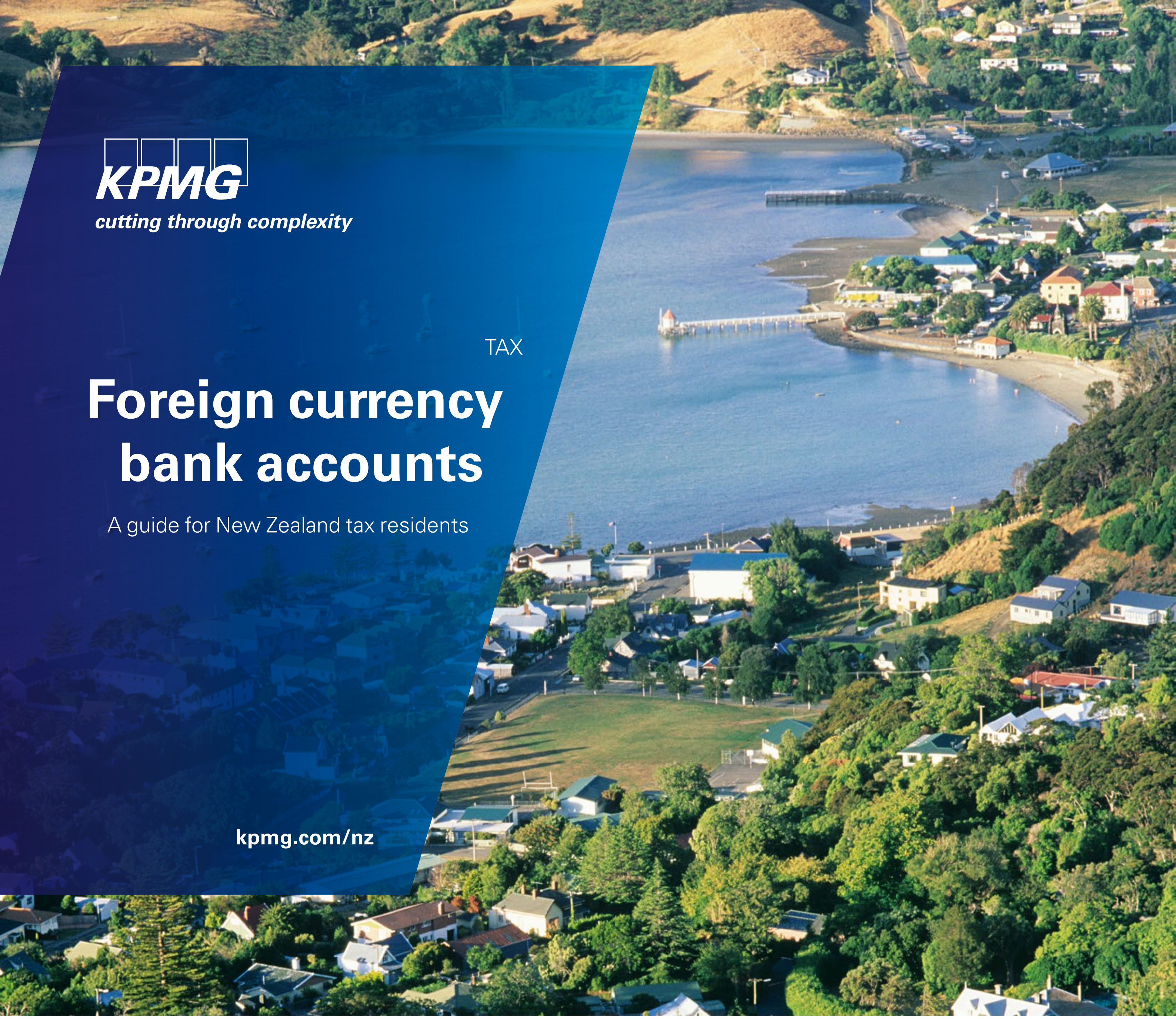

cutting through complexity

TAX

Foreign currency bank accounts

A guide for New Zealand tax residents

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Tax impact of holding foreign currency accounts and loans

Bank accounts or loans in a foreign currency are subject to the financial arrangement rules. This means any foreign exchange gains are, or will become, taxable. Many people do not realise they have an obligation to report these gains to Inland Revenue.

N.B: This document only applies for individuals who are tax resident in New Zealand.

Overview

Foreign currency accounts are financial arrangements, and are therefore subject to the financial arrangement rules - unless there is a specific exclusion to treat them as an excepted financial arrangement. If one of the exclusions applies, interest is taxable as received.

'Financial arrangements' include any debt instruments and securities, such as bank accounts, loans and most derivatives. Shares, options over shares and some other specific arrangements (called excepted financial arrangements) are excluded from the financial arrangement rules.

The total return on financial arrangements is taxable. In the context of a foreign currency bank account, this includes any foreign exchange movement. The main issue is when that income or loss should be recognised. Or, in some limited circumstances, whether you are excluded from these rules altogether.

Approach

You need to consider the following questions to establish whether your tax position is affected by the information in this document and, if so, how you might be taxed on exchange gains or losses from foreign currency bank accounts.

1. Do you have bank accounts or loans in a currency other than NZD? If not, this information does not apply to you.

2. Are those accounts excluded from the financial arrangement rules? If so, return interest received or credited to your account each year. In the case of a loan, deductibility of interest needs to be determined under ordinary tax rules (e.g. was the interest incurred to produce taxable income and not of a private nature).

3. Can you account for interest on a cash basis? If so, you will need to return interest received or credited to your account each year, and calculate exchange gains on maturity (e.g. when the account is closed, or a term deposit rolled over.) In the case of a mortgage, interest is deductible when incurred (usually, as it is accrued) and exchange movements on the principal will be accounted for when the loan is repaid. If not, you will need to account for interest and foreign exchange movements each year.

Exclusions from the financial arrangement rules

The main exclusions relevant to foreign currency bank accounts are:

Call accounts/on-demand loans less than $50,000

There is an exclusion for minor VPDIs (variable principal debt instruments). These include bank accounts where the principal of the loan or deposit can be varied at will, e.g. cheque accounts, and on-call savings accounts.

If the aggregate balance of all such accounts (regardless of whether they are foreign currency or NZD) held during the year is less than $50,000 on every day of the tax year, the account can be excluded from the financial arrangement rules.

If the $50,000 threshold is exceeded on any day in an income year, the accounts cannot be excluded for that year.

Private/domestic foreign currency loans

A loan in a foreign currency where the borrower is a cash-basis person (see below), and that is used for private or domestic purposes, can be excluded from the financial arrangement rules.

Other investments

These rules only apply to direct investments in financial arrangements. If you have an exposure to foreign currency through a pooled vehicle, such as a unit trust, mutual fund or PIE (portfolio investment entity), these amounts will be subject to different rules and should not contribute to the various thresholds discussed here.

Returning income on an accrual or cash basis

The total income from a bank account, i.e. interest and exchange gains, will have to be returned, unless you satisfy one of the specific exclusions from the financial arrangement rules (discussed above).

If an account is subject to the financial arrangements rules, it is then a question of when the income has to be returned.

Cash basis income

A cash-basis person (below) returns income on a cash basis. This means the interest is returned when received or credited to your account. Interest in a foreign currency is converted into NZD using spot rates or mid-month rates.

Any exchange gain is returned as part of the base price adjustment (a wash-up calculation to ensure all income has been returned), which is done when the financial arrangement terminates or matures. This means when the bank account is closed, a term deposit rolls over, or when a loan matures or is repaid.

Accrual income

Someone who is not a cash-basis person needs to spread income, which includes picking up accrued interest and foreign exchange movements to the end of the tax year. There are a range of spreading methods available under the rules.

For foreign currency accounts, a common method is to return interest (converted into NZD) and revalue the principal at balance date. But other options might be available.

In some cases, you can choose to spread "expected" income over the term of the arrangement on a yield-to-maturity basis. Expected income is calculated at the start of the arrangement using the forward rates for each known cash flow. This approach cannot be used if the term and cash flows are not known at the time the account is opened. So it should be available for mortgages and term deposits, but not call accounts.

A straight line approach to spreading income can be taken if the total value of all financial arrangements (held or issued) is less than $1,850,000.

Calculation

Both the accrual basis and cash basis will typically require each transaction to be translated at the appropriate spot rate, and a comparison made between the total amounts withdrawn and total amounts deposited.

The main difference is that a cash basis person does not need to return income (other than cash income received) every year, only on termination of the arrangement (e.g. by closing the account). This should be a compliance costs saving, except for the ironic fact that to determine whether you are a cash-basis person, you need to know what your accrual basis income would have been.

Cash basis person

The thresholds

A cash basis person is a person who falls under at least one of the following thresholds:

- The absolute value of all financial arrangements is $1,000,000 or less.
- Absolute value of income and expenses is $100,000 or less.

These tests require both assets and liabilities (or income and expenditure) to be aggregated as absolute values – for example borrowing $500,000 and lending $600,000 would total $1.1 million.

Additional threshold

In addition to being under one of the above thresholds, the income deferred by returning on a cash-basis, rather than an accrual basis, must be no more than $40,000.

This amount of deferred income is cumulative from year to year, i.e. comparing all accrual income that would have been returned since the start of the arrangement and all cash basis income that has been returned since inception for all financial arrangements held on 31 March.

Trusts and jointly-held property

The thresholds discussed above focus on each taxpayer and the New Zealand tax year (1 April to 31 March). This means you do not include any assets/ loans held through a trust in your own calculation. In most cases, joint income can be split to effectively double the threshold per couple. Though, when considering the financial arrangement held, this looks at any arrangement the individual is a party to.

Example

Take for example, a person who:

- Borrows $200,000 and pays $20,000 of interest per annum for 5 years
- Lends $200,000 with $110,000 interest payable in year 5.

Assuming these are the only financial arrangements held or issued by the person:

Year 1: cash basis person

- The absolute value threshold is met by virtue of the value of financial arrangements ($400,000)
- The deferral threshold is met as accrual (net) income on a straight line basis is $2,000 and on a cash basis ($20,000) – the deferral is $22,000.

Year 2: not cash basis person

- The absolute value threshold is met by virtue of the value of financial arrangements ($400,000)
- The deferral threshold is breached as accrual (net) income accumulated for year 1 and 2 on a straight line basis is $4,000 and on a cash basis ($40,000) – the deferral is $44,000.

Impact of exchange rates

Recent years have seen significant movements in the New Zealand dollar against various currencies. This could impact on your taxable income or loss, your provisional tax requirements and even your status as a cash-basis person.

Assuming 100,000 of each of the following currencies was held throughout the 2011 to 2015 tax years, the approximate taxable income arising would be as shown in the table.

Potential impact for tax returns

These exchange movements could impact on your:

» Tax return for the current year

» Provisional tax liability for the current year and exposure to use of money interest

» Provisional tax liability for the following year if using the standard uplift method

Currency held	2011	2012	2013	2014	2015
AUD 100,000	5,310	(9,660)	(1,980)	(17,710)	(4,360)
USD 100,000	(11,170)	(8,400)	(2,780)	(2,770)	15,770
SGD 100,000	2,340	(6,680)	(870)	(3,900)	3,860
EUR 100,000	(5,570)	(25,830)	(9,900)	6,440	(16,250)
GBP 100,000	(5,240)	(16,440)	(14,240)	10,490	4,160

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