Determination G30

Debt Securities, Finance Leases and Hire Purchase Agreements Denominated in New Zealand Dollars

This determination may be cited as "Determination G30: Debt Securities, Finance Leases and Hire Purchase Agreements Denominated in New Zealand Dollars".

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

This determination may be applied to all debt securities held or issued by a person who is in the business of lending money where the person has adopted the International Financial Reporting Standards (IFRS) for financial reporting purposes. The determination also applies to financial arrangements that are finance leases or hire purchase agreements in respect of the person that receives the rental or hire payments under the lease or agreement where that person has adopted IFRS for financial reporting purposes. However, the determination does not apply to debt securities that are held or issued for dealing or liquidity purposes. Where a financial arrangement comes within the scope of this determination, the determination is an alternative to Determination G3: Yield to Maturity Method and Determination G11A: Present Value Based Yield to Maturity Method or an alternative to Determination G26: Variable Rate Financial Arrangements.

Before the adoption of IFRS, a person in the business of lending money generally applied the following tax treatment in relation to debt securities. Gross income included interest income (being interest actually received and accrued for the reporting period) on the principal amount of the loan plus relevant fee income, adjusted for doubtful debt provisions. Fee income was brought to account over a period not exceeding the period of the loan. The recognition of interest and relevant fee expenditure by the person used the same method. That method was acceptable for reporting income and expenditure for tax purposes under the financial arrangements rules. Specifically it was an alternative method to the yield to maturity method that satisfied the requirements of section EW 16(2) of the Income Act 2004 ("the Act"). The method was acceptable for the same reasons under the old financial arrangements rules.

Following the adoption of IFRS, the method no longer complies with the requirements of section EW 16(2) of the Act because the tax method would not be used by the taxpayer for financial reporting purposes. It also does not comply with section EW 20(2) of the Act, in relation to debt securities where yield to maturity cannot apply, for the same reason.

This determination will allow persons in the business of lending money to continue to apply the same tax treatment as above for interest income and expenditure following their adoption of IFRS.

This determination also sets a method in respect of contingent fees and, in the case of the old financial arrangements rules, certain non-contingent fees. The recognition of all (contingent and non-contingent) fee income and expenditure by persons in the business of lending money under IFRS for financial reporting will result in compliance with the requirements of this determination.

The application of this determination results in any impaired asset adjustments and adjustments to reflect fair value movement or changes in interest rates, made under IFRS, being disregarded for tax purposes. Bad debt deductions may continue to be made in accordance with section DB 23 of the Act.

Where a taxpayer changes its spreading method, it is required to make a spreading method adjustment which may give rise to income or expenditure in the year of adjustment. Where a person that has previously applied the method described above and then applies this determination, the net effect of the spreading method adjustment should be a one-off recognition, in the year of adjustment, of any difference in treatment of fees between the previous method and this determination method.

This determination may also be applied to all existing and new finance leases and hire purchase agreements by a person that receives the rent or hire payments under the lease or hire purchase agreement and where the person has adopted IFRS for financial reporting purposes.

2. Reference

This determination is made:

(a) For the purposes of the financial arrangements rules, pursuant to section 90AC (1) (e), section 90AC (1)(f) and section 90AC (1) (g) of the Tax Administration Act 1994; and

(b) for the purposes of the old financial arrangements rules, pursuant to section 90 (1)(d) and section 90 (1)(f) of the Tax Administration Act 1994.

3. Scope

(1) This determination applies to:

  (a) A person's interest income, interest expenditure, fee income and fee expenditure for debt securities held or issued by the person where the person is in the business of lending money and has adopted IFRS for financial reporting purposes; and

  (b) a person's income or expenditure from financial arrangements that are finance leases or hire purchase agreements where:

    (i) the lease or agreement is for a fixed term with fixed rent or hire payments made on a regular basis at least annually;

    (ii) the lease or agreement is denominated in New Zealand dollars; and

    (iii) the person is the party that receives the rent or hire payments made under those financial arrangements and the person has adopted IFRS for financial reporting purposes.

(2) This determination does not apply to:

  (a) debt securities which have been identified at the time the financial arrangements were acquired and allocated to a specific portfolio for the purpose of liquidity management, including real time gross settlement; or

  (b) debt securities held for the purpose of dealing.

(3) A person may use this determination for all debt securities that satisfy sub-clause (1) (a) (and do not fall within sub-clause (2)) above irrespective of when the person in the business of lending money became a party to that debt security. A person may also use this determination for all financial arrangements that satisfy sub-clause (1) (b) irrespective of when that person became a party to that financial arrangement.

4. Principle

(1) The income deemed to be derived or expenditure deemed to be incurred from a debt security to which this determination applies:

(a) interest income or interest expenditure will be equal to the interest amount calculated on the principal amount outstanding on the debt security during the income year; and

(b) fee income and fee expenditure will be recognised for tax purposes in the same manner as they are recognised under IFRS.

(2) The income deemed to be derived or expenditure deemed to be incurred by a person in respect of a finance lease or hire purchase agreement to which this determination applies will be calculated in the same way as for a debt security, under sub-clause 4 (1), using the interest rate that is inherent in the terms of the finance lease or hire purchase agreement.

(3) For the avoidance of doubt, no impaired asset, fair value movement or interest rate adjustment that may be required by IFRS is permitted under this determination.

5. Interpretation

(1) A reference to “the Act” is a reference to the Income Tax Act 2004.

(2) “debt securities” means a class of financial arrangements involving an instrument creating or acknowledging a debt that:

(a) is issued or acquired for its face value (or an amount not materially different from its face value);

(b) incorporates interest rest periods of no less than one period per income year;

(c) has an appropriate market rate of interest that is either fixed or floating and applies to the principal outstanding at each rest;

(d) in respect of which fees may be imposed when the instrument is issued, whether those fees are required to be spread across the instrument’s term or not; and

(e) has all amounts payable under the instrument denominated in New Zealand dollars.

“core acquisition price” means the core acquisition price as defined in section EZ 45 of the Act.

“fee expenditure” means:

(a) in relation to a financial arrangement subject to the financial arrangements rules any contingent fee charged to a party to the financial arrangement that relates to the financial arrangement; or

(b) in relation to a financial arrangement subject to the old financial arrangements rules any contingent fee charged to a party to the financial arrangement that relates to the financial arrangement plus the smaller of –

(i) the amount of consideration provided in relation to the financial arrangement by the party to the financial arrangement that is not contingent on the implementation of the financial arrangement; or

(ii) 2% of the core acquisition price of the financial arrangement.

"fee income" means:

(a) in relation to a financial arrangement subject to the financial arrangements rules any contingent fee charged by a party to a financial arrangement that relates to the financial arrangement; or

(b) in relation to a financial arrangement subject to the old financial arrangements rules any contingent fee charged by a party to the financial arrangement that relates to the financial arrangement plus the smaller of –

  (i) the amount of consideration provided in relation to the financial arrangement to the party to the financial arrangement that is not contingent on the implementation of the financial arrangement; or

  (ii) 2% of the core acquisition price of the financial arrangement.

"financial arrangements rules" means the financial arrangements rules as defined in section EW 1(2) of the Act.

"IFRS" means the New Zealand equivalent of the International Financial Reporting Standards, operating within the framework of Generally Accepted Accounting Principles.

"interest", for the purposes of this determination, means any periodic payment or periodic receipt, accrual or capitalisation in relation to a debt security to the extent that it is intended to provide a return to the lender on the sums provided to the borrower, not including fees or payments effecting a reduction in principal.

"interest expenditure" means any amount of interest that is incurred by a borrower under a debt security.

"interest income" means any amount of interest that is derived by a lender under a debt security.

"old financial arrangements rules" means the old financial arrangements rules as defined in section OB 1 of the Act.

(3) All other terms used have the same meaning given to them in the Act for the purposes of the financial arrangements rules or the old financial arrangements rules, as appropriate.

6. Method

(1) Interest income or interest expenditure for a debt security will be equal to the interest amount calculated under the terms of the debt security on the principal amount outstanding on the debt security during the income year. Non-fee income or non-fee expenditure for a financial arrangement that is a finance lease or a hire purchase agreement will be calculated in the same way as interest income or expenditure for a debt security by using the interest rate that is inherent in the terms of finance lease or hire purchase agreement.

(2) Fee income and fee expenditure for a debt security or a financial arrangement that is a finance lease or hire purchase agreement is to be determined in the same manner as recognised for the purposes of IFRS.

7. Transitional adjustment

(1) Where a taxpayer changes its spreading method, section EW 26 of the Act requires a spreading method adjustment to be calculated under section EW 27 of the Act. This may give rise to an amount of income or expenditure in the year of adjustment.

(2) Where a debt security gives rise to interest income or expenditure only, the results obtained under the previous method generally adopted by persons in the business of lending money would be expected to be the same as the result under this determination. As a result, the spreading method adjustment should give rise to an amount of income or expenditure (where the previous method had been applied) only where, and to the extent, the treatment of fees under the previous method was different to the treatment under IFRS.

8. Example

(1) A bank with a 30 June balance date has made a loan to a customer in accordance with standard banking practice. The loan was for $100,000.00 and was issued on 1 July 2005 for a term of 15 years and is secured by way of a mortgage over a residential property.

(2) The interest rate applicable to the loan is based on a floating rate of interest which was initially set at 9.25%. Principal and interest repayments by the customer have been calculated in accordance with the pricing formula of a table mortgage type of financial arrangement with monthly rests. Equal payments of $1,029.19 per month over 180 (15 years x 12 months) months are required in order to fully repay this loan. The monthly instalments are paid on the last day of each month.

(3) An establishment fee of $500.00, amounting to 0.5% of the amount lent, has been charged to the customer. The fee has been netted off against the amount of principal lent to the customer, resulting in a net amount of $99,500.00 paid by the bank to the customer on 1 July 2005.

(4) No fee was paid by the bank to a mortgage broker in order to originate the loan.

(5) The calculation method required under this determination must be made in accordance with clause 6. A separate calculation is required for interest and for fees. Interest income or expenditure must be calculated in accordance with sub-clause 6 (1).

(6) Interest income for the income year is the aggregate of the monthly interest component of the total monthly repayment of $1,029.19. All fees are excluded from this part of the accrual calculation. Interest calculated under the table mortgage calculation formula and the YTM method are therefore identical. In accordance with the standard table mortgage formula, the interest income component for the first month is $770.83. In the second month it would be $768.84. In the third month it would be $766.83 and so on and so forth aggregating to $9,115.12 for the 2006 income year.

(7) Fee income or expenditure must be calculated in accordance with sub-clause 6 (2) and allocated to income years in accordance with its treatment under IFRS.

(8) The bank’s accrual income for the 2006 income year is therefore:

$9,115.12 + fee income as per IFRS.

(9) On the basis that the loan is not written off as bad, the bank's accrual income for the 2007 income year is:

$8,802.85 + fee income as per IFRS.

(10) Similarly, the bank's accrual income for the 2008 income year is:

$8,460.44 + fee income as per IFRS.

(11) If the loan were to run for the full 15-year term of the financial arrangement and the interest rate is not changed, total accrual income of $85,755.09 would be returned under the calculation methodology of this determination.

Further examples are provided in the Schedule.

Signed on the 28th day of March 2006.

JIM GORDON
Policy Manager
Inland Revenue Department

SCHEDULE: Further examples

Example A:

This example has an identical fact pattern to the example given in clause 8, except that the loan was made on 15 July 2005 and the repayments are made on the 15th of each month.

In calculating the interest income for the year ending 30 June 2006, the interest component of the payment due on 15 July 2006 must be apportioned, on a daily basis, between the year ending 30 June 2006 and the subsequent year. This same apportionment must be carried out at the end each year during the term of the loan, with adjustment for last year's apportionment.

Example B:

This example has an identical fact pattern to the example given in clause 8, except that the bank paid a mortgage broker a fee of $1,000.00 to originate the loan.

This determination requires accrual income and expenditure to be calculated in accordance with clause 6.

The amount of gross income in relation to interest income is $9,115.12 (the same amount as the example given in clause 8) for the 2006 income year.

In relation to making the loan, the bank charged the customer $500.00 in fees and incurred a fee of $1,000.00 from the mortgage broker. The income and expenditure from these fees is to be allocated to income years in accordance with the treatment of the fees under IFRS.

Accrual income for the 2006 income year is therefore $9,115.12 less net fee expenditure as per IFRS.

Example C:

This example concerns a cash basis person, on 1 July 2005, placing $500,000.00 on deposit with a bank at a fixed interest rate of 7.25% p.a. paid quarterly, for a term of three years. There were no fees in relation to this transaction.

The deposit is repaid in one bullet payment of $500,000.00 on 1 July 2008, together with the final quarterly interest amount of $9,062.50.

As there are no fees in relation to the deposit, the fixed interest rate of 7.25% p.a. paid quarterly (1.8125% per calendar quarter) by the bank is the same as the YTM rate of 7.25%.

Interest paid by the bank to the customer for the 2006 income year is $38,250.00 ($9,062.50 x 4 quarters) and is gross expenditure.

Accrual expenditure for the 2006 income year is therefore $38,250.00.