the asset for \$2,000. Therefore there would be no loss or gain on the sale for the lessor.

Example

This example illustrates an early termination of a finance lease. On 4 December 1996 a taxpayer leases a computer. The lease is for three years, and the purchase price of the computer is \$15,000. Lease instalments of \$608.36 are paid monthly. The lessee returns the computer system on 2 January 1999 (after the 25th lease instalment). The lessee is required to pay a penalty of \$1,200.

Lessee

The principal and interest outstanding when the lease is terminated have been calculated as \$5,883.99. Therefore the outstanding balance would be \$4,683.99 (\$5,883.99, less the payment of \$1,200).

$$\begin{aligned} a &= 15,000 \\ b &= (25 \times 608.36) + 1,200 + 4,683.99 = 21,092.99 \\ c &= 0 \\ d &= 1,277.65 + 3,199.35 = 4,477 \\ e &= 0 \end{aligned}$$

$$\text{Base price adjustment } 15,000 - 21,092.99 - 0 + 4,477 + 0 = (1,615.99)$$

The base price adjustment gives a negative result, making it accrual expenditure incurred by the lessee.

The lessee also claims a loss on sale of the lease asset of \$3,116.01 (\$7,800 - \$4,683.99, being the book value of the asset less the deemed sale price).

Lessor

The lessor would be deemed to acquire the computer for \$4,683.99 (the outstanding balance). The interest from the deemed loan in the year the computer was returned would be:

$$\begin{aligned} a &= (25 \times 608.36) + 1,200 + 4,683.99 = 21,092.99 \\ b &= 15,000.00 \\ c &= 1,277.65 + 3,199.35 = 4,477.00 \\ d &= 0 \\ e &= 0 \end{aligned}$$

$$\text{Base price adjustment } 21,092.99 - 15,000 - 4,477 + 0 + 0 = 1,615.99$$

The base price adjustment gives a positive result, making it accrual income of the lessee.

CHAPTER 13

SECURITY ARRANGEMENTS

Proposed policy

- Exclude security arrangements relating to credit risk from the accrual rules.
- Keep security arrangements relating to prices and interest rates as substitutes for derivative transactions such as forward contracts within the rules.
- Retain the prohibition on deductions for expenditure incurred by a surety in section EH 4, in which the surety and the principal debtor are related parties.
- Repeal section EH 5(3), which provides a deduction for creditors who are unable to deduct losses arising from financial arrangements for which they are indemnified.

Security arrangements and the accrual rules

- 13.1 A guarantee or other security arrangement for which a fee is paid to the guarantor will fall squarely within the definition of a financial arrangement adopted by the accrual rules. It is an arrangement whereby a person (the surety) obtains money (the fee) in consideration for a promise by any other person (the surety) to provide money to any person (the creditor) at some future time or times, or upon the occurrence of some future event (default by the debtor).
- 13.2 There has been doubt whether guarantees for which no fee is paid could also pass the financial arrangement test. A recent case heard in the High Court, *McElwee v Commissioner of Inland Revenue*²³, established that personal guarantees when there is no fee are not financial arrangements.

Practical difficulties

- 13.3 Many problems with the application of the accrual rules to security arrangements have been identified. They include:
- the scope of the definition of financial arrangement in relation to guarantees and security arrangements;
 - uncertainties as to how income or expenditure should be recognised on an accrual basis given the contingent nature of the cashflows;

²³ (1997) 18 NZTC 13,288.

- whether the existence of a guarantee should always mean there is a wider financial arrangement;
- the calculation of the acquisition price for the surety when no fee is paid, but the consideration for the guarantee is the provision of financial accommodation to a third party; and
- how to treat any debt outstanding between the guarantor and the debtor if the rights of the original creditor are subrogated to the guarantor.

13.4 A guarantee generally enables a third party to be provided with credit. It reduces the credit risk and affects the pricing of an associated financial transaction for the lender of funds. A guarantee or indemnity is analogous to a collateral security for a primary financing arrangement. It can also be used in the same way as a derivative over foreign exchange or interest rates. These features make the distinction between guarantees and other debt substitutes somewhat arbitrary.

13.5 The distinction between security arrangements and insurance contracts is even more difficult to draw. Guarantees, security arrangements and insurance contracts are able to be substituted because all may reduce the credit risk faced by the lender of funds. Since contracts of insurance are excepted financial arrangements, and security arrangements are included in the accrual rules, different tax results could arise depending on the form of arrangement used.

Proposed reform

Removal of security arrangements relating to credit risk from the accrual rules

13.6 Many of the difficulties described above could be resolved by removing security arrangements from the ambit of the accrual rules. The Valabh Committee recommended this course of action for two reasons: because of uncertainty arising from the issues mentioned above; and on policy grounds, since guarantees are not debt or debt substitutes but more akin to insurance contracts (which are excluded from the accrual rules).

13.7 We agree with this approach if the security arrangement enables a third party to be provided with credit. This type of security arrangement is ultimately closer to an insurance contract than to a derivative financial arrangement.

- 13.8 An amendment to the definition of excepted financial arrangement is the best way to legislate for this because guarantees and security arrangements cannot be easily removed from the core definition of financial arrangement. They exhibit the fundamental feature of a financial arrangement – an exchange of money for a promise to pay money on the happening of a future event.

Guarantees as substitutes for derivative financial arrangements

- 13.9 Some security arrangements indemnify or secure a person against foreign exchange fluctuations or other changes in market prices such as interest rate changes. These arrangements are capable of having the same effect as a derivative such as a forward contract for foreign exchange. Derivative contracts are included in the accrual rules because they can be used as debt substitutes and can alter the income or expenditure profile of a debt instrument denominated in a foreign currency. Security arrangements, apart from those insuring against credit risk, will continue to be taxed under the accrual rules.
- 13.10 If all security arrangements were excepted financial arrangements it might be possible to avoid the application of the accrual rules by structuring or writing derivative contracts in the form of an indemnity.

Effect of removing security arrangements from the accrual rules

The creditor

- 13.11 For the creditor, a base price adjustment will result in expenditure incurred²⁴ equal to the difference between the amount lent and the amount repaid by the borrower. Expenditure, which is currently deemed to be interest for the purposes of the accrual rules, will be deductible under section DD 1(b) if it is payable in deriving the taxpayer's gross income or in the course of business.
- 13.12 However, the deduction will be restricted by section DJ 1(c) if the creditor is indemnified against losses on a loan. That section prohibits deductions for amounts recoverable under a contract of insurance or right of indemnity unless expressly provided for in the Act.
- 13.13 Recoveries under any guarantee will be determined according to non-accrual income recognition rules. Generally, recoveries will not be gross income except to the extent that payment represents compensation of a revenue nature. This “non-deductible – non-assessable” approach should achieve a correct and symmetrical result for the creditor.

²⁴ Note that we are proposing that the automatic deduction be repealed for holders.

The debtor

- 13.14 For the debtor, the timing of the base price adjustment in relation to a financial arrangement is significant because at that point remission income on amounts not repaid will arise. The base price adjustment of the loan will occur when the debtor is discharged from making any remaining payments under the financial arrangement. The effect of the base price adjustment will be to bring to account as remission income amounts owed and not repaid by the debtor.
- 13.15 Guarantee fees paid by a debtor may be deductible under section DJ 11. That section allows a deduction for expenditure incurred in the borrowing of money employed by the taxpayer as capital in the derivation of gross income.

The guarantor

- 13.16 A deduction for an amount paid by a guarantor under a security arrangement will be dependent on the deductibility tests in section BD 2. Assuming the guarantee is on revenue account and the expenditure or loss is not recoverable under any right of indemnity, a deduction will be available.
- 13.17 A recovery made by the guarantor which is compensation for the payment made under the guarantee should have the character of income if the recovery replaces a loss previously deducted as a cost of deriving income.
- 13.18 Guarantee fees will be assessable when derived.

Other proposals in relation to guarantees***Deductions for expenditure incurred by a surety where the surety and the principal debtor are related parties***

- 13.19 The Consultative Committee on Accrual Tax Treatment of Income and Expenditure²⁵ (the Brash Committee) was concerned that if a financial arrangement is guaranteed, the base price adjustment can be deferred indefinitely, particularly between related parties. This could allow more than one deduction for the cost of borrowing: the debtor gets a deduction for the cost of borrowing, and the guarantor pays the principal and claims a deduction on the basis that giving guarantees is part of its business. The debt is left outstanding, so no remission income arises. The Committee considered this inappropriate if the parties were related.
- 13.20 As a result, section EH 4(8) was enacted to disallow a deduction for losses incurred by a surety as a result of the actions of, or events under the control of, a related party.

²⁵ Supplementary report to the Minister of Finance, 9 June 1987, pages 13, 14.

- 13.21 The Valabh Committee recommended that the pre-accrual law which would have allowed deductions to associates if the surety was in the business of giving guarantees should be retained because guarantees by related parties are common commercial practice.
- 13.22 We do not agree with the Valabh Committee on this point because we consider that the original concerns of the Brash Committee are valid. In addition, any change in the current policy could undermine the restrictions on bad debt deductions between associates by shifting the deduction for what is effectively a capital loss to an associated company that is in the business of providing guarantees.
- 13.23 The Income Tax Amendment Act (No. 3) 1993 introduced a new section 64G (EH 5) which clearly provides that bad debt deductions in respect of financial arrangements are governed solely by section EH 5, which limits bad debts between associated parties.
- 13.24 The policy behind the restrictions on bad debt deductions for associates is that the absence of such restrictions would encourage businesses to fund subsidiaries through debt in order to allow losses to be deductible if they arose. Gains, on the other hand, would be exempt, assuming the shares in the subsidiary were held on capital account.
- 13.25 We therefore propose retaining the current policy restrictions on deductions for losses under guarantees provided by associates.

Repeal section EH 5(3)

- 13.26 Section EH 5(3) allows a deduction, up to the amount of the security payment made, if the holder has not been able to take a deduction for losses on the secured arrangement under any other provision of the Act.
- 13.27 This provision will no longer be necessary because the inclusion or otherwise of security payments in income will be determined according to its character as compensation for a capital or revenue item.

CHAPTER 14

TRUSTS AND ESTATES

Proposed policy

Transfer of a financial arrangement on death

Establish that transfer of a financial arrangement, necessitating a base price adjustment, will occur:

- on the death of a party to a financial arrangement; and
- on the distribution of a financial arrangement to a beneficiary under a will or on intestacy.

Natural love and affection

Clarify section EH 4(6) to make it clear that:

- if a creditor forgives a debt (whether in a will or otherwise) because of the natural love and affection that the creditor has for the debtor, and
- if a creditor forgives a debt owing by a trust because of natural love and affection that the creditor has for the beneficiaries of that trust,

amounts forgiven will be deemed to have been paid for the purpose of the accrual rules and will not give rise to income to the debtor.

Accrued beneficiary income

Continue to treat accrued income arising to a trust not paid or applied to a beneficiary as trustee income.

Application of the accrual rules to non-resident trustees who derive New Zealand sourced income

Require non-resident trustees who derive New Zealand sourced income from a financial arrangement if a trust settlor is resident in New Zealand to account for this income and expenditure under the accrual rules.

Deceased estates and the accrual rules

- 14.1 The accrual rules require a base price adjustment to be carried out when a financial arrangement matures or is remitted, sold or otherwise transferred. There is uncertainty as to if and when this should be done on the death of a party to a financial arrangement.

- 14.2 A will usually provides for the appointment of one or more executors. In the absence of a will, a court will appoint someone to administer the deceased's estate.
- 14.3 Legal and beneficial ownership of the deceased's property vests in the executors. The same rights will vest in an administrator on the grant of letters of administration, and this vesting will relate back to the time of death. Since legal and beneficial ownership vests in the personal representatives during the period of administration, a beneficiary under the will or on intestacy will merely have an inchoate right to have the deceased's estate administered properly during this time.
- 14.4 The duties of the deceased's representative are to collect the assets of the deceased, pay all debts, testamentary expenses and taxes and to distribute the remaining assets in accordance with the terms of the will or, in the absence of a will, with the laws on intestacy. Generally, executors have one year in which to complete these duties.
- 14.5 Once an executor or administrator has taken possession of the assets of the deceased person, paid debts and testamentary and administrative expenses, and distributed the legacies in accordance with the terms of the will, the administration of the estate is complete. At this stage the personal representative becomes a trustee of the net residue for the persons beneficially entitled. Transfers of property for an intestate estate are subject to the Administration Act 1969, and statutory trusts may be constituted under that Act in favour of beneficiaries.
- 14.6 Property that has been bequeathed under a will may be gifted as a specific legacy, general legacy or residuary gift. A specific legacy constitutes an identifiable part of the estate, whereas a general legacy is a gift which the personal representative is bound to provide out of the deceased's general estate but in relation to which the testator has given no indication as to which part of the estate should be used to satisfy the legacy. A residuary gift is generally all property left over in the estate that has not been specifically disposed of.
- 14.7 Under the "doctrine of relation back", specific legacies take effect from the date of death. Thus once an executor has given his or her assent to a specific legacy, legal and beneficial title vests in the specific legatee, and such vesting relates back to the time of death of the deceased. As a consequence, a legatee of such a gift has claim to all rights and benefits that have accrued to the subject matter of the legacy from the date of death. The legatee must bear all expenses over this period in relation to the asset in question. General and residuary legacies vest in the beneficiary at the time of distribution (when assent is given by the executor).

- 14.8 Once the executor assents to hold the assets of the deceased on the trusts created by the will, the beneficial ownership of the assets subject to these trusts pass to the beneficiaries entitled. The exception is discretionary trusts, under which beneficiaries cannot obtain beneficial title until the trustee has exercised discretion in their favour.

Practical difficulties

- 14.9 Uncertainty and confusion surround the application of the accrual rules to financial arrangements on the death of a taxpayer through to final distribution of the deceased's assets. In particular, uncertainty exists over the requirement to perform a base price adjustment in relation to financial arrangements held by the executor or trustee of a deceased.

Options for change

- 14.10 Where a financial arrangement is held by a deceased estate, a base price adjustment will be required as at the date of death, and on distribution of the financial arrangement to a beneficiary.

Base price adjustment on death

- 14.11 The transfer on death should be deemed to be a disposal at market value. The Act recognises that there is a change of ownership of a taxpayer's assets at death. A requirement for a base price adjustment to occur on death in relation to financial arrangements held is consistent with other provisions in the Act.²⁶ In the absence of a base price adjustment on the death of a taxpayer, it would be possible:

- for assets to move from an accrual basis holder to a cash basis holder and vice versa; or
- for assets to be gifted to beneficiaries who were tax exempt.

- 14.12 A requirement to carry out a base price adjustment at the date of death should not lead to added compliance costs because the estate is in an ascertainable form, and a tax return must be filed at this date.

Base price adjustment on distribution

- 14.13 A requirement for taxpayers to perform a base price adjustment on a distribution of a financial arrangement by a trustee to a beneficiary would be consistent with the fact that the income tax system treats trustees and beneficiaries as separate taxable entities.

²⁶ See, for instance, section FB 3 - Disposal of Trading stock, section EL 1(3) - Valuation of livestock on death of a taxpayer, and section CG 23(4) - Interest in a foreign investment fund deemed to be disposed of at death.

- 14.14 This is the correct treatment for residuary beneficiaries. Any income arising from the financial arrangement between death and distribution will be taxed to the estate, and the beneficiary will take the financial arrangement at its market value on the day it is transferred to the beneficiary.
- 14.15 If a financial arrangement is transferred to a beneficiary under a specific legacy, the doctrine of relation back (see paragraph 14.7) means that the beneficiary takes the financial arrangement at its market value at the date of death. This suggests that the beneficiary should take the financial arrangement at that date (along with any corresponding tax obligations). However, we are not proposing to take this approach for the purposes of the accrual rules.
- 14.16 Requiring a base price adjustment on death and distribution for both specific legatees and residuary beneficiaries will result in the residuary estate meeting the cost of any tax payable over that period. This will include tax on an increase in value of the financial arrangement that is the subject of a specific legacy. Thus a specific legatee of a financial arrangement may be advantaged over the residuary beneficiaries, depending on the value of the financial arrangement. Although we acknowledge this as a drawback to our proposal, we consider the compliance costs of the alternatives (discussed below) to be prohibitive. In any event, we understand that it is rare for a will to provide that income arising during the period of administration of the estate from a financial arrangement that is the subject of a specific legacy belongs to the specific legatee.
- 14.17 We note that our proposal accords with the recommendations of the Valabh Committee as set out in its final report.

Other options considered

- 14.18 Theoretically, a base price adjustment should be performed every time there is a change of beneficial ownership. This could include the point at which assets are transferred from an executor to a trustee of a testamentary trust at the end of an administration period, and in some cases, on each distribution to a beneficiary. The vesting of legacies can occur at different times for different beneficiaries. For example, specific legacies vest in the specific legatee from the date of death, while residuary beneficiaries will only take from the date of actual distribution.
- 14.19 However, we acknowledge that to require a base price adjustment on all three events may significantly increase compliance costs. The Valabh Committee was also of the view that such a requirement would be excessive and would create unnecessary complexity in income tax law. We also acknowledge that to require a base price adjustment at the change from executor to trustee may create difficulties, since it is sometimes difficult to ascertain the precise time at which an executor assents to hold assets of the estate on trust.

- 14.20 We have also considered an option that would require only one base price adjustment at the time of death. Thereafter a beneficiary would acquire the financial arrangement at the market value as at the date of death. This market value would be adjusted to take account of any income or expenditure accounted for by the personal representatives in respect of the financial arrangement during the period of administration of the estate.
- 14.21 However, this proposal would require the introduction of additional rules for the calculation of the adjusted acquisition cost for the beneficiary (or person entitled on intestacy), which would increase the complexity of the rules and add to compliance costs.

Specific issues for consultation

We prefer the approach of base price adjustments on death and distribution over that of one base price adjustment on death, with an adjustment (if necessary) on distribution, for tax paid by the estate. Do the compliance costs associated with the latter approach outweigh the potential effect on the value of the gift to specific legatees associated with the former approach?

Forgiveness of debt in consideration of natural love and affection and the accrual rules

- 14.22 Under the accrual rules a debt that is remitted or forgiven will give rise to assessable income to the debtor. However, if a debt is forgiven by a natural person in consideration of natural love and affection, section EH 4(6) treats the amount forgiven as if it had been paid for the purposes of the accrual rules. Thus the amount will not give rise to income to the debtor.
- 14.23 The Commissioner has issued a public binding ruling which states that section EH 4(6) can apply to:²⁷
- a debt forgiveness between near relatives such as a father and child, brother and sister, husband and wife and de facto parents;
 - a debt forgiven in a will; and
 - a debt forgiveness by a trust settlor or creditor to a family trust where the creditor has or would have had a relationship of natural love and affection with the trust beneficiaries. (Depending on the particular case, this may also apply to debts owing by discretionary trusts.)

²⁷ BR Pub 96/4 published in Volume Seven, No. 10 of the *Tax Information Bulletin*.

14.24 Under this interpretation the section does not apply to:

- a forgiveness of debt owing by a company; or
- a debt owing by the beneficiaries to a trust if it has been forgiven by a trustee, irrespective of the trustee's natural love and affection for the beneficiaries.

Practical difficulties

14.25 The lack of clarity as to the scope of the section leads to uncertainty for taxpayers, particularly in its application to debt forgiveness by or to trusts.

Options for change

14.26 We propose that section EH 4(6) apply to:

- a creditor forgiving a debt owing by a debtor because of the natural love and affection that the creditor has for the debtor (which would also include the situation where the forgiveness of debt occurs in the creditor's will in consideration of natural love and affection for the debtor); and
- a trust settlor or creditor forgiving a debt owing by a trust because of natural love and affection that the creditor has for the beneficiaries of that trust.

Other options considered

Forgiveness of debt owing to the estate or trust

14.27 We are not proposing to extend section EH 4(6) to apply to a trustee, executor or administrator who forgives a debt owing by beneficiaries to a trust or estate in consideration of the natural love and affection the settlor has or had for the beneficiaries of the trust.

14.28 A trustee can be taxed as a separate tax entity from a settlor who holds the property subject to the trust on behalf of, and for the benefit of, the beneficiaries of that trust. Therefore we consider that extending section EH 4(6) to include forgiveness by an executor or trustee would not be acceptable. In relation to the forgiveness of debts owed to a testamentary trust, under this option the subjective intention of the deceased settlor would have to be considered. This would be difficult in practice.

Forgiveness of company debt obligations

14.29 Section EH 4(6) should not be extended to include forgiveness of debts owing by companies whose shareholders were persons for whom the creditor had natural love and affection.

- 14.30 A company has a separate legal identity from its shareholders. In contrast, a trust is a form of relationship in which one person (the trustee) holds property in his or her own ownership for the benefit of a second party (the beneficiary). The property is held according to terms that are dictated by the person who constituted the trust (the settlor). The function of trust law is to enforce the duties implicit in the trust relationship that exists between the trustee and the beneficiary and to provide remedies for a breach of those duties.
- 14.31 A forgiveness of a debt owing by a trust will benefit the beneficiaries of that trust. However, there may be situations where a loan to a company that is subsequently remitted does not beneficially flow through to shareholders – for example, if a company is insolvent, or in loss.
- 14.32 If section EH 4(6) were extended to the forgiveness of debts owing by companies, proximity problems could arise if the shareholders were not ordinary persons but were other entities (such as trusts or companies) controlled by natural persons for whom there was natural love and affection.
- 14.33 We note that the Valabh Committee, in its 1991 report, was also opposed to extending section EH 4(6) to cover forgiveness of debts owing by companies.

Extending section EH 4(6) to financial arrangements other than debts

- 14.34 We have also considered whether section EH 4(6), which refers to the forgiveness of “debt”, should be extended to include a forgiveness of an obligation under all financial arrangements.
- 14.35 Section EH 4(6) is a concession intended to apply to simple family transactions. To extend its scope could mean that it is used in complicated forms of tax planning.

Altering the tax treatment of creditors

- 14.36 We have also considered the argument that section EH 4(6) is unfair in that it imposes a tax liability on a creditor for interest income that has never been paid by the debtor. However, we agree with the Valabh Committee that the policy behind the provision was that a remission of a debt in consideration of natural love and affection should be no different from a repayment having been made by the debtor, and the creditor subsequently gifting the payment back to the debtor. The tax consequences in each situation should be the same, and on this basis the creditor would be taxable on interest income. Therefore we do not propose altering the tax treatment of creditors under section EH 4(6).

Accrued beneficiary income and the accrual rules

14.37 The term “beneficiary income” is defined in the Act as income derived by a trustee during an income year which vests absolutely in interest in a beneficiary, or is paid or applied by the trustee to or for the benefit of a beneficiary during or within six months after the end of that income year.

Practical difficulties

14.38 It is not clear whether the definition of beneficiary income includes income considered to be derived in relation to a financial arrangement.

14.39 Gross income, under the accrual rules, can include income that has not been received by the trust. Accordingly, the income cannot be paid or applied to, or vested absolutely in interest in a beneficiary. That income must, therefore, be taxed as trustee income at 33%, whereas the beneficiary who ultimately receives the income may be on a lower rate.

Options for change

14.40 If the Commissioner could be satisfied that the income from a particular financial arrangement would eventually be paid or applied to a particular beneficiary on a lower tax rate, it might be possible to tax that gross income as beneficiary income. However, there appears to be no workable and practical test that could be applied to classify income arising from a financial arrangement as beneficiary income. Reliance on trustees’ resolutions and accounts would be unacceptable from the Government’s point of view because of the opportunity it presents for subsequent reversal. Accordingly, we do not propose any change.

Specific issues for consultation

Is there a satisfactory and irreversible way to clarify income accruing from financial arrangements as beneficiary income?

Non-resident trustees holding financial arrangements and the accrual rules

14.41 Trusts are generally taxed on the basis of the residence of the settlor. The residence of the trustee is disregarded for New Zealand tax purposes. A trustee, whether resident or non-resident, is liable to income tax on all trustee income that the trustee derives from New Zealand.²⁸

²⁸ Section AA 2 refers.

Practical difficulties

14.42 Part H of the Act specifically provides a mechanism for non-resident trustees who derive foreign sourced income to be subject to the accrual rules. Because there is no such specific rule for New Zealand sourced income, the accrual rules do not apply to income derived or expenditure incurred in relation to financial arrangements held or issued by non-resident trustees.

14.43 Thus there is inconsistent treatment between:

- non-resident trustees deriving foreign sourced income from financial arrangements; and
- non-resident trustees deriving New Zealand sourced income from financial arrangements, who may not be subject to the accrual rules (if the financial arrangement does not relate to a business carried on through a fixed establishment in New Zealand).

Proposed reform

14.44 There is no justifiable policy reason for this difference in treatment. Section EH 9 should be amended to clarify that non-resident trustees (where a settlor is resident in New Zealand) who derive New Zealand sourced income from a financial arrangement are subject to the accrual rules.

CHAPTER 15

AGREEMENTS FOR THE SALE AND PURCHASE OF PROPERTY OR THE PROVISION OF SERVICES

Proposed policy

- Amalgamate the rules applying to trade credits into the rules for agreements for the sale and purchase of property.
- Extend the rules relating to agreements for the sale and purchase of property to apply to the provision of services.
- Introduce accumulation provisions to enable the accrual rules to apply to prepayments.
- Extend the definition of property (which currently includes trading stock) to include revenue account property that is not trading stock.

Agreements for sale and purchase of property and the accrual rules

- 15.1 The accrual rules were intended to bring to tax on an accrual basis amounts associated with charges for the use of money. The rules were to cover interest, whether explicit or implicit, on exchanges with deferred payment.
- 15.2 The rules were not intended to bring to tax changes in the value of property, goods or services that are the subject of an agreement for the sale and purchase of property between the date the parties agreed to a future price and the settlement date. The “lowest price” concept in determining the consideration for trade credits and property transactions (including specified options) ensures this effect is achieved.

Practical difficulties

- 15.3 A number of problems have arisen relating to the application of these rules:
- Problems arise because the property and trade credit rules overlap. For example, the period between the date of delivery of property and the date on which the purchase price is paid (settlement) can sometimes constitute a trade credit for the purposes of the accrual rules. This creates uncertainty as the core acquisition price is defined differently for trade credits and property agreements.

- The rules do not cater for payment for the use of money over time in a contract for services.
- A prepayment for services is not within the trade credit or property agreement rules, so paragraph (e) of the definition of core acquisition price applies. This means that movement in the value of the services is brought to tax.
- There are no interest accumulation rules to deal with prepayments generally.
- The current definition of “core acquisition price” deals only with the original parties to the financial arrangement and does not deal with the on-selling of the financial arrangement.
- The definition of property may not be comprehensive enough to cover all situations in which the rules should be applied.

Proposed reform

Agreements for the sale and purchase of property and services

- 15.4 The first three of these problems can be addressed by amalgamating the trade credit rules to the property rules, and applying the rules for property agreements to services.
- 15.5 A trade credit is defined as a debt for goods or services, and therefore those rules have a wider scope than the rules for property agreements, which do not currently apply to services.
- 15.6 If the property rules are applied to services, the two sets of rules can be integrated and the concept of a trade credit will be redundant. This means that there will be no question as to whether an agreement for the sale and purchase of property becomes a trade credit at any point.
- 15.7 At present there are no rules relating to prepayments for services. The trade credit rules apply to debts for goods and services. It appears that a prepayment is not a trade credit or short-term trade credit as currently defined because these refer to payments after the supply of goods or services. Integrating trade credits and the property rules (which will cover services) overcomes this problem.

Integrating agreements for the sale and purchase of property with trade credits: consequential issues

Definition of excepted financial arrangements

- 15.8 As a result of the proposed changes, the definition of short-term trade credits will also be amalgamated with short-term property agreements. However, the measurement periods for short-term property agreements and short-term trade credits are not consistent. For property agreements the measurement period runs from the date the agreement was entered into. For trade credits the relevant date is the date that the goods and services are supplied, or for continuous supplies (such as electricity) the date of invoice.
- 15.9 The rules for the measurement period for property agreements are broader. This is because an agreement for the sale and purchase of property can result in a loan from the buyer to the seller of property (if there is a prepayment) or a loan from the seller to the buyer (if payment is deferred). The date of supply of property is, therefore, an inappropriate point from which to measure the term of an arrangement.
- 15.10 We propose bringing the trade credit rules into line with those for property agreements except if the supply of goods or services is continuous. In that case the period will run from the date of invoice. Aligning the measurement periods means that the measurement period for trade credits now runs from the date the agreement was entered into. As a result, some short-term trade credits may become financial arrangements because agreements are entered into before the supply of goods or services. To alleviate the effect of this we will increase the term of short-term agreements for the sale and purchase of property and services to 93 days.

Short-term excepted financial arrangements as financial arrangements by election

- 15.11 For the purposes of the accrual rules, taxpayers are allowed to treat short-term trade credits as financial arrangements provided notice in writing is given to the Commissioner. This flexibility is required because many taxpayers include all income or expenditure from trade credits in income for accounting and tax purposes. Separating out the short-term from the long-term trade credits can be a compliance burden.
- 15.12 The election will be extended to short-term agreements for the sale and purchase of property.

Determination of acquisition price

- 15.13 There are differences in the rules specifying the core acquisition price for deferred settlement sales. The core acquisition price of a trade credit can be the cash price of the goods under the Credit Contracts Act 1981.

- 15.14 We intend to retain this option in determining the consideration paid under an agreement where the disclosure requirements of the Credit Contracts Act 1981 apply.
- 15.15 The new rules for determining the consideration paid under an agreement for the sale and purchase of property or services will be:
- the cash price determined under the Credit Contracts Act 1981 where that Act applies; or
 - the lowest price the parties would have agreed on the basis of full payment when the first right in the property is transferred or the services are provided; or
 - the discounted value of the amounts payable using a method determined by the Commissioner under a determination issued under the Tax Administration Act 1994; or
 - if there is a combination of payments before and after the first right in the property is transferred or services are provided, the aggregate of the future value of the payments made before the transfer of the property and the discounted value of the amounts payable after transfer of the property (see below).

Bad debts

- 15.16 A deduction for an amount written off as a bad debt in respect of a trade credit is available to taxpayers who carry on the business of dealing in goods or services. If the distinction between agreements for the sale and purchase of property and trade credits is removed, the deduction will also be available in respect of those agreements, as long as the taxpayer is a dealer in the goods or services that are the subject of the agreement.

Interest accumulation

- 15.17 In some circumstances all or part of the purchase price of a property is paid before the transfer of any right in the property. This means that the seller has the use of the buyer's money while retaining the use of the property and the benefits that flow from the property. The buyer, on the other hand, may require compensation for not being able to use the money or the property.
- 15.18 The price agreed to be paid for the property is likely to reflect these costs and benefits. Any interest element contained in the valuation of the property should be subject to the accrual rules. The rules should isolate that element and spread recognition of the associated income or expense over the term of the arrangement.

- 15.19 We propose amending the accrual rules to include a provision allowing an adjustment to the consideration if the purchaser of the property pays in advance and obtains a reduction of the purchase price by doing so.
- 15.20 The Tax Administration Act 1994 would also be amended to give the Commissioner power to make determinations setting out how and when accumulation rules will apply.

The definition of consideration if a property agreement is on-sold

- 15.21 If an agreement for the sale and purchase of property (or a specified option) is on-sold, the income or expenditure as calculated under the base price adjustment is incorrect. This is because the core acquisition price is designed for situations where the arrangement is held to maturity. It does not deal with situations where the arrangement is sold for a price that reflects the change in the underlying value of the property.
- 15.22 The rules for valuing consideration under a property agreement should be limited to the parties who originally entered into the arrangement. If the agreement is on-sold, the consideration should be calculated by reference to what the acquiring party actually pays.
- 15.23 The hire purchase rules have made this distinction by applying the core acquisition price rules to the “first holder” only. The integration of the hire purchase and agreement for the sale and purchase of property rules will deal with this problem.

The definition of property

- 15.24 In its final report the Valabh Committee recommended that the definition of “agreement for the sale and purchase of property” be amended by widening the definition of “property”. It was concerned that the existing definition would not cover all assets held on revenue account. This is because the definition of “trading stock” depends on the circumstances of the taxpayer, and a particular revenue asset may not qualify if the asset is not held as trading stock.
- 15.25 The Committee recommended that the definition of property for the accrual rules be extended to cover property of any kind, whether real or personal, legal or equitable, tangible or intangible, and modified to exclude foreign exchange and financial arrangements. The separate definition of “trading stock” for accrual purposes can be repealed. We agree with these recommendations and propose to make the changes.

CHAPTER 16

DEFINITIONS

Proposed policy

Clarify the definition of agreements for the sale and purchase of property, forward contracts and futures contracts so that:

- The rules for valuing consideration under a property agreement will only apply if the agreement must be settled by physical delivery of property.
- A futures contract is a forward contract traded on a recognised futures exchange.

Distinctions in the accrual rules between agreements for the sale and purchase of property, forward contracts and futures contracts

- 16.1 In 1988 special rules for the taxation of agreements for the sale and purchase of property were introduced. The purpose of the new rules was to ensure that for agreements where the main purpose is the transfer of property, only that part of a deferred settlement which can be substituted for debt, the financing element, is subject to the accrual rules. Changes in the value of the underlying property are not treated as accrual income or expenditure.
- 16.2 For forward contracts, on the other hand, movement in the value of the underlying property is brought to tax. For this reason, the distinction between property agreements and forward contracts is important.
- 16.3 A distinction can be drawn between an agreement for the sale and purchase of property under which the property will pass to the purchaser, with an interest component that compensates the vendor for deferred payment, and an agreement that is effectively a “bet” as to the value of a commodity in the future.
- 16.4 In the first case, any movement in the value of the property concerned is not brought to tax under the accrual rules. The second is an example of a forward contract that uses a particular commodity as a pricing index, and that should be subject to the same tax rules as other forward contracts.
- 16.5 Yet both can be written as an agreement for the sale and purchase of property since the definitions of these agreements and of forward contracts are not sufficiently clear.

- 16.6 Futures contracts are not defined in the legislation. The distinction between forward and futures contracts is important in the accrual rules because under the spreading provisions in section EH 1(6), the market valuation method is available for all futures contracts, but only for forward contracts for foreign exchange.

Proposal

- 16.7 The rules for agreements for the sale and purchase of property were intended to deal with actual transfers of property. They were not intended to apply if the property is being used only as a pricing index. If there is a cash settlement option in a property agreement, this is an indication that the property is being used as a pricing index. The agreement should then be treated as a forward contract.²⁹
- 16.8 Current practice is to treat forward contracts as futures contracts only where they are traded on a recognised exchange. The policy rationale behind this is that the market valuation method available for futures contracts is restricted to recognised markets where the risk of default is low. Our proposal is that this be made explicit in the legislation.

²⁹ We note that this is consistent with the approach suggested by the International Accounting Standards Committee in its discussion paper *Accounting for Financial Assets and Financial Liabilities*, March 1997.

CHAPTER 17

MISCELLANEOUS ISSUES

Proposed policy

- Repeal the disclosure requirements contained in section 60 of the Tax Administration Act 1994.
- Amend section GD 11(1) by removing the reference to a connection between the parties, and by extending it to apply if a financial arrangement is issued, acquired, varied, sold or otherwise transferred.
- Remove non-contingent fees from the scope of the accrual rules.
- Treat a distribution of a financial arrangement *in specie* by a company in liquidation as a disposition requiring a base price adjustment.
- Replace the word “comprises” in provisions in the accrual rules with the word “includes”.
- Remove the necessity for a base price adjustment for a financial arrangement if a New Zealand resident becomes non-resident and still carries on business through a fixed establishment.
- Exempt temporary residents from the requirement to calculate a base price adjustment under section EH 4(9)(d) provided they become non-resident for tax purposes within three years of initially obtaining tax residence. This applies only to financial arrangements to which they were a party before first becoming a New Zealand resident.

Disclosure of financial arrangements

- 17.1 The definition of financial arrangement includes composite arrangements.
- 17.2 Disclosure provisions for interrelated arrangements (under section 60 of the Tax Administration Act 1994) were introduced to assist the Commissioner in identifying composite arrangements. Subsidiary objectives were the provision of information for general purposes, such as to assist with audit targeting, and the specific purpose of determining a taxpayer’s liability to tax.

Practical difficulties

- 17.3 The Valabh Committee noted the following problems with the disclosure provisions:
- The Commissioner can already request information from specific taxpayers under section 17 of the Tax Administration Act 1994.
 - The provision is poorly targeted, resulting in burdensome compliance obligations on taxpayers.
 - Acceptability of non-compliance with the provision by taxpayers and Inland Revenue undermines the credibility of the accrual rules.
 - Circularity inherent in the drafting of the section, on a strict interpretation, makes it redundant.
- 17.4 Commentators have described the disclosure requirements as unwieldy because it is difficult to determine if constituent parts of a financial arrangement are “related”, and disclosure may result in breach of confidentiality.

Proposed reform

- 17.5 We propose the repeal of section 60 of the Tax Administration Act 1994. Recent reforms, such as the new compliance and penalties legislation and changes to the international tax rules, have resulted in a more robust tax system. That fact, coupled with a commitment to compliance cost reduction and the failure of the disclosure rules to operate as an effective deterrent to tax avoidance, support this approach.
- 17.6 We considered whether the information gathering powers of the Commissioner should be strengthened in the absence of the general accrual disclosure provisions. This would enable Inland Revenue to seek information on particular transactions as required, rather than receive information as a matter of course.
- 17.7 The Valabh Committee acknowledged that Inland Revenue may need to require disclosure of particular arrangements or types of arrangements, from certain groups of taxpayers, or perhaps all taxpayers, and that the existing section 17 may not authorise that level of disclosure.
- 17.8 Changes to the general information gathering powers of the Commissioner, however, are beyond the scope of the accruals review.

Non-market transactions

- 17.9 Section GD 11 is aimed at transactions that attempt to defeat the intent and application of the accrual rules. The provision allows the consideration agreed between the parties to be replaced with arm's length consideration.
- 17.10 We propose to extend the scope of the provision to ensure that it does not set unnecessary limitations on the power of Inland Revenue to set independent or market related prices.
- 17.11 First, the requirement of a connection between the parties will be removed. Taxpayers, whether associated persons or not, may act in concert to manipulate their income tax liabilities.
- 17.12 Second, the current provision is limited to the issue or transfer of a financial arrangement, which is too narrow. The section will be extended to apply where an arrangement is issued, acquired, varied, sold or otherwise transferred.

The treatment of fees***Current treatment***

- 17.13 Currently, the treatment of fees incurred in relation to a financial arrangement is dependent upon whether the fees are contingent or non-contingent. Contingent fees must be spread over the term of the financial arrangement. Non-contingent fees up to 2% of the core acquisition price do not have to be spread.
- 17.14 The policy behind this treatment is that the fees should be taken into account as a cashflow in calculating income or expenditure, since the fees of a financial arrangement affect the cost of funds. Non-contingent fees are deductible immediately only up to 2%, as an anti-avoidance measure.
- 17.15 The Valabh Committee could not find a substantive justification for distinguishing between different classes of fees. The Committee also noted that taxpayers often had difficulty determining whether a fee was contingent or non-contingent. For example, brokerage payable in connection with the issue of debt securities may or may not be a contingent fee, depending on whether the brokerage is payable on applications received or applications accepted.

Proposed reform

- 17.16 Our proposal is that all contingent fees will be spread because they can be substituted for interest. Non-contingent fees will not be spread.

17.17 The difficulty of determining whether brokerage is contingent or non-contingent can be overcome by referring to the specific agreement or contract. If the brokerage is payable on applications received, and is non-refundable, it is non-contingent. If it is payable on applications accepted, it is contingent.

17.18 However, we consider the avoidance problem to have been overstated. Accordingly, the 2% threshold for non-contingent fees will be removed for two reasons. First, taxpayers have commented on the complexity of complying with the requirements of this threshold, and the removal of the distinction between holder and issuer and the introduction of the new base price adjustment will not alleviate this. Second, we consider that non-contingent fees, regardless of the amount involved, should not be spread, since they cannot readily be substituted for interest.

Distributions by companies

17.19 A distribution *in specie* of a financial arrangement by a company in liquidation should occur at market value, requiring a base price adjustment. This is consistent with the Act's approach to the distribution of other assets such as those governed by:

- section GD 2, which considers a distribution of trading stock to shareholders to be a sale for market value; and
- section GD 11(3), which considers a financial arrangement distributed for a non-market value consideration (if the transferor is a dealer or acquired it for the purpose of sale or disposal) to be a sale at market value.

17.20 This is also consistent with the Valabh Committee's proposal and with our recommendations in chapter 14.

“Comprises”

17.21 Various provisions in the accrual rules refer to a taxpayer whose business “comprises” dealing in financial arrangements.³⁰ The question is whether the word “comprises” in these provisions has an exhaustive or inclusive meaning and whether that meaning is consistent with the intended policy. The provision was intended to apply even if only part of the taxpayer's business, such as the treasury function within a company, involves dealing in financial arrangements.³¹ Even so, the specific financial arrangement, which is the subject of the provisions, must arise as part of that business of dealing.

³⁰ Sections EH 1(6)(c)(i), EH 4(5), EH 5(2)(a) and GD 11(3)(b).

³¹ In the context of bad debts, “comprise” has an inclusive meaning. See *Tax Information Bulletin*, No. 3, September 1989, Appendix C.

- 17.22 To apply the exhaustive meaning would be too restrictive. We propose to replace “comprises” with “includes”.

Change of residence

- 17.23 Section EH 4(9)(d) requires that when persons becomes non-resident (even if they continue to carry on business in New Zealand through a fixed establishment) they are required to perform a base price adjustment for any financial arrangement to which they are a party.
- 17.24 We consider that if a taxpayer continues to carry on business in New Zealand through a fixed establishment, a base price adjustment should not be required, because the taxpayer continues to be taxed according to the accrual rules.
- 17.25 Section EH 4(9)(d) will be amended to reflect this.

Temporary residents with financial arrangements denominated in foreign currencies

- 17.26 Under the current accrual rules, temporary residents may be taxed on foreign exchange gains and losses on mortgages denominated in a foreign currency even though those gains and losses may never be realised. This is because section EH 4(9)(d) requires persons to calculate a base price adjustment at the date they cease to be a New Zealand resident. The problem is most evident with expatriate employees on short-term assignments in New Zealand who have mortgages denominated in the currency of their country of origin.
- 17.27 In the case of loans, some taxpayers will be relieved from complying with the accrual rules because the loans are for private and domestic purposes. Other taxpayers will be relieved from accounting for foreign exchange gains and losses during the term of an arrangement on other assets and liabilities under the new cash basis rules, but will still be subject to section EH 4(9)(d).
- 17.28 We propose introducing further relief for temporary residents who are able to claim cash basis status, in order to ease compliance burdens. They will be exempt from section EH 4(9)(d) provided they become non-resident for tax purposes within three years of initially obtaining tax residence.
- 17.29 This relief will apply to financial arrangements to which the person was a party before first becoming a New Zealand resident. The three-year term is consistent with the exemption in the foreign investment fund rules for temporary residents.

CHAPTER 18

RELATIONSHIP BETWEEN THE ACCRUAL RULES AND OTHER PROVISIONS OF THE INCOME TAX ACT

Proposed policy

- Retain section EH 8(1) to clarify that the accrual rules determine the amount and the timing of income and expenditure relating to financial arrangements.
- Recognise that the core provisions of the Act determine assessability or deductibility of income or expenditure.
- Ensure the transfer pricing rules override the accrual rules to determine the amount of consideration paid or received in applicable cross-border financial arrangements.
- Clarify that income or expenditure of a financial arrangement issued or held by a controlled foreign company is to be determined under the accrual rules except in the first year in which attributed foreign income is calculated. Section CG 11(5)(b) will apply in that case, to deem the consideration for the financial arrangement to be the market value (or adjusted base price under that section).
- Repeal section CE (3)(1)(b) but retain a targeted non-resident withholding tax anti-avoidance provision.

The accrual rules and other provisions of the Act

- 18.1 Section EH 8 governs the relationship between the accrual rules and the rest of the Act. Section EH 8(1) is the general provision. It provides that:

Notwithstanding any other provision in this Act, gross income or expenditure in an income year in respect of a financial arrangement under the qualified accrual rules shall be calculated under those rules.

- 18.2 The phrase “notwithstanding any other provision in this Act” inadequately deals with the relationship between the accrual rules and the rest of the Act. The way the provision is drafted implies a broader application than may have been intended. For example, an extreme interpretation may be that the provision overrides the application of the general anti-avoidance provision.

- 18.3 Section EH 8(2) relates to property that is transferred under financial arrangements. The purpose of section EH 8(2) is to ensure consistency between the price at which property is transferred under a financial arrangement and the price used as a basis for applying other provisions of the Act (for example, the cost basis for depreciation purposes). No changes are recommended to the provision other than to include reference to services as well as property, an amendment that arises as a result of our proposals in chapter 15.

Practical difficulties

- 18.4 Section EH 8(1) is capable of being misconstrued, thus producing uncertainty as to the application of provisions outside the accrual rules. Examples of such provisions are the anti-avoidance provision and the transfer pricing provisions.

Options for change

- 18.5 The role of section EH 8(1), in our view, should be to deal with conflicting rules in the Act regarding the amount of accrual income or expenditure to be taken into account for tax purposes and the allocation of that amount to income years. The provision should apply when another section of the Act dealing with the amount or timing of income or expenditure from financial arrangements dictates a result different from that under the accrual rules. The general rule is that in the absence of any indication to the contrary, the accrual rules should apply.
- 18.6 The provision should not override the core assessability and deductibility provisions in the Act except by explicit amendment of the deductibility or assessability provisions. An example of this type of amendment is our proposal to allow a deduction for expenditure under a base price adjustment if the general deductibility provisions do not apply but a loss arises under a financial arrangement because of income that is taxed, but unrealised, in earlier years.
- 18.7 Section EH 8(1) should more clearly reflect this purpose. We also intend to clarify problematic relationships between particular provisions.
- 18.8 The Valabh Committee recommended that section EH 8(1) be repealed because its role seemed to be merely declaratory as to the primacy of the accrual rules for calculating income or expenditure. The Committee believed that conflicts between the accrual rules and other provisions of the Act could be resolved by taking a scheme and purpose approach to interpreting the Act. However, simply repealing the provision would, in our view, create more uncertainty because the scheme and purpose of the Act, and the primacy of conflicting policy intents may not be readily evident.

Specific issues

Section GD 13

- 18.9 Commentators have in the past raised the issue of whether section EH 8(1) precludes the transfer pricing provisions from applying.
- 18.10 The transfer pricing provisions aim to stop manipulation of income by the payment of inadequate or excessive consideration for the transfer of goods, services, intangibles and loans between jurisdictions. Section GD 13(3) and (4) deems an amount of consideration payable or receivable by a taxpayer under an arrangement to be equal to an arm's length amount for all purposes of the Act.
- 18.11 The transfer pricing rules are intended to have overriding effect and should determine the appropriate cashflows used to calculate income or expenditure under the accrual rules as well as any other provisions of the Act. Any redraft of section EH 8(1) should ensure this outcome continues.

Section CG 11(5)

- 18.12 The controlled foreign company rules attribute income derived by non-resident companies to New Zealand resident owners of that company.
- 18.13 The amount attributed is the income or loss of the controlled foreign company that would be calculated in accordance with the Act (modified by any rules detailed in section CG 11) as if the company were resident in New Zealand.
- 18.14 Section CG 11(5) provides rules for calculating the acquisition price of a financial arrangement held by a controlled foreign company. There are two problems with this provision. First, given the wording of section CG 11(2), it is not clear whether the controlled foreign company rules or the accrual rules take precedence in determining the acquisition price of an arrangement.
- 18.15 The income or expenditure of a controlled foreign company is intended to be calculated as if the company was a New Zealand resident, but subject to the special rules provided in section CG 11. This relationship will be clarified.
- 18.16 Secondly, the definition of "acquisition price" in section CG 11(5)(a) does not give the correct result, so we propose repealing the section. It provides that the acquisition price of a financial arrangement is the value of that arrangement at the end of the immediately preceding period. This means the acquisition price will fluctuate from year to year as the value of the arrangement changes, and will give incorrect results in the year that the base price adjustment applies. The appropriate acquisition price, if a person has had attributed foreign income in a previous period, is that calculated under the accrual rules or section CG 11(5)(b).

- 18.17 Section CG 11(5)(b) applies if no attributed foreign income is calculated in the previous period. The acquisition price is the market value of the instrument or the adjusted acquisition price. This is appropriate because it is analogous to a taxpayer entering the tax base.

Section CE 3(1)(b)

- 18.18 Section CE 3(1)(b) includes in assessable income of residents the amount of the redemption payment received by a person on a commercial bill if that bill was held at any time by a non-resident. A redemption payment is defined in the Act as the difference between the amount paid to the holder of a bill upon redemption and the amount received by the original issuer of the bill. Section CE 3(1)(b) is designed to prevent non-residents avoiding non-resident withholding tax on the redemption payment by disposing of the bills to a resident immediately before maturity of the bills.
- 18.19 A resident taxpayer who redeemed such a bill is subject to tax on the full amount of the difference between the face value of the bill and the issue price, even though the real gain may be considerably less. (For example, the taxpayer might have purchased it for considerably more than the original issue price.)
- 18.20 Section CE 3(1)(b) is an anti-avoidance provision which could render the entire redemption payment assessable, whereas a base price adjustment under the accrual rules would give only the difference between the purchase price paid by the person redeeming the bill and the redemption value (assuming no interest coupons are paid). This difference in outcome raises the issue of the compatibility of section CE 3(1)(b) with the accrual rules, and whether section EH 8 effectively makes section CE 3(1)(b) redundant as a charging provision.
- 18.21 The Valabh Committee, in its final report, recommended the repeal of section CE 3(1)(b) because it was a crude anti-avoidance provision. It mentioned the fact that with bearer instruments, unless they were directly acquired from non-residents, ownership cannot be traced.³² The Committee also considered that with the introduction of the approved issuer levy for registered securities and the zero rating of non-resident withholding tax on such securities, the retention of the provision could not be justified.

Proposed reform

- 18.22 We consider that the accrual provisions and section CE 3(1)(b) can be made compatible. The purpose behind section CE 3(1)(b), to prevent a non-resident selling commercial bills to residents to avoid non-resident withholding tax, remains relevant, although we agree the current provision is too broad. In open capital markets, a broad-brush anti-avoidance provision such as section CE 3(1)(b) is not appropriate or feasible because the tax residence of the bearer of traded bonds is unknown to the purchaser.

³² *The Final Report of the Consultative Committee on the Taxation of Income Capital*, The Valabh Committee, October 1992, page 100.

- 18.23 The accrual rules should be the main provision used to calculate income or expenditure from all financial arrangements, including commercial bills. The anti-avoidance flavour of section CE 3(1)(b) should be retained but it need not remain in its present form. The provision could be moved to Part G of the Act and apply only where an arrangement exists to defeat the application of the non-resident withholding tax or approved issuer levy rules.