EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

Inland Revenue
Te Tari Taake

RULINGS UNIT

ISSUES PAPER NO.5

Interest deductibility in certain arrangements

Adjudication & Rulings
Inland Revenue Department

Issues Papers

Inland Revenue's Rulings Unit is responsible for developing and publishing public rulings and interpretation statements on aspects of tax law. Draft public rulings and interpretation statements are circulated to interested parties for their comment before the rulings or interpretation statements are issued in their final form.

The nature of the issues involved in some public rulings means that we prepare an "issues paper" to accompany draft public rulings and interpretation statements. This issues paper is concerned with the deductibility of interest, and outlines the Commissioner's revised view of interest deductibility in relation to certain arrangements. It follows on from a previous issues paper on the same subject, referred to as IRRUIP 3. It discusses the approach in that paper, the reasons why the Commissioner's view has now changed from the view in IRRUIP 3, and the Commissioner's proposed new approach. Because of the change in view, we considered it necessary to release this second issues paper for consultation.

Attached to this paper are draft public rulings that reflect that Commissioner's revised view. A commentary would normally accompany draft public rulings, but as the commentary would be a condensed version of this paper, the commentary will be released at a later stage.

Status of Issues Papers

Draft items, including this issues paper, produced by the Adjudication & Rulings Business Group represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

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Submissions

Inland Revenue welcomes your written comments on any of the technical or practical issues raised in this paper and on the draft rulings. Submissions should be forwarded to:

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EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY

INTEREST DEDUCTIBILITY IN CERTAIN ARRANGEMENTS

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1. Summary

Issues and conclusions

1.1 This paper deals with the issue of whether interest is deductible in certain arrangements where the principal on which interest is payable is not directly used in an income earning process or business.

1.2 The Rulings Unit previously circulated issues paper IRRUIP 3 on this topic, making it available for public comment during September to November 1998. We received a number of submissions relating to a range of issues. The submissions caused us to reconsider the conclusions in that paper.

1.3 Consequently, a revised interpretation of the law is outlined in this paper, on which we invite submissions.

1.4 The view put forward in IRRUIP 3 was that interest may be deductible under the interest deductibility provisions in sections DD 1(b)(i) and DD 1(b)(ii) of the Income Tax Act 1994 (the "Act") on money borrowed and used in certain arrangements that are not directly productive of income. The paper concluded that interest was deductible under these arrangements, if the total amount of the borrowings used for the arrangements did not exceed the aggregate market value of assets less borrowings directly used in an income producing activity. An apportionment would be needed to exclude the amount of the borrowings financing any assets that did not produce gross income. Also, the interest incurred on those borrowed funds would not be deductible if the direct use of the borrowed funds was for private or exempt use. If this test was met, the Commissioner's view was at that time that the income earning assets would be "financed" by the borrowings. This view was primarily based on the Court of Appeal decision in *Public Trustee v CIR* [1938] NZLR 436, and was also consistent with the decision of the Full Federal Court of Australia in *FC of T v Roberts; FC of T v Smith* 92 ATC 4,380.

1.5 It was made clear in IRRUIP 3 that although the interest deductibility test discussed in that paper was based on the statutory provision, *Public Trustee* and other cases, the scope and detail of the test could not be found in any particular case. As the specific facts of the arrangements are not dealt with in any case, an interest deductibility test was proposed that was based on the available law, using a conceptual basis to deal with these other fact situations.

1.6 Having considered the submissions and reconsidered the law in this area, our view is now that the "financing assets" approach proposed in IRRUIP 3 is unlikely to have been the intention of Parliament in enacting the interest deductibility provision, and would be unlikely to be the approach taken by a court.

1.7 Our view is now that the correct interpretation of the law is a narrower application of the principles in the authoritative cases in the area; *Public Trustee* and *Roberts* and *Smith*. In brief, these principles are:

[from *Public Trustee*]

- interest is deductible to the extent that it is incurred on funds borrowed and used to preserve income earning assets or assets that are part of a business carried on for the purpose of deriving income, from a sale that would otherwise be necessary to meet a liability that is an involuntary expense arising out of the holding of the income earning assets or otherwise out of the continuing income earning activity or business. To qualify, the direct use of the borrowed funds must not be a private use.

[from *Roberts* and *Smith*]

- *Roberts* and *Smith* establishes the principle that interest is deductible on borrowed funds used to repay funds that were invested directly in the taxpayer's or partnership's continuing income earning activity or business. In such an arrangement, the borrowings replace the funds repaid and inherit the deductibility status of those repaid funds. This principle will apply to provide that interest is deductible in the following arrangements:

    - Interest incurred on funds borrowed and used to return capital contributed to a partnership or company, to the extent that contributed capital was used directly in the partnership's or company's income earning activity or business.

    - Interest incurred on funds borrowed and used to repay debt, if interest on that repaid debt was deductible because either:

        - the debt repaid was used (or can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing that was used) to return contributed capital that was used directly in a partnership's or a company's income earning activity or business; or

        - the debt repaid was used directly in the taxpayer's or partnership's income earning activity or business (or can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing that was used directly in the taxpayer's income earning activity or business); or

        - the debt repaid was used by a company taxpayer to purchase shares in a wholly owned company, and the interest on those funds was deductible under section DD 1(b)(iii) (or can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing that was put to that use); or

        - the debt repaid was used (or can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing that was used) to pay an expense in circumstances where the elements of the *Public Trustee* test had been satisfied, i.e. the money repaid was borrowed and used to preserve income earning assets or assets that are part of a business, from a sale that would be otherwise necessary to meet an involuntary expense arising out of the income earning activity or business.

- Apportionment will be appropriate if the borrowed funds or capital that is repaid were only partly used directly in the income earning activity or business (or the borrowed funds were only partly used for some use in respect of which the interest was otherwise deductible in terms of the bullet points above).

1.8 Adopting these bases would have the result that interest may be deductible when the borrowed money is used:

- in some limited circumstances, to pay income tax and use of money interest.
- to return partners' capital.
- to repurchase shares.
- to repay debt invested in the income earning process.

1.9 This list of arrangements contrasts with the arrangements dealt with in the previous issues paper, in that it includes debt used to repay debt, and excludes debt used to pay dividends, to pay partnership profits, and by a company to make a payment to share in a company's losses (a "subvention payment").

1.10 The Government released a discussion document "Interest deductions for companies" in September 1999, proposing changes to the interest deductibility legislation. The proposed changes would make interest incurred by companies deductible, except if the companies are qualifying companies or companies that derive exempt income other than exempt dividends. Also, interest incurred by companies would not be deductible if the thin capitalisation or conduit allocation rules apply.

1.11 Submissions on these proposals are currently being considered by Government, and Inland Revenue officials in the Policy Advice Division.

1.12 If these proposals are enacted, the binding rulings proposed in this paper would no longer apply to companies affected by the proposed legislation, from the time any new legislation became effective. The binding rulings would continue to apply to taxpayers to whom the proposed new legislation would not apply.

1.13 However, this paper is not concerned with those reform proposals, nor does it supersede them.

Structure of this paper

1.14 This paper first discusses the reasons why the Commissioner no longer adopts the interpretation of the law put forward in the previous issues paper, IRRUIP 3.

1.15 The paper then analyses in turn the decisions in *Public Trustee* and *Roberts* and *Smith*, and identifies the principles from those cases. The implications of these principles are also discussed.

1.16 Other possible bases for an indirect interest deduction, that we have considered and rejected, are discussed at the end of this paper. One of these bases is the idea that section DD 1(b)(ii) ("the second limb") creates such a broad test for interest incurred by businesses that there is no need to consider an indirect test for the arrangements that are the subjects of the proposed public rulings. We received a number of submissions on this issue.

2. Background

Previous issues paper

2.1 As mentioned above, an issues paper on whether interest is deductible in certain arrangements was circulated to interested parties outside Inland Revenue. The arrangements were the deductibility of interest incurred in relation to money borrowed and used:

- by a company to repurchase shares.
- by a company to pay dividends.
- by a partnership to return capital contributions.
- by a partnership to pay profits to partners.
- by any taxpayer to pay income tax and use of money interest.
- to pay subvention payments.

2.2 The issues paper concluded that interest would be deductible in respect of these arrangements, if the total amount of such "indirect" borrowings did not exceed the aggregate market value of assets less borrowings directly used in an income producing activity. In these circumstances, we considered that the interest incurred on the borrowed funds would have a sufficient connection with the income earning activity or business, because the borrowed funds would be supporting the assets. There was also a proviso that no "indirect" interest, as we termed it, would be deductible if the direct use of the borrowed funds was a private use or a use that directly produced exempt income.

2.3 The financing assets approach was an interpretation attempting to reconcile the cases that dealt with different factual situations, in order to provide a consistent conceptual basis for interest deductions for any use of borrowed money that was not directly productive of income.

2.4 However, submissions received, and our own further analysis, identified a number of problems with the financing assets approach, and we have now come to the view that the financing assets approach is not the correct view of the law. These problems, and the reasons for our conclusion that the approach is not sustainable, are discussed after the following extracts from the legislation.

Legislation

2.5 Section DD 1 states:

> Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:
>
> ...
>
> (b) Interest (not being interest of any of the kinds referred to in section DB 1(1)(e) and not being interest to which section LF 7 applies to prohibit a deduction), except so far as the Commissioner is satisfied that-
>
> (i) It is payable in deriving the taxpayer's gross income; or
>
> (ii) It is necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income; or
>
> (iii) It is payable by one company included in a group of companies in respect of money borrowed to acquire shares in another company included in that group of companies:
>
> Provided that for the purpose of this paragraph expenditure incurred under the accrual rules is treated as interest payable:
>
> Provided further that for the purposes of this paragraph any 2 companies shall be treated as being included in a group of companies in respect of any income year only if those companies are members of the same group of companies at the end of that income year:

2.6 Also relevant is section BD 2:

> BD 2(1) DEFINITION An amount is an allowable deduction of a taxpayer …
>
> (a) …
>
> (b) …
>
> BD 2(2) EXCLUSIONS An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is
> (a) of a private or domestic nature, or
> (b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined) or F (Apportionment and Recharacterised Transactions), or
> (c) incurred in deriving income from employment, or

(d) incurred in deriving schedular gross income subject to final withholding, or
(e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions), or
(f) disallowed as a deduction under Part D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment of Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

Defined: allowable deduction, amount, business, gross income, income from employment, schedular gross income subject to final withholding, taxpayer

3. The financing assets approach outlined in the previous issues paper and the reasons for rejecting that interpretation

Summary

3.1 The view expressed in IRRUIP 3 was that interest was deductible for borrowings used indirectly in an income earning activity or business if the money borrowed could be regarded as financing income earning assets. A limit was imposed on "indirect" interest deductions, to the extent that the total of all the taxpayer's debt did not exceed the value of the taxpayer's assets. Indirect interest would be apportioned to the extent that the taxpayer had non-income earning assets.

3.2 The problems with the financing assets approach identified through consultation and by further consideration of the issues are:

- The financing assets approach is too far removed from the reasoning of the Court in *Public Trustee*. The Court in *Public Trustee* referred to the assets as being *retained*, and not financed. However, if the basis for interest deductions is simply that assets are retained by a borrowing, the problem identified in the issues paper remained – if an interest deduction is based on the reasoning that assets are retained, then any interest will be deductible. That result, which meant that there would be no boundaries to such a test, cannot have been the intention of Parliament and would not be followed by a court.

- The limits on the deductible amounts of interest in the financing assets approach might be seen as an inappropriate attempt by the Commissioner to prescribe how much taxpayers should borrow.

- Some of the requirements of the proposed indirect test would make compliance with the test so difficult that it would be unworkable; suggesting that the financing assets approach cannot have been the intention of Parliament in enacting the interest deductibility legislation and would not be followed by a court.

- If returns of capital (by a partnership or a company) are subject to the financing assets test, then logically debt that refinances debt should also be subject to the test. The consequent increase in the number of arrangements that would be subject to the compliance requirements of the financing assets approach also indicates that the financing assets approach cannot have been the intention of Parliament and would not be followed by a court.

Problem one – interpretation of **Public Trustee** *and retaining assets*

3.3 The Court of Appeal in *Public Trustee* said that in the circumstances it was considering, the borrowing had the effect of retaining income earning assets from being sold. The Court did not discuss a wider principle that any borrowing has the effect of financing a taxpayer's assets that are not already financed by debt. It can be argued, therefore, that the idea that debt finances a taxpayer's assets is too far removed from the reasoning of the Court.

3.4 The facts of *Public Trustee* were that an estate did not have sufficient cash to pay death duties, and so the trustee of the estate borrowed to pay them. The death duties were a charge on all the assets of the estate. In a majority judgment, the Court held that the interest was deductible.

3.5 The leading judgment was given by Myers CJ. Myers CJ expressed his reasoning in several key sentences (p.452):

> The death duties were a charge on the whole estate. If the estate had had the necessary money available in cash and had paid the duties with that cash, and had then found it necessary to borrow … for the purpose of maintaining the income of the estate, and had borrowed accordingly, could it be doubted that in such circumstances the interest on the money borrowed would be deductible under para. *(h)* of s. 80(1)? What the estate has in fact done is substantially the same thing, and has the same effect.

3.6 And at the bottom of p.452:

> The true inference, I think, in the present case is that the money borrowed enabled the trustee to pay out of the estate the amount of the death duties and left the money so borrowed or its equivalent in capital assets in the estate to be employed in the production of income.
>
> Where moneys are borrowed as in this case, it seems to me that they are in reality borrowed for the dual purposes of enabling the death duties to be paid and of maintaining the income from the assets of the estate.

3.7 The judgment of Callan J from the same case shows similar reasoning (p.457):

> The issue under s. 80(1)(*h*), in my view, comes to this: "Is borrowed money spent in *retaining* the possession and use of such tangible assets in the same category as money spent in *acquiring* the tangible assets?" It is considered for the Commissioner that this question must be answered in the negative. I have come to the opposite conclusion. In neither case is the assessable income produced directly by the use of the borrowed money. That happens only in the case of money lending. But in each of the cases now contrasted, the assessable income is earned by the use or employment of tangible assets other than money. I see no sufficient reason for saying that borrowed money spent in obtaining such an asset is capital employed in the production of income, but that money spent in retaining such an asset is not.

3.8 Clearly, it was important to the Court's reasoning that the assets were retained. However, as IRRUIP 3 argued, the intent of the Legislature cannot have been a principle of interest deductibility based on the idea that assets are retained by a borrowing. The reason is that there would be no boundaries to such a test, and that result cannot have been the intent behind the legislation.

3.9 The legislation requires a nexus between interest and the derivation of income, and provides for apportionment to the extent that the nexus is not met. If the basis for interest deductions were that a borrowing may retain income earning assets, then in almost any circumstances, a taxpayer could successfully claim that selling assets was an alternative to borrowing. Any borrowing can be said to be retaining assets. A taxpayer could go on borrowing on the basis that the same income earning asset was retained. There would seldom be a need to apportion interest deductions, because a taxpayer could claim that the borrowing retained the income earning assets. It would be inconsistent with the legislative test if any interest were deductible without the need to examine whether the nexus with income has been established. Therefore, in the Commissioner's view, the idea that the statutory test may be satisfied merely by the fact a borrowing may retain income earning assets, cannot have been the intent of the Legislature.

Certain factors are not relevant to the Commissioner's interpretation

3.10 The Commissioner rejects an interpretation of *Public Trustee* that would provide interest deductibility if the borrowing simply serves to retain assets. Two points should be made on this view. The concern as to no limit to interest deductions is not a concern about revenue loss. It is an interpretative position.

3.11 Secondly, that taxpayers may be limited by practical reasons, in that lenders may cease to lend once a taxpayer's debt exceeds the value of assets, does not change this matter of interpretation.

Problem two – the financing assets approach might be seen as the Commissioner telling taxpayers how to do business

3.12 The financing assets approach provided for interest deductions to the extent that a taxpayer had income earning assets that were not fully financed by debt. This proposed ceiling on deductions might have be seen as an attempt by the Commissioner to prescribe how much taxpayers should borrow. That sort of approach was rejected in *Cecil Bros Pty Ltd v FCT* (1964) 111 CLR 430 and by the Judicial Committee in both the *Europa Oil* cases [1971] NZLR 641, 649; [1976] 1 NZLR 546, 552, amongst other cases.

Problem three – complexity of the financing assets approach

3.13 The majority of the submissions we received were concerned with the complexity of the proposed financing assets approach. The financing assets approach required taxpayers to monitor the extent to which the market value of income earning assets exceeded debt attributed to those assets. This required taxpayers to know, on an on-going basis, the market value of all of their assets, including non-income producing ones, and the level of debt. The market values of assets needed to be current right throughout the period that interest is incurred. Balance sheet values could not be used because those values would not reflect the extent to which assets could be financed at the time the interest deduction would be sought. Taxpayers with shares, sole traders with private assets, and taxpayers with unusual assets would have special difficulties.

3.14 If debt exceeded income earning assets, any indirect interest deduction would need to be apportioned. If a taxpayer had non-income earning assets or assets producing exempt income, the interest deduction would need to be apportioned based on the ratio of income earning assets to other assets. Also, the on-going valuation requirement would have meant that where an apportionment was required, the proportion of deductible interest would fluctuate, leading to more calculations.

3.15 The compliance issues with the financing assets approach would have arisen predominately when taxpayers had non-income producing assets or assets producing exempt income, and/or their debt levels exceeded aggregate asset values. If a taxpayer had no non-income earning assets or assets producing exempt income, (and these assets under the financing assets approach would in the common case be shares in wholly owned companies, qualifying companies, CFCs or FIFs), or if a taxpayer's debt was obviously below the value of assets, then no calculations would need to be performed, as it could be safely assumed that the taxpayer was within the parameters to satisfy the test.

3.16 However, the possibility that taxpayers might be required to extract this information, and perform elaborate calculations to secure an interest deduction, led us to the view that Parliament could not have intended such requirements, and it also seemed unlikely that they would be accepted by a court.

Problem four – refinanced debt

3.17 Issues paper IRRUIP 3 raised the issue that any test that applies to debt that refinances returns of capital to partners or share repurchases, logically would also apply to debt that refinances debt. When a loan is taken out to refinance an existing debt, the direct use of the new loan funds is to pay back the lender of the first loan. Therefore, the second loan is not directly used in the borrower's income earning activity. At best, only an indirect connection with income earning will exist. The paper did not reach any conclusions on the point, but sought comment.

3.18 The submissions received on this point did not cause us to change the view that most refinanced debt must logically be treated the same as borrowings used to repay partner's capital or share capital. Both types of funds are used indirectly in an income earning process to return the existing funds to their owners.

3.19 The submissions did make it clear that for many taxpayers a high proportion of their debt is refinanced. The practical difficulties taxpayers would face in complying with the financing assets approach would be greatly increased if refinanced debt were also subject to the approach. We came to the conclusion that refinancing debt is such a normal part of commercial life that the Legislature could not have intended taxpayers to go to such lengths to comply with the interest deductibility provision. For this further reason, the financing assets approach should be rejected.

4. The Commissioner's revised approach to when interest is deductible under the arrangements

Background to the Commissioner's revised approach

4.1 Two authoritative cases in this area have not been judicially questioned and represent the law: *Public Trustee* and *Roberts* and *Smith*. The financing assets approach was an attempt to find a broad principle drawn from both cases. For the reasons already given, that broad approach has been rejected.

4.2 We have considered other broad bases for establishing interest deductions in circumstances where borrowed funds are not used to directly produce income, and rejected these. One is the argument that section DD 1(b)(ii) provides a broad basis for deductibility so that almost any interest incurred by a business is deductible. These other bases are discussed at the end of this paper.

4.3 This has left us to consider whether there are separate principles, based on each of the two cases. These two cases are discussed in turn.

Public Trustee *– the principle from the case*

4.4 The point was discussed above that *Public Trustee* cannot stand for the principle that interest is deductible merely because borrowed funds permit or facilitate the taxpayer's retention of the income earning assets. Such a principle has no limit, and it is not necessary to establish any connection with income. In the Commissioner's view, that principle cannot have been the intention of Parliament in enacting a provision that the courts have said requires a sufficient connection with income, and requires apportionment where that connection is not established.

4.5 We have considered whether the principle from *Public Trustee* might require that assets are preserved from sale, rather than a lesser standard of requiring assets to be retained. However, even with a test that required preservation of assets from sale, a deductible result was still possible for uses of money such as fines for criminal offences, expenses incurred in relation to avoidance schemes, expenses relating to someone else's business, and a nil interest loan to a sister company. It did not seem a correct result that interest incurred in these circumstances would be deductible under the statutory test.

4.6 A possible mechanism to exclude such uses from giving rise to deductible interest, would be to add an extra requirement, that the expense be "not divorced from the income earning process". But if an extra requirement is necessary, the preservation reasoning is not a reason for a connection with income, and so not a basis for interest deductions.

4.7 The idea of a requirement that the use of the borrowed funds be "not divorced" from income earning led to another problem too. The expense that the Court was concerned with in *Public Trustee* was not of a type that was "not divorced" from the income earning process. By section 28 of the Death Duties Act, 1921, the death duties constituted, as from the death of the deceased, a charge upon the whole dutiable estate of the deceased and upon all property included in that estate. The expense arose as a result of the estate holding the assets, but it was not connected with the income earning activities of the estate. The death duties were not even a consequence of that process, as income tax or goods and services tax might be described. Therefore, the expense arose as a result of the estate holding the assets, but it was not connected with the income earning activities of the estate.

4.8 All these difficulties in forming a principle have led us to the conclusion that the case must be confined to its facts. The facts that are the features of the decision are:

- borrowings are used to preserve income earning assets from a sale; and
- the sale would be otherwise necessary to meet a liability; and
- the liability is an involuntary expense; and
- the liability arises out of the holding of the income earning assets or otherwise out of the continuing income earning activity or business; and
- the direct use of the borrowed funds is not for private use.

4.9 The first bullet point requires there to be a possible sale. The preservation requirement will be demonstrated if the requirements of the next two bullet points are satisfied.

4.10 The requirement in the second bullet point, that the sale would otherwise be necessary but for the borrowing, may lead to debates over how necessary the sale would have been. Satisfaction of the "involuntary expense" requirement in the third bullet point could also be disputed.

4.11 The Commissioner's view is that an involuntary expense is one similar in nature to tax or death duties. An expense arising as a result of a taxpayer voluntarily entering into a contract would not be viewed as involuntary. The circumstances in which many expenditures are incurred could potentially be manipulated so that the expenditure is arguably involuntary. However, if there is evidence of matters being arranged so as to make an expense appear involuntary, that would suggest that it was not in fact incurred involuntarily.

4.12 The fourth bullet point requires that the liability which the borrowings were used to pay arises out of the holding of the income earning assets or otherwise out of the continuing income earning activity or business. Its purpose is to require some degree of connection with the income earning activity, in accordance with the statutory test, even though it is as distant as arising simply because the income earning assets are held. It will prevent, for example, deductions for interest incurred on borrowed money used to pay fines and penalties unrelated to the income earning process.

4.13 This approach to *Public Trustee* could be criticised in that the Court did not explicitly refer to these requirements. However, an examination of *Public Trustee*, and other more recent cases, supports a narrow interpretation.

Does* Public Trustee *support a requirement that the expenditure be involuntarily incurred?

4.14 A particular criticism might be of the view that the expense for which the borrowed funds are used must be an involuntary one. The Commissioner took this view of the case in the Commissioner's current published view, published in *Tax Information Bulletin* Vol 3, No 9 (June 1992). Susan Glazebrook and Jan James (*NZ Journal of Taxation* March 1995 p.153) have suggested that this view was not correct, arguing that the involuntariness of the expenditure did not form part of the ratio of the judgment.

4.15 Myers CJ mentioned involuntariness as a way of distinguishing the decision in *Ward and Co. Ltd. v The Commissioner of Taxes* [1923] AC 145. It was important in forming his judgment that *Ward* was distinguished. *Ward* was a decision of the Privy Council that stood for the proposition that a payment to protect a taxpayer from something that would destroy the profit-bearing thing was not deductible. Thus it was a critical factor in *Public Trustee* that Myers CJ found the expenses to be involuntary. However, as Glazebrook and James pointed out (*Ibid* p.154):

> Although their Lordships [in *Ward*] referred to the expense being "voluntary", it is clear that their decision was not based on the voluntary nature of the expense, but on the payment being to prevent the destruction of the profit-bearing assets rather than for the "direct purpose of producing profits". In our view, even if the payment in *Ward* had been involuntary, it would not have been deductible. Therefore, Myers CJ distinguished *Ward* on a basis that was not essential to their Lordships' decision.

4.16 Myers CJ also referred to the involuntariness of the payment in distinguishing the Australian High Court decision in *The Federal Commissioner of Taxation v Munro* (1926) 38 CLR 153. In that case, the Court had rejected the idea that because loans were secured over rent-producing property, the interest would be deductible, despite the fact that the loans were used for private purposes. Isaacs J said (p.197):

> But in employing the borrowed money for purposes independent of the property, leaving its condition entirely unaffected, that result cannot be postulated.

4.17 Myers CJ quoted *Munro*, and italicised the statement above of Isaacs J and the following similar statements of Chief Justice Knox (p.454 of *Public Trustee* and p.171 of *Munro*):

> The assessable income of the taxpayer was in *no way referable* to the transaction with the bank out of which the liability to pay interest arose, and the loan by the bank *was in no way instrumental in or conducive to the production of the assessable income …*
>
> *The debt having been incurred for a purpose wholly unconnected with the production of assessable income of the respondent*, I think it impossible to say that the interest paid on the

amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income.

4.18 Directly after this quotation, Myers CJ said:

> Here, the death duties were not a voluntary debt. They were a debt of the estate, which was charged upon the estate, and which the trustee was compelled to pay. The Death Duties Act, 1923, authorizes him to borrow money upon the security of the assets of the estate in order to enable him to pay the duties. It was not therefore a voluntary expense incurred by the estate as the Privy Council held the payment in *Ward and Co.'s case (supra)* to have been. Here, also, the money was borrowed in order to prevent reduction of the income. The borrowed money was not employed, to quote the words of *Isaacs* J., for purposes alien to or independent of the property, and, to use the language of *Knox* C.J., the loan here *was* instrumental in or conducive to the production of the assessable income. It cannot be said that the debt was incurred for a purpose wholly unconnected with the production of the assessable income of the estate. On the contrary, it was incurred for the very purpose of maintaining the income of the estate and preventing its reduction.

4.19 In order to distinguish *Munro*, Myers CJ found it necessary to rely on the fact that the debt was involuntary. Although the Chief Justice also seems to argue that the situations are distinguishable on the basis that in *Public Trustee* the loan really was connected with income, in both cases, the borrowing left the assets unchanged. The difference, it seems, is that because the debt in *Public Trustee* was involuntary, the assets truly were preserved from sale, and that was the link with the assets. In *Munro*, it was only a possibility that the assets would be sold if the interest was not paid and the lenders consequentially exercised their rights over the assets.

4.20 Although it was important to Myers CJ's judgment that the expenses were involuntary, it can also be argued that the nature of the expense was not crucial to the ratio of the case which arguably stated a wider principle about retaining assets and maintaining income. However, for the reasons given in this paper, it is considered that a wider interpretation cannot be accepted. The references to the involuntary nature of the expenditure in Myers CJ's judgment are consistent with the view taken in this paper. With respect, the need for Myers CJ to refer to new ground - the nature of the expense - in order to distinguish the precedential cases of *Ward* and *Munro* also casts some doubt on the robustness of his Honour's reasoning, and adds another reason not to give *Public Trustee* a broad interpretation. Further, the Court did not consider the implications of its decision in other circumstances. For these reasons *Public Trustee* should be viewed as a decision confined to its facts.

4.21 Other case law supports this narrow interpretation of *Public Trustee*. In *Roberts* and *Smith*, Hill J noted that in *Yeung & Anor v FC of T* 88 ATC 4193 the court had referred to the concept of maintaining the income earning assets. In this following quotation from *Roberts* and *Smith*, note that the facts and decision in *Begg v FC of T* (1937) 4 ATD 257 were very similar to *Public Trustee*. At p. 4,389, Hill J said:

> The reference to "maintenance of the income earning properties" appears to be a reference to the considerations accepted by Reed AJ in the difficult case of *Begg v DFC of T* (1937) 4 ATD 257 to which Davies J [in *Yeung*] refers shortly before the passage cited. In *Begg* it was held that interest paid on moneys borrowed by an executor to pay succession and estate duties

and other outgoings and for the general administration of the estate were deductible because the effect of the borrowing was to preserve the assets and thereby to retain the income which would otherwise be lost if the assets were sold. The case has stood for a long time and the present is not an appropriate occasion to consider its correctness. There may, however, be thought to be some difficulties in reconciling what was said there with the decision of the High Court in *Munro*. For present purposes it is sufficient to note that the result reached in *Yeung* seems clearly correct if the case is viewed simply as one involving a borrowing to fund the repayment of moneys originally advanced by a partner and used as partnership capital, particularly given that the original funds were used to purchase the rental property.

4.22 *Begg* has been criticised in other cases too. Dr Dabner says in an article in CCH's *Tax Week* (Issue 35 31 July 1998 p.504) that:

> *Begg v DFC of T (SA)* (1937) SASR 97 is often cited as authority for the proposition that, if funds are borrowed to fund a private venture when the alternative would have been to dispose of an income-producing asset, then the purpose of the borrowing is to preserve an income stream and therefore the interest ought to be deductible. This "preservation of assets" argument does not appear to have found much favour (certainly with the Commissioner), and the case is probably best viewed as restricted to factual situations where the application of the primary test is ambivalent.

4.23 In *Hayden v FCT* (1996) 33 ATR 352 the Australian Federal Court held that the taxpayer could not deduct interest indirectly connected to the derivation of income. The taxpayer was the executor of a deceased estate. As a result of an action by the testator's son, the Supreme Court made an order that provision be made out of the estate for the testator's son of the amount of $150,000. The executor borrowed the amount and paid it to the son. A factor influencing her decision to borrow was to avoid selling two properties and so carry out the testator's wish to preserve the properties for the ultimate use of a religious organisation.

4.24 The taxpayer argued that the interest was incurred to satisfy the order so as to maintain the income earning assets of the estate. Spender J rejected this argument, and held that the focus must be on the use to which the borrowed funds are put, following *Fletcher & Ors v FC of T* 91 ATC 4950 for the proposition that interest is deductible when the direct use of the borrowed funds produces income.

4.25 His Honour referred to the decision in *Roberts* and *Smith* but did not expressly apply it or distinguish it. His Honour discussed *Public Trustee* and *Begg*, noting that both decisions were factually similar to the one he was concerned with. His Honour found himself unable to reconcile *Public Trustee* and *Begg* with the decision in *Munro*.

4.26 The narrow interpretation of *Public Trustee* is also consistent with the very clear direction of Canadian courts in restricting the scope of this type of principle; see *The Queen v Phyllis Bronfman Trust* [1987] 1 CTC 117, *74712 Alberta Ltd v Minister of National Revenue* [1997] 2 C.T.C. 30, and *Chase Manhatten Bank of Canada v R* [1997] 2 CTC 3097.

CIR v Williams

4.27 The High Court decision in *Williams v CIR* (1988) 10 NZLR 5,078, is the only other New Zealand case on point, and appears to follow *Public Trustee* for the proposition that interest is deductible when the borrowing retains income earning assets. In *Williams v CIR*, the taxpayer borrowed to satisfy his spouse's matrimonial claim on a farm. The High Court found that the interest was deductible. Barker J held that despite the concurrent use to meet the matrimonial claim, the interest was deductible because in the circumstances, the taxpayer's borrowing served to retain the farm. The taxpayer apparently did not have any other assets that he could sell to meet the claim.

4.28 The concerning aspect to this case, is that the borrowed funds were used for a private use. Because it was private in nature, the interest should not, therefore, have been deductible. In *FC of T v Munro* (1926) 38 CLR 153 the Court held that interest incurred on borrowed funds used for private use, but secured over income producing assets, was not deductible.

4.29 In the Commissioner's view, interest will not be deductible if the direct use of the borrowed funds is for private use. That was not a requirement mentioned by the Court in *Public Trustee*, because there was no element of private use in *Public Trustee*. However, in the Commissioner's opinion, it should be a requirement of the *Public Trustee* principle, because of the express statutory prohibition against deductions for private expenditure.

4.30 Therefore, although the borrowing in *Williams* may have satisfied some of the requirements of the principle from *Public Trustee*, with respect, the Commissioner's view is that the case should not be followed, because the interest was private in nature.

Apportionment

4.31 The *Public Trustee* principle is that interest will be deductible if a particular asset or number of assets are preserved from otherwise being sold. Apportionment of an interest deduction will not be necessary if only an income earning asset or assets are preserved from sale, because the interest will all be connected with the income earning asset or assets.

4.32 If the borrowing preserves both income earning and non-income earning and exempt income-producing assets from being sold, an apportionment will be necessary.

4.33 Possibly, a taxpayer with a mix of assets could demonstrate that it was only the income producing assets that would otherwise have been sold. If those truly were the circumstances, an apportionment would not be required. However, that situation would be unusual, and where any asset might be sold, a taxpayer cannot simply nominate which assets would otherwise have been sold.

Arrangements to which the* Public Trustee *principle applies

4.34 Interest on borrowings used to pay income tax would be deductible under this principle, if its requirements are met. These requirements, listed above, are again:

- borrowings are used to preserve income earning assets from a sale; and
- the sale would be otherwise necessary to meet a liability; and
- the liability is an involuntary expense; and
- the liability arises out of the holding of the income earning assets or otherwise out of the continuing income earning activity or business; and
- the direct use of the borrowed funds is not for private use.

4.35 Interest on borrowings used to pay use of money interest on unpaid tax that related to an income earning activity or a business, would also be deductible.

Borrowing to pay tax on employment income

4.36 In the previous issues paper, it was concluded that if the indirect test were met, individuals would be able to deduct interest incurred on funds borrowed to pay tax on employment income. The reason was that the prohibition for deductions relating to employment in section BD 2(2)(c) excludes expenditure "incurred in deriving income from employment". Tax is not incurred in deriving the income. Tax is a cost only indirectly related to earning income. Therefore, the prohibition against deductions would not apply.

4.37 Following the change in the Commissioner's interpretation of *Public Trustee*, deductibility of interest incurred on money borrowed and used to pay tax on employment income will depend on whether the elements of the *Public Trustee* test are satisfied, i.e.:

- borrowings are used to preserve income earning assets from a sale; and
- the sale would be otherwise necessary to meet a liability; and
- the liability is an involuntary expense; and
- the liability arises out of the holding of the assets or the income earning activity or business

4.38 The interest would not be deductible because two of these requirements will not be met. The first and fourth bullet points together require that the liability arises out of any income earning activity or business, and that the assets that would otherwise be sold are part of that activity or business. Tax on employment income arises out of employment, and there is no income earning asset of that employment. The taxpayer might have income earning assets, but the test requires that the liability arises in respect of assets that would otherwise be sold.

4.39 The second reason that interest would not be deductible in this situation is that even if there were an asset, it would be expected that there would rarely be any necessity to sell the asset, because tax on employment income is deducted by employers and paid to Inland Revenue as the income is earned.

Roberts* and *Smith* – *the principle from the case

4.40 The facts of *Roberts* and *Smith* were that the partners in a firm borrowed in order to repay themselves part of their capital contributions. The Australian Full Federal Court held that the interest was deductible.

4.41 Hill J, who delivered the leading judgment, considered that the interest was deductible, but only to the extent that the borrowed funds replaced the amount of partnership capital contributed by partners. His Honour explained (p.4,388):

> As the cases, including *Kidston*, all show, the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds are put. However, a rigid tracing of funds will not always be necessary or appropriate: cf *FC of T v Total Holdings (Australia) Pty Limited* 79 ATC 4279 and the discussion of tracing in the context of s. 51(1) in Parsons, *Income Taxation in Australia*, Law Book Co, 1985 at 348ff.
>
> For example, let it be assumed that there are undrawn partnership distributions available at any time to be called upon by the partners. The partnership borrows from a bank at interest to fund the repayment to one of the partners who has called up the amount owing to him. That partner uses the moneys so received to purchase a house. A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of assessable income.
>
> In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. Both these cases would equally satisfy the second limb of s. 51(1). In no sense could the interest outgoing in either case be characterised as private or domestic. Similarly, where moneys are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible, irrespective of the use which the partner repaid makes of the funds.

4.42 Hill J found some support for his approach in *Yeung*. In that case a partnership borrowed money to repay to the partners. The interest was held to be deductible. Davies J said at page 4,204:

> I am prepared to accept that from the partnership's point of view, what occurred was that two of the partners decided to withdraw funds from the partnership. It does not materially matter whether those funds were loan funds or capital which the partners had invested in the properties. The notional payment out to Dr and Mrs Yeung and the borrowing of an amount from Ozanu Pty. Ltd. necessarily effected a change in the capital interests which each of the partners had in the partnership. What the partnership achieved by the borrowing from Ozanu Pty. Ltd. was the maintenance of the income-earning properties. Funds were withdrawn, but were replaced by loan funds and the income-earning properties remained held by the six members of the family.

4.43 One of the comments of Myers CJ in *Public Trustee* is consistent with this reasoning (p. 452):

> … the money borrowed enabled the trustee to pay out of the estate the amount of death duties and left the money so borrowed or its equivalent in capital assets in the estate to be employed in the production of income.

4.44 The basis of Hill J's reasoning is that interest will have a sufficient connection with income earning when the borrowed funds replace funds that were used in the income earning activity. The key requirements are that:

- the borrowing repays funds, and
- those repaid funds have been directly used in the income earning activity, and
- the income earning activity or business is continuing when the repayment occurs.

4.45 In these circumstances, in Hill J's view, the borrowings replace the repaid borrowings. A question might be raised about why the replaced borrowings would have a sufficient connection with income as a result of "replacing" funds that have a sufficient connection. The actual use of the replacing funds in *Roberts* and *Smith* was to pay the partners their capital. The "replacement" occurs in the books of the partnership in that equity is reduced and debt increased. There might seem to be some difficulty in understanding how one debt, with its own parties, conditions, and direct use can inherit the deductibility status of a completely different debt. A basic principle of deductibility would seem to be that deductibility of any item should depend on the circumstances related to its incurrence.

4.46 Hill J supports his reasoning by saying that interest on a debt that replaces a debt is deductible. But that statement is not an explanation, and it is not clear that a debt replacing a debt inherits its deductibility status. A contrary approach was taken in the Canadian decision in *Interior Breweries Ltd v Minister of National Revenue* [1955] C.T.C. 143, 55 D.T.C. 1090 (Exch.). In that case Cameron J of the Exchequer Court held that interest was not deductible where the borrowed funds were used to pay a bank loan. His Lordship considered that the borrowed money was not used to earn income, but was "used entirely to pay off the bank loan…" (p.148).

4.47 However, *Interior Breweries* does not appear to have been applied in any later cases. In Canada, the reason is that legislation was introduced to reverse its effect. It seems likely that the decision may not be accepted in New Zealand or Australia if it was argued, because there is quite a strong case law development in Canada, of which *Interior Breweries* is part, strictly limiting deductions for interest in circumstances where the funds in relation to which it is payable, are not used to directly produce income. New Zealand and Australian courts have been cautious about allowing indirect deductions, (particularly in the lower courts where there has been private use of funds), but have not taken such a strict approach as the Canadian courts. The fact that *Public Trustee* has never been questioned in New Zealand is one example, and *Williams v CIR* (1988) 10 NZLR 5,078 and *Roberts* and *Smith* are others.

4.48 Despite these considerations, it seems that the position is, following Hill J's judgment, that repayment can be seen as an in substance replacement. Debt will take on the character of the money it replaces, and the interest will be deductible if the original funds were used directly in the income earning process. The reasoning might be that debt has no character itself, and may be seen to take on the character of the assets or income earning activity in relation to which it is used. As money is not identifiable, but a notion of value, the balance of the initial investment of capital may be repaid and so replaced without the money or its replacement losing its association with the income earning assets or activity. Provided the income earning activity or business is continuing, there still exists the relevant link at the time interest is incurred.

4.49 This principle is referred to in this paper as the "replacement principle".

A requirement of the replacement principle – the funds must return to their owners

4.50 The key requirements of the replacement principle are that:

- the borrowing repays funds, and
- those repaid funds have been directly used in the income earning activity, and
- the income earning activity or business is continuing when the repayment occurs.

4.51 The first element, that borrowings repay funds, must require also that the repaid funds return to their source. The reason for this requirement is because without it, the "replaced" funds can be used for any use unconnected with the income earning process and interest on the new borrowings funds will be deductible.

4.52 Without the requirement that funds must be returned to the person or entity that contributed them, the principle would have no limit except the amount of shareholders' funds over and above contributed capital or debt. The replacement principle is based on the idea that funds in an income earning activity or business have a connection with income. If the principle was not restricted to amounts repaid, the amount of any profit, unrealised gain, or internally generated goodwill could be "replaced" with borrowed funds. If this were the principle, the interest would be deductible because arguably the borrowed funds would be replacing funds that had a nexus with income earning.

4.53 The direct use of the funds would not be relevant (as similarly, the direct use of funds to repay capital to partners or shareholders is not relevant). Those funds could be employed for uses that clearly should not be deductible, such as a nil interest loan to a sister company, an investment in a company which was barred from making distributions, criminal fines, or private use (ignoring the statutory prohibition).

4.54 If these uses of borrowed funds gave rise to deductible interest, the principle must be wrong, because these examples illustrate that any use of funds would lead to deductible interest. Like the retaining assets argument, a basis that leads to all interest being deductible, in the context of the interest provision which requires a sufficient connection and apportionment where that connection is not established, cannot be the correct interpretation. Professor Parsons refers to this issue in his paper "Roberts and Smith: Principles of Interest Deductibility by Professor Parsons" Taxation in Australia Red Edition. Vol.1 No.5 June 1993 p.261 at p.266.

4.55 The principle must be confined to its statement by Hill J. That is:

> The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or in other words, the partnership business" (p 4,390).

What happens if the lender's right is assigned?

4.56 The Commissioner's view is that the principle from *Roberts* and *Smith* is that funds may be replaced with borrowed funds and the interest will be deductible, if the repaid funds are returned to their owners. The exception would be the repayment of a debt, where the right to receive the amount advanced has been assigned to someone else. Interest would still be deductible under the replacement principle. In those circumstances there is still a repayment of funds invested, because the repayment can be traced back to the original investor through the assignment of the debt.

What happens if the debt is forgiven?

4.57 If a debt has been forgiven to the taxpayer, the taxpayer cannot borrow to repay that debt. The debt would no longer exist, so it cannot be replaced, and no further interest deductions would be available in respect of that forgiven debt.

The arrangements to which the replacement principle applies

Returns of capital to partners

4.58 It was held in *Roberts* and *Smith* that interest is deductible if the borrowed funds are used to repay partners their interests in the partnership.

4.59 Hill J reasoned that as a debt may take on the character of the amount it replaces, by analogy the same reasoning may apply to replacements of equity. Of course, partners' capital does not give rise to a potentially deductible income flow as debt does, so there is no deductibility status to inherit. However, this does not prevent contributed capital having the sufficiency of connection with income to satisfy the deductibility test if the capital were instead debt. If the contributed capital has been used directly in the income earning process, then it has the appropriate connection, despite the fact that the "cost" of capital– a return of profits–is not deductible.

4.60 It should be noted that a return of capital, whether by a partnership or a company, is not connected with income simply because it is an ordinary part of running a business. A return of capital is not part of the income earning process. The connection with income in this arrangement is, following *Roberts* and *Smith*, that borrowing to return capital has the effect of replacing the funding of the income earning activity. Hill J in *Roberts* and *Smith* considered that the character of the refinancing takes on the same character as the original borrowing. The borrowed funds replace funds and continue the connection that those funds had. The argument that returns of capital are deductible under the second limb as an ordinary business outgoing is further considered later in this paper.

4.61 Therefore, the replacement principle may apply to returns of capital to partners.

Share repurchases

4.62 A repurchase of shares by a company involves a payment by a company to its shareholders of amounts previously contributed by shareholders. The effect of the payment by the company is a diminishment of the shareholder's capital holding in the company. This arrangement is sufficiently analogous to a return of capital to partners in a partnership such that the replacement principle should apply equally to share repurchases.

4.63 Therefore, the replacement principle may apply to share repurchases.

Payments of profits to partners, and dividends

4.64 In applying the principle to the facts he was considering, Hill J discussed the amounts which could be replaced. He explained that it was necessary to identify whether the partners received a refund of capital, or whether they received amounts in excess of their capital. Capital, Hill J considered, was the aggregate amounts contributed by the partners for the purpose of commencing or carrying on the partnership business (p.4,389). The partnership accounts he was considering did not separate out the contributed capital from other items. He thought it was possible that the amount of capital represented in the partnership accounts included contributed capital, asset revaluations, internally generated goodwill, undrawn distributions and profits of the year not yet distributed. In Hill J's view, of all those items, only contributed capital, undrawn profit distributions, and a further item - advances made by partners, could be replaced with a deductible result. However, although he did not specifically say so, the implication in his discussion was that current year's profits could not be included in the amount able to be replaced.

4.65 Hill J's view was that the types of amounts that could be replaced with a deductible result were funds which have actually been invested in the partnership and which the partners were entitled to withdraw at the time of the borrowing. The reason why current year's profits not yet distributed would not be able to be replaced is not specifically explained, but it must be because they are not amounts actually invested in the partnership and which the partners are entitled to withdraw.

4.66 In contrast, he considered that once profits have been allocated to partners, but not paid out, they can be replaced with borrowings and the interest would be deductible. The reason must be that Hill J analysed allocated past years' profits as advances to the partnership, or investments of capital. In the following passage from Hill J's judgment, it can be seen that the characterisation of amounts as funds actually invested by partners is essential to the principle he was discussing. It is not sufficient that the funds replaced have been involved in earning income, and it is not sufficient that the funds replaced are entitlements of partners at some stage:

> Let it be assumed that the original partnership capital in the Lord Lindley sense [i.e. contributed capital] was $10 and that the balance in the account designated as "the capital account" of the partnership was $125,000, which included goodwill. That would mean that the equity of each partner in the partnership, assuming five partners, was $25,000. But it could not be said that each partner had invested funds totalling $25,000 as capital in the partnership. A cheque for $25,000 drawn on the partnership bank account would not operate to repay the partner any funds invested. The partnership capital would remain at $10, and all that would happen is that there would be a borrowing which was used to pay the partner $25,000. That borrowing would reduce the partner's equity in the partnership, but it could not represent a repayment of capital invested. The partnership assets would remain constant. The goodwill would still be worth $125,000; it would not have been distributed to the partners, nor could it be.
>
> On these facts, there could be no question of there being a refund of pre-existing capital contribution. Rather, looking at the facts objectively, the only purpose of the borrowing would be the provision of funds to the partners to which they were not entitled during the currency of the partnership (save of course by agreement among themselves). The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership, or in other words, the partnership business" (p.4,390).

4.67 Hill J went on to discuss profits (p.4,390):

> If at least $125,000 of the amount in that account represents partnership capital in the Lord Lindley sense, undrawn profit distributions, advances by partners *or other funds which have actually been invested in the partnership* and which the partners were entitled to withdraw in June 1984, then in my view the taxpayer is entitled to succeed [italics added].

4.68 In the first passage, Hill J is talking about goodwill. Goodwill is different to profits, in that it cannot be distributed, and profits can. Goodwill also differs in that it is not an amount of cash arising that could be reinvested in that business. It is the value put on the attraction to customers of the entity's brand. However, both are similar in that they are not amounts invested. The fact that goodwill cannot be distributed is not important. In fact it can be distributed if the business, or part of it, is sold. The relevant aspect of its nature is that it is not an amount invested in an income earning activity.

4.69 The importance of this analysis of the various amounts is that if goodwill and profits could be replaced with borrowings and the interest would be deductible, the result would not be consistent with the interest deductibility provision. The view has already been given under the previous heading that the replacement principle must only extend to amounts actually invested in the business, that are returned to their owners. If profits and goodwill are included, the replacement principle would enable deductions for any use of borrowed funds. If there is no element of a return of an amount invested, borrowings can be used for any use and the interest will be deductible, on the basis that funds with the nexus with income were replaced. This result is not consistent with the interest deductibility provision that requires a sufficient connection with the income earning process and apportionment where the connection is not established. As previously noted, examples of uses of funds on which the interest would be deductible would be a nil interest loan to a sister company, an investment in a company which was barred from making distributions, criminal fines, or private use (ignoring the statutory prohibition).

4.70 Therefore, in the Commissioner's opinion, profits should not be included in the replacement principle unless they have been actively reinvested as capital. If the profits have been allocated, but not paid out, then the Commissioner's view is that they are not amounts invested in the income earning activity or business and cannot be replaced to achieve deductible interest. If a partner reinvests profits into the partnership, the new amount contributed can form part of the amount able to be replaced with a deductible result.

4.71 This conclusion could be seen as incompatible, to some extent, with Hill J's analysis. However, Hill J's analysis might be seen as internally inconsistent in the same respect. His Honour said that only amounts actually invested were within the principle, but he also said that those amounts could include past year profits. If his Honour meant past years' profits that had actually been reinvested, these two statements are compatible. However, if those profits are held waiting to be distributed, the Commissioner does not consider that they can be seen as invested in the partnership business.

4.72 Hill J did not see the investment element as critical in terms of the statutory deductibility provision, in the way that we have just discussed. His Honour simply seemed to say that, to be deductible, the borrowed funds must replace an amount invested. However, this statement is not necessarily true, and is only supportable in that it reflects the intent of the statutory provision, which restricts interest deductions to situations where the interest is sufficiently connected with income, as already explained in paragraph 4.69.

4.73 In the Commissioner's opinion, this same analysis applies to company profits. Although the treatment of profits in a partnership and a company is in some respects fundamentally different, there are also similarities. The differences are that in a partnership, once profits are determined, they are in most cases due to partners from that time. It might seem that partnership past year profits could more readily be analysed as amounts reinvested by, or advances from, partners. In a company, profits not distributed are carried forward as retained earnings. Retained earnings are not a current entitlement of shareholders like partnership profits are.

4.74 Nonetheless, partnership profits and retained earnings have sufficient similarities such that they should be treated in the same way. Both are at the disposal of the business until the decision is made to pay them out. Just as partners would not necessarily make any active decision to reinvest past profits, shareholders would not usually make any decision to reinvest profits in the business. Company profits cannot accurately be described as amounts invested by shareholders. Even once they are declared as a dividend, although they are owing to shareholders, shareholders would not usually decide to invest those profits pending their payment to themselves. Therefore, borrowing to pay partnership profits or dividends will not give rise to deductible interest under the replacement principle, because they are not returns of amounts invested.

4.75 If company profits are distributed as bonus issues, the amount can be seen as capital able to be replaced under the replacement principle. However, the replacement principle will not apply to the extent to which the bonus issues are paid out of an unrealised asset revaluation reserve or internally generated goodwill.

4.76 Some other attributes of profits suggest that they are different in nature from capital, and should not therefore necessarily be treated the same. One is that there are different methods of calculating profits. Different figures can be allocated to expenses. Examples are research, expenses that relate to more than one year, and different depreciation rates. The amount of a profit may be debatable, whereas the amount of contributed capital is usually certain.

4.77 Another issue that relates to the calculation of profits, is that profits are not known the moment they are earned. Profits can be only determined at a point, usually at year-end, when total income and expenses, including items like depreciation, can be calculated. The relevance of this observation is that if the replacement principle extended to profits, it would be very difficult to determine how profits have been spent.

4.78 If profits were to be included in the replacement principle, they should only be able to be replaced with a deductible result if they were used in the income earning process. If some of the profits were used to purchase assets that produce exempt income, not all the interest should be deductible. However, it would be difficult to identify how the profits had been used. If different variables are added, such as the profits paid out only represent a portion of the profits available, and the profits relate to a number of years, the difficulties increase in trying to identify which profits were used to purchase the exempt income-producing assets.

4.79 These difficult practical problems might also arise with borrowings used to repay debt or capital. It will sometimes be difficult to determine which capital contribution or debt was used to purchase an asset producing exempt income. It may in fact be difficult to know whether capital, debt, or profits were used. However, as capital and debt are usually introduced to a business or activity in a lump sum, generally it should be easier to see how they are spent.

Repayment of debt

4.80 Hill J in *Roberts* and *Smith* said that where a loan is taken out and used to repay a debt that was used directly in an income earning process or business, the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. In Hill J's mind, there is no difference in terms of interest deductibility between repaying one debt with another and borrowing to return capital, and both situations should be similarly treated.

4.81 It would seem logical that if the first refinancing takes on the character of the debt it replaces, subsequent refinancings should also inherit that character. This would include refinancing of a debt used for one of the other arrangements in respect of which interest is deductible under this replacement principle, e.g. returns of capital and share repurchases, and it would also include refinancing of a debt under which the interest was deductible for another reason, e.g. under section DD 1(b)(iii) for an investment in a wholly owned subsidiary.

4.82 Therefore, the replacement principle may apply to debt that can be traced to debt that was used directly in the taxpayer's income earning activity or business, or to debt where the interest incurred was deductible for another reason.

Subvention payments

4.83 Subvention payments satisfy one of the key requirements of the replacement test. Like returns of capital, they may involve the distribution of amounts used in the income earning activity. It is arguable that borrowings used to pay a subvention payment are used to replace funds that have been, until distributed as a subvention payment, used in the income earning process.

4.84 However, they do not satisfy the other key requirement - that the borrowing repays funds. If borrowed funds are used to pay a subvention payment, they are not repaid to a person who originally advanced them. As discussed above, without this requirement, the replaced funds can be used for any use unconnected with the income earning process and interest on the replacing funds would be deductible with no limit. That result cannot have been the intention of the Legislature.

4.85 Therefore, the use of borrowed funds to pay a subvention payment does not satisfy the replacement principle from *Roberts* and *Smith*, and the interest incurred on borrowed funds used for that purpose would not be deductible.

Can individuals apply the replacement principle?

4.86 Individuals cannot make a return of capital or profits to themselves. Any money they invest in a business or activity, they continue to own. It is artificial to describe a transaction with oneself as a replacement of funds.

4.87 An individual can, however, refinance a debt used directly in the individual's income earning activity or business and the interest incurred can be deductible.

Goodwill

4.88 Hill J singled out internally generated goodwill as an amount in the partnership capital account that could not be replaced with a deductible result. A payment to partners of goodwill could not, in Hill J's opinion, represent a repayment of capital invested. At p. 4,390, Hill J explained that a payment of goodwill is not a "refund of a pre-existing capital contribution." He went on to say:

> The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership.

4.89 In Hill J's view, internally generated goodwill is not a repayment of funds contributed. Goodwill may be an amount that is an asset of a business, and has value, but it is not funds, or an amount, that is invested in the business. Therefore, internally generated goodwill is not an amount that can be replaced with borrowed funds with a deductible result.

4.90 However, the situation will be different if goodwill is purchased. In that situation, funds, either equity or debt, are used to purchase the goodwill. These funds can be replaced with borrowed funds and the interest would be deductible.

4.91 If purchased goodwill is revalued internally, the extent of the internal revaluation is not represented by an amount invested in the business that can be replaced. Therefore, interest on an amount borrowed purporting to replace the extent of internally generated goodwill will not be deductible.

The extent of the deduction

4.92 The principle from *Roberts* and *Smith* is that the borrowed funds will give rise to deductible interest if they replace funds used in a continuing income earning process or business. Hill J did not discuss apportionment in relation to non-income producing assets or assets producing exempt income, but did discuss it in relation to amounts returned in excess of amounts contributed. His Honour held that the extent of the amount that could be replaced and on which the interest would be deductible, was the aggregate amount of contributed partnership capital, undrawn profit distributions, advances by the partners or other funds which have actually been invested in the partnership and which the partners were entitled to withdraw at the time of the borrowing. To the extent that the borrowing exceeds these amounts, Hill J considered an apportionment necessary. In the Commissioner's view, this apportionment will be required in the replacement test proposed in this paper.

4.93 As discussed above, the Commissioner does not consider that undrawn profits distributions, that are not amounts actually contributed by partners, can be replaced with a deductible result. The Commissioner's opinion differs from the comments of Hill J in this regard. The reason is, as has been explained, if profits were able to be replaced and the interest on the replacing borrowings would be deductible, interest deductions would be available for uses of funds unconnected with the income earning activity or business.

4.94 An apportionment of interest will also be required if the funds replaced have been used both in an income earning process, and for non-income earning uses, or to produce exempt income. In a different situation, if the borrowed funds are used to some extent to replace funds used in an income earning process and to some extent for uses that are not part of an income earning process, again the interest should be apportioned.

4.95 The replacement principle can be described as a direct test of interest deductibility. Although the direct use of funds is to repay capital or another debt, Hill J's principle is that the new debt inherits the deductibility status of the direct debt it replaces. Therefore, as is the case with the direct test, the use of the debt (and in the case of a replacement debt, the previous debt or equity) is traced. Any apportionment is based on how the funds were originally used.

4.96 It is not correct to apportion on the basis of the value of income producing and other assets at the time of the borrowing. That was the appropriate method of the financing assets approach proposed in the previous issues paper on interest. It was appropriate for that approach because the financing assets approach was concerned with the assets available for financing at the time a loan was taken out.

4.97 It is recognised that in some instances it will be difficult to trace the use of funds. This will be particularly so for a company operating a treasury function, where there is on-going management of debt, and no linking of debt with assets, except to satisfy the solvency test for company law purposes. However, apportionment must remain a part of the replacement principle, because it is the logical extension of the principle in situations where funds are not all connected with income or a business. The courts have found through a series of cases that the deductibility of interest depends upon tracing the use of funds. Although those cases, such as *Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5 and *C of IR v Brierley* (1990) 12 NZTC 7,184, were concerned with the previous form of the interest deductibility provision, which referred to the use of capital, they indicate that the courts will require tracing to establish deductibility if that is the test they are faced with.

4.98 However, although an apportionment calculation may be difficult, in practice, apportionment will seldom be required, because there will only be a small class of expenditure that will require an apportionment.

Relevant exempt income

Wholly owned companies

4.99 Only a small number of uses of funds would require an apportionment. The main one would be shares producing exempt income. These shares would be shares in foreign companies owned in part by a company resident in New Zealand, or owned by the trustee of any group investment fund if the dividends are derived as category A income of that fund. Dividends received in these circumstances are exempt under section CB 10(1). Companies receiving exempt income are required to make a dividend withholding payment from these exempt dividends.

4.100 Although shares in *wholly* owned New Zealand companies give rise to exempt dividends under section CB 10(2), the derivation of exempt income from those shares will not mean that an apportionment of interest deductions will be required under the replacement principle. The reason is that there is a specific statutory provision in section DD 1(b)(iii) providing that interest is deductible in respect of borrowed funds used to purchase shares in a wholly owned company. Shares held in foreign companies are included in the scope of this provision, following the decision in *CIR v Alcan New Zealand Ltd* (1994) 16 NZTC 11,175. If the exempt income derived from these shares rendered the interest not deductible, then section DD 1(b)(iii) would have no effect. Therefore, for the purposes of section DD 1(b)(iii), the exemption in CB 10(2) cannot apply. The necessity to take this interpretation of the legislation has been recognised by a number of commentators (see, for example, the discussion document on *Interest deductions for companies* (September 1999) p.7; and *Interest Deductibility*, and paper given at the Institute of Chartered Accountants of New Zealand 1999 Tax Conference, by John Cantin and Niels Campbell.

4.101 Therefore, interest will only be apportioned under the replacement test in relation to expenditure on shares, if the shares are held in foreign companies in which a company owns less than 100% of the shares.

How are interests in QCs, CFCs and FIFs treated?

4.102 Shareholders in qualifying companies, controlled foreign companies, and foreign investment funds may receive both gross and exempt income in respect of those shares. The Commissioner's view is that interest should not be apportioned if the borrowed funds are used, or in terms of the replacement principle, borrowed funds are used to repay borrowings used, to purchase shares in qualifying companies, controlled foreign companies, or foreign investment funds that produce both gross income and exempt income.

Qualifying companies

4.103 QCs are small, closely held companies. Shareholders in QCs may receive both taxable and exempt dividends. A QC pays taxable dividends to the extent of the amount of imputation credits it has available (section HG 13). Once the company no longer has any imputation credits, the dividends it pays are exempt.

4.104 This treatment of qualifying companies was proposed by the Consultative Committee on the Taxation of Income from Capital ("the Valabh Committee"). In its report, "The Taxation of Distributions from Companies" (November 1990), the Committee noted that closely held companies are viewed by their shareholders as substitutes for partnerships or sole proprietorships. The Committee commented that the deemed dividend provisions would impact more significantly on shareholders of closely held companies than widely held companies. The dividend provisions are broad, and tax most distributions from companies.

4.105 The Committee recognised that shareholders of closely held companies felt that the use of companies to own assets should not give rise to worse tax treatment than if the shareholders own the assets. This different treatment might arise, for example, if a shareholder is given free rent in a house owned by the company. The shareholder would be taxed on that benefit. If a partnership owned a house and provided it free of rent to a partner, there would be no adverse tax consequences. By providing that dividends from QCs would be either fully imputed or exempt, these tax consequences would not arise to shareholders of QCs.

4.106 The QC regime operates so that income derived by a QC is taxed, and thus the QC will have sufficient imputation credits to pass on to shareholders in respect of that income. In the usual situation, any further distributions would be distributions of capital gains, which would not be taxed if the company was a partnership or sole proprietorship, or other amounts that would not be taxable but for the corporate structure, e.g. the provision of free accommodation by the company to a shareholder.

4.107 A specific provision has been included to deal with interest deductions of shareholders in QCs. Section HG 9(4) states:

> (4) For the purpose only of determining whether a deduction is allowed under section DD 1 for interest expenditure incurred in respect of money borrowed to acquire shares in a qualifying company—
>
> (a) Section HG 13 shall be treated as not deeming to be exempt income distributions from a qualifying company to a shareholder of that company; and
> (b) Those distributions shall be treated as excluded from the definition of "dividends" under section CF 2.

4.108 For the purposes of calculating the interest deduction of a shareholder in a QC, this section provides that income otherwise treated as exempt, by the operation of section HG 13, shall not be treated as exempt. This provision was first introduced into the Act by the Taxation Reform (No 5) Bill 1992 as an amendment to section 393I(3) of the Income Tax Act 1976. The wording of this section has changed only to reflect the rewriting of the Act to its 1994 form. The explanatory notes to that Bill stated:

> Under the new *section (3A)*, for the purpose only of determining whether a deduction is available under section 106 of the Act for interest expenditure, distributions from a qualifying company to its shareholders are treated as being neither exempt nor being dividends. This leaves the test for deductibility as being the same as that applying to other types of investments, such as partnerships, that yield a mixture of taxable and non-taxable amounts.

4.109 Section HG 13 provides that distributions from a QC that do not have imputation credits attached are exempt income. These amounts would commonly be capital gains or amounts that are deemed to be distributions, and which would not be gross income if the shareholder was a partner in a partnership. However, the difference between a person investing in a QC and in a partnership, is that in a QC, distributions that are not gross income are exempt income, whereas in a partnership, distributions that are not gross income are capital or otherwise not income at all. The TEO has pointed out (TEO Newsletter No 58 16 July 1992, p.11) that it could have been argued that the decision in *Brierley* would apply to the partnership situation, because in that case no apportionment was required because no exempt income was derived, whereas it might be argued that the decision would not apply to the QC situation where exempt income is derived. To remove the matter from doubt, section HG 9(4) was enacted.

4.110 Therefore, no apportionment of interest deductions will be required if the interest is incurred in respect of an investment in a QC that distributes gross income and exempt income.

CFCs and FIFs

4.111 Like QCs, CFCs and FIFs also may distribute both gross income and exempt income to their shareholders, but no specific section deals with the issue of apportionment of interest deductions as exists for shareholders in QCs. However, in the Commissioner's view, interest deductions should not be apportioned in respect of shares held in CFCs or FIFs.

4.112 CFCs and FIFs give rise to attributed income to their shareholders. Attributed income is gross income under section CG 1. Dividends received by a company (or a trustee of a group investment fund as category A income) and paid by CFCs and FIFs are exempt under section CB 10. Foreign dividend withholding payments are required to be made in respect of these dividends, but that liability can be offset if the shareholder has credits in a branch equivalent tax account. Credits arise to a branch equivalent tax account through tax paid on attributed income. The result is that in any year, a person holding an interest in a CFC or an FIF, might receive exempt income and/or gross income in respect of the interest.

4.113 Interest should not be apportioned in relation to funds invested, or funds replacing funds invested, in shares in CFCs or FIFs producing exempt and gross income. This view is consistent with the decisions in *Pacific Rendezvous, Brierley*. In those cases, the Court of Appeal held that an interest apportionment was not required in certain situations where an investment produced both income and capital returns.

4.114 This approach to CFCs and FIFs seems to be correct from a policy perspective. The policy behind the CFC/FIF regime is to prevent double taxation of the economic owners of companies. Dividends would generally be sourced from company profits, which will have been taxed already as attributed income. Therefore, the dividends are exempt not because they are unrelated to earning income, but because they represent wealth that is derived from earning income, but that has already been taxed.

Other uses of funds not connected with deriving gross income

4.115 A few uses of funds that are unconnected with the income earning activity or business will lead to the apportionment of interest deductions. They might include the use of funds that was not part of the income earning process, such as shares in a company that was barred from making a distribution, or a piece of land that was not part of that process, such as was the finding of the Court of Appeal in *de Pelichet McLeod Ltd v CIR* (1982) 5 NZTC 61,216. They would also include some of the examples given earlier when the limits of the interest deductibility test were discussed – for example, nil interest loans to other companies and criminal fines.

Private use

4.116 Apportionment would also be required if borrowed funds are used for private use. In terms of the replacement principle, funds would be used for private use if funds are borrowed and used to repay funds themselves used for private use, or used to repay funds used to purchase an asset that has since been removed from the income earning activity or business and is now used for private purposes.

4.117 If funds are borrowed and used to return capital to partners or shareholders, and those partners or shareholders use the funds for private use, in the Commissioner's opinion that use will not be a private use of the funds. The reason is that there is arguably no private use of the funds by the partnership or company. This situation can be analysed as comprising three uses of the funds. The partnership uses the funds for two uses. One is to pay partners or shareholders their capital, and the other is to replace funding. This second use is the indirect use with which the replacement principle is concerned. The third use is the application by partners or shareholders of the capital for private use.

4.118 In comparison, if a sole trader borrows to achieve a replacement of capital invested in the sole trader's income earning activity or business, but the direct use of the funds is to repay a private debt, the interest will be private. Unlike the partnership or company situation, it is the same person who has replaced funds and used them for private use.

4.119 It is possible to argue that interest incurred on funds used to return capital to partners should be analysed in the same way as funds used in this way by a sole trader. Unlike a company, a partnership is not a taxpayer. Each partner claims any expenses related to the partnership. Section 42(1)(b)(ii) of the Tax Administration Act 1994 states:

> In the case of partners … There shall be no joint assessment, but each partner shall make a separate return of income, taking into account the share of the gross income derived from the firm by that partner and the allowable deductions of that partner in respect of that gross income, and shall be separately assessed accordingly.

4.120 In *Hadlee v C or IR* [1991] 3 NZLR 517, at p.529, Richardson J said:

> New Zealand tax legislation does not isolate partnership income as a separate source of income. In New Zealand law a partnership is not a separate tax entity. It is not a "taxpayer" and partners make a return of partnership income only for the purpose of providing information on which their separate incomes are calculated.

4.121 Therefore, interest deductibility is considered in relation to each partner. Interest incurred by a partnership is deducted or not by the partners, not the partnership. So arguably, if a partnership borrows to return capital, and the partners use the funds for private use, then the same person – each partner – is seeking to deduct the interest whilst using the funds for private use.

4.122 This issue was discussed in the previous issues paper on interest, IRRUIP 3. The Commissioner is still of the view expressed in that paper, i.e. that funds borrowed by a partnership are not related to partners of the partnership. The partnership is not the same thing as any one of the partners.

4.123 The Partnership Act 1908, which is declaratory of various matters relating to partnerships, defines "partnership" in section 4(1) as:

> Partnership is the relation which subsists between persons carrying on a business in common with a view to profit.

Partners receive partnership income jointly, and have joint liability for partnership expenses.

4.124 In *Crowe v Commissioner of Taxation* (1958) 100 CLR 532, a partnership took out life insurance on the life of each partner. The firm paid the premiums, and each premium was debited to the partner to whose life it related. The Court found that the premiums were expenses of the firm, and not expenses of each member. Fullagar J held that the firm paid the premiums in respect of each partner for itself, and not on behalf of each member. The premiums were paid jointly, and not by any one of them only. His Honour said at p.535:

> [T]hat a partnership has, in English law, no legal personality distinct from those of the individual partners … does not mean that there is not a very real difference between a right or obligation of a partnership (or partners as such) and a right or obligation of an individual member of a partnership.

4.125 Not only is interest not attributed to any partner, but also any borrowing of a partnership relates to the partnership, and not to any one partner. Partners do not have rights to specific partnership property, but only to share in annual profits, and rights on resignation, retirement or dissolution (see *Hadlee & Sydney Bridge Nominees Ltd v C or IR* (1993) 15 NZTC (PC)). Therefore, any borrowing by a partnership is connected to the partnership property and thus the partnership activity. It is not connected to the partners because they do not have direct rights to the borrowed funds.

4.126 So if a partnership borrows to return capital to partners, arguably there is no private use by the partnership. Deductibility of the interest is considered in terms of its relationship with the income earning activity or business of the partnership. Following *Roberts* and *Smith*, a replacement of partners' capital has a connection with the income earning activity or business. Hill J considered that funds borrowed and used to return capital to partners were not used for private use. The funds were used to return capital, and so were employed in the partnership business because they replaced the funds withdrawn. Although the partners may go on and use the funds for private use, they do so in their capacity as individuals, and not as partners.

4.127 There is recognition in the Income Tax Act too that a partnership is something separate from the identities of its constituent partners. A partnership is a "person" under the Income Tax Act. "Person" is defined in section OB 1 to include an unincorporated body of persons, which would include a partnership. Incidentally, the significance of a partnership being a person relates to a partnership's obligation to file a return of income, and to provisions such as those relating to determining when persons are associated. Partnerships have obligations in relation to subsections DZ 6(10) and DZ 6(11), regarding petroleum miners, and section NF 10(6) applying to resident withholding tax.

4.128 Therefore, the Commissioner's view is that interest incurred by a partnership on borrowed funds used to return capital to partners, will not be private in nature, and can not be challenged as non-deductible on that basis.

Conclusions on the extent of apportionment required

4.129 Apportionment, where it is required, may be difficult, because it will involve identification of the funds used to derive exempt income or otherwise not used in deriving gross income. The importance of these conclusions just discussed on when apportionment is required is that there will be relatively few situations under the replacement principle where interest deductions will need to be apportioned. This means that the replacement test will not require onerous apportionment calculations.

4.130 Apportionment will mainly be required where borrowings replace funds used:

- To purchase shares in foreign companies if the taxpayer owns less than 100% of the shares. Apportionment will not be required if those foreign companies are CFCs or FIFs.
- For a use unconnected with deriving gross income, for example, payment of subvention payments, payment of dividends, nil interest loans to other companies and criminal fines; and
- For private use.

Comparison with the financing assets approach

4.131 One of the main problems with the previously proposed financing assets approach was that it required very complicated calculations if a taxpayer had assets producing exempt income or that were otherwise not part of the gross income earning activity. Probably the most common type of asset in this class, shares in wholly owned companies, was treated as an asset producing exempt income.

4.132 The financing assets approach also required apportionment if borrowings exceeded the value of assets. On-going calculations and valuations would have been necessary to ensure that the ceiling was not breached, and a reduction in the proportion of interest deductible if the ceiling was breached. This is not a requirement of the replacement principle.

4.133 These problems are to a large extent, removed with the new approach. Apportionment will still be required and may be difficult to calculate, but the number of situations in which it is necessary will be far less.

4.134 Another aspect of apportionment that led to compliance difficulties with the financing assets approach, was that assets were required to be valued at market values. Under the replacement principle cost is used, and so the apportionment exercise will be easier.

4.135 An important consequence of using cost, which follows from deductibility status being inherited, is that the amount of deductible interest will not change merely as a result of asset values changing. Under the financing assets approach, the interest deduction was always subject to the ability of debt to finance assets. If asset values changed, and, for example, as a result taxpayers' debts exceeded the value of their assets, or their exempt income producing assets became more valuable than their income producing assets, then the proportion of deductible interest would change. Under the replacement principle, deductible interest will only become non-deductible if it can be traced to funds originally used to purchase an asset, and that asset is removed from the gross income earning process, or once an income earning activity or business has ceased and the nexus with gross income has been lost.

4.136 Also, under the replacement principle the Commissioner cannot be criticised for telling taxpayers how much to borrow. Deductible interest has no ceiling as was the case with the financing assets approach. Interest deductions are limited, but on the basis of whether funds with a connection with income are being replaced rather than on an across the board basis.

4.137 Therefore, the replacement principle does not have the same weaknesses as the financing assets approach.

Is direct tracing required?

4.138 The replacement principle requires identifying how the original funds were used, whether contributed capital or debt, and tracing the replacement debt to repayment of those original funds. To satisfy these requirements, the use of the original funds and the replacement funds will need to be traced.

4.139 We have considered whether this requirement is essential to the replacement principle. It is recognised that for some taxpayers, particularly large companies with daily changes to their borrowings, the requirement will be very difficult to meet.

4.140 One approach would be to allow a deduction if the refinancing loan is taken out and the first loan paid back about the same time. However, it seems likely that this "around the same time" requirement would not be any requirement at all, and would result in any borrowing qualifying.

4.141 An alternative, which takes into account what is practical where a treasury function is maintained, is that the Commissioner would accept that a loan is a replacement provided there is no private or exempt use of the borrowed funds. However, that approach would, in the Commissioner's view, be too wide. Any use of the borrowings would satisfy the test (apart from private and exempt uses). The test would not be limited to replacement of funds that are returned to their owners. *Roberts* and *Smith* stands for the principle that a nexus with income may be established if the borrowed funds are used to replace funding of an income earning activity or business, and the original funding returns to its owners. Without the element of replacement, there would be not be a sufficient nexus with income. Uses of funds that would qualify would be those uses that would not seem to be within the intent of the interest deductibility provision - nil interest loans to sister companies, investments in companies prohibited from making distributions, and so on.

4.142 Therefore, the Commissioner takes the view that the replacement principle requires that borrowings should be traced to replacement of funds invested directly in an income earning activity or business. A smaller taxpayer should usually be able to trace money. It is considered that borrowing to return capital is an unusual enough event that the use of borrowed funds to make these transactions can be identified. The situation in which it will often be difficult to trace funds would be debt replacements. It is acknowledged that there will be compliance issues for medium and larger taxpayers, particularly with debt replacements. However, this is a consequence of the replacement principle.

4.143 It should be remembered that debt is subject to a tracing test. If borrowed funds are used to directly purchase an income earning asset, the interest continues to be deductible until (to take one example) the asset is used for private use (*CIR v Banks* (1978) 3 NZTC 61,236). To satisfy the direct test, debt should be traced until it no longer satisfies the deductibility test.

What happens if the interest remains payable after a business has ceased?

4.144 Some uncertainty currently exists in New Zealand law over the correct treatment of interest expense once a business has ceased. In *Riverside Road Pty Ltd (in liq)* 90 ATC 4567, the Australian Federal Court found that interest on funds borrowed to fund a motel business remained deductible after the motel was sold until such time as the loan was refinanced. Refinancing broke the business nexus. The Court in *Riverside Road* followed *AGC Advances Ltd v FC of T* 75 ATC 4057 for the authority that an expense may be incurred in an income earning process, even if that process or business has ceased.

However, the connection back to the business may be lost if the loan is refinanced, with the effect of creating a new occasion for the incurrence of the interest (p.4,575).

4.145 Thus the Court in *Riverside Road* held that interest is deductible if the occasion of a borrowing arose out of the income earning process. This "occasion" principle is a different test than the "use" test applied in such New Zealand cases as *Pacific Rendezvous*, *Brierley,* and *Banks*. The two tests coincide when a loan is taken out, as they both require that the borrowed funds have a nexus with income at that time. They differ in that the occasion test provides for on-going deductions once it is satisfied, whereas the use test needs to be satisfied throughout the period that an interest deduction is sought. Under the use test, interest is deductible if borrowed funds have a sufficient nexus with a continuing income earning activity or business, during the period in which the interest is incurred.

4.146 A similar approach to *Riverside Road* was taken in *Brown v FC of T* 99 ATC 4600. The Full Federal Court held that interest was deductible after a business has ceased, because the occasion of the interest was to be found in a transaction entered into in the carrying on of the partnership business. However, if the taxpayer had had the opportunity either to repay the principal and thereby avoid incurring liability for interest, or to roll over the loan and to continue to be liable for the interest, the link with the business would probably have been lost.

4.147 The High Court in *Steele v DFC of T* 99 ATC 4242 took a similar view, stating that a taxpayer may still be entitled to a deduction after the business has ceased in respect of the recurrent liability for interest (p.4251):

> … provided the occasion of a business outgoing is to be found in the business operations directed towards the gaining or production of assessable income generally.

4.148 It should be noted that Carr J in the lower court in *Brown* made it clear that the usual "use" test could not apply in *Brown* because the funds had been lost in the failed business. The funds had ceased to exist so could no longer be identified. The Australian Tax Office has taken the view that the decision in *Brown* is only applicable to situations where the loan funds have been lost (TR 2000/D3 *Income Tax: deductions for interest following the* Steele *and* Brown *decisions*).

Problems with the occasion principle

4.149 The occasion principle, from *Riverside Road, Brown,* and *Steele*, is that interest will be deductible if the occasion of the borrowing arose out of an income earning process. It has been pointed out by Dr Dabner, in CCH's *Tax Week* Issue 27 2 July 1999 p. 431, that the occasion principle does not deal with a change in use of the assets funded by the loan from income producing to non-income producing, and vice versa.

4.150 Also, the occasion principle is difficult to reconcile with statements in New Zealand cases that the interest deductibility test is concerned with the period in which the interest is incurred, and not the period when the funds were first borrowed (see *Banks* p.61,247).

The differences between New Zealand and Australia

4.151 New Zealand courts have consistently applied the use principle. Australian courts, in comparison, have in recent years introduced other concepts into the question of interest deductibility. The occasion principle is one, the taxpayer's object is another.

4.152 There is some authority in New Zealand that an interest deduction ceases when the business ceases. In the decision of the Taxation Review Authority in *Case N7* (1991) 13 NZTC 3,048, Judge Barber followed *Banks* for the proposition that interest is only deductible in the period in which the capital is employed in earning income, and not once the business has ceased. *Case N7* concerned the deductibility of expenses relating to a farming partnership that had ceased some years before the interest in question was incurred.

Conclusion on interest, refinancing, and business cessation

4.153 The law in New Zealand, in this area of whether interest deductions continue after a business ceases, is uncertain. New Zealand courts have not been asked to consider the occasion principle, so it is not clear which approach New Zealand courts would take. Some Australian authority exists that interest may continue to be deductible after a business has ceased, but only in some circumstances. The indications from the TRA and from *Pacific Rendezvous* and *Brierleys* are that New Zealand courts will look to the use of borrowed funds in the period that interest is incurred. Despite the change in words in the interest deductibility provision, the use of borrowed funds will usually be relevant to the question of whether interest has a link with the derivation of income or a business (this point is discussed further below in paragraph 5.21).

4.154 Therefore, it is not certain whether a New Zealand court would adopt the decision in *Brown*. In any event, a court would be likely to take the view that an interest deduction would cease at some point in time. Given these circumstances, and the nexus with income being a question of fact, the Commissioner cannot issue a binding ruling on this matter. The binding rulings will be concerned only with continuing income earning activities or businesses.

***Australian Tax Office's view on* Roberts *and* Smith**

4.155 The ATO has issued a ruling on the interpretation it takes of *Roberts* and *Smith*. The ATO's view is similar to the view expressed in this paper. See TR 95/25 *Income Tax: Deductions for Interest Under Subsection 51(1) of the Income Tax Assessment Act 1936 Following FC of T v Roberts; FC of T v Smith*, issued 29 June 1995. Two addenda have been added to TR 95/25, primarily to update the references in the ruling to the Australian Income Tax Assessment Act 1997.

5. Other bases for interest deductibility considered

An argument based on a broad second limb test

5.1 We have considered the argument that indirect interest incurred by companies and others in business is deductible under section DD 1(b)(ii) (the "second limb") without the need to apply the indirect test. The argument is that the second limb offers a very wide base of deductibility to corporate taxpayers and other entities in business. Arguably the arrangements can be seen as normal business transactions, and therefore covered by the second limb.

5.2 The uses of money that the arrangements in the draft rulings appended to this paper are concerned with (payments of tax, returns of capital by partners, share repurchases, and debt repayments), and the further arrangements of payments of profits and dividends, and subvention payments, are not themselves deductible expenses. If they are not deductible for the reason that they do not have a sufficient connection with income, the interest on the amounts borrowed and used to make those outgoings would also lack a sufficient connection with income in this respect. To consider this argument therefore, it is necessary then to determine whether these outgoings are not deductible because they lack a sufficient connection with income, or for some other reason.

Tax and use of money interest

5.3 Tax is an application of profits once they have been earned. Although there is a specific statutory prohibition against deductions of tax in section DB 1(1)(a), even without it, tax would not be deductible. Tax is not incurred in deriving income. In *Smiths' Potato Crisps (1929) Ltd v I.R.C.* [1948] A.C. 508, Lord Normand said at pages 529-530 "... income tax is an impost made upon profits after they have been earned, and ... a payment out of profits after they have been earned is not within the purposes of the trade carried on by the taxpayer."

5.4 As a payment of tax is not connected with deriving income simply on the basis that it is incurred by a person who earns income, interest incurred on money borrowed and used to pay tax will also not be connected with income on that basis.

5.5 The same logic and conclusion applies to use of money interest.

Returns of capital to partners and share repurchases

5.6 The most obvious basis on which to argue that returns of capital, and by analogy, share repurchases, are not deductible is because they are capital in nature, and an excluded deduction under section BD 2(2)(e). There is a distinction between capital in the tax sense of the business structure, and capital in the commercial law sense of amounts contributed or accumulated profits forming part of partners' or shareholders' funds. However, it can be supposed that contributed capital, which is the sense that is relevant in terms of the arrangement, will generally equate to the tax sense. That is, partners' or shareholders' funds will fund the capital assets of the taxpayer and will not be used to meet the on-going expenses of the business. If this is the only reason that returns of capital are not deductible, interest incurred for this use will still be deductible, because section BD 2(2)(e) provides that interest cannot be denied a deduction on the grounds that it is capital.

5.7 The real question of concern is whether returns of capital and share repurchases are not deductible for the additional reason that they are not sufficiently connected with the income earning process. The deductibility test requires a sufficient connection with the carrying on of the business (see for example *New Zealand Co-operative Dairy Company Limited v CIR* (1989) 11 NZTC 6,066 (High Court) and *Europa Oil (NZ) Ltd* (Court of Appeal). The deductibility test also contemplates apportionment. These two features indicate that an expenditure must be more than simply spent by a business, it must have a sufficient connection with its profit-making process. The second limb is not intended to capture any expense incurred by a business. Returns of capital and share repurchases are commercial actions, but they are not directly related to the profit making activity of the business. They are not transactions that can be said to be part of the running of the business.

5.8 Therefore, the simple fact that returns of capital and share repurchases are arrangements carried out by a business does not make them deductible. Returns of capital and share repurchases are not part of the profit making process. Interest on money borrowed to return capital repurchase shares is not deductible on this basis.

Dividends and returns of profits

5.9 Dividends are a return of profits to shareholders. Returns of profits to partners are the same transaction in the partnership context. No statutory prohibition exists against deducting dividends, but it is clearly accepted that they are not deductible. The reason that dividends are not deductible is that they are not an outgoing incurred in deriving income; they are a distribution of net income, that is, income less expenses, once it has been derived.

5.10 This distinction was discussed in *Pondicherry Railway Company Limited v IRC* (1931) 58 LR IA 239. In that case, a railway company had contracted to give a portion of its profits to the French government. The company argued that as it was a condition of making any profits that one half of them must be handed over to the government, and that it could never receive the whole profits, the payment made was in the nature of rent. The Privy Council did not accept that analogy. Their Lordships said that "a payment out of profits and conditional on profits being earned cannot accurately be described as a payment made to earn profits. It assumes that profits have first come into existence. But profits on their coming into existence attract tax at that point, and the revenue is not concerned with the subsequent application of profits".

5.11 *Pondicherry* was followed in *Boulder Perseverance Ltd v CT* (1937) 4 ATD 389, in which the court held that the fixed interest component of returns on debentures was deductible, but the component that was a share in profits was not deductible. It did not matter that the holders were not shareholders, the payment was still a distribution of profits.

5.12 Lord MacMillan, who heard the *Pondicherry* case, discussed the *Pondicherry* case in *Union Cold Storage Co Ltd v Adamson* (1931) 16 TC 293, heard by the House of Lords. In *Union Cold Storage*, the taxpayer was required to pay rent under a lease. Rent would be abated under the lease if the company's profits were insufficient to pay interest on debentures and dividends to a certain extent. Lord MacMillan distinguished the two situations, saying that *Pondicherry* concerned a case in which the obligation was, first of all, to ascertain the profits in a prescribed manner, after providing for all outlays incurred in earning them, and then to divide them. In *Union Cold Storage* he said the question is whether or not a deduction for rent has to be made in ascertaining the profits, and the question is not one of the distribution of profits at all.

5.13 The Courts in *Pondicherry*, *Boulder Perseverance*, and *Union Cold Storage* distinguished between payments made in deriving profits, and applications of those profits. Payments of dividends are applications of profits to shareholders. The principle discussed in these cases therefore applies to dividends. The authority is clear that dividends are not an expense incurred in the income earning process or business activity. They are an outgoing paid after that process is completed. Therefore, dividends are not deductible, because they lack a sufficient connection with deriving income. Interest on money borrowed to pay a dividend is not deductible on this basis. The interest is not connected with income simply on the basis that a dividend is a business transaction. Payment of a dividend is not a business transaction that is sufficiently concerned with money-making.

5.14 The same logic and conclusion applies to distributions of partnership profits.

Subvention payments

5.15 Section IG 2(2) provides companies with the ability to make a payment to, or to simply offset profit with, a company in loss that has certain common ownership with the profit company. Such a payment to a group company is sometimes called a subvention payment, although strictly speaking, that term related to previous rules.

5.16 The purpose of a subvention payment is to reduce the tax impost of a company with taxable income. It is not a payment to generate income, and does not contribute to the income earning process. It is an outlay made after income has been earned. Therefore, interest incurred on money borrowed and used to make a subvention payment will not have a sufficient connection with the income earning process.

5.17 This conclusion about the relationship between a subvention payment and the income earning process is arguably supported by the approach indicated in section IG 2(2). Section IG 2(2)(g) states:

> In the case of any payment made by the profit company, -
>
> (i) The payment would not (otherwise than under this subsection) be taken into account in calculating the taxable income of either the loss company or the profit company; …

5.18 The payment must not be a payment that is taken into account in determining taxable income. "Taxable income", in short, through the operation of sections BC 6 and 7, is the profit company's net income (i.e. income less deductible expenses). Therefore, the payment by the profit company to the loss company must not be an amount which can be taken into account in calculating taxable income, so cannot be an expense that is an "allowable deduction", as defined in the Act. An allowable deduction under section BD 2 includes expenditure that has a nexus with income (but excludes certain things such as capital and private expenditure). An example of a deductible payment between group companies is a payment for services, e.g. a management fee.

5.19 Therefore, the conclusion that subventions are not incurred in earning income, is consistent with the requirement in section IG 2(2) that a subvention cannot be an amount that is incurred in earning income and is deductible.

Conclusion of the second limb argument

5.20 The cases have held that the second limb is, like the first limb, concerned with the relationship between an expense and the income earning process. Returns of capital, and payments of dividends, profits and subventions might be transactions typical of a business, but they are not part of the income earning process. Interest incurred on money borrowed and used to effect these transactions is not connected with income on the basis that these are business transactions.

Another argument for deductions – interest is deductible without reference to the money borrowed

5.21 This paper has considered several interpretations of the law on indirect interest deductions. The remaining basis that we have considered and rejected is the idea that interest should be considered as an expense unconnected with the funds to which it relates.

5.22 In its support, this approach to interest seems consistent with the current wording of the interest deductibility provision. The words refer to interest that is payable, and do not, like the previous form of the provision, refer to the capital to which it relates.

5.23 The problem with this approach is that in the usual case interest has no character. It is simply an expense that arises. Therefore, there would be no limit to the circumstances in which interest will be deductible. Those uses of borrowed funds which it would be expected that the Legislature would have intended to exclude, and which the courts would be likely to exclude – payment of criminal fines, loans to sister companies, subventions and even private or exempt uses - would lead to deductible interest. The only way to exclude interest that was clearly intended not to be deductible, such as private uses of funds, is to refer to the use of the principal.

6. Conclusions

Reasons for rejecting the financing assets approach outlined in the previous issues paper

6.1 The financing assets approach proposed in the issues paper IRRUIP 3 previously circulated for consultation should not be adopted as the Commissioner's view, for the following reasons:

- The financing assets approach is too far removed from the reasoning of the Court in *Public Trustee*. However, in evaluating the financing assets approach, we have remained of the view that *Public Trustee* cannot stand for a principle that interest is deductible if borrowing retains income earning assets.

- The ceiling on deductions that was a requirement of the financing assets approach might be seen to have the effect of the Commissioner telling taxpayers how much they could borrow.

- The complexity and elaborateness of the financing assets approach cannot have been the intention of Parliament, and would be unlikely to be accepted by a court;

- The financing assets approach logically also applies to refinanced debt. The complexity that would result from applying the financing assets approach to refinanced debt also indicates that the financing assets approach cannot have been the intention of Parliament, and would be unlikely to be accepted by a court.

The Commissioner's revised approach

Public Trustee stands for the principle that borrowings may preserve assets from being sold to meet an involuntary expense

6.2 The principle of interest deductibility from *Public Trustee* is that interest is deductible if it is incurred on funds borrowed and used:

- to preserve income earning assets from a sale; and

- the sale would be otherwise necessary to meet a liability; and

- the liability is an involuntary expense; and

- the liability arises out of the holding of the income earning assets or otherwise out of the income earning activity or business, and if

- the direct use of the borrowed funds is not a private use.

6.3 The principle from *Public Trustee* will apply to borrowing to pay income tax and use of money interest that relates to the income earning process, if the requirements are met.

6.4 Interest incurred on borrowed funds used to pay tax arising from employment income will not be deductible.

Interest deductions when funds are replaced

6.5 Following *Roberts* and *Smith*, interest will have a sufficient connection with the derivation of income when the borrowed funds replace funds that were used in the income earning activity or business. The requirements are that:

- the borrowing repays funds; and

- the repaid funds are returned to their owners who invested them (or to an assignee of the investor), and

- those repaid funds have been directly used in the borrowing entity's income earning activity or business, or can be traced to funds in respect of which interest is deductible, and

- the income earning activity or business is continuing when the repayment occurs.

6.6 This replacement principle from *Roberts* and *Smith* is based on the idea that debt may take on the connection with the income earning activity or business that the replaced amount possessed.

6.7 The replacement principle applies in relation to money borrowed and used to return partners' or shareholders' capital and to repay debt used in an income earning process or business. It does not apply in relation to borrowings used to pay dividends or profits to partners, or borrowings used to pay a subvention payment. The reason is that if those arrangements were included, so too would any use of profits. Profits could be replaced and used for any reason whatsoever. That limitless result does not seem consistent with the statutory interest provision, which requires a sufficient connection with income, and apportionment when that connection is not met. Payments of dividends and profits are distinguishable from returns of capital and refinancing debt, because they are not returns of amounts previously invested.

6.8 Interest on borrowings used to return share capital or repay debt will be deductible in full if all of those funds were used in the income earning process or business. If not all of the funds were used in the income earning activity or business, then the deductible portion of interest will be the portion incurred on funds that replace funds used in that activity or business or that are otherwise deductible (e.g. under the *Public Trustee* principle, or under section DD 1(b)(iii)). The apportionment will be on the basis of the use of the funds replaced, and not on the basis of the proportions of gross income and exempt income producing assets.

6.9 Apportionment of interest deductions is not required for certain shares that produce exempt income. If borrowed funds repay borrowed funds used to acquire shares in a wholly owned company, and the interest on the original funds was deductible under section DD 1(b)(iii) (the 'third limb' of the interest deductibility provision), the replacing borrowings take on that deductibility status.

6.10 Apportionment is also not required if the borrowed funds replace funds used to acquire shares in a QC. Under section HG 9(4), interest is not apportioned in respect of borrowed funds used to purchase shares in a QC.

6.11 Apportionment is also not required if the borrowed funds replace funds used to acquire shares in a CFC or an FIF. Funds invested in these shares are fully invested in earning gross income (*Pacific Rendezvous* and *Brierley*).

6.12 Apportionment will be required if borrowed funds are used for private use. The Commissioner does not view the use of borrowed funds to return partner's capital by a partnership as a private use of the borrowed funds.

6.13 A number of features of the replacement principle will mean that the compliance difficulties will not be as significant under the replacement principle, as they were under the previously proposed financing assets approach. There will be few situations where application of the replacement principle will require an apportionment. When considering how funds have been used, the appropriate valuation method for assets will be cost, and not market value. The fact that deductibility status will be able to be "inherited", and that continual adjustments will not be required to ensure borrowings may reflect income earning assets, is another difference between the replacement principle and the financing assets approach.

6.14 Another reason to prefer the replacement principle over the financing assets approach, is that the replacement principle cannot be challenged as an attempt by the Commissioner to prescribe how much taxpayers should borrow.

6.15 The replacement principle will require direct tracing to funds used in an income earning process or business to funds in respect of which the interest is deductible.

6.16 Individuals cannot apply the replacement principle because they cannot transact with themselves.

6.17 There is some Australian authority that interest may continue to be deductible once an income earning activity or business has ceased, but it is not clear whether New Zealand courts would follow that approach. The issue involves matters of fact on which the Commissioner cannot rule. The draft binding rulings are restricted to continuing income earning activities or businesses.

Other bases for interest deductions considered

The second limb does not result in interest deductions for uses not connected with income

6.18 The second limb of the interest deductibility provision does not establish a test that is so broad that any interest incurred by a business is deductible. Interest incurred on funds used to pay tax, return capital, repurchase shares, pay out profits, pay dividends or to pay subvention payments is not deductible simply because it is incurred by a business. The underlying expense in these arrangements (the tax or return of capital etc.) does not have a sufficient connection with deriving income to be deductible. Therefore, interest incurred in relation to these arrangements also does not have a sufficient connection with deriving income on this basis.

A test that does not refer to the use of the borrowed funds is not supportable

6.19 We have also rejected the idea that interest should be considered as an expense unconnected with the funds to which it relates. Under this approach, there would be no limit to the circumstances in which interest will be deductible, and that result cannot have been the intention of Parliament and would not be followed by a court.

APPENDIX

Please quote reference: PU3502a

INTEREST DEDUCTIBILITY - MONEY BORROWED TO PAY INCOME TAX AND USE OF MONEY INTEREST

PUBLIC RULING – BR Pub 00/xx

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section DD 1(b)(i) and DD 1(b)(ii).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of (and the payment of interest on) money used by a taxpayer carrying on a continuing income earning activity or business to pay an income tax liability or a use of money interest liability (payable under section 120D of the Tax Administration Act 1994) to the Commissioner of Inland Revenue.

The Arrangement only includes situations where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include situations where:

- Subpart BG of the Act applies [Part BG relates to tax avoidance arrangements.]; or

- Part or all of the Arrangement or the use of the borrowed funds is a sham.

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expense of the group. The rules in Part FG are sometimes known as thin capitalisation rules.]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described as the Arrangement if the interest is incurred on funds borrowed and used by a taxpayer:

    - to preserve the taxpayer's income earning assets from a sale; and

  - the sale would be otherwise necessary to meet a liability of the taxpayer; and
  - the liability is an involuntary expense; and
  - the liability arises out of the holding of the taxpayer's income earning assets or otherwise out of the taxpayer's income earning activity or business; and
  - the direct use of the borrowed funds is not for private use.
- If the borrowing preserves both income earning and non-income earning assets from being sold, the interest will be apportioned between deductible and non-deductible interest, based on the value of the assets.

The period for which this Ruling applies

This Ruling will apply for the period from XX/XX/XX to XX/XX/XX.

Please quote reference: PU3502b

INTEREST DEDUCTIBILITY - MONEY BORROWED BY A PARTNERSHIP TO RETURN CAPITAL CONTRIBUTIONS

PUBLIC RULING - BR Pub 00/xx

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section DD 1(b)(i) and DD 1(b)(ii).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of (and the payment of interest on) money used by a partnership carrying on a business for the purpose of deriving gross income, to return capital previously contributed by partners.

The Arrangement only includes situations where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include situations where:

- Subpart BG of the Act applies [Part BG relates to tax avoidance arrangements.]; or

- Part or all of the Arrangement or the use of the borrowed funds is a sham.

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expense of the group. The rules in Part FG are sometimes known as thin capitalisation rules.]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible in the circumstances described as the Arrangement to the extent that the partners' capital contributions were used directly in the partnership's income earning activity or business.

The interest incurred under the Arrangement will not be required to be apportioned in respect of repayments of partners' capital contributions used by the partnership to purchase shares in wholly owned companies; or controlled foreign companies, foreign investment funds or qualifying companies producing both gross income and exempt income.

The period for which this Ruling applies

This Ruling will apply for the period from XX/XX/XX to XX/XX/XX.

Please quote reference: PU3502c

INTEREST DEDUCTIBILITY - MONEY BORROWED BY A COMPANY TO REPURCHASE SHARES

PUBLIC RULING - BR Pub 00/xx

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section DD 1(b)(i) and DD 1(b)(ii).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of (and the payment of interest on) money used by a company carrying on a gross income earning activity or a business for the purpose of deriving gross income, to repurchase shares from its shareholders as authorised by the Companies Act 1993, or to purchase shares from its shareholders by way of a court ordered capital reduction under the Companies Act 1955.

The Arrangement only includes situations where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include situations where:

- Subpart BG of the Act applies [Part BG relates to tax avoidance arrangements.]; or

- Part or all of the Arrangement or the use of the borrowed funds is a sham.

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expense of the group. The rules in Part FG are sometimes known as thin capitalisation rules.]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows.

- Interest will be deductible in the circumstances described as the Arrangement to the extent that the funds that were represented by the shares and returned to shareholders, were funds contributed by the shareholders and used directly in the company's income earning activity or business.

- Interest will be deductible in the circumstances described as the Arrangement if the shares are bonus issue shares, to the extent that the funds represented by the shares were used directly in the company's income earning activity or business, and to the extent that the funds represented by the shares were not paid out of an unrealised asset revaluation reserve or from internally generated goodwill.

- The interest incurred under the Arrangement will not be required to be apportioned in respect of repayments of shareholders' capital contributions used by the company to purchase shares in wholly owned companies; or controlled foreign companies, foreign investment funds or qualifying companies producing both gross income and exempt income.

The period for which this Ruling applies

This Ruling will apply for the period from XX/XX/XX to XX/XX/XX.

Please quote reference: PU3502d

INTEREST DEDUCTIBILITY - MONEY BORROWED TO REPAY DEBT

PUBLIC RULING – BR Pub 00/xx

This is a public ruling made under section 91D of the Tax Administration Act 1994.

Taxation Law

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

This Ruling applies in respect of section DD 1(b)(i) and DD 1(b)(ii).

The Arrangement to which this Ruling applies

The Arrangement is the borrowing of (and the payment of interest on) money used by a taxpayer or a partnership carrying on a gross income earning activity or a business for the purpose of deriving gross income, to repay debt.

The Arrangement only includes situations where the interest rate on the borrowed funds is an arm's length rate.

The Arrangement does not include situations where:

- Subpart BG of the Act applies [Part BG relates to tax avoidance arrangements.]; or

- Part or all of the Arrangement or the use of the borrowed funds is a sham.

This Ruling is subject to Part FG of the Act. [The purpose of Part FG is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expense of the group. The rules in Part FG are sometimes known as thin capitalisation rules.]

How the Taxation Law applies to the Arrangement

The Taxation Law applies to the Arrangement as follows:

- Interest will be deductible in the circumstances described as the Arrangement to the extent that the money which is repaid:

  - was used directly in the taxpayer's or partnership's income earning activity or business; or

  - can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing that was used directly in the taxpayer's or partnership's income earning activity or business; or

- can be traced through one, or a series of borrowings used to repay borrowings, to a borrowing used by a company to purchase shares in a wholly owned company and in respect of which use of funds, the interest was deductible under section DD 1(b)(iii).

- can be traced through one, or a series of borrowings used to repay borrowings, to borrowings used for one of the Arrangements that are the subjects of the Commissioner's rulings in the Public Rulings referred to as PUB3502a, PUB3502b, or PUB3502c, (which are borrowings used to pay tax or use of money interest, return partners' capital, or repurchase shares).

- The interest incurred under the Arrangement will not be required to be apportioned in respect of repayments of loan funds used to purchase shares in wholly owned companies; or controlled foreign companies, foreign investment funds or qualifying companies producing both gross income and exempt income.

The period for which this Ruling applies

This Ruling will apply for the period from XX/XX/XX to XX/XX/XX.