

INTERPRETATION STATEMENT

Cash basis persons under the financial arrangements rules

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IS 22/05

This interpretation statement explains when a person can account for income and expenditure from financial arrangements on a cash basis instead of an accrual basis. It also sets out the adjustment that must usually be made when a person ceases to be a cash basis person and must account for their financial arrangements using the accrual basis.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

RELATED ITEM

- **IS 22/05 FS** Fact sheet for cash basis persons under the financial arrangements rules

Contents

Summary	2
Introduction.....	4
The financial arrangements rules.....	4
Requirements to be a cash basis person.....	5
Effect of being a cash basis person	5
The four steps to determining cash basis person status	6
Example 5: Whether a person is a cash basis person for 2015/16	18
Example 6: Whether a person is a cash basis person for 2016/17	22
Electing to use a spreading method	25
Cash basis adjustment	25
When a cash basis adjustment is required	26
Calculating the cash basis adjustment	26
Example 7: Cash basis adjustment calculation for 2016/17	28
Accounting for the cash basis adjustment	29
References.....	31
Legislative references.....	31
Other references.....	31
About this document	32

Summary

1. This interpretation statement answers a specific question that arose from [IS 20/07](#) *Income tax – Application of the financial arrangements rules to foreign currency loans used to finance foreign residential rental property*.¹ While [IS 20/07](#) explains who qualifies as a cash basis person (CBP), at [39] it states that the details of the cash basis adjustment (CBA) calculation are beyond its scope. This statement revisits the meaning of CBP. It also covers how to perform a CBA and provides worked examples.
2. Under the financial arrangements rules (FA rules), a CBP² can account for income when it is received and for expenditure when it is paid during the life of an arrangement. This approach is simpler than accounting for income and expenditure from a financial arrangement on an accrual basis. However, like a person on the accrual basis, at the end of the arrangement a CBP must do a wash-up calculation called a base price adjustment (BPA). [IS 20/07](#) deals with BPAs in detail.
3. To be a CBP, a person must not hold financial arrangements that exceed the following thresholds:
 - NZD100,000 for the income and expenditure threshold (s EW 57(1)); or
 - NZD1 million for the financial arrangement threshold³ (s EW 57(2));

and

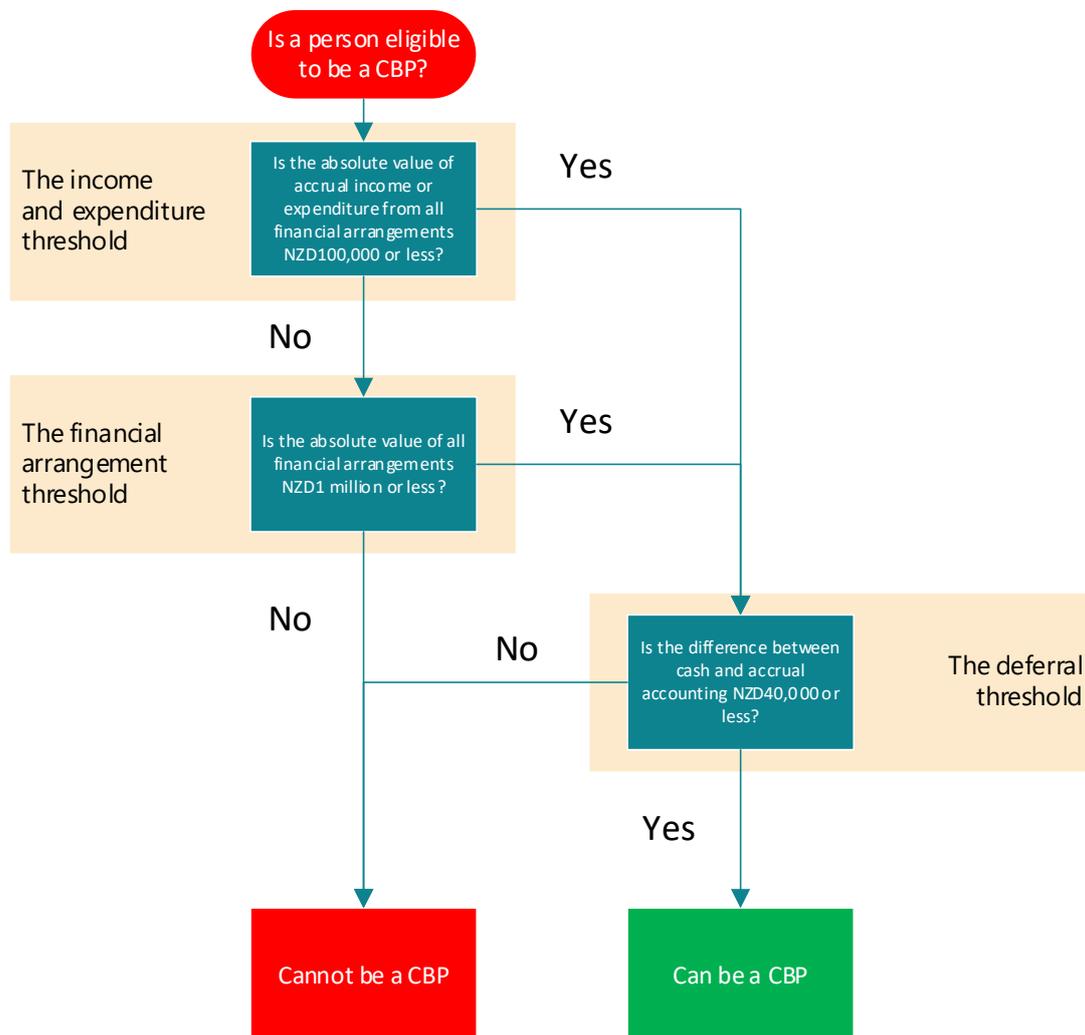
 - NZD40,000 for the deferral threshold (s EW 57(3)).
4. If **both** the income and expenditure and financial arrangement thresholds are exceeded, a person cannot be a CBP. If **neither** threshold **or only one** is exceeded, whether a person can be a CBP depends on whether the deferral threshold is exceeded. This is summarised in Figure 1.

¹ *Tax Information Bulletin* Vol 32, No 7 (August 2020): 110.

² The Commissioner may treat a CBP as not being a CBP for a class of financial arrangements if there has been structuring and promotion of the class to defer a tax liability. This also may apply where the parties to a financial arrangement are associated and calculate different amounts of income and expenditure: s EW 59.

³ This is referred to as the absolute value threshold in the legislation.

Figure 1 – Is a person eligible to be a CBP?



5. Determining whether the first two thresholds are exceeded involves adding the absolute values of income and expenditure from financial arrangements for the income and expenditure threshold and the absolute values of those arrangements for the financial arrangement threshold. Absolute values ignore whether an amount is positive or negative.
6. A CBP needs to review their compliance with the thresholds annually. Some financial arrangements are known as excepted financial arrangements (EFAs) and are not counted.
7. Whether a person has exceeded the deferral threshold is not something one can always tell at a glance. Where the financial arrangement is cross-border, for example, fluctuations in the New Zealand dollar against a foreign currency can cause the deferral threshold to be exceeded. If this occurs and the person is a CBP, they will usually have to perform a CBA.

8. This statement applies to New Zealand tax residents, both natural persons and entities, with financial arrangements who may be eligible to account for income and expenditure as a CBP. The FA rules generally do not apply to non-residents, but there are exceptions⁴.
9. New Zealand residents who are transitional residents are not subject to the FA rules until their transitional residency ends. This applies if no other party to the arrangement is a New Zealand resident and the arrangement is not for the purpose of a business carried on in New Zealand⁵. The values a transitional resident must use on entering the FA rules are not addressed in this statement. Financial arrangements of transitional residents are covered from paragraph 9 in [IS 20/07](#).

Introduction

10. This interpretation statement explains when a person can account for income and expenditure from financial arrangements on a cash basis instead of an accrual basis. It also sets out the adjustment that must usually be made when a person ceases to be a CBP and must account for their financial arrangements using the accrual basis.

The financial arrangements rules

11. Generally, a financial arrangement occurs when money is received now in consideration for money to be paid later (such as with a loan), unless specifically excluded by the Act.⁶ The tax treatment of financial arrangements is governed by the FA rules.
12. The FA rules essentially require parties to a financial arrangement to spread income or expenditure from the arrangement over its term. The key purposes of the rules are to prevent deductions for expenditure being accelerated and income recognition being deferred.
13. This statement builds on [IS 20/07](#). IS 20/07 is related to [IS 20/06: Income tax – Tax issues arising from owning foreign residential rental property](#)⁷ and [FX 20/01: Approval – foreign residential rental property amounts – currency conversion](#).⁸

⁴ Sections EW 9(3) and EW 9(4).

⁵ Section EW 5(17).

⁶ Section EW 3.

⁷ *Tax Information Bulletin* Vol 32, No 7 (August 2020): 98.

⁸ *Tax Information Bulletin* Vol 32, No 7 (August 2020): 28.

14. [IS 20/07](#) considered how the FA rules apply to foreign currency loans used to finance foreign residential rental properties. In doing so, [IS 20/07](#) covered several topics including:
- the scope of the FA rules;
 - EFAs;
 - CBPs and non-CBPs;
 - income under the FA rules; and
 - expenditure under the FA rules.
15. Although [IS 20/07](#) explains who qualifies as a CBP, at [39] it states that the details of the CBA calculation are beyond its scope. This statement explains, with examples:
- the requirements to be a CBP; and
 - how to perform a CBA.

Requirements to be a cash basis person

16. Before working through the requirements to be a CBP, it is useful to understand the effect of being a CBP.

Effect of being a cash basis person

17. Income and expenditure from a financial arrangement must be accounted for on an accrual basis during the life of the arrangement unless the person is a CBP. A CBP accounts for income when it is received and for expenditure when it is paid. A CBP is not required to apply any of the spreading methods to their financial arrangements, unless they choose to do so.⁹ This approach is simpler than accounting for financial arrangements on the accrual basis and may reduce compliance costs.
18. A person using the accrual basis spreads income and expenditure over the term of the arrangement, regardless of when it has actually been received or paid. The accrual basis sometimes requires complex calculations to determine the amounts of income and expenditure allocated to each year. In this statement, the term “non-CBP” refers to a person who accounts for their financial arrangements on the accrual basis.
19. Both a CBP and non-CBP must usually calculate a BPA.¹⁰ A BPA must usually be performed when a financial arrangement matures or ends – for example, a loan is

⁹ Section EW 55(1) and see from [66] to [69].

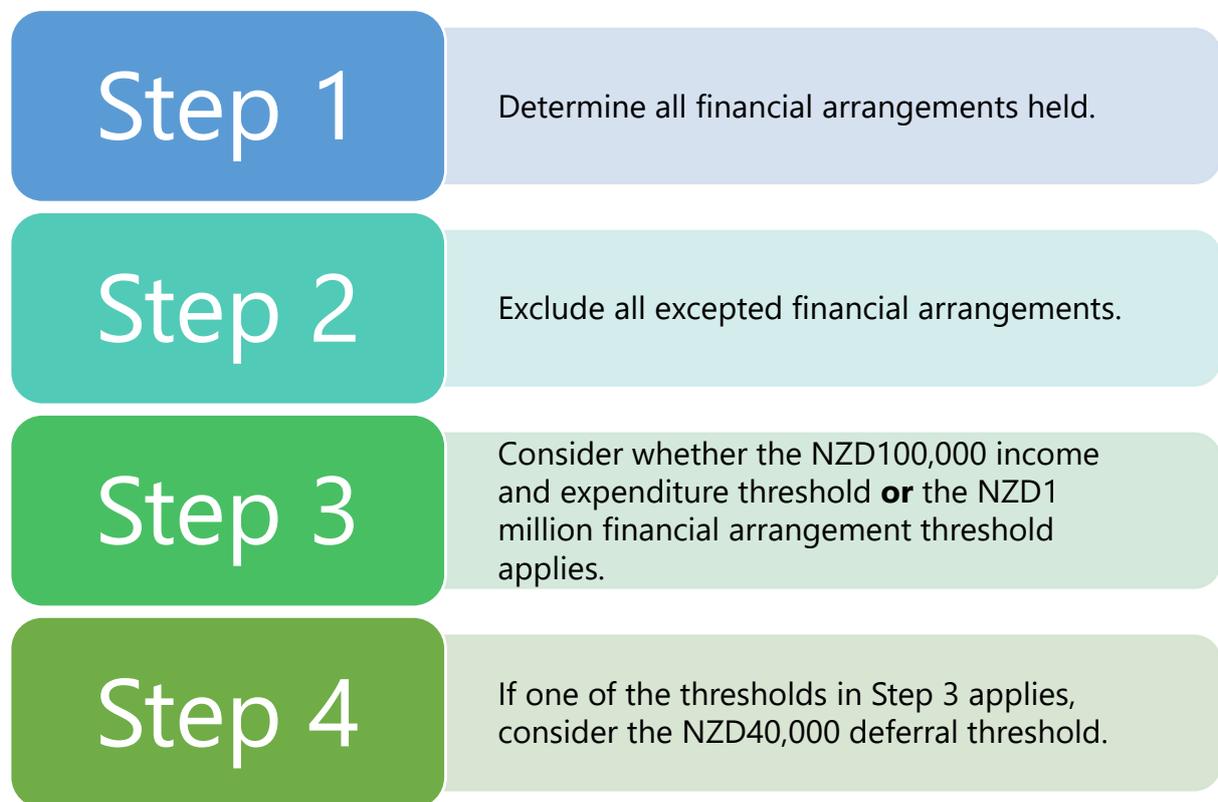
¹⁰ The BPA is covered in [IS 20/07](#), from [51] to [64]. The formula for the BPA is in s EW 31.

repaid, or the person ceases to be a New Zealand tax resident.¹¹ A BPA is different from a CBA. A CBA is performed when a person's status changes from CBP to non-CBP, or vice versa. It is also performed when a CBP elects to use a spreading method.

The four steps to determining cash basis person status

20. Determining whether a person is a CBP involves working through various requirements in the legislation. A person's status should be reviewed annually. If a person ceases to qualify as a CBP, they usually need to make a CBA.
21. The four steps are outlined in Figure 2.

Figure 2 - The four steps



Step 1: Determine all financial arrangements held

22. The first step is to identify all the financial arrangements a person holds. Generally, a financial arrangement occurs when money is received now in consideration for money

¹¹ Section EW 29(1).

to be paid later (such as with a loan), unless the Act specifically excludes it.¹² The tax treatment of financial arrangements is governed by the FA rules.

23. [IS 20/07](#) specifically considered a foreign currency loan that had been taken out to finance a foreign residential rental property. Foreign currency loans are “debt”, which s EW 3(3)(a) uses as an example of a financial arrangement. A home loan in New Zealand dollars is also a financial arrangement and needs to be included in determining whether the thresholds have been exceeded even though no income or expenditure is likely to arise. Other examples of financial arrangements are term deposits and foreign currency bank accounts.

Step 2: Excepted financial arrangements

24. Section EW 4(3) provides that EFAs are not financial arrangements for the purposes of the FA rules. This means there is no need to use a spreading method or perform a BPA when the arrangement ends. Section EW 5 lists the types of financial arrangements that are EFAs.
25. Explaining the full range of EFAs is beyond the scope of this statement and each person needs to consider their own circumstances. However, four common arrangements that may be EFAs are:
- variable principal debt instruments (VPDIs);
 - foreign currency loans for private or domestic purposes for CBPs;
 - loans in New Zealand dollars that are interest-free and repayable on demand for the lender; and
 - shares.

Variable principal debt instruments

26. A VPDI is defined in s YA 1 as:

variable principal debt instrument,—

- (a) in the financial arrangements rules, means a financial arrangement that contemplates that 1 party may, on demand or call,—
 - (i) advance further amounts to the other party; or

¹² Section EW 3.

- (ii) require the return of all amounts advanced to the other party, if the other party's rights and obligations under the financial arrangement are expressed in a foreign currency:
- (b) in the old financial arrangements rules, is defined in [section EZ 48](#) (Definitions)

27. A VPDI is an EFA if the total value on every day in an income year of all VPDIs to which the person is a party is NZD50,000 or less.¹³ *Example 1* illustrates one situation.

Example 1: VPDI that is an excepted financial arrangement

Manaia's only VPDI is his New Zealand credit card account with a limit of NZD10,000. This is an EFA because on every day of the income year the total value of the account is below NZD50,000.

28. VPDIs are also considered further from [44] of this statement and at [19] to [21] of [IS 20/07](#).
29. If the VPDI in the example was a bank account earning interest, the person would need to account for the income on a cash basis but would not need to do a BPA when the account was closed.

Foreign loans for private or domestic purposes for cash basis persons

30. A loan in a foreign currency used for a private or domestic purpose is an EFA for CBPs.¹⁴ An example is a loan denominated in Australian dollars (AUD) from an Australian bank¹⁵ to finance a holiday home on the Gold Coast that is used exclusively for private or domestic purposes.
31. Note that the loan must be included in the calculations to determine whether a person is a CBP. The loan will not be an EFA if the person is not a CBP. The loan will also not be an EFA if circumstances change and the foreign property becomes a rental property.

Interest-free repayable on demand loans in New Zealand dollars

32. A loan in New Zealand dollars which is interest-free and repayable on demand is an EFA for the lender. These loans are commonly used in trust arrangements.

¹³ Section EW 5(25).

¹⁴ Section EW 5(18).

¹⁵ IS 20/06 explains at paragraph 78 that there may be an obligation to deduct non-resident withholding tax.

33. The loan is not an EFA for the borrower and must be included in the threshold calculations.

Shares

34. A share is generally an EFA.¹⁶ However, money borrowed to buy shares is likely to be a financial arrangement.¹⁷

Summary

35. When considering the different thresholds, it is important to determine what is a financial arrangement and what is an EFA. *Example 2* illustrates what Jemima needs to consider when she reviews her portfolio of financial assets and liabilities before she can determine whether she is eligible to be a CBP.

Example 2: Examples of financial arrangements and excepted financial arrangements

Before determining whether she qualifies as a CBP, Jemima lists her financial assets and liabilities and determines which are financial arrangements.

- Jemima has a loan from a bank in the United Kingdom in British pounds (GBP) that finances a rental property she owns in the UK – **financial arrangement**.
- Jemima has a loan from an Australian bank in AUD that finances a holiday home she owns on the Gold Coast and only uses for her private purposes – **financial arrangement (it becomes an EFA if Jemima satisfies the criteria to be a CBP)**.
- Jemima has a home loan from a New Zealand bank to finance her New Zealand residence – **financial arrangement**.
- Jemima owns a share portfolio¹⁸ – **EFA**.
- Jemima took out a loan from a New Zealand bank that she used to buy the share portfolio – **financial arrangement**.
- Jemima recently inherited a New Zealand government bond from her aunt's estate – **financial arrangement**.

¹⁶ Section EW 5(13).

¹⁷ Section EW 3(2).

¹⁸ Shares in foreign companies may be subject to the foreign investment fund rules. See IR461 *Guide to foreign investment funds*.

Jemima needs to consider her financial arrangements for the purpose of the threshold calculations.

Step 3: The income and expenditure and financial arrangement thresholds

36. A CBP is defined in s YA 1 by referring to the definition in s EW 54. A person can be a CBP¹⁹ if, for the income year, they do not exceed the deferral threshold in Step 4 and either:
- the NZD100,000 income and expenditure threshold (s EW 57(1)); or
 - the NZD1 million financial arrangement threshold (s EW 57(2)).
37. Sections EW 57(1) and EW 57(2) state:

EW 57 Thresholds

Income and expenditure threshold

- (1) For the purposes of section EW 54(1)(a)(i), this subsection applies if the absolute value of the person's income and expenditure in the income year under all financial arrangements to which the person is a party is \$100,000 or less.

Absolute value threshold

- (2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is \$1,000,000 or less. The value of each arrangement is,—
- (a) for a fixed principal financial arrangement, its face value;
 - (b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement;
 - (c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

38. To satisfy Step 3, the person must not exceed the income and expenditure threshold or the financial arrangement threshold. This requires:

¹⁹ The trustee of an estate is a CBP for financial arrangements in the estate if, at the date of death, the deceased was a CBP and the financial arrangements in the estate meet the requirements of s EW 54. This status lasts for 5 income years unless the requirements are no longer met: s EW 60.

- the absolute value of income and expenditure calculated on an accrual basis for the income year under all financial arrangements held by the person does not exceed NZD100,000; or
 - on every day in the income year, the total absolute value of all financial arrangements held by the person does not exceed NZD1 million.
39. If both thresholds are exceeded, the person is not a CBP in that year and will have to use a spreading method. If the person is under one of the thresholds, they need to consider the deferral threshold in Step 4 before they can determine whether they are a CBP.

Absolute value

40. The term “absolute value” is defined in s YA 1 as “the value irrespective of whether the value’s sign is positive or negative”. This means that income under one financial arrangement is not offset by expenditure under another financial arrangement. Rather, the two amounts are added together as though they were both positive numbers. Similarly, the values of financial arrangements are added together in absolute terms regardless of whether they are assets or liabilities.

The income and expenditure threshold

41. *Example 3* shows how the income and expenditure threshold applies when a person has both income and expenditure from their financial arrangements.

Example 3: Income and expenditure threshold

Wei is a New Zealand resident and has a rental property on the Gold Coast that he financed with an AUD500,000 loan from an Australian bank. Wei has also made a loan of NZD60,000 to Jake. Wei needs to consider both loans to determine whether he is eligible to be a CBP.

Income and expenditure threshold

Wei notes that the amount of annual interest expenditure on the Australian loan converted to NZD at the appropriate rate is NZD30,000. Wei also notes that the annual interest income from the loan to Jake is NZD5,000. Both amounts are calculated on an accrual basis. In adding the absolute values of these amounts, Wei must ignore the fact that one of them is expenditure and the other is income. The absolute values of these amounts total NZD35,000, which is under the NZD100,000 income and expenditure threshold.

Having satisfied the income and expenditure threshold, there is no reason for Wei to consider the financial arrangement threshold because he only needs to satisfy one of the thresholds in Step 3 before considering the deferral threshold in Step 4.

The financial arrangement threshold

42. Under s EW 57(2), the value of each arrangement on any day is:
- for a fixed principal financial arrangement, its face value;
 - for a VPDI, the amount owing by or to the person under the financial arrangement; or
 - for a financial arrangement to which the old financial arrangements rules²⁰ apply, the value determined under those rules.

Fixed principal financial arrangement

43. A “fixed principal financial arrangement” is defined in s YA 1 as a financial arrangement other than a VPDI. An example of a fixed principal financial arrangement would be a fixed sum loan repayable at the end of the agreed term.

Variable principal debt instrument

44. As noted at [26], VPDIs are financial arrangements that may need to be accounted for under the FA rules if they exceed the NZD50,000 threshold on any day in the year. An example of a VPDI is a revolving credit facility where the borrower can borrow or repay principal at any time. Other examples are credit card accounts and everyday bank accounts.

Financial arrangements to which the old financial arrangements rules apply

45. Section EZ 33 provides that the old FA rules apply for financial arrangements entered into before 20 May 1999. The old FA rules are essentially contained in ss EZ 33 to EZ 52D. The provisions are essentially the same in terms of characterising financial arrangements as fixed principal financial arrangements or VPDIs and valuing the financial arrangements. Therefore, this statement focuses on the current FA rules.

²⁰ See from [45].

Threshold satisfied on every day of the income year

46. The financial arrangement threshold cannot be exceeded on **any day** of the income year. At first, it may seem onerous to consider every day in the year, but it can be relatively easy to determine whether the threshold has been exceeded, especially if there is only one financial arrangement. For fixed principal financial arrangements, the daily outstanding balance needs to be considered. Generally, the balance at the start of a period will be the relevant amount because it would be expected to decline as repayments of principal and interest are made. Therefore, if this is the only financial arrangement and the total is under the threshold at the start of the period, it is likely to be under the threshold for the whole year.
47. An exception to this general approach occurs when the financial arrangement is in a foreign currency and subject to exchange rate fluctuations. In these cases, identifying when the New Zealand dollar is at its lowest point compared with the foreign currency and calculating the value at that time is likely to give the highest value of the financial arrangement if the principal has not changed materially.
48. For VPDIs, the amount owing each day needs to be considered. Where the VDPI has a limit, such as an overdraft or credit card, it will simplify the calculations if the limit is used rather than the daily balance unless the threshold is close to being breached.
49. *Example 4* illustrates the approach to applying the financial arrangement threshold.

Example 4: Financial arrangement threshold

Carrying on from *Example 3*, Wei does not need to consider the financial arrangement threshold to be eligible to be a CBP because he was under the income and expenditure threshold. However, this example will consider the financial arrangement threshold to illustrate how it might be applied.

As noted, Wei has a rental property on the Gold Coast that he financed with a loan of AUD500,000 from an Australian bank. Wei has also made a loan of NZD60,000 to Jake.

Wei notes that loan with the Australian bank is a fixed principal financial arrangement, meaning that the value is determined by its face value each day. However, as it is denominated in AUD, the exchange rate also needs to be factored in. For the 2021 income year, Wei notes that the NZD/AUD exchange rates for 1 April 2020 and 31 March 2021 were as follows:

Date	NZD/AUD rate	Loan value
1 April 2020	0.9710	NZD514,933.06
31 March 2021	0.9182	NZD544,543.67

Wei also notes that on 18 August 2020 the NZD/AUD rate was 0.9062. This was the lowest value for the year. Therefore, on this date the loan value peaked at NZD551,754.58 (assuming that the principal value of the loan did not decrease over the course of the year).

The loan to Jake is also a fixed principal financial arrangement, meaning that its value is determined by its face value each day. As it is denominated in NZD, its value is NZD60,000 (once again, assuming that the principal value of the loan did not decrease over the course of the year).

In adding the absolute values of these amounts, Wei has to ignore the fact that one of them is a liability and the other is an asset to him. The absolute values of the highest amounts for the year are NZD551,754.58 plus NZD60,000 equals NZD611,754.58. This is under the NZD1 million financial arrangement threshold.

Therefore, Wei is under both the income and expenditure and financial arrangement thresholds. He only needs to be under one of the thresholds to move to Step 4, which is the deferral threshold.

Step 4: The deferral threshold

50. To determine whether a person can be a CBP, Step 4 involves checking whether their financial arrangements are under the deferral threshold. The deferral threshold is set out in s EW 57:

Deferral threshold

- (3) For the purposes of section EW 54(1)(b), this subsection applies if the result of applying the formula in subsection (4) to each financial arrangement to which the person is a party at the end of the income year and adding the outcomes together is \$40,000 or less.

Formula

- (4) The formula is—
$$(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure}).$$

Definition of items in formula

- (5) The items in the formula are defined in subsections (6) to (9).

Accrual income

- (6) **Accrual income** is the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and

ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

- (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
- (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
- (c) an alternative method approved by the Commissioner.

Cash basis income

- (7) **Cash basis income** is the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Cash basis expenditure

- (8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Accrual expenditure

- (9) **Accrual expenditure** is the amount that would have been expenditure incurred under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:
- (a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
 - (b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or
 - (c) an alternative method approved by the Commissioner.

51. Determining whether the deferral threshold has been breached requires comparison of income and expenditure calculated on a cash basis and an accrual basis. A person is a CBP if the result of applying the formula does not exceed NZD40,000. If the result is greater than NZD40,000, the person cannot be a CBP. If a person was a CBP in the previous year, they must usually calculate a CBA and use a spreading method until they qualify again.
52. Income and expenditure are calculated from when the person became party to the financial arrangement up to the end of the income year for which the calculation is made. The effect of this is to determine the difference between accounting for the

financial arrangement on a cash versus accrual basis over the period for which the person has been party to the financial arrangement. It means, for example, that if the person acquired the financial arrangement in Year 1, then to do the calculation for Year 2, the person must combine income and expenditure from Year 1 and Year 2.

Applying the formula

53. The formula in s EW 57(4) is:

$$(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure})$$

54. The formula adds the difference between the income calculated on an accrual versus cash basis to the difference between the expenditure calculated on a cash versus accrual basis. It determines whether income has been deferred or expenditure has been accelerated.

Cash basis amounts

55. Calculating the income and expenditure on a cash basis is generally straightforward. The cash basis focuses on actual cash flows under the financial arrangement. The essential step is to include all cash basis income or expenditure from the start of the financial arrangement through to the end of the income year for which the calculation is being made.

Accrual basis amounts

56. Calculating the income and expenditure on an accrual basis is generally more complicated, especially when it is necessary to convert foreign currencies to New Zealand dollars. Sections EW 57(6) and EW 57(9) state that accrual income and expenditure are calculated using one of the following methods:

- the yield to maturity method
- the straight-line method
- an alternative method approved by the Commissioner.

57. For the purposes of calculating the deferral threshold, there is concessionary treatment for using the yield to maturity and straight-line methods. Firstly, they can be used whether the person is normally permitted to use them. For example, s EW 17(1) would normally prevent the use of the straight-line method if the total value of all financial arrangements exceeded NZD1.85 million.

58. Secondly, they can also be used whether a person has chosen to use the method for their financial arrangement. For example, a person who is currently a non-CBP and

using yield to maturity to calculate income and expenditure can use the straight-line method to determine if they are under the deferral threshold in the current income year.

59. The Commissioner has approved a number of alternative methods in determinations. For the purposes of *Example 5*, *Example 6* and *Example 7*, we have used [Determination G9A](#): *Financial arrangements that are denominated in a currency or commodity other than New Zealand dollars*.²¹
60. [Determination G9A](#) applies where it is necessary to calculate income or expenditure for a financial arrangement and any right or obligation is fixed or otherwise determined in a currency or commodity other than New Zealand dollars. [IS 20/07](#) also explains at [40] to [49] how to apply [Determination G9A](#) and provides a worked example – see [50].
61. [Determination G9A](#) follows what is known as a “mark to spot” methodology. This involves converting the New Zealand dollar equivalent amount of all the foreign currency transactions that occur over the term of the arrangement, together with the end-of-year outstanding principal balances, at the relevant spot rate.
62. For the purposes of [Determination G9A](#), [Determination G6D](#): *Foreign currency rates*²² sets out relevant methods and sources of rates to use when converting foreign currency amounts into New Zealand dollars
63. For the purposes of the FA rules and [Determination G9A](#), accrual income or expenditure is a net amount, so that the result is either income or expenditure.²³ If applying [Determination G9A](#) results in a positive figure, it represents income derived in the relevant income year. In the context of a foreign currency loan, an increase in the value of the New Zealand dollar can cause the borrower to be deemed to have derived an amount of income.
64. If applying [Determination G9A](#) results in a negative figure, it is expenditure incurred in the relevant income year. The expenditure under the FA rules may be more or less than the actual expenditure on the loan, depending on the movement of foreign exchange rates. Deductibility is discussed from [80] of this statement.

²¹ Inland Revenue, 1989.

²² Inland Revenue, 1991.

²³ Section EW 14(3).

Example 5: Whether a person is a cash basis person for 2015/16

The facts of this example are carried through to Example 6: Whether a person is a cash basis person for 2016/17 and Example 7: Cash basis adjustment calculation for 2016/17. The examples illustrate the threshold calculations as well as the CBA. The financial arrangement is shown for two income years to illustrate the different treatment that can occur from year to year.

On 5 April 2015, Adam, who is a New Zealand resident, obtained a loan of GBP500,000 from a bank in the UK to finance a rental property in London. The loan was for 20 years with monthly repayments and an interest rate of 3%.

Adam received rental income from the property. Rental income is not financial arrangement income and is taxed under s CC 1.

The loan is a financial arrangement. Adam needs to determine whether he is a CBP for 2015/16.

Income and expenditure threshold

Adam calculates his income and expenditure from the loan on an accrual basis to see whether it is under the income and expenditure threshold. The results of the calculations are also used for the deferral threshold. As the loan is denominated in a foreign currency, he uses the method described in Determination G9A.

Calculate closing tax book value in British pounds

The first step is to calculate the closing tax book value of the loan in British pounds. The formula is:

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

The variables are:

e = opening tax book value (which is always zero in the first year)

f = consideration paid by the person

g = accrual income

h = consideration paid to the person

i = accrual expenditure.

As the loan is a table mortgage, Adam chooses to use the yield to maturity method in Determination G3 to calculate income or expenditure. For amounts which fall into two income years, he uses Determination G1A to apportion them on a daily basis.

The amounts for 'e', 'g' and 'h' in the example are easily identifiable. As this is the first year of the loan, 'e' is zero. Similarly, there is no accrual income so 'g' is zero. The only consideration paid to Adam was the initial amount of the loan advanced to him so 'h' is GBP500,000. Adam needs to calculate the amounts for 'f' and 'i'.

In order to do so, he uses a template in Excel to produce the following loan amortisation schedule that shows each monthly loan payment, the split between principal and interest and the declining balance. All amounts are in GBP.

Table 1: Loan payments for 2015/16 in GBP

Dates	Monthly payments	Principal	Interest	Balance
5 May 2015	2,772.99	1,522.99	1,250.00	498,477.01
5 Jun 2015	2,772.99	1,526.80	1,246.19	496,950.22
5 Jul 2015	2,772.99	1,530.61	1,242.38	495,419.60
5 Aug 2015	2,772.99	1,534.44	1,238.55	493,885.17
5 Sep 2015	2,772.99	1,538.28	1,234.71	492,346.89
5 Oct 2015	2,772.99	1,542.12	1,230.87	490,804.77
5 Nov 2015	2,772.99	1,545.98	1,227.01	489,258.79
5 Dec 2015	2,772.99	1,549.84	1,223.15	487,708.95
5 Jan 2016	2,772.99	1,553.72	1,219.27	486,155.24
5 Feb 2016	2,772.99	1,557.60	1,215.39	484,597.64
5 Mar 2016	2,772.99	1,561.49	1,211.49	483,036.14
Total to 31 March	30,502.87	16,963.86	13,539.01	
5 Apr 2016	2,772.99	1,565.40	1,207.59	481,470.75

The figure for 'f' is GBP30,502.87, being the total of the monthly payments during the year to 31 March (shown in Table 1).

The figure for 'i' is GBP14,551.83. This is the total interest to 31 March of GBP13,539.01 plus the portion of interest paid on 5 April 2016 that relates to the 2015/16 year. This amount is GBP1,207.59 divided by 31 days times 26 days, or GBP1,012.82.

The CTBV is then negative GBP484,048.96 as follows:

$$\begin{aligned}
 \text{CTBV} &= e + f + g - h - i \\
 \text{CTBV} &= 0 + 30,502.87 + 0 - 500,000 - 14,551.83 \\
 \text{CTBV} &= -\text{GBP}484,048.96
 \end{aligned}$$

Calculate income or expenditure in New Zealand dollars

The next step is to calculate the income or expenditure in 2015/16 in New Zealand dollars. The formula is:

$$\text{accrual income or expenditure} = a + b - c - d$$

The variables are:

a = closing tax book value

b = consideration paid to the person

c = opening tax book value (always zero in the first year)

d = consideration paid by the person

Adam obtains the spot rates for the conversions below from a registered bank.

The figure for 'a' is the closing tax book value of negative GBP484,048.96 divided by 0.4812, which was the exchange rate on 31 March 2016. The result is negative NZD1,005,920.53.

The figure for 'b' is the loan of GBP500,000 divided by 0.5065, which was the exchange rate on 5 April 2015. The result is NZD987,166.83.

The figure for 'c' is zero as there was no opening balance.

The figure for 'd' is NZD68,393.90. This is the total of the monthly payments in British pounds converted into New Zealand dollars as shown in Table 2. Table 2 also shows interest converted into New Zealand dollars. Adam uses the total later in the deferral threshold calculation.

Table 2: Loan payments for 2015/16 converted to NZD

Dates	Monthly payments GBP	Interest GBP	Exchange rates	Monthly payments NZD	Monthly interest NZD
5 May 2015	2,772.99	1,250.00	0.4984	5,563.78	2,508.03
5 Jun 2015	2,772.99	1,246.19	0.4645	5,969.83	2,682.87
5 Jul 2015	2,772.99	1,242.38	0.4293	6,459.32	2,893.96
5 Aug 2015	2,772.99	1,238.55	0.4200	6,602.35	2,948.93
5 Sep 2015	2,772.99	1,234.71	0.4138	6,701.28	2,983.84
5 Oct 2015	2,772.99	1,230.87	0.4244	6,533.90	2,900.25
5 Nov 2015	2,772.99	1,227.01	0.4285	6,471.38	2,863.51
5 Dec 2015	2,772.99	1,223.15	0.4447	6,235.64	2,750.50
5 Jan 2016	2,772.99	1,219.27	0.4587	6,045.32	2,658.10

5 Feb 2016	2,772.99	1,215.39	0.4615	6,008.64	2,633.56
5 Mar 2016	2,772.99	1,211.49	0.4779	5,802.44	2,535.04
Totals	30,502.87	13,539.01		68,393.90	30,358.58

Adam puts these figures into the formula as follows:

$$\begin{aligned} \text{accrual income or expenditure} &= a + b - c - d \\ \text{accrual income or expenditure} &= -1,005,920.53 + 987,166.83 - 0 - 68,393.90 \\ \text{accrual expenditure} &= -87,147.60 \end{aligned}$$

The result of applying the formula is negative NZD87,147.60. The absolute value is NZD87,147.60. As this is under the income and expenditure threshold of NZD100,000, Adam can consider the deferral threshold in Step 4.

Financial arrangement threshold

Because Adam is under the income and expenditure threshold, he does not need to consider this threshold. However, if he did, he would notice that when he drew the loan down on 5 April 2015, the value in New Zealand dollars was NZD987,166.83. This was close to exceeding the financial arrangement threshold of NZD1 million. He would also notice that the New Zealand dollar depreciated during the year. The effect of this is to increase the value of the loan.

For example, on 5 May 2015 the exchange rate was 0.4984. Table 1 shows the value of the loan in British pounds was GBP498,477.01 on this date. The value of the loan in New Zealand dollars was NZD1,000,154.51. This was above the financial arrangement threshold.

Deferral threshold for the 2015/16 income year

Adam needs to calculate his cash basis income and expenditure and his accrual income and expenditure in New Zealand dollars. He then needs to put these amounts into the formula in s EW 57(4) to determine whether he is under the deferral threshold.

Cash basis income or expenditure

Adam has no cash basis income from the financial arrangement.

Adam paid interest of NZD30,358.58 to the UK bank as shown in Table 2. This is his cash basis expenditure.

Accrual income or expenditure

Adam's accrual expenditure was NZD87,147.60 as calculated above.

The deferral threshold

The formula for the deferral threshold is:

$$\begin{aligned} &(\text{accrual income} - \text{cash basis income}) + (\text{cash basis expenditure} - \text{accrual expenditure}) \\ &(0 - 0) + (30,358.58 - 87,147.60) = -56,789.02 \end{aligned}$$

As NZD56,789.02 is a negative amount, it is below the deferral threshold of NZD40,000. Adam has not exceeded the income and expenditure and deferral thresholds. He is eligible to be CBP in 2015/16. He can deduct NZD30,358.58 as his cash basis expenditure.

65. *Example 6* shows Adam’s calculations for 2016/17 income year.

Example 6: Whether a person is a cash basis person for 2016/17

Adam needs to do the same calculations in 2016/17 as in 2015/16 to see whether he is under the thresholds.

Income and expenditure threshold

Calculate closing tax book value in British pounds

The first step is to calculate the closing tax book value of the loan in British pounds. The formula as set out above is:

$$\text{CTBV} = e + f + g - h - i$$

As in 2015/16, the amounts for ‘e’, ‘g’ and ‘h’ in the example are easily identifiable. The opening tax book value for 2016/17 is the same as the CTBV from 2015/16. This means that ‘e’ is -484,048.96. Once again ‘g’ is zero as there is no accrual income for 2016/17. No further amounts are advanced to Adam so ‘h’ is zero. Adam needs to calculate the amounts for ‘f’ and ‘i’.

The loan amortisation schedule Adam created shows the following for 2016/17.

Table 3: Loan payments for 2016/17 in GBP

Dates	Monthly payments	Principal	Interest	Balance
5 Apr 2016	2,772.99	1,565.40	1,207.59	481,470.75
5 May 2016	2,772.99	1,569.31	1,203.68	479,901.43
5 Jun 2016	2,772.99	1,573.23	1,199.75	478,328.20
5 Jul 2016	2,772.99	1,577.17	1,195.82	476,751.03
5 Aug 2016	2,772.99	1,581.11	1,191.88	475,169.92

5 Sep 2016	2,772.99	1,585.06	1,187.92	473,584.86
5 Oct 2016	2,772.99	1,589.03	1,183.96	471,995.83
5 Nov 2016	2,772.99	1,593.00	1,179.99	470,402.83
5 Dec 2016	2,772.99	1,596.98	1,176.01	468,805.85
5 Jan 2017	2,772.99	1,600.97	1,172.01	467,204.88
5 Feb 2017	2,772.99	1,604.98	1,168.01	465,599.90
5 Mar 2017	2,772.99	1,608.99	1,164.00	463,990.92
Total at 31 March	33,275.86	19,045.23	14,230.63	
5 Apr 2017	2,772.99	1,613.01	1,159.58	462,377.91

The figure for 'f' is GBP33,275.86, being the total of the monthly payments during the year to 31 March (shown in Table 3).

The figure for 'i' is GBP14,190.70. This is the total interest to 31 March of GBP14,230.63 less GBP1,012.82 accrued in 2015/16 plus the portion of the interest paid on 5 April 2017 that relates to the 2016/17 year. This amount is GBP1,159.98 divided by 31 days times 26 days, or GBP972.89.

The CTBV is then negative GBP464,963.80 as follows:

$$\begin{aligned}
 \text{CTBV} &= e + f + g - h - i \\
 \text{CTBV} &= -484,048.96 + 33,275.86 + 0 - 0 - 14,190.70 \\
 \text{CTBV} &= -\text{GBP}464,963.80
 \end{aligned}$$

Calculate income or expenditure in New Zealand dollars

The next step is to calculate income or expenditure in 2016/17 in New Zealand dollars.

The formula as set out above is:

$$\text{accrual income or expenditure} = a + b - c - d$$

The figure for 'a' is the closing tax book value of negative GBP464,963.80 divided by 0.5600, which was the exchange rate on 31 March 2017. The result is negative NZD830,292.50.

The figure for 'b' is zero as Adam received no further loans in the year.

The figure for 'c' is the opening balance of negative NZD1,005,920.53 from 2015/16.

The figure for 'd' is NZD61,744.31. This is the total of the monthly payments in British pounds converted into New Zealand dollars as shown in Table 4.

As in 2015/16, the table also shows interest converted into New Zealand dollars. Adam would use the total later in the deferral threshold calculation if required.

Table 4: Loan payments for 2016/17 converted to NZD

Dates	Monthly payment GBP	Interest GBP	Exchange rates	Monthly payment NZD	Interest NZD
5 Apr 2016	2,772.99	1,207.59	0.4775	5,807.30	2,528.99
5 May 2016	2,772.99	1,203.68	0.4748	5,840.33	2,535.12
5 Jun 2016	2,772.99	1,199.75	0.4775	5,807.30	2,512.57
5 Jul 2016	2,772.99	1,195.82	0.5438	5,099.28	2,199.01
5 Aug 2016	2,772.99	1,191.88	0.5472	5,067.60	2,178.14
5 Sep 2016	2,772.99	1,187.92	0.5495	5,046.38	2,161.83
5 Oct 2016	2,772.99	1,183.96	0.5646	4,911.42	2,096.99
5 Nov 2016	2,772.99	1,179.99	0.5869	4,724.80	2,010.55
5 Dec 2016	2,772.99	1,176.01	0.5585	4,965.06	2,105.65
5 Jan 2017	2,772.99	1,172.01	0.5669	4,891.49	2,067.41
5 Feb 2017	2,772.99	1,168.01	0.5860	4,732.06	1,993.19
5 Mar 2017	2,772.99	1,164.00	0.5716	4,851.27	2,036.39
Totals	33,275.86	14,230.63		61,744.31	26,425.84

Adam puts these figures into the formula as follows:

$$\begin{aligned}
 \text{accrual income or expenditure} &= a + b - c - d \\
 \text{accrual income or expenditure} &= -830,292.50 + 0 - -1,005,920.53 - 61,744.31 \\
 \text{accrual income} &= \text{NZD}113,883.72
 \end{aligned}$$

The result of applying the formula is NZD113,883.72. The absolute value is the same amount. As this is over the income and expenditure threshold of NZD100,000, Adam needs to consider the financial arrangement threshold.

Note that even though Adam has borrowed money, there is income as the New Zealand dollar strengthened during the giving rise to a foreign exchange gain.

Financial arrangement threshold

The opening value of the loan was NZD1,005,920.53. This exceeds the financial arrangement threshold of NZD1 million.

As Adam has exceeded both the income and expenditure and financial arrangement thresholds, he cannot be a CBP and must do a CBA.

Electing to use a spreading method

66. A CBP may elect to calculate income or expenditure from an arrangement using a spreading method²⁴. They can do this as long as it is not a year in which they must calculate a BPA.²⁵ They make the election by calculating a CBA.²⁶
67. A CBP who chooses to use a spreading method must then use a spreading method for:
- all financial arrangements they are a party to at the time of making the election; **and**
 - all financial arrangements they enter into after the income year in which they make the election.²⁷
68. A person can revoke the election by giving notice to the Commissioner with a return of income within the prescribed timeframe.²⁸ The revocation applies to all financial arrangements entered into after the income year in which the person gives the notice.²⁹ However, a person must continue to use a spreading method for those arrangements covered by the election even though they may qualify to be a CBP.
69. Although the cash basis is generally seen as simpler, there are at least three reasons why a person may elect to account for income and expenditure on an accrual basis. First, the accrual basis may result in limited deferral of income or acceleration of expenditure compared to the cash basis. Second, a person may expect to breach the thresholds in a subsequent year and decide that it is easier to account for the financial arrangement on an accrual basis from the outset. Thirdly, as a CBP also has to do a BPA, it may also be easier to account for financial arrangements on an accrual basis from the beginning of the arrangement.

Cash basis adjustment

70. There are three circumstances in which a person may need to make a CBA in an income year. The effect of the CBA is to adjust a person's income or expenditure from the start of a financial arrangement to the end of the current income year for their new method of accounting or status.

²⁴ Section EW 61(1)

²⁵ Section EW 61(2)

²⁶ Sections EW 61(2) and EW 62(1)

²⁷ Section EW 61(4).

²⁸ Section EW 61(5) and s 37 of the Tax Administration Act 1994

²⁹ Section EW 61(6).

When a cash basis adjustment is required

71. Section EW 62 sets out when a person needs to make a CBA. A CBA is required when a person:
- elects to use a spreading method;³⁰ or
 - becomes a CBP; or
 - ceases to be a CBP.
72. If a person is using a spreading method but qualifies to be a CBP and does not make a CBA, the person is not a CBP.³¹
73. There are some limited exceptions to having to make a CBA. If a person qualifies to be a CBP in an income year, they must not calculate a CBA:³²
- if they choose to continue to use a spreading method in that year; or
 - for a financial arrangement that they already account for on the cash basis.
74. Likewise, if a person ceases to be a CBP, they must not calculate a CBA for a financial arrangement that is already subject to a spreading method.³³

Calculating the cash basis adjustment

75. A CBA is calculated using the formula in s EW 63. The CBA results in income or expenditure for the income year. A positive CBA is income and a negative CBA is expenditure.

EW 63 Cash basis adjustment formula

Formula

- (1) A person calculates a cash basis adjustment using the formula—
- $$\text{adjusted income} - \text{adjusted expenditure} - \text{previous income} + \text{previous expenditure}.$$

Definition of items in formula

- (2) The items in the formula are defined in subsections (3) to (6).

³⁰ Electing to use a spreading method is covered from [66].

³¹ Section EW 62(6).

³² Section EW 62(3).

³³ Section EW 62(5).

Adjusted income

- (3) **Adjusted income** is,—
- (a) for a person who becomes a cash basis person, the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made; and
 - (b) for a person who ceases to be a cash basis person, the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Adjusted expenditure

- (4) **Adjusted expenditure** is,—
- (a) for a person who becomes a cash basis person, the amount that would have been expenditure incurred by the person under the financial arrangement if they had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made; and
 - (b) for a person who ceases to be a cash basis person, the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Previous income

- (5) **Previous income** is income derived by the person under the financial arrangement in earlier income years.

Previous expenditure

- (6) **Previous expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

76. The CBA formula is different depending on whether the person is becoming a CBP or ceasing to be one. Where a person becomes a CBP and needs to calculate a CBA, the terms in the formula have the following meanings:³⁴

³⁴ Sections EW 63(3)(a), EW (4)(a), EW (5) and EW (6).

- “adjusted income” is income they would have derived if they had been a CBP from the start of the financial arrangement to the last day of the income year for which the CBA calculation is being made;
- “adjusted expenditure” is expenditure they would have incurred if they had been a CBP from the start of the financial arrangement to the last day of the income year for which the CBA calculation is being made;
- “previous income” is the income they derived under the financial arrangement in earlier income years; and
- “previous expenditure” is the expenditure they incurred under the financial arrangement in earlier income years.

77. If the person ceases to be a CBP, the terms in the formula mean the following:³⁵

- “adjusted income” is income they would have derived if they had been required to use a spreading method from the start of the financial arrangement to the last day of the income year for which the CBA calculation is being made;
- “adjusted expenditure” is expenditure they would have incurred if they had been required to use a spreading method from the start of the financial arrangement to the last day of the income year for which the CBA calculation is being made;
- “previous income” is the income they derived under the financial arrangement in earlier income years; and
- “previous expenditure” is the expenditure they incurred under the arrangement in earlier income years.

78. *Example 7* carries on from *Example 6*. It shows the adjustment that Adam must make at the end of the 2016/17 income year on ceasing to be a CBP.

Example 7: Cash basis adjustment calculation for 2016/17

The formula for the CBA is:

$$\text{CBA} = \text{adjusted income} - \text{adjusted expenditure} - \text{previous income} + \text{previous expenditure}$$

In working out whether Adam has adjusted income or expenditure from the GBP500,000 loan, the calculations need to be made from when Adam obtained the loan on 5 April 2015 through to 31 March 2017 (the end of the income year for which he must make the CBA).

³⁵ Sections EW 63(3)(b), EW (4)(b), EW (5) and EW (6).

Adjusted income

Adam's adjusted income is negative NZD87,147.60 in the 2015/16 income year plus NZD113,883.72 in the 2016/17 year, which equals NZD26,736.12.

Adjusted expenditure

Adam has no adjusted expenditure.

Previous income

Adam returned no previous income.

Previous expenditure

Adam deducted NZD30,358.58 in the 2015/16 income year.

Calculation of the CBA

This leads to the following result:

$$\begin{aligned} \text{CBA} &= 26,736.12 - 0 - 0 + 30,358.58 \\ \text{CBA} &= 57,094.70 \end{aligned}$$

The CBA for 2016/17 is income of NZD57,094.70.

The CBA puts Adam in the same position as if he had accounted for the financial arrangement on an accrual basis from the start of the financial arrangement to the end of the 2016/17 year. The correct position under the accrual basis is that Adam should return income of NZD26,736.12 from the start of the arrangement to the end of the 2016/17 income year. As Adam claimed expenditure of NZD30,358.58 in the 2015/16 income year, he needs to return income of NZD57,094.70 in the 2016/17 income year to achieve this result.

If Adam had instead made an election in 2015/16, he could have deducted NZD87,147.60 using a spreading method instead of NZD30,358.58 on a cash basis. However, he would need to continue using the spreading method in 2016/17 and return NZD113,883.72. The net result in terms of income over the two years is the same (i.e. NZD26,736.12 of accrual income) but the timing differs.

Accounting for the cash basis adjustment

79. Once the CBA has been calculated, s EW 62 sets out the next steps. Section EW 62(8) provides that the CBA is the only income or expenditure under a financial arrangement in an income year in which one is made.
80. Section EW 62(9) states that if the CBA is positive, then it is income under s CC 3(1) for the person in that income year. If the CBA is negative, then it is expenditure incurred

by the person in the year the calculation is made. It is still necessary to consider whether that expenditure is deductible. The relevant deductibility provision is s DB 6 because financial arrangement expenditure is treated as “interest” under the definition in s YA 1.

81. Section DB 6 provides:

DB 6 Interest: not capital expenditure

Deduction

(1) A person is allowed a deduction for interest incurred.

Exclusion

(2) Subsection (1) does not apply to interest for which a person is denied a deduction under section DB 1.

...

Link with subpart DA

(4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

82. The interest expenditure must satisfy the general permission for deductibility in s DA 1. Where the financial arrangement in question is a foreign currency loan used to finance a foreign rental property, the general permission will likely be satisfied because of the nexus between the financial arrangement expenditure incurred and the rental income derived from the property that the loan finances.
83. Residential property deductions are generally “ring-fenced”. This means they can only be used against income from residential property, with any deductions in excess of the income being carried forward to the next income year the taxpayer derives income from residential property. For further information on the residential ring-fencing rules, see [“Ring-fencing of residential property deductions”](#).³⁶
84. Note also that the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022 contained an amendment to the definition of “residential income” in s EL 3 so that foreign exchange gains on a loan can be offset against deductions. The same Act introduced the interest limitation rules which affect how much interest can be deducted in respect of residential rental property.³⁷

³⁶ *Tax Information Bulletin* Vol 31, No 8 (September 2019): 53.

³⁷ <https://taxpolicy.ird.govt.nz/publications/2022/2022-sr-interest-limitation-bright-line-changes>

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Tax Administration Act 1994, s 37

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